

FARMERS NATIONAL BANC CORP /OH/

Form 10-Q

August 08, 2006

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q  
Quarterly Report Under Section 13 or 15(d) of the  
Securities Exchange Act of 1934  
For the Quarter ended June 30, 2006  
Commission file number 0-12055  
**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

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  No   
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Securities Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No   
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class

Outstanding at July 31, 2006

Common Stock, No Par Value

13,031,963 shares

**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements

Included in Part I of this report:

	Page Number
Farmers National Banc Corp. and Subsidiary	
<u>Consolidated Balance Sheets</u>	1
<u>Consolidated Statements of Income and Comprehensive Income</u>	2
<u>Condensed Consolidated Statements of Cash Flows</u>	3
<u>Notes to Unaudited Consolidated Financial Statements</u>	4-8
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	8-15
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	15
<u>Item 4. Controls and Procedures</u>	15

**PART II OTHER INFORMATION**

<u>Item 1. Legal Proceedings</u>	16
<u>Item 1A. Risk Factors</u>	16
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	16
<u>Item 3. Defaults Upon Senior Securities</u>	16
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	16
<u>Item 5. Other Information</u>	17
<u>Item 6. Exhibits</u>	17
<b><u>SIGNATURES</u></b>	18
<b>10-Q Certifications</b>	19-20
<b>Section 906 Certifications</b>	21-22
<u>EX-31.A</u>	
<u>EX-31.B</u>	
<u>EX-32.A</u>	
<u>EX-32.B</u>	

**Table of Contents****CONSOLIDATED BALANCE SHEETS  
FARMERS NATIONAL BANC CORP. AND SUBSIDIARY  
(Unaudited)**

	(In Thousands of Dollars)	
	<b>June 30, 2006</b>	<b>December 31, 2005</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 25,962	\$ 31,614
Federal funds sold	8,290	0
TOTAL CASH AND CASH EQUIVALENTS	34,252	31,614
Securities available for sale	249,837	259,485
Loans	510,650	511,914
Less allowance for loan losses	5,848	5,860
NET LOANS	504,802	506,054
Premises and equipment, net	14,950	15,143
Other assets	16,365	14,773
TOTAL ASSETS	\$820,206	\$827,069
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Deposits:		
Noninterest-bearing	\$ 62,535	\$ 61,896
Interest-bearing	556,060	568,904
TOTAL DEPOSITS	618,595	630,800
Federal funds purchased and repurchase agreements	77,996	76,152
Federal Home Loan Bank advances	45,452	39,077
Other borrowings	471	1,242
Other liabilities	4,336	3,934
TOTAL LIABILITIES	746,850	751,205
Commitments and contingent liabilities		
Stockholders Equity:	86,506	84,595

Edgar Filing: FARMERS NATIONAL BANC CORP /OH/ - Form 10-Q

Common Stock	Authorized 25,000,000 shares; issued 14,394,450 in 2006 and 14,227,538 in 2005		
Retained earnings		10,416	10,709
Accumulated other comprehensive income (loss)		(4,705)	(2,536)
Treasury stock, at cost; 1,349,487 shares in 2006 and 1,184,315 in 2005		(18,861)	(16,904)
	TOTAL STOCKHOLDERS EQUITY	73,356	75,864
	TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$820,206	\$827,069

See accompanying notes

1

---

**Table of Contents**

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

	(In Thousands except Per Share Data)			
	For the Three Months Ended		For the Six Months Ended	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>INTEREST AND DIVIDEND INCOME</b>				
Loans, including fees	\$ 8,197	\$ 7,767	\$16,220	\$15,244
Taxable securities	1,884	2,095	3,758	4,259
Tax exempt securities	612	523	1,199	984
Dividends	168	96	278	211
Federal funds sold	165	70	207	119
<b>TOTAL INTEREST AND DIVIDEND INCOME</b>	<b>11,026</b>	<b>10,551</b>	<b>21,662</b>	<b>20,817</b>
<b>INTEREST EXPENSE</b>				
Deposits	3,791	2,826	7,219	5,479
Short-term borrowings	668	408	1,191	704
Long-term borrowings	528	421	1,059	827
<b>TOTAL INTEREST EXPENSE</b>	<b>4,987</b>	<b>3,655</b>	<b>9,469</b>	<b>7,010</b>
<b>NET INTEREST INCOME</b>	<b>6,039</b>	<b>6,896</b>	<b>12,193</b>	<b>13,807</b>
Provision for loan losses	60	0	170	269
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>5,979</b>	<b>6,896</b>	<b>12,023</b>	<b>13,538</b>
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	759	676	1,442	1,284
Security gains (losses)	138	(83)	395	185
Other operating income	434	336	787	666
<b>TOTAL NONINTEREST INCOME</b>	<b>1,331</b>	<b>929</b>	<b>2,624</b>	<b>2,135</b>
<b>NONINTEREST EXPENSES</b>				
Salaries and employee benefits	2,875	3,074	5,667	5,838
Occupancy and equipment	595	658	1,241	1,365
State and local taxes	225	231	450	462
Loan expenses	104	100	199	188
Other operating expenses	1,090	1,102	2,095	2,192
<b>TOTAL NONINTEREST EXPENSES</b>	<b>4,889</b>	<b>5,165</b>	<b>9,652</b>	<b>10,045</b>

