FARMERS \& MERCHANTS BANCORP INC
Form 10-Q
August 04, 2011

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# SECURITIES AND EXCHANGE COMMISSION <br> Washington, D.C. 20549 <br> FORM 10-Q 

p Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended June 30, 2011

## OR

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from to $\qquad$
Commission File Number 0-14492
FARMERS \& MERCHANTS BANCORP, INC.
(Exact name of registrant as specified in its charter)

## OHIO

(State or other jurisdiction of incorporation or organization)
34-1469491
(I.R.S Employer Identification No.)

43502
(Zip Code)

Idintion

(Address of principal executive offices)
307-11 North Defiance Street, Archbold, Ohio
(419) 446-2501

Registrant s telephone number, including area code (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 b No o 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). p Yes o 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer p Non-accelerated filer o (Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). b Yes o No
Indicate the number of shares of each of the issuers classes of common stock, as of the latest practicable date:
Common Stock, No Par Value 4,682,697

## Class

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ITEM 1 FINANCIAL STATEMENTS
FARMERS \& MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(in thousands of dollars)

|  | $\begin{gathered} \text { June } 30, \\ 2011 \end{gathered}$ |  | $\begin{gathered} \text { December 31, } \\ 2010 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| ASSETS: |  |  |  |  |
| Cash and due from banks | \$ | 13,357 | \$ | 14,675 |
| Interest bearing deposits with banks |  | 7,234 |  | 14,312 |
| Federal funds sold |  | 2,034 |  | 14,392 |
| Total cash and cash equivalents |  | 22,625 |  | 43,379 |
| Securities available for sale (Note 2) |  | 327,666 |  | 287,317 |
| Other Securities, at cost |  | 4,365 |  | 4,406 |
| Loans, net (Note 4) |  | 500,671 |  | 521,883 |
| Bank premises and equipment |  | 17,137 |  | 17,202 |
| Goodwill |  | 4,074 |  | 4,074 |
| Mortgage Servicing Rights |  | 2,126 |  | 2,178 |
| Other Real Estate Owned |  | 3,559 |  | 4,468 |
| Accrued interest and other assets |  | 21,209 |  | 21,456 |
| TOTAL ASSETS | \$ | 903,432 | \$ | 906,363 |
| LIABILITIES AND SHAREHOLDERS EQUITY |  |  |  |  |
| LIABILITIES: |  |  |  |  |
| Deposits: |  |  |  |  |
| Noninterest bearing | \$ | 71,285 | \$ | 70,554 |
| Interest bearing |  |  |  |  |
| NOW accounts |  | 188,465 |  | 176,897 |
| Savings |  | 159,082 |  | 159,698 |
| Time |  | 303,775 |  | 317,364 |
| Total deposits |  | 722,607 |  | 724,513 |
| Federal funds purchased and securities sold under agreement to repurchase |  | 48,946 |  | 51,241 |
| FHLB Advances |  | 26,765 |  | 29,874 |
| Dividend Payable |  | 890 |  | 894 |
| Accrued expenses and other liabilities |  | 5,648 |  | 5,438 |
| Total Liabilities |  | 804,856 |  | 811,960 |
| SHAREHOLDERS EQUITY: |  |  |  |  |
| Common stock, no par value authorized 6,500,000 shares; issued |  |  |  |  |
| $5,200,000$ shares |  | 12,677 |  | 12,677 |
| Treasury Stock 489,368 shares 2011, 465,326 shares 2010 |  | $(10,028)$ |  | $(9,799)$ |


| Unearned Stock Awards 27,935 shares 2011, 27,675 shares 2010 | $(560)$ | $(580)$ |  |
| :--- | ---: | ---: | ---: |
| Retained Earnings | 93,335 | 91,567 |  |
| Accumulated other comprehensive income | 3,152 | 538 |  |
| Total Shareholders Equity | 98,576 | 94,403 |  |
|  |  |  |  |
| TOTAL LIABILITIES AND SHAREHOLDERS | EQUITY | $\$$ | 903,432 |$\$ \$ 906,363$

See Notes to Condensed Consolidated Unaudited Financial Statements.
Note: The December 31, 2010 Balance Sheet has been derived from the audited financial statements of that date.

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INTEREST INCOME:

| Loans, including fees | $\$$ | 7,088 | $\$$ | 8,086 | $\$$ | 15,111 | $\$$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Debt Securities: |  |  | 16,568 |  |  |  |  |
| U.S. Treasury securities | 107 |  | 76 |  | 207 | 102 |  |
| Securities of U.S. Government agencies |  | 1,046 |  | 1,087 | 1,980 | 2,301 |  |
| Obligations of states and political subdivisions | 536 | 532 |  | 1,068 | 1,076 |  |  |
| Dividends | 48 | 48 | 97 | 96 |  |  |  |
| Federal funds sold | 3 | 4 | 9 | 6 |  |  |  |
| Other | 16 | 36 |  | 27 | 4 |  |  |


| Total Interest Income | 8,844 | 9,869 | 18,499 | 20,193 |
| :---: | :---: | :---: | :---: | :---: |
| INTEREST EXPENSE: |  |  |  |  |
| Deposits | 1,772 | 2,321 | 3,655 | 4,776 |
| Federal Funds purchased and securities sold under agreements to repurchase | 76 | 66 | 151 | 134 |
| Borrowed funds | 261 | 422 | 524 | 819 |
| Total Interest Expense | 2,109 | 2,809 | 4,330 | 5,729 |
| NET INTEREST INCOME BEFORE |  |  |  |  |
| PROVISION FOR LOAN LOSSES | 6,735 | 7,060 | 14,169 | 14,464 |
| PROVISION FOR LOAN LOSSES (Note 4) | 657 | 1,985 | 1,429 | 3,675 |
| NET INTEREST INCOME AFTER |  |  |  |  |
| PROVISION FOR LOAN LOSSES | 6,078 | 5,075 | 12,740 | 10,789 |
| NONINTEREST INCOME |  |  |  |  |
| Customer service fees | 914 | 743 | 1,705 | 1,512 |
| Other service charges and fees | 837 | 837 | 1,613 | 1,567 |
| Net gain (loss) on sale of other assets owned | (166) | (16) | (814) | (32) |
| Net gain on sale of loans | 63 | 109 | 138 | 176 |
| Net gain on sale of securities | 33 | 260 | 372 | 518 |
| Total Noninterest Income | 1,681 | 1,933 | 3,014 | 3,741 |
| NONINTEREST EXPENSE |  |  |  |  |
| Salaries and wages | 2,155 | 2,018 | 4,408 | 4,332 |
| Pension and other employee benefits | 546 | 658 | 1,361 | 1,569 |
| Occupancy expense (net) | 457 | 211 | 770 | 484 |
| Furniture and Equipment | 352 | 433 | 744 | 848 |
| Data processing | 230 | 255 | 460 | 522 |
| Franchise Taxes | 224 | 208 | 442 | 448 |
| FDIC Assessment | 120 | 270 | 440 | 524 |


| Mortgage servicing rights amortization |  | 90 |  | 93 |  | 181 |  | 196 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Other general and administrative |  | 1,392 |  | 1,122 |  | 2,328 |  | 2,282 |
| Total Noninterest Expense |  | 5,566 |  | 5,268 |  | 11,134 |  | 11,205 |
| INCOME BEFORE FEDERAL INCOME |  |  |  |  |  |  |  |  |
| TAX |  | 2,193 |  | 1,740 |  | 4,620 |  | 3,325 |
| FEDERAL INCOME TAXES |  | 626 |  | 399 |  | 1,072 |  | 728 |
| NET INCOME | \$ | 1,567 | \$ | 1,341 | \$ | 3,548 | \$ | 2,597 |
| OTHER COMPREHENSIVE INCOME (NET OF TAX): |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| Unrealized gains on securities | \$ | 2,029 | \$ | 534 | \$ | 2,614 | \$ | 224 |
| COMPREHENSIVE INCOME | \$ | 3,596 | \$ | 1,875 | \$ | 6,162 | \$ | 2,821 |
| NET INCOME PER SHARE | \$ | 0.33 | \$ | 0.28 | \$ | 0.76 | \$ | 0.55 |
| Weighted Average Shares Outstanding |  | 86,008 |  | 0,309 |  | 89,285 |  | 32,402 |
| DIVIDENDS DECLARED | \$ | 0.19 | \$ | 0.18 | \$ | 0.38 | \$ | 0.36 |

No disclosure of diluted earnings per share is required as shares are antidilutive as of quarter end.
See Notes to Condensed Consolidated Unaudited Financial Statements.

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FARMERS \& MERCHANTS BANCORP, INC. CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)<br>(in thousands of dollars)

|  | June 30, 2011 |  | Ju | ded 30,2010 |
| :---: | :---: | :---: | :---: | :---: |
| CASH FLOWS FROM OPERATING ACTIVITIES: |  |  |  |  |
| Net income | \$ | 3,548 | \$ | 2,597 |
| Adjustments to Reconcile Net Income to Net |  |  |  |  |
| Cash Provided by Operating Activities: |  |  |  |  |
| Depreciation |  | 675 |  | 688 |
| Accretion and amortization of securities |  | 1,422 |  | 599 |
| Amortization of servicing rights |  | 181 |  | 196 |
| Amortization of core deposit intangible |  | 156 |  | 79 |
| Provision for loan losses |  | 1,429 |  | 3,675 |
| Gain on sale of loans held for sale |  | (138) |  | (176) |
| Originations of loans held for sale |  | $(16,958)$ |  | $(19,275)$ |
| Proceeds from sale of loans held for sale |  | 18,501 |  | 19,218 |
| Loss on sale of other assets |  | 814 |  | 32 |
| Gain on sale of investment securities |  | (372) |  | (518) |
| Change in Operating Assets and Liabilities, net |  | (922) |  | $(2,179)$ |
| Net Cash Provided by Operating Activities |  | 8,336 |  | 4,936 |
| CASH FLOWS FROM INVESTING ACTIVITIES |  |  |  |  |
| Activity in securities: |  |  |  |  |
| Maturities, prepayments and calls |  | 12,806 |  | 48,452 |
| Sales |  | 19,758 |  | 28,301 |
| Purchases |  | $(69,960)$ |  | $(91,029)$ |
| Proceeds from sale of assets |  | 10 |  | 2 |
| Additions to premises and equipment |  | (629) |  | (345) |
| Loan originations and principal collections, net |  | 18,240 |  | 21,873 |
| Net Cash (Used) in Investing Activities |  | $(19,775)$ |  | 7,254 |
| CASH FLOWS FROM FINANCING ACTIVITIES |  |  |  |  |
| Net decrease in deposits |  | $(1,906)$ |  | (301) |
| Net change in short-term debt |  | $(2,295)$ |  | (299) |
| Proceeds from issuance of long-term debt |  |  |  | 9,000 |
| Repayments of long-term debt |  | $(3,109)$ |  | (133) |
| Purchase of Treasury stock |  | (220) |  | (533) |
| Cash dividends paid on common stock |  | $(1,785)$ |  | $(1,704)$ |
| Net Cash Provided by Financing Activities |  | $(9,315)$ |  | 6,030 |
| Net Increase (Decrease) in cash and cash equivalents |  | $(20,754)$ |  | 18,220 |
| Cash and cash equivalents Beginning of year |  | 43,379 |  | 33,648 |
| Cash and cash equivalents End of period |  | 22,625 | \$ | 51,868 |
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| RECONCILIATION OF CASH AND CASH EQUIVALENTS: |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: |
| Cash and cash due from banks | $\$ 13,357$ | $\$$ | 14,978 |  |
| Interest bearing deposits with banks | 7,234 |  | 36,141 |  |
| Federal funds sold | 2,034 |  | 749 |  |
|  | $\$ 22,625$ | $\$$ | 51,868 |  |
| Supplemental Information |  |  |  |  |
| Cash paid during the period for: <br> Interest | $\$ 4,385$ | $\$$ | 5,942 |  |
| Income Taxes | $\$$ | 565 | $\$$ | 975 |

See Notes to Condensed Consolidated Unaudited Financial Statements.

