

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
July 28, 2014  
Table of Contents

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period June 30, 2014**

**or**

**.. Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 0-14492**

**FARMERS & MERCHANTS BANCORP, INC.**

**(Exact name of registrant as specified in its charter)**

<b>OHIO</b> <b>(State or other jurisdiction of</b> <b>incorporation or organization)</b>	<b>34-1469491</b> <b>(IRS Employer</b> <b>Identification No.)</b>
<b>307 North Defiance Street, Archbold, Ohio</b> <b>(Address of principal executive offices)</b> <b>(419) 446-2501</b>	<b>43502</b> <b>(Zip Code)</b>

**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 Section 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  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 <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

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

Common Stock, No Par Value	4,614,748
Class	Outstanding as of July 28, 2014

**Table of Contents**

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

INDEX

Form 10-Q Items	Page
PART I. FINANCIAL INFORMATION	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Condensed Consolidated Balance Sheets-June 30, 2014 and December 31, 2013</u>	3
<u>Condensed Consolidated Statement of Income &amp; Comprehensive Income - Three and Six Months Ended June 30, 2014 and June 30, 2013</u>	4
<u>Condensed Consolidated Statements of Cash Flows-Six Months Ended June 30, 2014 and June 30, 2013</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6-32
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32-51
Item 3. <u>Qualitative and Quantitative Disclosures About Market Risk</u>	51-52
Item 4. <u>Controls and Procedures</u>	52
PART II. <u>OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	53
Item 1A. <u>Risk Factors</u>	53
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
Item 3. <u>Defaults Upon Senior Securities</u>	53
Item 4. <u>Mine Safety Disclosures</u>	53
Item 5. <u>Other Information</u>	53
Item 6. <u>Exhibits</u>	53
<u>Signatures</u>	54
Exhibit 31. Certifications Under Section 302	
Exhibit 32. Certifications Under Section 906	
101.INS XBRL Instance Document (1)	
101.SCH XBRL Taxonomy Extension Schema Document (1)	
101.CAL XBRL Taxonomy Extension Calculation Linkbase Document (1)	

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (1)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (1)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (1)

- (1) Pursuant to Rule 406T of Regulation S-T, the interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**Table of Contents**ITEM 1 FINANCIAL STATEMENTS  
FARMERS & MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

**Farmers & Merchants Bancorp, Inc. and Subsidiary**

	Condensed Consolidated Balance Sheets (in thousands of dollars)	
	June 30, 2014	December 31, 2013
<b>Assets</b>		
Cash and due from banks	\$ 15,455	\$ 15,376
Interest bearing deposits with banks	3,099	2,889
Federal Funds Sold	544	998
<b>Total cash and cash equivalents</b>	<b>19,098</b>	<b>19,263</b>
Securities - available for sale (Note 3)	284,628	324,509
Other Securities, at cost	3,717	4,216
Loans, net (Note 4)	592,176	570,919
Bank premises and equipment	19,962	18,709
Goodwill	4,074	4,074
Mortgage Servicing Rights	2,023	2,066
Other Real Estate Owned	1,541	2,091
Accrued interest and other assets	21,009	20,091
<b>Total Assets</b>	<b>\$ 948,228</b>	<b>\$ 965,938</b>
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest-bearing	\$ 115,371	\$ 110,452
<b>Interest-bearing</b>		
NOW accounts	211,438	215,185
Savings	216,443	214,467
Time	217,820	236,360
<b>Total deposits</b>	<b>761,072</b>	<b>776,464</b>
Federal funds purchased and securities sold under agreement to repurchase	70,066	69,756
FHLB Advances		4,500
Dividend payable	963	967
Accrued expenses and other liabilities	5,594	5,911

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Total liabilities	837,695	857,598
<b>Stockholders Equity</b>		
Common stock - No par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares	12,677	12,677
Treasury Stock - 585,292 shares 2014, 561,562 shares 2013	(12,190)	(11,611)
Unearned Stock Awards - 30,805 shares 2014, 31,530 shares 2013	(621)	(642)
Retained earnings	110,489	107,910
Accumulated other comprehensive income	178	6
<b>Total stockholders equity</b>	<b>110,533</b>	<b>108,340</b>
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 948,228</b>	<b>\$ 965,938</b>

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2013 Balance Sheet has been derived from the audited financial statements of that date.