INCOME BEFORE INCOME TAXES	2,421	2,660	4,995	5,628
<b>INCOME TAXES</b>	533	665	1,145	1,459
NET INCOME	\$ 1,888	\$ 1,995	\$ 3,850	\$ 4,169
<b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:</b>				
Change in net unrealized gains (losses) on securities, net of reclassifications	(2,165)	1,335	(2,169)	(920)
COMPREHENSIVE INCOME (LOSS)	(\$277)	\$ 3,330	\$ 1,681	\$ 3,249
<b>NET INCOME PER SHARE basic and diluted</b>				
	\$ 0.15	\$ 0.15	\$ 0.30	\$ 0.32
<b>DIVIDENDS PER SHARE</b>	\$ 0.16	\$ 0.16	\$ 0.32	\$ 0.32

See accompanying notes

2

**Table of Contents**

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

	(In Thousands of Dollars)	
	<b>Six Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
NET CASH FROM OPERATING ACTIVITIES	\$ 5,203	\$ 5,345
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from maturities and repayments of securities available for sale	24,840	28,870
Proceeds from sales of securities available for sale	8,459	14,705
Purchases of securities available for sale	(27,234)	(50,520)
Loan originations and payments, net	556	(12,938)
Additions to premises and equipment	(273)	(191)
NET CASH FROM INVESTING ACTIVITIES	6,348	(20,074)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net change in deposits	(12,205)	(45)
Net change in short-term borrowings	1,094	11,705
Proceeds from Federal Home Loan Bank borrowings and other debt	10,000	9,694
Repayment of Federal Home Loan Bank borrowings and other debt	(3,646)	(7,159)
Repurchase of Treasury Stock	(1,957)	(901)
Cash dividends paid	(4,096)	(4,112)
Proceeds from dividend reinvestment	1,897	2,284
NET CASH FROM FINANCING ACTIVITIES	(8,913)	11,466
NET CHANGE IN CASH AND CASH EQUIVALENTS	2,638	(3,263)
Beginning cash and cash equivalents	31,614	33,570
Ending cash and cash equivalents	\$ 34,252	\$ 30,307
Supplemental cash flow information:		
Interest paid	(8,990)	(6,839)
Income taxes paid	(1,085)	(1,680)
See accompanying notes		



**Table of Contents**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**Principles of Consolidation:**

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

**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 2005 Annual Report to Shareholders included in the Company s 2005 Annual Report on Form 10-K. The interim condensed 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.

**Estimates:**

To prepare financial statements in conformity with U.S. GAAP, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses is 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 evaluated on a Company-wide basis. Accordingly, all the Company s banking operations are considered by management to be aggregated in one reportable operating segment.

**Stock Options:**

Prior to January 1, 2006, the Company accounted for stock-based compensation expense using the intrinsic value method set forth in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. No compensation cost for stock options was reflected in net income for 2005, as all options granted had an exercise price equal to the market price of the underlying common stock at date of grant.

On January 1, 2006, the Company adopted SFAS No. 123(R) (revised version of SFAS No. 123) which requires measurement of compensation cost for all stock-based awards be based on the grant-date fair value and recognition of compensation cost over the requisite service period of stock-based awards, which is usually the same as the period over which the options vest. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the

**Table of Contents**

Company's valuation methodology previously utilized for options in footnote disclosures required under SFAS No. 123. The fair value of future stock grants will also be determined using the Black-Scholes valuation model. The Company has adopted SFAS No. 123(R) using the modified prospective method, which provides for no retroactive application to prior periods and no cumulative adjustment to equity accounts. It also provides for expense recognition, for both new and existing stock-based awards, as the required services are rendered. SFAS No. 123(R) also amends SFAS No. 95, Statement of Cash Flows, and requires tax benefits relating to excess stock-based compensation deductions be presented in the statement of cash flows as financing cash inflows.