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2011 are not necessarily indicative of the results that are expected for the year ended December 31, 2011. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2010. NOTE 2 FAIR VALUE OF INSTRUMENTS
FAIR VALUE OF FINANCIAL INSTRUMENTS
Fair values of financial instruments are management s estimate of the values at which the instruments could be exchanged in a transaction between willing parties. These estimates are subjective and may vary significantly from amounts that would be realized in actual transactions. In addition, other significant assets are not considered financial assets including deferred tax assets, premises, equipment and intangibles. Further, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered in any of the elements.
The following assumptions and methods were used in estimating the fair value for financial instruments.

## Cash and Cash Equivalents

The carrying amounts reported in the balance sheet for cash, cash equivalents and federal funds sold approximate their fair values. Also included in this line item are the carrying amounts of interest-bearing deposits maturing within ninety days which approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.
Securities and Other Securities
Fair values for securities, excluding Federal Home Loan Bank stock, are based on quoted market price, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

## Loans

Most commercial, agricultural and real estate mortgage loans are made on a variable rate basis. For those variable rate loans that re-price frequently, and with no significant change in credit risk, fair values are based on carrying values. The fair values of the fixed rate and all other loans are estimated using discounted cash flow analysis. This is accomplished by using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality.
Deposits
The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed term money market

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)
Deposits (Continued)
accounts and certificates of deposit approximate their fair value at the reporting date. Fair value for fixed- rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.
Borrowings
Short-term borrowings are carried at cost that approximates fair value. Other long-term debt was generally valued using a discounted cash flow analysis with a discounted rate based on current incremental borrowing rates for similar types of arrangements, or if not available, based on an approach similar to that used for loans and deposits.
Accrued Interest Receivable and Payable
The carrying amounts of accrued interest approximate their fair values.
Dividends Payable
The carrying amounts of dividends payable approximate their fair values and are generally paid within forty days of declaration.
Off Balance Sheet Financial Instruments
Fair values for off-balance sheet, credit related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counter- parties credit standing. The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of June 30, 2011 and December 31, 2010 are reflected below.

|  | (In Thousands) |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | June 2011 |  | December 2010 |  |
|  | Carrying Amount | Fair Value | Carrying <br> Amount | Fair Value |
| Financial Assets: |  |  |  |  |
| Cash and Cash Equivalents | \$ 22,625 | \$ 22,625 | \$ 43,379 | \$ 43,379 |
| Securities available for sale | 327,666 | 327,666 | 287,317 | 287,317 |
| Other Securities | 4,365 | 4,365 | 4,406 | 4,406 |
| Loans, net | 500,671 | 498,003 | 521,883 | 520,766 |
| Accrued interest receivable | 3,847 | 3,847 | 4,036 | 4,036 |
| Financial Liabilities: |  |  |  |  |
| Deposits | \$ 722,607 | \$ 725,021 | \$ 724,513 | \$ 725,270 |
| Short-term debt Repurchase agreement sold | 48,946 | 48,946 | 51,241 | 51,241 |
| Federal Home Loan Bank advances | 26,765 | 27,666 | 29,874 | 30,764 |
| Accrued interest payable | 416 | 416 | 471 | 471 |
| Dividends payable | 890 | 890 | 894 | 894 |
| Off-Balance Sheet Financial Instruments |  |  |  |  |
| Commitments to extend credit | \$ | \$ | \$ | \$ |
| Standby letters of credit |  |  |  |  |
|  | 5 |  |  |  |

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Fair Value Measurements

The following tables present information about the Company s assets and liabilities measured at fair value on a recurring basis at June 30, 2011, and the valuation techniques used by the Company to determine those fair values. In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.
Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.
Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability.
In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Company s assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.
Disclosures concerning assets and liabilities measured at fair value are as follows:

|  | Assets and Liabilities Measured at Fair Value on a Recurring Basis |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Quoted |  |  |  |  |  |
|  | Prices in |  |  |  |  |  |
|  |  | Active |  | Significant |  | Significant |
|  |  | Markets for |  | Observable |  | Unobservable |
| (In Thousands) |  | Identical |  | Inputs |  | Inputs |
|  | Assets |  |  |  |  |  |
| June 30, 2011 |  | (Level 1) |  | (Level 2) |  | (Level 3) |
| Assets-Securities Available for Sale |  |  |  |  |  |  |
| U.S. Treasury | \$ | \$ 36,819 |  |  |  |  |
| U.S. Government agency |  | 188,604 |  |  |  |  |
| Mortgage-backed securities |  | 38,773 |  |  |  |  |
| State and local governments |  |  | \$ | 52,249 | \$ | 11,221 |
| Total Securities Available for Sale | \$ | \$ 264,196 | \$ | 52,249 | \$ | 11,221 |
| Liabilities | \$ |  | \$ |  | \$ |  |
|  |  | Quoted |  |  |  |  |
|  |  | Prices in |  |  |  |  |
|  |  | Active |  | Significant |  | Significant |
|  |  | Markets for |  | Observable |  | Unobservable |
|  |  | Identical |  | Inputs |  | Inputs |
|  |  | Assets |  |  |  |  |
| December 31, 2010 |  | (Level 1) |  | (Level 2) |  | (Level 3) |
| Assets-Securities Available for Sale |  |  |  |  |  |  |
| U.S. Treasury | \$ | \$ 32,279 |  |  |  |  |
| U.S. Government agency |  | 165,703 |  |  |  |  |
| Mortgage-backed securities |  | 24,531 |  |  |  |  |


| State and local governments | $\$$ | 53,502 | $\$$ | 11,302 |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Total Securities Available for Sale | $\$$ | 222,513 | $\$$ | 53,502 | $\$$ |
| 11,302 |  |  |  |  |  |
| Liabilities | $\$$ | $\$$ |  | $\$$ |  |

The Company did have assets measured at fair value that were categorized as Level 3 during the period. The Company s available for sale securities includes bonds issued by local municipalities. Those municipal bonds that did not have CUSIP or credit rating numbers were treated as Level 3. Those bonds, including municipalities, that did have CUSIP numbers or have similar characteristics of those in like markets, were considered comparable and marketable and reported as Level 2.
The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At June 30, 2011, such assets consist primarily of impaired loans and other real estate. The Company has established the fair values of these assets using Level 3 inputs, each individually described below. Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management $s$ best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)
Other real estate is reported at either the fair value of the real estate minus the estimated costs to sell the asset or the cost of the asset. The determination of fair value of the real estate relies primarily on appraisals from third parties. If the fair value of the real estate, minus the estimated costs to sell the asset, is less than the asset s cost, the deficiency is recognized as a valuation allowance against the asset through a charge to expense.

|  | Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2011 |
| :--- | :---: | :---: | :---: | :---: | :---: |
| (In Thousands) |  |


|  |  | sets Me <br> nce at <br> ember <br> 2010 <br> 4,369 | at Fair Value 2010 Quoted Prices in Active Markets for Identical Assets (Level 1) | nrecurring B usands) <br> Significant Observable Inputs <br> (Level 2) \$ | De | er 31, <br> icant <br> rvable ts <br> 3) <br> 4369 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Impaired loans | \$ |  | \$ |  | \$ | 4,369 |
| Other real estate owned residential mortgages | \$ | 2,110 | \$ | \$ | \$ | 2,110 |
| Other real estate owned commercial | \$ | 2,328 | \$ | \$ | \$ | 2,328 |
| Total change in fair value NOTE 3 ASSET PURCHASE |  |  |  |  |  |  |

On July 9, 2010, the Bank completed its purchase of a branch office in Hicksville, Ohio from First Place Bank. Deposits of close to $\$ 28$ million and loans of $\$ 14$ million were included in the purchase. The new office is located within the Bank s current market area, shortening the distance between offices in the Ohio and Indiana market area. The following table summarizes the estimated values of the assets acquired and the liabilities assumed:
(In
Thousands)
Cash
\$ 114
Loans, Net of Discount 13,792
Accrued Interest on Loans 64
Premises and Equipment $\quad 1,803$
Core Deposit Intangible $\quad 1,087$
Other Assets 11
Total Assets Acquired ..... \$ 16,871
Deposits ..... \$ 27,749
Accrued Interest on Deposits ..... 13
Other Liabilities ..... 10
Total Liabilities Assumed ..... 27,772
Net Liabilities Assumed ..... \$ ..... 10,901

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) ASSET PURCHASE (Continued)
In connection with the purchase, the Bank recognized an addition to core deposit intangible by $\$ 1.1$ million, which is being amortized on a straight line basis over the estimated remaining economic life of the deposits of 7 years.
Amortization of these core deposit intangibles is scheduled to be as follows:

|  | (In |
| :--- | ---: |
|  | Thousands) |
| 2011 | $\$$ |
| 2012 | 234 |
| 2013 | 312 |
| 2014 | 312 |
| 2015 | 312 |
| Thereafter | 155 |
| Total Core Deposit Intangible | 235 |

NOTE 4 LOANS
Loan balances as of June 30, 2011 and December 31, 2010.:

|  | (In Thousands) |  |  |
| :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { June } 30, \\ 2011 \end{gathered}$ | $\begin{gathered} \text { December 31, } \\ 2010 \end{gathered}$ |  |
| Loans: |  |  |  |
| Commercial real estate | \$ 193,993 | \$ | 194,268 |
| Agricultural real estate | 32,228 |  | 33,650 |
| Consumer real estate | 81,557 |  | 86,036 |
| Commercial and industrial | 113,947 |  | 117,344 |
| Agricultural | 57,221 |  | 65,400 |
| Consumer | 25,342 |  | 29,008 |
| Industrial Development Bonds | 1,965 |  | 1,965 |
|  | \$ 506,253 | \$ | 527,671 |
| Less: Net deferred loan fees and costs | (93) |  | (82) |
|  | 506,160 |  | 527,589 |
| Less: Allowance for loan losses | $(5,489)$ |  | $(5,706)$ |
| Loans Net | \$ 500,671 | \$ | 521,883 |