On March 29, 2005, the Securities and Exchange Commission (SEC) published Staff Accounting Bulletin No. 107 (SAB 107), which expressed the views of the Staff regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations and provided the Staff's views regarding the valuation of stock-based payment arrangements for public companies. SAB 107 requires that stock-based compensation be classified in the same expense category as cash compensation. Accordingly, the Company has included stock-based compensation expense in salaries and employee benefits in the condensed consolidated statements of income.

The adoption of SFAS No. 123(R) had the following effect on reported amounts compared with amounts that would have been reported using the intrinsic value method under previous accounting.

	<b>Three months ended June 30, 2006</b>			<b>Six months ended June 30, 2006</b>		
	Using Previous Accounting	SFAS 123(R) Adjustment	As Reported	Using Previous Accounting	SFAS 123(R) Adjustment	As Reported
Income before taxes	\$2,428	\$ (7)	\$2,421	\$5,009	\$ (14)	\$4,995
Income taxes	533	0	533	1,145	0	1,145
Net Income	\$1,895	\$ (7)	\$1,888	\$3,864	\$ (14)	\$3,850
Basic earnings per share	\$ .15	\$ 0	\$ .15	\$ .30	\$ 0	\$ .30
Diluted earnings per share	.15	0	.15	.30	0	.30

The following table illustrates the effect on the prior year comparable periods net income and earnings per share if expense had been measured using the fair value recognition provision of SFAS No. 123(R).

	<b>Three months ended June 30, 2005</b>			<b>Six months ended June 30, 2005</b>		
	As Reported	SFAS 123(R) Adjustment	If Under SFAS 123(R)	As Reported	SFAS 123(R) Adjustment	If Under SFAS 123(R)
Income before taxes	\$ 2,660	\$ (7)	\$ 2,653	\$ 5,628	\$ (14)	\$ 5,614
Income taxes	665	0	665	1,459	0	1,459
Net Income	\$ 1,995	\$ (7)	\$ 1,988	\$ 4,169	\$ (14)	\$ 4,155
Basic earnings per share	\$ .15		\$ .15	\$ .32		\$ .32
Diluted earnings per share	.15		.15	.32		.32



**Table of Contents**

Options to buy stock are granted to directors, officers and employees under the Company's Stock Option Plan, which provides for issue of up to 375,000 options. Exercise price is the market price at the date of grant. The maximum option term is ten years, and options vest over a five year period. All options outstanding were granted in 2001 and will become fully vested in 2006. Shares with respect to which options may be granted may be either authorized and unissued shares or shares issued and thereafter acquired by the Company.

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

	Three months ended June 30, 2006			Six months ended June 30, 2006		
	Total options outstanding			Total options outstanding		
	Shares	Weighted Average Exercise Price	Weighted Average Fair Value	Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Outstanding, beginning of period	49,500	\$ 11	\$ 2.71	49,500	\$ 11	\$ 2.71
Forfeited	1,500			1,500		
Exercised	0			0		
Granted	0			0		
Outstanding, end of period	48,000	\$ 11	\$ 2.71	48,000	\$ 11	\$ 2.71
Exercisable, end of period	38,400	\$ 11	\$ 2.71	38,400	\$ 11	\$ 2.71

The aggregate intrinsic value of all options outstanding at June 30, 2006 was \$2 thousand. The aggregate intrinsic value of all options that were exercisable at June 30, 2006 was \$2 thousand.

The remaining compensation cost yet to be recognized for stock-based awards that have been awarded but not vested is \$10 thousand. This cost will be recognized in its entirety in 2006.

**Securities:**

Securities available for sale at June 30, 2006 and December 31, 2005 are summarized as follows:

(In Thousands of Dollars)	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
<b>June 30, 2006</b>			
U.S. Treasury and U.S. Government sponsored enterprises	\$ 78,860	\$ 1	\$(1,892)
Corporate debt securities	2,254	0	(5)
Mortgage-backed securities	102,053	6	(5,079)
Obligations of states and political subdivisions	59,523	68	(1,394)
Total debt securities	242,690	75	(8,370)
Equity securities	7,147	1,048	0
<b>TOTALS</b>	<b>\$249,837</b>	<b>\$1,123</b>	<b>\$(8,370)</b>

**Table of Contents**

(In Thousands of Dollars) <b>December 31, 2005</b>	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
U.S. Treasury and U.S. Government sponsored enterprises	\$ 78,299	\$ 20	\$(1,144)
Corporate debt securities	2,270	14	0
Mortgage-backed securities	110,725	13	(3,660)
Obligations of states and political subdivisions	59,710	555	(647)
Total debt securities	251,004	602	(5,451)
Equity securities	8,481	947	0
<b>TOTALS</b>	<b>\$259,485</b>	<b>\$1,549</b>	<b>\$(5,451)</b>

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

**Earnings Per Share:**

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

(Dollars in Thousands, except Per Share Data)	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
<b>Basic EPS computation</b>				
Numerator Net income	\$ 1,888	\$ 1,995	\$ 3,850	\$ 4,169
Denominator Weighted average shares outstanding	12,974,678	13,013,301	12,979,980	12,985,212
<b>Basic earnings per share</b>	\$ .15	\$ .15	\$ .30	\$ .32
<b>Diluted EPS computation</b>				
Numerator Net income	\$ 1,888	\$ 1,995	\$ 3,850	\$ 4,169
Denominator Weighted average shares outstanding for basic earnings per share	12,974,678	13,013,301	12,979,980	12,985,212
Effect of Stock Options	219	11,396	3,967	13,005
Weighted averages shares for diluted earnings per share	12,974,897	13,024,697	12,983,947	12,998,217
<b>Diluted earnings per share</b>	\$ .15	\$ .15	\$ .30	\$ .32

## **Table of Contents**

### **Comprehensive Income:**

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income consists solely of unrealized gains and losses on securities available for sale.

### **Reclassifications:**

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

### **Recent Accounting Pronouncements**

In May 2005, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*. This statement changes the requirements for the accounting for and reporting of a change in accounting principle. It is effective for fiscal years beginning after December 15, 2005 and applies to the Company effective January 1, 2006. The adoption of this pronouncement has not had an impact on the Company's consolidated financial statements.

The FASB also issued FAS 155, *Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140*. This Statement changes the accounting for various derivatives and securitized financial assets. This Statement will be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning in 2007. Management does not expect the adoption of this standard to have a material impact on the Company's financial statements.

In March 2006, the FASB issued FAS No. 156, *Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140*, which changes the accounting for all loan servicing rights which are recorded as the result of selling a loan where the seller undertakes an obligation to service the loan, usually in exchange for compensation. FAS 156 amends current accounting guidance by permitting the servicing right to be recorded initially at fair value and also permits the subsequent reporting of these assets at fair value. FAS 156 is effective beginning January 1, 2007. Because the Company has no obligation to service loans for others, management does not expect the adoption of this standard to have a material impact on the Company's financial statements.

In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. Management does not expect that the adoption of this standard will have a material impact on the Company's financial statements.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Forward Looking Statements**

When used in this Form 10-Q, or in future filings with the Securities and Exchange Commission, in press releases or other public or shareholder communications, or in oral statements made with the approval of an authorized executive officer, the words or phrases "will likely result", "are expected to", "will continue", "is anticipated", "estimate", "project", similar expressions are intended to identify forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the Corporation's actual results to be materially different from those indicated. Such statements are subject to certain risks and uncertainties including changes in economic conditions in the market areas the Corporation conducts business, which could materially impact credit quality trends, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in the market areas the Corporation conducts business, and competition, that could

**Table of Contents**

cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Corporation wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. The Corporation undertakes no obligation to publicly release the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

**Results of Operations****Comparison of June 30, 2006 and 2005 and the Six Months Then Ended**

(Dollars in Thousands, except Per Share Data)	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Total Assets	\$820,206	\$832,464
Net Income	\$ 3,850	\$ 4,169
Basic and Diluted Earnings Per Share	\$ .30	\$ .32
Return on Average Assets (Annualized)	.94%	1.02%
Return on Average Equity (Annualized)	10.33%	10.77%
Efficiency Ratio (Year-to-date)	66.93%	63.75%
Capital to Asset Ratio	8.94%	9.51%
Dividends to Net Income (Year-to-date)	107.66%	99.59%
Loans to Assets	62.26%	59.81%
Net Loans to Deposits	81.60%	79.04%

The Corporation's net income for the first six months of 2006 was \$3.850 million, or \$.30 per diluted share, which is a 7.65% decrease compared with the \$4.169 million, or \$.32 per diluted share earned during the same period last year.

The Corporation's annualized return on average assets and return on average equity for the six month period ended June 30, 2006 was .94% and 10.33% respectively, compared to 1.02% and 10.77% for the same period in 2005.

Net Interest Income. The following schedules detail the various components of net interest income for the periods indicated. All asset yields are calculated on a tax-equivalent basis where applicable. Security yields are based on amortized cost.