The following is a maturity schedule by major category of loans as of June 30, 2011:

|  | (In Thousands) |  |
| :---: | :---: | ---: |
|  | After One |  |
| Year |  |  |
| Within | Within | After |
|  | Five Years | Five Years |


|  | One |  |  |  |
| :--- | ---: | ---: | ---: | ---: |
|  | Year |  |  |  |
|  | $\$ 32,032$ | $\$$ | 114,655 | $\$ 7,306$ |
| Commercial Real Estate | 2,556 |  | 12,896 |  |
| Agricultural Real Estate | 5,511 | 16,776 |  |  |
| Consumer Real Estate | 78,992 | 15,820 | 60,226 |  |
| Commercial/Industrial | 39,601 | 27,844 | 7,111 |  |
| Agricultural | 5,493 | 14,920 | 2,700 |  |
| Consumer | 556 | 17,781 | 1,975 |  |
| Industrial Development Bonds | 446 | 963 |  |  |

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of June 30, 2011.
Variable rate loans whose current rates are equal to their floor or ceiling are classified as fixed in this table.

|  | (In Thousands) |  |
| :--- | ---: | ---: |
|  | Fixed | Variable |
|  | Rate | Rate |
| Commercial Real Estate | $\$ 77,983$ | $\$ 116,010$ |
| Agricultural Real Estate | 18,517 | 13,711 |
| Consumer Real Estate | 69,412 | 12,145 |
| Commercial/Industrial | 84,188 | 29,759 |
| Agricultural | 49,126 | 8,095 |
| Consumer | 20,860 | 4,389 |
| Industrial Development Bonds | 1,965 |  |

As of June 30, 2011 and 2010 one to four family residential mortgage loans amounting to $\$ 71.2$ million and $\$ 75.3$ million, respectively, have been pledged as security for loans the Bank has received from the Federal Home Loan Bank.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)
Note 4 Loans (Continued)
The percentage of delinquent loans has trended downward since the beginning of 2010 from a high of $2.85 \%$ of total loans in January to a low of $.76 \%$ as of the end of March 2011. At the end of the second quarter 2011, the percentage increased to $1.99 \%$ with one large agricultural related credit behind the increase. A credit for which the Bank is fully collateralized and should be removed yet in 2011. Consumer delinquency continued to decrease and remained extremely low. These percentages do not include nonaccrual loans which are not past due. This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, and the writing down of uncollectible credits in a timely manner.
Industrial Development Bonds are included in the commercial and industrial category for the remainder of the tables in this Note 4.
The following table represents the contractual aging of the recorded investment in past due loans by class or loans as of June 30, 2011 and December 31, 2010 (in thousands):


Commercial and
Industrial

| Consumer | 147 |  | 6 |  | 33 | 186 | 28,740 |  | 28,926 |  | 33 |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Total | $\$$ | 2,262 | $\$$ | 87 | $\$$ | 2,952 | $\$ 5,301$ | $\$ 522,288$ | $\$$ | 527,589 | $\$$ | 48 |

The following table presents the recorded investment in nonaccrual loans by class or loans as of June 30, 2011 and December 31, 2010:

|  | (In Thousands) |  |
| :--- | ---: | ---: |
|  | June | December |
|  | 30 | 31 |
| Consumer real estate | 2011 | 2010 |
| Agricultural real estate | $\$ 1,132$ | $\$$ |
| Agricultural | 223 | 587 |
| Commercial Real Estate | 4,577 | 531 |
| Commercial and Industrial | 1,216 | 1,474 |
| Consumer | 1,716 | 1,705 |
|  | 3 | 1,543 |
| Total | $\$ 8,867$ | $\$$ |

The Bank uses a nine tier risk rating system to grade its loans. The grade of a loan may change during the life of the loan. The risk ratings are described as follows.

1. Zero (0) Unclassified. Any loan which has not been assigned a classification.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) Note 4 Loans (Continued)
2. One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of RMA ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank s loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.
3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50 , and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.
4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans that are meeting the terms of repayment.

Loans may be graded 3 when there is no recent information on which to base a current risk evaluation and the following conditions apply: At inception, the loan was properly underwritten and did not possess an unwarranted level of credit risk:
a. At inception, the loan was secured with collateral possessing a loan value adequate to protect the Bank from loss;
b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;
c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.
5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.
6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential , versus defined , impairments to the primary
source of loan repayment and collateral.
7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.
c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
e. Unusual courses of action are needed to maintain a high probability of repayment.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) Note 4 Loans (Continued)
f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.
g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.
h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.
i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.
j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.
8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:
a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.
b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.
c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.
9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution s financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.
The following table represents the risk category of loans by class based on the most recent analysis performed as of June 30, 2011 and December 31, 2010 (in thousands):

| Agriculture |  | Commercial | Commercial <br> and |
| :---: | :---: | :---: | :---: |
| Real | Andustrial |  |  |
| Estate | Agriculture | Real Estate | Industrial |

June 30, 2011

| $1-2$ | $\$ 513$ | $\$$ | 1,131 | $\$$ | 56 | $\$$ | 613 |
| :---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| 3 | 12,530 |  | 23,427 |  | 21,961 |  | 20,549 |
| 4 | 17,833 |  | 27,709 |  | 159,388 |  | 83,415 |
|  | 222 |  | 356 |  | 6,165 |  | 2,260 |
| 5 | 1,110 |  | 4,577 |  | 6,368 |  | 733 |
| 6 | 20 |  | 21 |  | 55 |  | 257 |
| 7 |  |  |  |  |  |  |  |
| 8 | $\$ 32,228$ | $\$$ | 57,221 | $\$ 193,993$ | $\$$ | 113,947 | $\$$ |
|  |  |  |  |  |  |  |  |
| Total |  |  |  |  |  |  |  |


|  | Agriculture Real Estate | Agriculture |  | Commercial <br> Real Estate |  | Commercial and Industrial |  | Industrial Development <br> Bonds |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| December 31, 2010 |  |  |  |  |  |  |  |  |  |
| 1-2 | \$ 484 | \$ | 109 | \$ |  | \$ | 341 | \$ | 275 |
| 3 | 12,216 |  | 27,964 |  | 26,333 |  | 14,026 |  | 733 |
| 4 | 19,624 |  | 35,655 |  | 153,948 |  | 92,066 |  | 957 |
| 5 | 208 |  | 173 |  | 6,765 |  | 3,388 |  |  |
| 6 | 1,097 |  | 1,474 |  | 6,771 |  | 6,688 |  |  |
| 7 | 21 |  | 25 |  | 451 |  | 835 |  |  |
| 8 |  |  |  |  |  |  |  |  |  |
| Total | \$ 33,650 | \$ | 65,400 | \$ | 194,268 | \$ | 117,344 | \$ | 1,965 |
| 11 |  |  |  |  |  |  |  |  |  |

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) Note 4 Loans (Continued)
For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned grading as of June 30, 2011 and December 31, 2010 (in thousands):

|  |  | Consumer <br> Real <br> Estate | Consumer <br> Real Estate <br> December |  |
| :--- | :--- | :---: | :---: | :---: |
|  |  |  | June 30 | 31 |
|  |  |  | 2011 | 2010 |

The Bank did classify approximately $\$ 3.5$ million of its impaired loans as troubled debt restructured (TDR) during 2010 and this balance decreased to $\$ 3.2$ million as of June 30,2011 for those TDRs still current and accruing. The following table indicates the number of contracts and their corresponding balances which the Bank has classified as TDR (\$ in thousands).

| June 30, 2011 |  | Pre- <br> Modification Outstanding | Post- <br> Modification Outstanding |
| :---: | :---: | :---: | :---: |
|  | Number of | Recorded | Recorded |
| Troubled Debt Restructurings | Contracts | Investment | Investment |
| Commercial Real Estate | 5 | \$ 3,940 | \$ 3,255 |
| Ag Real Estate | 2 | \$ 154 | \$ 152 |
| Commercial and Industrial | 2 | \$ 1,431 | \$ 159 |


|  | Number |  |
| :--- | :---: | :---: |
|  | of | Recorded |
| Troubled Debt Restructurings | Contracts | Investment |
| That Subsequently Defaulted | 1 | $\$$ |
| Commercial Real Estate |  | $\$$ |
| Ag Real Estate | 1 | $\$$ |
| Commercial and Industrial |  | 132 |

For the majority of the Bank s impaired loans, the Bank will apply the observable market price methodology. However, the Bank may also utilize a measurement incorporating the present value of expected future cash flows discounted at the loan s effective rate of interest. To determine observable market price, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the collateral value used.
The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off, whether a partial or full loan balance. A charge down in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) Note 4 Loans (Continued)
the collateral or sooner upon the recognition of collateral deficiency. Commercial and agricultural credits are charged down at 120 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy. unsecured debt is charged off. Additional charge-off may be realized as further unsecured positions are recognized.
The following table presents loans individually evaluated for impairment by class of loans as of June 30, 2011 and December 31, 2010 (in thousands):

| June 30, 2011 | Recorded <br> Investment |  | Unpaid <br> Principal <br> Balance |  | Related <br> Allowance |  | Average <br> Recorded <br> Investment |  | Interest <br> Income <br> Recognized |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| With no related allowance recorded: |  |  |  |  |  |  |  |  |  |  |
| Consumer real estate | \$ | 137 | \$ | 137 | \$ |  | \$ | 191 | \$ | 6 |
| Agriculture real estate |  |  |  |  |  |  |  | 291 |  | 5 |
| Agriculture |  | 4,900 |  | 4,900 |  |  |  | 4,582 |  | 1 |
| Commercial real estate |  | 760 |  | 953 |  |  |  | 1,506 |  | 12 |
| Commercial and industrial |  | 1,148 |  | 2,192 |  |  |  | 100 |  |  |
| Consumer |  |  |  |  |  |  |  | 4 |  |  |
| With a specific allowance recorded: |  |  |  |  |  |  |  |  |  |  |
| Consumer real estate |  | 915 |  | 924 |  | 292 |  | 463 |  | 1 |
| Agriculture real estate |  |  |  |  |  |  |  |  |  |  |
| Agriculture |  |  |  |  |  |  |  |  |  |  |
| Commercial real estate |  | 106 |  | 106 |  | 25 |  | 288 |  |  |
| Commercial and industrial |  |  |  |  |  |  |  | 595 |  | 4 |
| Consumer |  |  |  |  |  |  |  |  |  |  |
| Totals: |  |  |  |  |  |  |  |  |  |  |
| Consumer real estate | \$ | 1,052 | \$ | 1,061 | \$ | 292 | \$ | 654 | \$ | 7 |
| Agriculture real estate | \$ | 0 | \$ | 0 | \$ | 0 | \$ | 291 | \$ | 5 |
| Agriculture | \$ | 4,900 | \$ | 4,900 | \$ | 0 | \$ | 4,582 | \$ | 1 |
| Commercial real estate | \$ | 866 | \$ | 1,059 | \$ | 25 | \$ | 1,794 | \$ | 12 |
| Commercial and industrial | \$ | 1,148 | \$ | 2,192 | \$ | 0 | \$ | 695 | \$ | 4 |
| Consumer | \$ |  | \$ |  | \$ |  | \$ | 4 | \$ |  |
| December 31, 2010 | Recorded Investment |  | Unpaid <br> Principal <br> Balance |  | Related Allowance |  | Average Recorded Investment |  | Interest <br> Income Recognized |  |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |
| With no related allowance recorded: |  |  |  |  |  |  |  |  |  |  |
| Consumer real estate | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  |
| Agriculture real estate |  | 219 |  | 219 |  |  |  | 119 |  | 31 |
| Agriculture |  | 1,397 |  | 1,397 |  |  |  | 2,786 |  |  |
| Commercial real estate |  | 849 |  | 1,699 |  |  |  | 2,209 |  | 26 |


| Commercial and industrial |  |  |  |  |  |  | 2,221 |  |  | 2 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Consumer |  |  |  |  |  |  |  |  |  |  |
| With a specific allowance recorded: | 671 |  | 701 |  | 66 |  |  |  | 1,375 |  |  |  |
| Consumer real estate |  |  |  |  |  |  |  |  |  |  |  |
| Agriculture real estate |  |  |  |  |  |  |  |  |  |  |
| Agriculture |  |  |  |  |  |  |  |  |  | 5 |  | 1 |
| Commercial real estate |  | 476 |  | 476 |  | 73 |  | 296 |  | 1 |
| Commercial and industrial |  | 757 |  | 757 |  | 493 |  | 1,125 |  |  |
| Consumer |  |  |  |  |  |  |  |  |  |  |
| Totals: |  |  |  |  |  |  |  |  |  |  |
| Consumer real estate | \$ | 671 | \$ | 701 | \$ | 66 | \$ | 1,375 | \$ |  |
| Agriculture real estate | \$ | 219 | \$ | 219 | \$ | 0 | \$ | 119 | \$ | 31 |
| Agriculture | \$ | 1,397 | \$ | 1,397 | \$ | 0 | \$ | 2,791 | \$ | 1 |
| Commercial real estate | \$ | 1,325 | \$ | 2,175 | \$ | 73 | \$ | 2,505 | \$ | 27 |
| Commercial and industrial | \$ | 757 | \$ | 757 | \$ | 493 | \$ | 3,346 | \$ | 2 |
| Consumer | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  |
|  |  |  |  |  |  |  |  |  |  |  |

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) Note 4 Loans (Continued)
The ALLL has a direct impact on the provision expense. An increase in the ALLL is funded through recoveries and provision expense. The following tables summarize the activities in the allowance for credit losses.

|  | (In Thousands) |  |  |
| :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { June } \\ 30, \\ 2011 \end{gathered}$ | $\begin{gathered} \text { December 31, } \\ 2010 \end{gathered}$ |  |
| Allowance for Loan Losses |  |  |  |
| Balance at beginning of year | \$ 5,706 | \$ | 6,008 |
| Provision for loan loss | 1,429 |  | 5,325 |
| Loans charged off | $(1,854)$ |  | $(6,422)$ |
| Recoveries | 208 |  | 795 |
| Allowance for Loan \& Leases Losses | \$ 5,489 | \$ | 5,706 |
| Allowance for Unfunded Loan Commitments \& Letters of Credit | \$ 144 | \$ | 153 |
| Total Allowance for Credit Losses | \$ 5,633 | \$ | 5,859 |

The Company segregates its Allowance for Loan and Lease Losses (ALLL) into two reserves: The ALLL and the Allowance for Unfunded Loan Commitments and Letters of Credit (AULC). When combined, these reserves constitute the total Allowance for Credit Losses (ACL).
The AULC is reported within other liabilities on the balance sheet while the ALLL is netted within the loans, net asset line. The ACL presented above represents the full amount of reserves available to absorb possible credit losses. The next table breaks down the activity within ALLL for each loan portfolio segment and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs.
Additional analysis related to the allowance for credit losses (in thousands) as of June 30, 2011 and December 31, 2010 is as follows:


June 30, 2011
ALLOWANCE
FOR CREDIT
LOSSES:

| Beginning balance | $\$ 258$ | $\$$ | 122 | $\$$ | 327 | $\$$ | 1,868 | $\$$ | 2,354 | $\$$ | 380 | $\$$ | 153 | $\$$ | 397 | $\$$ |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Charge Offs | $(190)$ |  |  | $(24)$ | $(155)$ | $(1,316)$ |  | $(169)$ |  |  |  | $\$$ | $(1,854)$ |  |  |  |
| Recoveries | 23 |  |  | 65 | 29 | 6 |  | 85 |  |  |  | $\$$ | 208 |  |  |  |
| Provision | 432 |  | 34 |  | $(80)$ | 310 | 1,002 |  | 44 |  |  | $(313)$ | $\$$ | 1,429 |  |  |
| Other Non-interest | $\$$ |  |  |  |  |  |  |  |  | $(9)$ |  | $\$$ | $(9)$ |  |  |  |

expense related to
unfunded
Ending Balance $\begin{array}{llllllllllllllll} & \$ & 523 & \$ & 156 & \$ & 288 & \$ & 2,052 & \$ & 2,046 & \$ & 340 & \$ & 144 & \$ \\ 84 & \$ 8 & 5,633\end{array}$
Ending balance:
individually
evaluated for $\begin{array}{llllll}\text { impairment } & \$ 292 & 25 & \$ & 317\end{array}$

Ending balance:
collectively evaluated for $\begin{array}{lllllllllllllllll}\text { impairment } & \$ & 232 & \$ & 156 & \$ & 288 & \$ & 2,027 & \$ & 2,046 & \$ & 340 & \$ & 144 & \$ & 84\end{array}$

Ending balance: loans acquired with deteriorated credit quality 2 2 \$

FINANCING
RECEIVABLES:
Ending balance $\begin{array}{lllllll}\$ 81,557 & \$ 32,228 & \$ 57,221 & \$ 193,993 & \$ 115,912 & \$ 25,249 & \$ 506,160\end{array}$
Ending balance:
individually
evaluated for
$\begin{array}{llllllllll}\text { impairment } & \$ 1,052 & \$ & 4,900 & \$ & 1,749 & \$ & 265 & \text { 7,966 }\end{array}$
Ending balance:
collectively evaluated for impairment $\quad \$ 80,505$ \$ 32,228 $\$ 52,321 \quad \$ 192,244 \quad \$ 115,647 \quad \$ 25,249$

Ending balance:
loans acquired with deteriorated credit

| quality | $\$$ | 989 | $\$$ | $\$$ | $\$$ | $\$$ | $\$$ | $\$ 89$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued) Note 4 Loans (Continued)

December 31, 2010
ALLOWANCE
FOR CREDIT
LOSSES:

| Beginning balance | $\$$ | 439 | $\$$ | 120 | $\$$ | 647 | $\$$ | 1,810 | $\$$ | 2,494 | $\$$ | 497 | $\$$ | 227 | $\$$ |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |

related to unfunded
Ending Balance $\begin{array}{lllllllllllllllll} & \$ & 258 & \$ & 122 & \$ & 327 & \$ & 1,868 & \$ & 2,354 & \$ & 380 & \$ & 153 & \$ 397 & \$ \\ 5,859\end{array}$
Ending balance:
individually
evaluated for
$\begin{array}{llllllll}\text { impairment } & \$ & 66 & \$ 3 & \$ 93 & \$ & 632\end{array}$
Ending balance:
collectively evaluated for $\begin{array}{lllllllllllllllllll}\text { impairment } & \$ & 190 & \$ & 122 & \$ & 327 & \$ & 1,795 & \$ & 1,861 & \$ & 380 & \$ & 153 & \$ 397 & \$ & 5,226\end{array}$

Ending balance:
loans acquired with deteriorated credit quality $\$ \quad 2 \quad 2 \begin{array}{lll}4 & \$\end{array}$

## FINANCING <br> RECEIVABLES:

Ending balance $\begin{array}{lllllll}\$ 75,785 & \$ 34,446 & \$ 65,400 & \$ 204,327 & \$ 119,262 & \$ 28,451\end{array}$
$\begin{array}{llllllllllll}\text { Ending balance: } & \$ & 671 & \$ & 219 & \$ & 1,397 & \$ & 1,325 & \$ & 757 & \$ 469\end{array}$
individually
evaluated for
impairment

Ending balance:
collectively evaluated for impairment
$\$ 75,114 \quad \$ 34,227 \quad \$ 64,003 \quad \$ 203,002 \quad \$ 118,505 \quad \$ 28,451$
$\$ 523,302$

Ending balance:
loans acquired with
deteriorated credit
quality
\$ 987
156
\$ 1,143

## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## INTRODUCTION

Farmers \& Merchants Bancorp, Inc. (the Company ) was incorporated on February 25, 1985, under the laws of the State of Ohio. Farmers \& Merchants Bancorp, Inc., and its subsidiary The Farmers \& Merchants State Bank (the Bank ) are engaged in commercial banking. The executive offices of the Company are located at 307 North Defiance Street, Archbold 43502.
The Farmers \& Merchants State Bank engages in general commercial banking and savings business. Their activities include commercial, agricultural and residential mortgage, consumer and credit card lending activities. Because the Bank s offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such things as farm land, farm equipment, livestock and general operation loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for such items as autos, trucks, recreational vehicles, motorcycles, etc.
The Bank s underwriting policies exercised through established procedures facilitates operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank s practice has been not to promote innovative, unproven credit products which will not be in the best interest of the Bank or its customers. The Bank does offer a hybrid loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years they automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank s adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer Mac and Small Business Lending programs. The Bank does also retain the servicing on these partially or $100 \%$ sold loans. In order for the customer to participate in these programs they must meet the requirements established by these agencies.
The Bank does not fund sub-prime loans. Sub-prime loans are characterized as a lending program or strategy that target borrowers who pose a significantly higher risk of default than traditional retail banking customers.