**Table of Contents****Average Balance Sheets and Related Yields and Rates**

(Dollar Amounts in Thousands)

	Three Months Ended June 30, 2006			Three Months Ended June 30, 2005		
	AVERAGE		RATE (1)	AVERAGE		RATE (1)
	BALANCE	INTEREST		BALANCE	INTEREST	
<b>EARNING ASSETS</b>						
Loans	\$ 507,840	\$ 8,291	6.55%	\$ 491,098	\$ 7,848	6.41%
Taxable securities	190,622	1,884	3.96	221,482	2,094	3.79
Tax-exempt securities	61,319	942	6.16	51,239	816	6.39
Equity Securities (2)	11,058	201	7.29	12,400	107	3.46
Federal funds sold	13,471	165	4.91	8,477	70	3.31
Total earning assets	784,310	11,483	5.87	784,696	10,935	5.59
<b>NONEARNING ASSETS</b>						
Cash and due from banks	24,941			27,745		
Premises and equipment	14,914			15,422		
Allowance for Loan Losses	(5,890)			(6,230)		
Other assets	7,696			8,450		
Total Assets	\$ 825,970			\$ 830,082		
<b>INTEREST-BEARING LIABILITIES</b>						
Time deposits	\$ 277,883	\$ 2,807	4.05%	\$ 266,038	\$ 2,143	3.23%
Savings deposits	167,353	754	1.81	176,119	388	0.88
Demand deposits	115,963	230	0.80	134,631	295	0.88
Repurchase agreements	80,464	660	3.29	77,426	401	2.08
Borrowings	47,138	536	4.56	39,136	428	4.39
Total Interest-Bearing Liabilities	688,800	4,987	2.90	693,350	3,655	2.11
<b>NONINTEREST-BEARING LIABILITIES AND STOCKHOLDERS EQUITY</b>						
Demand deposits	57,719			55,606		
Other Liabilities	5,359			3,654		
Stockholders equity	74,091			77,472		
Total Liabilities and Stockholders Equity	\$ 825,970			\$ 830,082		





**Table of Contents**

**Average Balance Sheets and Related Yields and Rates**  
(Dollar Amounts in Thousands)

	Six Months Ended June 30, 2006			Six Months Ended June 30, 2005		
	AVERAGE		RATE	AVERAGE		RATE
	BALANCE	INTEREST		BALANCE	INTEREST	
<b>EARNING ASSETS</b>						
Loans	\$ 508,985	\$ 16,403	6.50%	\$ 486,437	\$ 15,387	6.38%
Taxable securities	190,977	3,758	3.97	220,960	4,259	3.89
Tax-exempt securities	60,367	1,845	6.16	47,924	1,515	6.37
Equity Securities (2)	11,712	323	5.56	13,120	241	3.70
Federal funds sold	8,658	207	4.82	8,881	119	2.70
Total earning assets	<b>780,699</b>	<b>22,536</b>	<b>5.82</b>	777,322	21,521	5.58
<b>NONEARNING ASSETS</b>						
Cash and due from banks	25,206			27,203		
Premises and equipment	14,990			15,502		
Allowance for Loan Losses	(5,887)			(6,172)		
Other assets	7,954			9,169		
Total Assets	<b>\$ 822,962</b>			\$ 823,024		
<b>INTEREST-BEARING LIABILITIES</b>						
Time deposits	\$ 281,977	\$ 5,448	3.90%	\$ 256,622	\$ 4,081	3.21%
Savings deposits	160,844	1,273	1.60	187,136	854	0.92
Demand deposits	120,121	498	0.84	130,202	544	0.84
Repurchase agreements	74,626	1,167	3.15	73,467	693	1.90
Borrowings	47,977	1,083	4.55	38,528	838	4.39
Total Interest-Bearing Liabilities	<b>685,545</b>	<b>9,469</b>	<b>2.79</b>	685,955	7,010	2.06
<b>NONINTEREST-BEARING LIABILITIES AND STOCKHOLDERS EQUITY</b>						
Demand deposits	57,003			55,194		
Other Liabilities	5,247			3,800		
Stockholders equity	75,167			78,075		
Total Liabilities and Stockholders Equity	<b>\$ 822,962</b>			\$ 823,024		

Net interest income	\$ 13,067	\$ 14,511
Net interest margin	3.38%	3.76%

- (1) Rates are calculated on an annualized basis.
- (2) Equity securities include restricted stock, which is included in other assets on the consolidated balance sheets.

**Table of Contents**

**Taxable equivalent net interest income.** Taxable equivalent net interest income for the first six months of June 30, 2006 totaled \$13.067 million, a decrease of \$1.445 million or 9.96% compared to the first six months of 2005. This decline is due to an increase in interest expense of \$2.46 million or 35.08%. Interest expense increased as deposits shifted out of the lower costing savings deposits and into the higher costing time deposits. Interest expense on time deposits increased \$1.367 million as average balances grew \$25.355 million or 9.88%. Interest income increased \$1.015 million or 4.72% during the same period. The Corporation's tax equated annualized net interest margin decreased from 3.76% for the period ending June 30, 2005 to 3.38% for the period ending June 30, 2006. This decline was primarily due to the shift in deposit mix to higher costing time deposits. Management will continue to evaluate future interest rate changes so that assets and liabilities may be priced accordingly to minimize the impact on the net interest margin.