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## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

INTRODUCTION (Continued)
Following are the characteristics and underwriting criteria for each major type of loan the Bank offers:
Commercial Real Estate Construction, purchase, and refinance of business purpose real estate. Risks include loan amount in relation to construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower s ability to repay in orderly fashion, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer s ability to repay in a changing rate environment before granting loan approval.
Agricultural Real Estate Purchase of farm real estate or for permanent improvements to the farm real estate. Cash flow from the farm operation is the repayment source and is therefore subject to the financial success of the farm operation.
Consumer Real Estate Purchase, refinance, or equity financing of one to four family owner occupied dwelling. Success in repayment is subject to borrower s income, debt level, character in fulfilling payment obligations, employment, and others.
Commercial/Industrial Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of profit projections, financial leverage, economic trends, management ability, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer s ability to repay in a changing rate environment before granting loan approval.
Agricultural Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re- finance of capital assets such as machinery and equipment, and livestock. The production of crops and livestock is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmers ability to hedge their position by using the future contracts. The risk related to weather is often mitigated by requiring federal crop insurance.
Consumer Funding for individual and family purposes. Success in repayment is subject to borrower s income, debt level, character in fulfilling payment obligations, employment, and others.
Industrial Development Bonds Funds for public improvements in the Bank s service area. Repayment ability is based on the continuance of the taxation revenue as the source of repayment.
All loan requests are reviewed as to credit worthiness and are subject to the Bank s underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on collateral types as set forth in the Bank s Loan Policy. In addition, credit scores of principal borrowers are reviewed and an approved exception from an additional officer is required should a credit score not meet the Bank s Loan Policy guidelines.
Consumer Loans:
Maximum loan to value (LTV) for cars, trucks and light trucks vary from $90 \%$ to $110 \%$ depending on whether direct or indirect. Loans above $100 \%$ are generally due to additional charges for extended warranties and/or insurance coverage periods of lost wages or death. Boats, campers, motorcycles, RV s and Motor Coaches range from $80 \%-90 \%$ based on age of vehicle. 1st or 2nd mortgages on 1-4 family homes range from $75 \%-90 \%$ with in-house first real estate mortgages requiring private mortgage insurance on those exceeding $80 \%$ LTV. Raw land LTV maximum ranges from $65 \%-75 \%$ depending on whether or not the property has been improved.
Commercial/Agriculture:
Real Estate:
Maximum LTVs range from 70\%-80\% depending on type.
Accounts Receivable:
Up to $80 \%$ LTV
Inventory:
Agriculture:
Livestock and grain up to $80 \%$ LTV, crops (insured) up to $75 \%$ and Warehouse Receipts up to $87 \%$

## Commercial:

Maximum LTV of $50 \%$ on raw and finished goods
Used vehicles, new recreational vehicles and manufactured homes not to exceed (NTE) 80\% LTV
Equipment:
New not to exceed $80 \%$ of invoice, used NTE $50 \%$ of listed book or $75 \%$ of appraised value
Restaurant equipment up to $35 \%$ of market value
Heavy trucks, titled trailers and NTE 75\% LTV and aircraft up to 75\% of appraised value
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## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS <br> INTRODUCTION (Continued)

Risks are mitigated through an adherence to Loan Policy with any exception being recorded and approved by Senior Management or committees comprised of Senior Management. Loan Policy defines parameters to essential underwriting guidelines such as loan-to-value ratio, cash flow and debt-to-income ratio, loan requirements and covenants, financial information tracking, collection practice and others. Limitation to any one borrower is defined by the Bank s legal lending limits and is stated in policy. On a broader basis, the Bank restricts total aggregate funding in comparison to Bank capital to any one business and agricultural sector by an approved sector percentage to capital limitation.
The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition ATM s (automated teller machines) are provided at most branch locations along with other independent locations such as major employers and hospitals in the market area. The Bank has custodial services for IRA s (Individual Retirement Accounts) and HAS s (Health Savings Accounts).
F\&M Investment Services, the brokerage department of the Bank, opened for business in April, 1999. Securities are offered through Raymond James Financial Services Inc.
The Bank s primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Williams and Wood and in the Indiana counties of DeKalb and Steuben. The commercial banking business in this market are highly competitive with approximately 17 other depository institutions doing business in the Bank s primary market. The Bank competes directly with other commercial banks, credit unions and farm credit services and savings and loan institutions in each of their operating localities. In a number of locations, the Bank competes against institutions which are much larger.
The Company s common stock is not listed on any exchange or the NASDAQ Stock Market. The stock is currently quoted in over-the-counter markets.

## 2011 IN REVIEW

The impact of new legislation, such as Health Care and Dodd-Frank Financial Reform (collectively, Financial Reform legislation ), weighs heavily on the minds of bankers along with their customers during its implementation. Legislation has impacted the collection of fees as related to overdraft protection during the first half of 2011. A carve out of limited regulation for banks under $\$ 10$ billion in assets as it relates to interchange fees may help to maintain the debit card program through the remainder of 2011 . However, the primary concerns at this point are the impact on future revenues and expenses and how quickly it will be felt should the carve out provide short term relief only. Short-term rates remain low and are expected to remain low throughout 2011. This has enabled the Company to continue to sell investment securities and recognize a gain without compromising the yield while modestly increasing the duration of the investment portfolio. In first half of 2010, the favorable gain produced from the sale of securities was $\$ 518$ thousand. Most of the securities sold were agencies maturing in a shorter time period than the securities that were purchased to replace them. For first half 2011, the favorable gain was at $\$ 372$ thousand and the securities sold were out of state municipals and agencies. The Bank was able to continue to capitalize on the steepness of the yield curve.
During the first quarter of 2011, the Bank received a payoff on a large nonaccrual loan. The collection of which included over $\$ 600$ thousand of interest and a reimbursement of over $\$ 300$ thousand in legal fees. The collection process took almost three years to complete. This boost to revenue is evident throughout from net interest margin, improved asset quality to lower non-interest expense for the quarter. It also offsets tightening margins due to soft loan demand and high liquidity caused from higher deposit growth. As was expected, the second quarter numbers, as they relate to interest earnings, were lower in yield than first quarter without an additional large influx of nonaccrual interest collection. However, the Bank was able to realize improvement in a lower loan provision requirement. In comparing to a year ago, provision expense was $\$ 2.25$ million lower for six months and $\$ 1.33$ million lower in comparing second quarter 2011 performance to second quarter 2010. This contributed to ROA and ROE remaining higher than a year ago. Unfortunately, another large large agricultural credit was placed in collection and on non-accrual. While the Bank expects to collect all principal, fees and interest owed on this credit, this will again

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impact the short term performance. Unlike the previous mentioned credit collection, the collection of this credit should occur within the current year and not extend over a three year process.
A large amount of write-downs and losses on the sale of other real estate owned (ORE) hampered the first half of 2011 as compared to the same time period 2010. The balance at $\$ 3.6$ million is almost $\$ 2$ million higher as of June 30, 2011 compared to June 30, 2010. While June 30, 2010 recognized $\$ 33.6$ thousand in losses from sales of ORE, as of June 30, 2011, the Bank has recognized $\$ 804.8$ thousand in a compilation of write-downs and losses on ORE. This impact is evident in the lower non-interest income for both the second quarter and year-to-date financials of 2011.

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## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

2011 IN REVIEW (Continued)
The Bank s local service area has experienced a very slight improvement in employment rates from mid year 2010 through first half 2011. The improvement is not considered significant at this time as unemployment remains close to, if not in, double digits in most of the Company s market areas. The majority of the Bank scommercial borrowers have experienced slight improvement, although a few still lag. As the economic recovery remains fragile and consumer confidence remains at lower levels, consumer sensitive industries and the retail sector may continue to experience pressures as well.
On July 9, 2010, the Bank completed its purchase of a branch office in Hicksville, Ohio from First Place Bank, a savings association with its main office in Warren, OH. Deposits of close to $\$ 28$ million and loans of $\$ 14$ million were included in the purchase. The new office is located within the Bank s current market area, shortening the distance between offices in the Ohio and Indiana market area. The transaction has been accretive to earnings during its first year of operation.
The Company remains strong, stable and well capitalized and has the capacity to continue to cover the increased costs of doing business in a tough economy and is seeking good loans to improve profitability.
CRITICAL ACCOUNTING POLICY AND ESTIMATES
The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the industries in which it operates. At times the application of these principles requires Management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.
Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL) and the valuation of its Mortgage Servicing Rights as the accounting areas that requires the most subjective or complex judgments, and as such have the highest possibility of being subject to revision as new information becomes available.
The ALLL represents management s estimate of credit losses inherent in the Bank s loan portfolio at the report date. The estimate is a composite of a variety of factors including past experience, collateral value and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion.
The Bank s ALLL methodology captures trends in leading, current, and lagging indicators which will have a direct affect on the Bank s allocation amount. Trends in such leading indicators as delinquency, unemployment, changes in the Bank s service area, experience and ability of staff, regulatory trends, and credit concentrations are referenced. A current indicator such as the total Watch List loan amount to Capital, and a lagging indicator such as the charge off amount are referenced as well. A matrix is formed by loan type from these indicators that is responsive in making ALLL adjustments.
Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest expense in proportion to, and over the period of, the estimated future servicing income of the underlying financial assets.
Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to the amortized cost. Impairment is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum. Fees received
for servicing loans owned by investors are based on a percentage of the outstanding monthly principal balance of such loans and are included in operating income as loan payments are received. Costs of servicing loans are charged to expense as incurred. The Bank utilizes a third party vendor to estimate the fair value of their mortgage servicing rights which utilizes national prepayment speeds in its calculations.
MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES
In comparing the balance sheet of June 30, 2011 to that of December 31, 2010, the liquidity of the Bank has increased by approximately $\$ 20$ million and remains strong with additional funds being moved from short-term Bank deposits to a higher yielding security portfolio. The Bank has taken advantage of the Federal Reserve s payment of interest and also placed funds in term deposits at a correspondent bank. The Bank also expects to receive additional payoffs from a few larger loans that along with security sales may be used to fund new loan growth.

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ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued) MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES (Continued)
Overall, cash and cash equivalents decreased $\$ 20.8$ million and securities increased an additional $\$ 40.4$ million over yearend 2010. The Company s increased liquidity came from a decrease of almost $\$ 21.2$ million in the Bank s loan portfolio. An additional correspondent bank relationship was formed giving the Bank access to another $\$ 18$ million of unsecured borrowing capacity bringing the total access to $\$ 45$ million of unsecured borrowings through correspondent banks and over $\$ 106$ million of unpledged securities which may be sold or used as collateral. The strength of the security portfolio is shown in the tables to follow. With the exception of stock, all of the Bank s security portfolio is categorized as available for sale and as such is recorded at market value. The charts which follow do not include stock. Investment securities will at times depreciate to an unrealized loss position. The Bank utilizes the following criteria to assess whether or not an impaired security is other than temporary. No one item by itself will necessarily signal that a security should be recognized as other than temporary impairment.

1. The fair value of the security has significantly declined from book value.
2. A down grade has occurred that lowers the credit rating to below investment grade (below Baa3 by Moody and BBB- by Standard and Poors).
3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.
4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.
5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
If the impairment is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value, thereby establishing a new cost basis. The amount of the write down shall be included in earnings as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value. The recovery in fair value shall be recognized in earnings when the security is sold. The first table is presented by category of security and length of time in a continuous loss position. Municipalities may be more likely to be in a loss position greater than 12 months due to their length to maturity and are not indicative of an issue with safety and soundness of the municipality. The Bank currently does not hold any securities with other than temporary impairment.

June 30, 2011
U.S. Treasury
U.S. Government agency

Mortgage-backed securities
State and local governments

Less Than Twelve
Months (In
Thousands)
Gross
Unrealized Fair
Losses Value

Twelve Months \& Over ( In Thousands) \}
Gross
Unrealized Fair
Losses Value
\$ 24,865

2,690
\$

The following chart shows the breakdown of the unrealized gain or loss associated within each category of the investment portfolio as of June 30, 2011.

June 30, 2011
(In Thousands)

|  | Amortized <br> Cost | Gross <br> Unrealized <br> Gains | Gross <br> Unrealized <br> Losses | Estimated <br> Market <br> Value |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Available-for-Sale: | $\$ 36,492$ | $\$ 327$ | $\$$ |  | $\$ 36,819$ |
| U.S. Treasury | 186,342 | 2,397 |  | $(135)$ | 188,604 |
| U.S. Government agency | 37,257 | 1,516 |  | 38,773 |  |
| Mortgage-backed securities | 62,799 | 2,100 |  | $(1,429)$ | 63,470 |
| State and local governments | $\$ 322,890$ | $\$ 6,340$ | $\$$ | $(1,564)$ | $\$ 327,666$ |

The following table shows the maturity schedule of the security portfolio with the largest portion due within less than 5 years. Management feels confident that loan growth can easily be funded from an orderly runoff of the investment portfolio.

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## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued) MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES (Continued)

|  | (In Thousands) |  |  |
| :--- | ---: | ---: | ---: |
|  | June 30, 2011 |  |  |
| Amortized |  |  |  |
|  | Cost | Fair Value |  |
|  | $\$ 4,078$ | $\$$ | 4,127 |
| One year or less | 222,849 | 225,829 |  |
| After one year through five years | 42,969 | 44,242 |  |
| After five years through ten years | 15,737 | 14,695 |  |
| After ten years |  |  |  |
|  | $\$ 285,633$ | $\$ 288,893$ |  |
| Subtotal | 37,257 | 38,773 |  |
| Mortgage Backed Securities | $\$ 322,890$ | $\$ 327,666$ |  |

As previously stated, net loans show a decrease of $\$ 21.2$ million for the six months ended June 30, 2011. $\$ 1.9$ million was charged-off during the six month period indicating the decrease was not all due to having charged-off. The balance of the decrease in loans was due to the payoff or refinancing of troubled loans. The loan watch list increased by a net $\$ 1.8$ million, which included $\$ 5$ million in new loans added to the list and a reduction of existing watch list loans of $\$ 3.2$ million.
The chart below shows the breakdown of the loan portfolio by category less deferred loan fees and costs as of June 30 for the last three years.

|  | (In Thousands) |  |  |
| :--- | ---: | ---: | ---: |
|  | June-11 <br> Amount | Amount <br> Ame-09 |  |
|  |  |  | Amount |
| Commercial Real Estate | $\$ 193,993$ | $\$ 221,905$ | $\$ 225,893$ |
| Agricultural Real Estate | 32,228 | 40,554 | 43,242 |
| Consumer Real Estate | 81,557 | 81,041 | 86,202 |
| Commercial and Industrial | 113,947 | 115,974 | 114,702 |
| Agricultural | 57,221 | 53,786 | 55,833 |
| Consumer, Overdrafts and other loans | 25,249 | 30,266 | 32,771 |
| Industrial Development Bonds | 1,965 | 2,491 | 2,115 |
|  |  |  |  |
| Total Loans | $\$ 506,160$ | $\$ 546,017$ | $\$ 560,758$ |

Agricultural loans are the only category of loans that experienced an increase in balances over the time periods shown. Overall, total assets of the Company decreased $\$ 2.9$ million from December 31, 2010 to June 30, 2011.
Deposits decreased $\$ 1.9$ million in total from December 31, 2010. The mix of the portfolio continued to transition to a higher level of core deposits as a result primarily of the Bank s offering of a high interest bearing transaction account along with an increase in health savings accounts. The success of this product is also the reason for the continued movement of deposits out of Certificates of Deposit to interest bearing transaction accounts. In 2010, the Bank
strengthened its line of deposit products by adding additional products which added additional options to its already highly successful Reward Checking, which was renamed KASASA Cash. The additional options include KASASA Saver, KASASA Giver and KASASA ITunes. KASASA Saver is the reason behind the retention of dollars in savings. These continue to be the deposit of choice and attract not only new money from existing customers but new customers to the Bank also.
The Certificate of Deposit (COD) portfolio has decreased $\$ 13.6$ million during the first six months of 2011 which is helping to decrease the cost of funds, as demonstrated below in the section of this MD\&A captioned MATERIAL CHANGES IN RESULTS OF OPERATION Interest Expense .
The Bank paid off $\$ 3.1$ million in FHLB advances during the second quarter and securities sold under agreement to repurchase decreased almost $\$ 2.3$ million during the first six months of 2011 as compared to yearend.
Capital increased approximately $\$ 4.2$ million from year-end during the six months of 2011. Positive earnings and an increase in accumulated other comprehensive income are the factors behind the increase. Comprehensive income increased $\$ 2.6$ million even with the shift of $\$ 372$ thousand from unrealized gain to realized gain with the sale of securities. Dividends remained stable during the period.

# ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued) <br> MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES (Continued) <br> The Company continues to be well-capitalized in accordance with Federal regulatory capital requirements as the capital ratios below show: 

| Primary Ratio | $10.45 \%$ |
| :--- | ---: |
| Tier I Leverage Ratio | $9.90 \%$ |
| Risk Based Capital Tier I | $14.80 \%$ |
| Total Risk Based Capital | $15.73 \%$ |
| Stockholders Equity/Total Assets | $10.91 \%$ |
| MATERIAL CHANGES IN RESULTS OF OPERATIONS |  |

## Interest Income

Annualized interest income and yield on earning assets is down in 2011 as compared to June 30, 2010. While total assets were only slightly lower than yearend, the decrease in interest income resulted primarily from the transition of the Company s earning assets from high yield to lower yield assets. As the table that follows confirms, the shift of funds within the interest earning portfolios of loans to investments caused a lower yield thereby causing lower interest income. The increased volume in the security portfolio, however, did not offset the loss in interest income due to rate changes. Nor was the spread between cash and investments as large as the spread between loans and investments. The portfolio was also impacted by calls due to the low rate environment.

The Bank worked to minimize the impact of the low rate environment on its loan portfolio with the use of floors on renewed and new loans. 2011 loan yield was positively impacted by the collection of nonaccrual interest and adjustments to the Farmer Mac portfolio, which is a loan participation program that generated additional interest income in first quarter 2010. To protect the yield, the Bank is working to add spread to the margin on the variable rate loans so that when prime does adjust up, the Bank s rate also adjusts up over the floor. Overall, interest income from loans was down $\$ 1.5$ million in comparing the six months ended June 30, 2011 to same period for 2010 and due to the decrease in balances.

Interest income and yield on the securities portfolio were down as agency notes continued to be called due to the low interest rate environment. Period ending balances are deceiving as compared to the interest earnings due to the shift of holdings from the sales, calls and maturity and the replacement securities. The average balances in the table are more useful to see the impact of those activities.

Total interest income was down almost $\$ 1.7$ million in comparing the first six months of 2011 to the first six months of 2010.Loans were the only earning asset that decreased in volume which emphasizes the importance of growing loans as it is the highest yielding earning asset. The overall asset yield also decreased 62 basis points between the two periods.

Interest Earning Assets:
Loans

| Taxable Investment Securities | 250,643 | 2,348 | $1.87 \%$ | $3.14 \%$ |
| :--- | ---: | ---: | ---: | ---: |
| Tax-exempt Investment Securities | 61,278 | 1,004 | $4.96 \%$ | $5.46 \%$ |
| Fed Funds Sold \& Interest Bearing Deposits | 31,050 | 36 | $0.23 \%$ | $0.25 \%$ |
| Total Interest Earning Assets | $\$ 852,535$ | $\$$ | 18,499 | $4.48 \%$ |

Change in June 30, 2011 Interest Income (In Thousands) Compared to June 30, 2010

|  | Change | Due to <br> Volume | Due to <br> Rate |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Interest Earning Assets: | $\$(1,457)$ | $\$$ | $(1,423)$ | $\$$ | $(34)$ |
| Loans | $(188)$ |  | 833 |  | $(1,021)$ |
| Taxable Investment Securities | $(35)$ |  | 88 | $(123)$ |  |
| Tax-exempt Investment Securities | $(14)$ |  | $(10)$ | $(4)$ |  |
| Fed Funds Sold \& Interest Bearing Deposits | $\$(1,694)$ | $\$$ | $(512)$ | $\$$ | $(1,182)$ |

The yields on tax-exempt securities and the portion of tax-exempt IDB loans included in loans have been tax adjusted based on a $34 \%$ tax rate in the charts above.

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## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

## Interest Expense

Interest expense continued to be lower than the comparable six months from 2010. Interest expense related to deposits was down $\$ 1.4$ million while the deposit balance increased by $\$ 46.5$ million in comparing the ending balances of each first six months. Approximately $\$ 28$ million of the growth came through the purchase of the Hicksville office. Time deposits continue to reprice down and the Bank continues to try and lengthen the duration of the portfolio with specials offered in terms longer than 12 months. However depositors continue to place more funds in shorter term deposits or move elsewhere. KASASA Cash and Saver helped to increase the savings deposit balances as seen in the increase due to volume.

Interest on borrowed funds was $\$ 295$ thousand lower for the six month periods ended June 30, 2011 and 2010. Additional borrowings from Federal Home Loan Bank in the amount of $\$ 9$ million were taken in the first quarter of 2010, and payoffs were than made for $\$ 13$ million of higher priced advances the remaining quarters of 2010. In second quarter 2011, $\$ 3$ million of borrowings were paid off. Thus the largest decrease in cost of funds for other borrowed money was due to a decreased volume though a third was due to rate change. Fed Funds Purchased and Securities Sold under Agreement to Repurchase was higher in 2011 than 2010 mainly through an increase in balances.