Taxable equivalent net interest income for the quarter ended June 30, 2006 totaled \$6.496 million, a decrease of \$784 thousand or 10.77% compared to the quarter ended June 30, 2005. The increase in interest expense is attributable to the 79 basis point increase in the cost of interest-bearing liabilities. Average time deposits increased by \$11.85 million or 4.45% over the prior year comparable quarter which drove up interest expense on time deposits by \$664 thousand. The cost of time deposits and repurchase agreements are up 82 basis points and 121 basis points respectively over the prior year comparable quarter as the Federal Reserve Bank continues to increase the target for the federal funds sold interest rate.

**Noninterest Income.** Total noninterest income for the six month period ended June 30, 2006 increased by \$489 thousand or 22.90% compared to the same period in 2005. This increase is mainly due to a \$210 thousand increase in gains on the sale of investment securities. Fees from overdrafts and return check charges also increased \$168 thousand or 17.73%.

Total noninterest income for the quarter ended June 30, 2006 increased by \$402 thousand from the prior year comparable quarter. Security gains resulting from the previously mentioned sales amounted to \$138 thousand for the quarter ended June 30, 2006 compared to security losses of \$83 thousand for the same period in 2005. Other operating income from various sources also increased \$98 thousand or 29.17%.

**Noninterest Expense.** Noninterest expense was \$9.65 million for the first six months of 2006 compared to \$10.05 million for the same period in 2005. This amounts to a decrease of 3.91%. Most of this decrease is the result of a \$171 thousand decline in salaries and employee benefits, resulting mainly from a 23.95% decline in health insurance costs, and a \$124 thousand decrease in occupancy and equipment expense.

Noninterest expense was \$4.89 million for the quarter ended June 30, 2006 compared to \$5.17 million for the same quarter in 2005. This decrease of 5.34% again occurred mainly in salaries and employee benefits and occupancy and equipment expense.

The efficiency ratio increased to 66.93% for the first six months of 2006 compared to 63.75% for the first six months of 2005. The efficiency ratio was adversely impacted by the \$1.61 million decline in net interest income, despite a \$393 thousand decrease in noninterest expenses. The efficiency ratio is calculated as follows: non-interest expense divided by the sum of net interest income plus non-interest income, excluding security gains. This ratio is a measure of the expense incurred to generate a dollar of revenue. Management will continue to closely monitor the efficiency ratio.

**Income Taxes.** Income tax expense totaled \$1.145 million for the first six months of 2006 and \$1.459 million for the first six months of 2005, a decrease of \$314 thousand or 21.52%. The effective tax rate for the first six months of 2006 was 22.92% compared to 25.92% for the same time in 2005. Income tax expense totaled \$533 thousand for the quarter ended June 30, 2006 and \$665 thousand for the quarter ended June 30, 2005, a decrease of 19.85%. This decrease is a result of the Corporation's increased purchases of tax-exempt municipal securities combined with a decrease in pretax income.

**Table of Contents**

**Other Comprehensive Income.** For the first six months of 2006, the change in net unrealized gains on securities, net of reclassifications, resulted in a loss of \$2.17 million compared to a loss of \$920 thousand for the same period in 2005. The losses were due to interest rate increases affecting the market values of the entire investment portfolio.

**Financial Condition**

Total assets decreased \$6.863 million or .83% since December 31, 2005, as the Corporation saw a decline in deposit balances. Capital ratios remain solid, as shown by the ratio of equity to total assets at June 30, 2006 of 8.94%.

**Securities.** Securities available for sale decreased \$9.65 million, mainly resulting from a decrease of \$12.205 million in deposits. The Corporation sold \$2 million in par value of Fannie Mae preferred equity securities and \$6.7 million in market value of State and Municipal Securities, resulting in a gain of \$395 thousand. In addition, there was a \$3.345 million decrease in the net unrealized gains (losses) on securities, resulting from an increase in market interest rates.

**Loans.** Gross loans decreased slightly since December 31, 2005. Commercial Real Estate loans grew \$9.919 million or 6.01% since December 31, 2005. The growth in commercial real estate loans offset the decline in balance in indirect installment loans, which decreased \$13.481 million or 10.67%. Commercial Real Estate loans have grown as the Corporation has used a combination of experienced personnel and marketing strategies to build this section of the portfolio as the local economy continues to recover. Loans contributed 74.88% of total interest income for the six months ended June 30, 2006 and 73.23% for the six months ended June 30, 2005.