The decrease in interest expense did not outpace the decrease in interest income as it did last year and remains a focus for improvement in 2011. Asset yield decreased 62 basis points while cost of funds decreased 47 basis points. The main focus is to increase asset yield by using excess cash and investments to fund loan growth.

| Interest Bearing Liabilities: |  |  |  |  |  |
| :--- | ---: | :---: | ---: | ---: | ---: |
| Savings Deposits | $\$ 348,799$ | $\$$ | 1,130 | $0.65 \%$ | $0.71 \%$ |
| Other Time Deposits | 308,345 |  | 2,525 | $1.64 \%$ | $2.35 \%$ |
| Other Borrowed Money | 29,578 |  | 524 | $3.54 \%$ | $3.98 \%$ |
| Fed Funds Purchased \& Securities Sold under |  |  | 151 | $0.60 \%$ | $0.60 \%$ |
| Agreement to Repurch | 50,241 |  |  |  |  |
| Total Interest Bearing Liabilities | $\$ 736,963$ | $\$$ | 4,330 | $1.18 \%$ | $1.65 \%$ |

## Change in June 30, 2011 Interest Expense (In Thousands) Compared to June 30, 2010

|  | Change | Due to Volume |  | Due to Rate |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Interest Bearing Liabilities: |  |  |  |  |  |
| Savings Deposits | \$ 91 | \$ | 182 | \$ | (91) |
| Other Time Deposits | $(1,212)$ |  | (75) |  | $(1,137)$ |
| Table of Contents |  |  |  |  | 46 |

Other Borrowed Money
Fed Funds Purchased \& Securities Sold under Agreement to Repurch

Total Interest Bearing Liabilities
(295)

17
\$ $(1,399) \quad \$$
(205)

16

## Net Interest Income

Net interest income is lower in three and six month comparisons, reversing the positive position of the first quarter s comparison. This comes as no surprise as the first quarter 2011 was boosted by the collection of $\$ 600$ thousand of nonaccrual interest income and the second quarter 2011 had an increase in the nonaccrual loan balances of almost $\$ 5$ million without collection of a significant amount of interest. (Accrued interest is reversed when a loan is placed into nonaccrual status.)

Net interest income, in comparison to 2010, should increase by yearend as the Bank continues to work to increase interest income by reducing the amount of nonaccrual loans, fully expecting to collect on the additional $\$ 5$ million that was placed into nonaccrual during the quarter and attempting to add spread on renewing loans. Interest expense on time deposits should also continue to show a decrease until depositors begin to transition back into longer-term deposits. If and when rates begin to rise, the challenge will be to delay the pricing up of deposits.

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## 25 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS <br> ITEM 2 OF OPERATIONS (Continued) <br> MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

## Provision Expense

Provision for loan loss was over $\$ 2.2$ million lower for the six months ended June 30, 2011 as compared to the same 2010 period. The decrease in the average balance in nonaccrual loans, along with improving asset quality and low loan growth warranted the lower provision to the loan loss reserve. The balance in nonaccrual loans decreased $\$ 3.7$ million as of June 30, 2011 as compared to the balances as of June 30, 2010. The overall loan portfolio was also $\$ 39.8$ million lower as of June 2011 compared to June 30, 2010. The Bank continues to focus on the commercial and commercial real estate portfolios for both asset quality and growth. As charts below will show for 2011, a large portion of the current provision was also to replace the reserve balance depleted from net charge-offs during the period. The longer the economy struggles, the more likely additional credits may encounter cash flow problems and the Bank remains diligent in providing funds to offset future losses.

The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off, whether a partial or full loan balance. A charge down in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency. Commercial and agricultural credits are charged down at 120 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy, unsecured debt is charged off. Additional charge-off may be realized as further unsecured positions are recognized.

Looking at the balance in impaired loans, it shows the Bank has recognized an increase in the overall balance of impaired loans when looking at December 2010 compared to June 2011. However, two positive factors can also been seen: A decrease in the current average balance during 2011 and a decrease in the impaired loans with a valuation allowance balance. These are due mainly to the collection of principal from the sale of collateral from one borrower and the remainder from charge-off activity within this classification of loans.

An increase in the impaired loans without a valuation allowance relates to one relationship of approximately $\$ 5$ million which the Bank expects to be fully collectible based on collateral valuation.

The following table tracks the change in impaired loans and their valuation allowance along with nonaccrual balances as of June 30, 2011 and December 31, 2010 upon which the previous comments were made.

|  | (In Thousands) |  |  |
| :---: | :---: | :---: | :---: |
|  | Six | Year Ended |  |
|  | months |  |  |
|  | June | $\begin{gathered} \text { December 31, } \\ 2010 \end{gathered}$ |  |
|  | $\begin{gathered} 30 \\ 2011 \end{gathered}$ |  |  |
| Impaired loans without a valuation allowance | \$7,128 | \$ | 2,849 |
| Impaired loans with a valuation allowance | 838 |  | 1,520 |
| Total impaired loans | \$ 7,966 | \$ | 4,369 |

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| Valuation allowance related to impaired loans | $\$ 317$ | $\$$ | 632 |
| :--- | :--- | ---: | ---: |
| Total non-accrual loans | $\$ 8,867$ | $\$$ | 5,844 |
| Total loans past-due ninety days or more and still accruing | $\$ 8$ | 7 | 48 |
| Average investment in impaired loans | $\$ 8,021$ | $\$$ | 10,136 |

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## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Provision Expense (Continued)
The Bank did classify almost $\$ 3.2$ million of its current and accruing loans as troubled debt restructured during the second quarter of 2011, down from $\$ 3.5$ million at December 31, 2010.

In determining the allocation for impaired loans the Bank applies the observable market price of the collateral securing the asset, reduced by applying a discount for estimated costs of collateral liquidation. In some instances where the discounted market value is less than the loan amount, a specific impairment allocation is assigned, which may be reducedor eliminated by the write down of the credit $s$ active principal outstanding balance.

For the majority of the Bank s impaired loans, the Bank will apply the observable market price methodology. However, the Bank may also utilize a measurement incorporating the present value of expected future cash flows discounted at the loan s effective rate of interest. To determine observable market price, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the collateral value used.

The ALLL has a direct impact on the provision expense. The increase in the ALLL is funded through recoveries and provision expense. The following tables both deal with the allowance for credit losses. The first table breaks down the activity within ALLL for each loan portfolio segment and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table discloses how much of ALLL is attributed to each segment of the loan portfolio, as well as the percent that each particular segment of the loan portfolio represents to the entire loan portfolio in the aggregate. As was mentioned in previous discussion, the commercial and commercial real estate portfolios are having a major impact on the ALLL and the provision expense.

|  | (In Thousands) |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { June-11 } \\ \$ 506,160 \end{gathered}$ | $\begin{gathered} \text { June-10 } \\ \$ \text { 546,051 } \end{gathered}$ |  |  | e-09 |
| Loans |  |  |  | \$ 560,855 |  |
| Daily average of outstanding loans | \$ 509,564 |  | 57,266 |  | 7,463 |
| Allowance for Loan Losses Jan 1 | \$ 5,706 | \$ | 6,008 | \$ | 5,497 |
| Loans Charged off: |  |  |  |  |  |
| Commercial Real Estate | 155 |  |  |  |  |
| Ag Real Estate |  |  |  |  |  |
| Consumer Real Estate | 190 |  | 289 |  | 242 |
| Commercial and Industrial | 1,316 |  | 1,907 |  | 403 |
| Agricultural | 24 |  | 100 |  | 122 |
| Consumer \& other loans | 169 |  | 154 |  | 183 |


|  |  | 1,854 |  | 2,450 |  | 949 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Loan Recoveries |  |  |  |  |  |  |
| Commercial Real Estate |  | 29 |  |  |  |  |
| Ag Real Estate |  |  |  |  |  |  |
| Consumer Real Estate |  | 23 |  | 17 |  | 4 |
| Commercial and Industrial |  | 6 |  | 261 |  | 11 |
| Agricultural |  | 65 |  | 2 |  |  |
| Consumer \& other loans |  | 85 |  | 84 |  | 84 |
|  |  | 208 |  | 364 |  | 100 |
| Net Charge Offs |  | 1,646 |  | 2,086 |  | 849 |
| Provision for loan loss |  | 1,429 |  | 3,675 |  | 1,737 |
| Acquisition provision for loan loss |  |  |  |  |  |  |
| Allowance for Loan \& Lease Losses June 30 | \$ | 5,489 | \$ | 7,597 | \$ | 6,384 |
| Allowance for Unfunded Loan Commitments \& Letters of Credit |  |  |  |  |  |  |
| June 30 |  | 144 |  | 230 |  | 259 |
| Total Allowance for Credit Losses June 30 | \$ | 5,633 | \$ | 7,827 | \$ | 6,643 |
| Ratio of net charge-offs to average Loans outstanding |  | 0.32\% |  | 0.37\% |  | 0.15\% |
| Ratio of Allowance for Loan Loss to Nonperforming Loans |  | 61.90\% |  | 61.54\% |  | 46.66\% |

* Nonperforming loans are defined as all loans on nonaccrual,plus any loans past due 90 days not on nonaccrual. 24


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ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Provision Expense (Continued)

|  | June-2011 |  | June-2010 |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Amount |  |  |  |  | \(\left.\begin{array}{l}\% <br>

of\end{array}\right)\)

The percentage of delinquent loans has trended downward since the beginning of 2010 from a high of $2.85 \%$ of total loans in January to $1.99 \%$ as of the end of June 2011. These percentages do not include nonaccrual loans which are not past due. This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, and the writing down of uncollectable credits in a timely manner.

Non-interest Income
Non-interest income was lower for the six months ended June 30, 2011 as compared to same period in June 30, 2010. First half 2011 has been hurt from the loss on other assets owned of $\$ 814$ thousand. This has come from not only sales but from write-downs to the Bank s ORE as new appraisals have been obtained. While both years show this line item in a loss position, 2011 is higher by $\$ 782$ thousand. The total $\$ 814$ thousand in the line item is made up of loss on sale of ORE and loss on sale or disposal of fixed assets. Somewhat offsetting this loss is the gain on sale of securities, $\$ 372$ thousand so far in 2011 and $\$ 518$ thousand for the six month period ended June 30, 2010.