**Allowance for Loan Losses.** The following table indicates key asset quality ratios that management evaluates on an ongoing basis.

**Asset Quality History**  
(In Thousands of Dollars)

	6/30/06	3/31/06	12/31/05	9/30/05	6/30/05
Nonperforming loans	\$ 1,884	\$ 2,609	\$ 2,017	\$ 1,593	\$ 1,908
Nonperforming loans as a % of total loans	.37%	.51%	.39%	.31%	.38%
Allowance for loan losses	\$ 5,848	\$ 5,870	\$ 5,860	\$ 6,144	\$ 6,151
Allowance for loan losses as a % of loans	1.15%	1.15%	1.14%	1.20%	1.24%
Allowance for loan losses as a % of nonperforming loans	310.33%	224.99%	290.53%	385.69%	322.38%

The allowance for loan losses as a percentage of loans increased slightly from 1.14% at December 31, 2005 to 1.15% at June 30, 2006. The provision for loan losses for the first six months of 2006 and 2005 was \$170 thousand and \$269 thousand, respectively. Net charge-offs totaled \$182 thousand for the first six months of 2006 down from \$260 thousand for the first six months of 2005. The provision for loan losses was \$60 thousand for the quarter ended June 30, 2006 compared to \$0 for the same time in 2005. The provision closely tracks net charge-offs. During 2006, approximately 84% of gross charge-offs have occurred in the indirect loan portfolio compared to 86% in 2005.

Non-performing loans to total loans have decreased slightly from .39% as of December 31, 2005 to .37% as of June 30, 2006. The ratio of the allowance for loan losses (ALLL) to non-performing loans remains solid at 310%.

## **Table of Contents**

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

**Deposits.** Total deposits decreased \$12.205 million since December 31, 2005. Balances in the Corporation's money market index accounts increased \$27.988 million since December 31, 2005, as management made a concerted effort to aggressively price this variable rate account. The growth in money market index accounts was offset by a decrease of \$16.840 million in time deposits. The Company prices deposit rates to remain competitive within the market and to attract and retain customers.

**Borrowings.** Total borrowings increased \$7.448 million or 6.39% since December 31, 2005. The Corporation offset the overall drop in deposits with Federal Home Loan Bank advances, which increased \$6.375 million during the six month period.

**Capital Resources.** Total stockholders' equity decreased from \$75.864 million at December 31, 2005 to \$73.356 million at June 30, 2006. During the first six months of 2006, the mark to market adjustment of securities decreased accumulated other comprehensive income by \$2.169 million and the repurchase of treasury stock decreased stockholders' equity by \$1.957 million.

The capital management function is a regular process which consists of providing capital for both the current financial position and the anticipated future growth of the Corporation. As of June 30, 2006 the Corporation's total risk-based capital ratio stood at 15.75%, and the Tier I risk-based capital ratio and Tier I leverage ratio were at 14.57% and 9.39%, respectively. Regulations established by the Federal Deposit Insurance Corporation Improvement Act require that for a bank to be considered well capitalized, it must have a total risk-based capital ratio of 10%, a Tier I risk-based capital ratio of 6% and a Tier I leverage ratio of 5%.

### **Critical Accounting Policies**

The Company follows financial accounting and reporting policies that are in accordance with U.S. GAAP. These policies are presented in Note A to the consolidated audited financial statements in Farmers National Banc Corp.'s 2005 Annual Report to Shareholders included in Farmers National Banc Corp.'s Annual Report on Form 10-K. Critical accounting policies are those policies that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. The Company has identified two accounting policies that are critical accounting policies and an understanding of these policies is necessary to understand our financial statements. These policies relate to determining the adequacy of the allowance for loan losses and other-than-temporary impairment of securities. Additional information regarding these policies is included in the notes to the aforementioned 2005 consolidated financial statements, Note A (Summary of Significant Accounting Policies), Note B (Securities), Note C (Loans), and the sections captioned "Loan Portfolio" and "Investment Securities".

### **Liquidity**

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

**Table of Contents**

overall financial condition. The Company's objective in liquidity management is to maintain the ability to meet loan commitments, purchase securities or to repay deposits and other liabilities in accordance with their terms without an adverse impact on current or future earnings. Principal sources of liquidity for the Company include assets considered relatively liquid, such as federal funds sold, cash and due from banks, as well as cash flows from maturities and repayments of loans, and securities.

The primary investing activities of the Company are originating loans and purchasing securities. During the first six months of 2006, net cash from investing activities amounted to \$6.35 million compared to \$20.07 million used in investing activities for the same period in 2005. Purchase of securities available for sale amounted to \$27.234 million in 2006 compared to \$50.520 million in 2005.