Improvements in non-interest income were reached in customer service fees and other service charges and fees. The increase in the checking and savings portfolios in terms of number of accounts in 2011 as compared to 2010 has been the main factor behind the additional collection of fees. With implementation of Regulation E on $8 / 15 / 2010$, even the increase in the number of accounts was not enough to offset the regulation changes and year-to-date overdraft fee income is $\$ 47$ thousand lower than during the same period last year. Increases came from debit card usage which is currently under regulatory scrutiny and has been impacted by a heavier volume of fraudulent activity on these cards in the second quarter of 2011. This revenue stream is very important to the Bank and the ability to offer free checking accounts to our customers. Overall, non- interest income decreased and ended
$\$ 727$ thousand lower for the first six months of operations in 2011 as compared to 2010.
The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights which is reported as an other asset on the balance sheet. The capitalization runs through non-interest income while the amortization thereof is included in non-interest expense. A slight impairment in the valuation of the ten year segment occurred in 2011.
(In Thousands)20112010
Beginning Balance, January 1 ..... \$ 2,178 ..... \$ 2,177
Capitalized Additions ..... 129 ..... 168
Amortizations ..... (179)
Valuation Allowance(2)(196)0
Ending Balance, June 30 ..... \$ 2,126 ..... \$ 2,149
Of concern for the remainder of the year is the impact of recently amended Federal Reserve Regulation E on overdraft revenue and the cost of compliance. Regulation E continues to be modified and costs are being incurred to reduce revenue. At this point in time, the Bank is also concerned with changes to interchange fees and the possible loss of revenue.

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## ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Non-interest Income (Continued)
As long as the opportunity exists for gains to be recognized from the sale of securities without impacting yield and extending the maturity duration too long, the Bank will continue to take advantage of it. This provides an opportunity for the Bank to offset the loss of noninterest income. The gain booked in 2010 was based on security sales of $\$ 28.3$ million while 2011 s gain was based on security sales of $\$ 19.8$ million. There were not any securities sold at a loss in either period. The sales during the second quarter of 2011 were mainly out-of-state municipalities which are not eligible for pledging in Ohio.

The movement of income from comprehensive income to realized gain on sale of securities is disclosed in the table to follow. Since the Bank classifies its entire investment portfolio, with the exception of stock, as available for sale, the majority of any gain/loss on the sale is a direct shift of funds from unrealized gain to realized gain. Since the purchase of additional or replacement securities occurs at the same time, those new securities immediately impact the other comprehensive income. Also impacting the comprehensive income is the movement of the market rates in general and its impact on the overall portfolio.

|  | ( In Thousands) |  |  |
| :---: | :---: | :---: | :---: |
|  | Six |  |  |
|  | Months | Six Months Ended |  |
|  | Ended |  |  |
|  | June |  |  |
|  | 30, |  |  |
|  | 2011 |  | 10 |
| Net Unrealized gain on available-for-sale securities | \$ 4,333 | \$ | 858 |
| Reclassification adjustment for gain on sale of available-for-sale securities | (372) |  | (518) |
| Net unrealized gains | 3,961 |  | 340 |
| Tax Effect | $(1,347)$ |  | (116) |
| Other comprehensive income | \$ 2,614 | \$ | 224 |

## Non-Interest Expense

Non-interest expense for the quarter ended June 30, 2011 was $\$ 298$ thousand higher than for the same period of 2010. Salaries and wages were higher by $\$ 137$ thousand during the quarter which was expected with the addition of the Hicksville office and the improved performance of the Company as a whole over 2010 and the likelihood of paying an incentive. Base pay was lower in 2011 than 2010.

Other general and administrative was higher during the quarter bringing the year-to-date comparison also higher. Driving this line item was loan collection expenses from legal fees to past due real estate fees as properties were moved and/or held in ORE. With respect to FDIC assessments, the expense is still large in 2011, though changes to the assessment calculation decreased for second quarter 2011 making the second quarter lower by $\$ 150$
thousand and FDIC expense was approximately $\$ 84$ thousand lower year-to-date than 2010 . Continuing on the positive side, a smaller decrease of $\$ 62$ thousand in comparing June 30, 2011 to June 30, 2010 was derived from a change in service bureaus for the Bank s core operating system in first quarter 2010. The improvement continued even with the addition of the new branch office in July 2010.

Occupancy expense was higher by $\$ 286$ thousand in the six months comparison of 2011 to 2010 . The increase is partly attributed to the increase in the number of offices. Overall, non-interest expense was $\$ 298$ thousand in the second quarter comparison but $\$ 71$ thousand lower in the year-to-date comparison of 2011 to 2010 . First quarter 2011 did include a reimbursement of $\$ 300$ thousand in loan collection fees.

## Net Income

Overall, net income was up $\$ 951$ thousand for the six months ended June 30, 2011, compared to the same period of 2010. The improvement in asset quality that has occurred over the last half of 2010 and the first six months of 2011 along with lower loan balances enabled the Company to have $\$ 2.2$ million less in provision expense in 2011 as compared to 2010 . This coupled with the collection of nonaccrual interest income and reimbursement of collection costs offset the increased cost of ORE write-downs and losses. The gain on sale of investments obviously plays a role in the improvement and the Company is fortunate that the opportunity existed to capture income that has been used to offset the provision expense of the last two years. The decrease in net interest income for the quarter is proof of the importance of the effect of balance sheet mix as the decreased loan balances impacts overall asset yield. The movement of the one large credit to nonaccrual has impacted the second quarter and will continue to impact through the third quarter but should be fully collected during the fourth.

The Company remains positioned for continued improvement in the net interest margin while rates remain low, if loan demand would increase. It will be a challenge to maintain the margin once short term rates begin to rise. However, the Bank remains focused on improving the asset yield through improved asset quality and added spread to prime on variable loans. As an industry, the Company is also limited from achieving higher profitability by the cost of increased regulatory requirements such as Regulation E, Dodd-Frank Wall Street Reform and Consumer Protection Act and any other additional regulations that may be enacted during 2011 and their corresponding cost of compliance. The Company will continue to seek to enhance existing products and services to increase revenue, improve efficiency and increase customer satisfaction.

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ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)
MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued) FORWARD LOOKING STATEMENTS

Statements contained in this portion of the Company s report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as intend, believe, expect, anticipate, should, planned, estimat potential. Such forward-looking statements are based on current expectations, but may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the company and its subsidiaries which include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank s market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.

## ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject to is interest rate risk. The majority of the Company s interest rate risk arises from the instruments, positions and transactions entered into for purposes, other than trading, such as lending, investing and securing sources of funds. Interest rate risk occurs when interest bearing assets and liabilities reprice at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework for the Company. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed.

The Company employs a sensitivity analysis in the form of a net interest rate shock as shown in the following table.

Interest Rate Shock on Net Interest

## Margin

\%

|  | \% <br> Change <br> to | Rate | Rate <br> Changes | Cumulative <br> Notal | \% Change <br> to |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Margin (Ratio) | Flat Rate | Direction | by | $(\$ 000)$ | Flat Rate |
| $2.90 \%$ | $-7.75 \%$ | Rising | $3.00 \%$ | 24,977 | $-7.70 \%$ |
| $2.99 \%$ | $-4.85 \%$ | Rising | $2.00 \%$ | 25,723 | $-4.94 \%$ |
| $3.07 \%$ | $-2.28 \%$ | Rising | $1.00 \%$ | 26,410 | $-2.40 \%$ |
| $3.14 \%$ | $0.00 \%$ | Flat | $0.00 \%$ | 27,060 | $0.00 \%$ |


| $3.11 \%$ | $-0.81 \%$ | Falling | $-1.00 \%$ | 27,030 | $-0.11 \%$ |
| :--- | ---: | :--- | :--- | :--- | :--- |
| $2.96 \%$ | $-5.74 \%$ | Falling | $-2.00 \%$ | 25,970 | $-4.03 \%$ |
| $2.80 \%$ | $-10.92 \%$ | Falling | $-3.00 \%$ | 24,850 | $-8.17 \%$ |

The net interest margin represents the forecasted twelve month margin. It also shows what effect rate changes will have on both the margin and the net interest income. The goal of the Company is to lengthen some of the liabilities or sources of funds to decrease the exposure to a rising rate environment. The Bank has offered higher rates on certificates of deposits for longer periods during 2010 and so far in 2011. Of course, customer desires also drive the ability to capture longer term deposits. Currently, the customer looks for terms twelve months and under while the Bank would prefer 24 months and longer. It is often a meeting in the middle that satisfies both.

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ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)
The Bank continues to remain focused on gaining more relationships per customer as a way to help control the cost of funds also. In the flat and rising rate environment scenario, the model cannot take into account the addition of floors and increased spread on the loan accounts. These are added as the note is renewed and cannot be captured until then. To the extent the Bank is successful in this endeavor, the flat and rising rate scenario will be less costly than forecasted here.

Overall, what the chart shows is that the Company cannot remain stagnant in its choices. Changes in portfolio and/or balance sheet composition are needed for the margin to improve regardless of any rate shock.

## ITEM 4 CONTROLS AND PROCEDURES

As of June 30, 2011, an evaluation was performed under the supervision and with the participation of the Company s management including the CEO and CFO, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. Based on that evaluation, the Company s management, including the CEO and CFO, concluded that the Company s disclosure controls and procedures were effective as of June 30, 2011. There have been no significant changes in the Company s internal control over financial reporting that occurred during the quarter ended June 30, 2011.
PART II
ITEM 1 LEGAL PROCEEDINGS
None
ITEM 1A RISK FACTORS
There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2010.
ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

|  | (a) Total <br> Number <br> of Shares <br> Purchased | (b) Average <br> Price <br> of Shares | Paid per <br> Share | (d) Maximum <br> of Publicly <br> Announced Plan <br> or Programs |
| :--- | :--- | :---: | :---: | :---: |
| Period |  | Number of Shares <br> that may yet be <br> purchased under <br> the Plans or <br> Programs |  |  |
| $4 / 1 / 2011$ to $4 / 30 / 2011$ | 5,000 | $\$$ | 18.75 | 5,000 |

(1) The Company purchased shares in the market pursuant to a stock repurchase program publicly announced on January 21, 2011. On that date, the Board of Directors authorized the repurchase of 200,000 common shares between January 21, 2011 and December 31, 2011.

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ITEM 3 DEFAULTS UPON SENIOR SECURITIES
None
ITEM 4 REMOVED AND RESERVED

## ITEM 5 OTHER INFORMATION

ITEM 6 EXHIBITS
3.1 Amended Articles of Incorporation of the Registrant (incorporated by reference to Registrant s Quarterly Report on Form 10-Q filed with the Commission on August 1, 2006)
3.2 Code of Regulations of the Registrant (incorporated by reference to Registrant s Quarterly Report on Form 10-Q filed with the Commission on May 10, 2004)
31.1 Rule 13-a-14(a) Certification -CEO
31.2 Rule 13-a-14(a) Certification -CFO
32.1 Section 1350 Certification CEO
32.2 Section 1350 Certification CFO

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.

Date: July 27, 2011

Date: July 27, 2011

Farmers \& Merchants Bancorp, Inc.,
By: /s/ Paul S. Siebenmorgen
Paul S. Siebenmorgen
President and CEO

By:/s/ Barbara J. Britenriker
Barbara J. Britenriker
Exec. Vice-President and CFO