The primary financing activities of the Company are obtaining deposits, repurchase agreements and other borrowings. Net cash used by financing activities amounted to \$8.91 million for the first six months of 2006 compared to \$11.47 million provided by financing activities for the same period in 2005. Most of this change is a result of the net decrease in deposits. Deposits decreased \$12.20 million for the six-month period ended June 30, 2006 compared to a \$45 thousand decrease for the same period in 2005.

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

The Company's ability to maximize net income is dependent, in part, on management's ability to plan and control net interest income through management of the pricing and mix of assets and liabilities. Because a large portion of assets and liabilities of the Company are monetary in nature, changes in interest rates and monetary or fiscal policy affect its financial condition and can have significant impact on the net income of the Company.

The Company monitors its exposure to interest rate risk on a quarterly basis through simulation analysis which measures the impact changes in interest rates can have on net income. The simulation technique analyzes the effect of a presumed 100 and 200 basis points shift in interest rates and takes into account prepayment speeds on amortizing financial instruments, loan and deposit volumes and rates, non-maturity deposit assumptions and capital requirements. The results of the simulation indicate that in an environment where interest rates rise or fall 100 and 200 basis points over a 12 month period, using June 30, 2006 amounts as a base case, the Company's change in net interest income would be within the board mandated limits.

The information required by Item 3 has been disclosed in Item 7A of the Company's Annual Report to Shareholders on Form 10-K for the year ended December 31, 2005. There has been no material change in the disclosure regarding market risk due to the stability of the balance sheet.

**Item 4. Controls and Procedures**

Based on their evaluation, as of the end of the period covered by this quarterly report, the Company's Chief Executive Officer and Chief Financial Officer have concluded the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) are effective. There have been no significant changes in internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. The Company's Chief Executive Officer and Chief Financial Officer have also concluded there have been no changes over the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

There are no material pending legal proceedings to which the registrant or its subsidiary is a party, or of which any of their property is the subject, except proceedings which arise in the ordinary course of business. In the opinion of management, pending legal proceedings will not have a material effect on the consolidated financial position of the registrant and its subsidiary.

**Item 1A. Risk Factors**

For information regarding factors that could affect the Corporation's results of operations, financial condition and liquidity, see the risk factors discussion provided under Part 1, Item 1A on Form 10-K for the fiscal year ended December 31, 2005. See also, Forward-Looking Statements included in Part 1, Item 2 of this Quarterly Report on Form 10-Q. There have been no material changes in risk factors since December 31, 2005.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Purchases of equity securities by the issuer.**

On June 13, 2006, the Corporation announced the adoption of a stock repurchase program that authorizes the repurchase of up to 4.9% or approximately 635,117 shares of its outstanding common stock in the open market or in privately negotiated transactions. This program expires in June 2007.

The following table summarizes the treasury stock purchased by the issuer during the second quarter of 2006:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares that May Yet Be Purchased Under the Program
April 1-30	15,032	\$11.55	15,032	288,446
May 1-31	19,000	\$10.78	19,000	269,446
June 1-30	0		0	635,117
TOTAL	34,032	\$11.12	34,032	

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable.

**Item 5. Other Information**

Not applicable.



**Table of Contents**

**Item 6. Exhibits**

(a) The following exhibits are filed or incorporated by reference as part of this report:

2. Not applicable.
- 3(i). The Articles of Incorporation, including amendments thereto for the Registrant. Incorporated by reference to Exhibit 4.1 to Farmers National Banc Corp s Form S-3 Registration Statement dated October 3, 2001. (File No. 0-12055).
- 3(ii). The Code of Regulations, including amendments thereto for the Registrant. Incorporated by reference to Exhibit 4.2 to Farmers National Banc Corp s Form S-3 Registration Statement dated October 3, 2001. (File No. 0-12055).
4. Incorporated by reference to initial filing.
10. Not applicable.
11. Refer to notes to unaudited consolidated financial statements.
15. Not applicable.
18. Not applicable.
19. Not applicable.
22. Not applicable.
23. Not applicable.
24. Not applicable.
- 31.a Certification of Chief Executive Officer (Filed herewith)
- 31.b Certification of Chief Financial Officer (Filed herewith)
- 32.a 906 Certification of Chief Executive Officer (Filed herewith)
- 32.b 906 Certification of Chief Financial Officer (Filed herewith)

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FARMERS NATIONAL BANC CORP.

Dated: August 8, 2006

/s/ Frank L. Paden

Frank L. Paden

President and Secretary

Dated: August 8, 2006

/s/ Carl D. Culp

Carl D. Culp

Executive Vice President

and Treasurer