**Table of Contents**

FARMERS &amp; MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED STATEMENT OF INCOME &amp; COMPREHENSIVE INCOME

(Unaudited)

**Farmers & Merchants Bancorp, Inc. and Subsidiary**Condensed Consolidated Statement of Income & Comprehensive Income  
(in thousands of dollars, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
<b>Interest Income</b>				
Loans, including fees	\$ 6,977	\$ 6,089	\$ 13,654	\$ 12,167
Debt securities:				
U.S. Treasury securities	63	64	126	125
Securities of U.S. Government Agencies	696	1,016	1,545	2,008
Municipalities	522	541	1,047	1,049
Dividends	40	45	83	94
Federal funds sold	1	4	1	11
Other	4	6	7	13
Total interest income	8,303	7,765	16,463	15,467
<b>Interest Expense</b>				
Deposits	905	1,079	1,783	2,206
Federal funds purchased and securities sold under agreements to repurchase	65	62	127	122
Borrowed funds		43	4	89
Total interest expense	970	1,184	1,914	2,417
<b>Net Interest Income - Before provision for loan losses</b>	7,333	6,581	14,549	13,050
<b>Provision for Loan Losses (Note 4)</b>	444	112	872	279
<b>Net Interest Income After Provision For Loan Losses</b>	6,889	6,469	13,677	12,771
<b>Noninterest Income</b>				
Customer service fees	1,278	1,256	2,524	2,617
Other service charges and fees	928	967	1,720	1,829
Net loss on sale of other assets owned	(19)	(110)	(58)	(126)
Net gain on sale of loans	203	322	292	802
Net gain on sale of securities - available for sale	180	377	302	598
Total noninterest income	2,570	2,812	4,780	5,720

**Noninterest Expenses**

Salaries and Wages	2,456	2,260	4,891	4,697
Pension and other employee benefits	720	610	1,565	1,454
Occupancy expense (net)	271	288	575	618
Furniture and equipment	399	358	793	707
Data processing	324	300	638	610
Franchise taxes	195	255	391	510
FDIC Assessment	130	141	262	260
Mortgage servicing rights amortization	84	120	166	257
Other general and administrative	1,444	1,438	2,910	2,783
<b>Total Noninterest Expense</b>	<b>6,023</b>	<b>5,770</b>	<b>12,191</b>	<b>11,896</b>
<b>Income Before Federal Income Taxes</b>	<b>3,436</b>	<b>3,511</b>	<b>6,266</b>	<b>6,595</b>
<b>Federal Income Taxes</b>	<b>882</b>	<b>1,009</b>	<b>1,755</b>	<b>1,941</b>
<b>Net Income</b>	<b>2,554</b>	<b>2,502</b>	<b>4,511</b>	<b>4,654</b>

**Other Comprehensive Income (Loss) (Net of Tax):**

Unrealized gain (loss) on securities, net of tax benefit (expense) of (\$437), \$2,532, (\$89), and \$2,918 respectively	847	(4,916)	172	(5,666)
<b>Comprehensive Income (Loss)</b>	<b>\$ 3,401</b>	<b>\$ (2,414)</b>	<b>\$ 4,683</b>	<b>\$ (1,012)</b>
<b>Basic Earnings Per Share</b>	<b>\$ 0.55</b>	<b>\$ 0.53</b>	<b>\$ 0.97</b>	<b>\$ 0.99</b>
<b>Weighted Average Shares Outstanding</b>	<b>4,626,309</b>	<b>4,679,971</b>	<b>4,632,054</b>	<b>4,681,805</b>
<b>Dividends Declared</b>	<b>\$ 0.21</b>	<b>\$ 0.20</b>	<b>\$ 0.42</b>	<b>\$ 0.40</b>



**Table of Contents**

FARMERS &amp; MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

**Farmers & Merchants Bancorp, Inc. and Subsidiary**

	Condensed Consolidated Statements of Cash Flows (in thousands of dollars)	
	Six Months Ended	
	June 30, 2014	June 30, 2013
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 4,511	\$ 4,654
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	719	609
Accretion and amortization of securities, net	809	1,220
Amortization of servicing rights	166	257
Amortization of core deposit intangible	240	156
Compensation expense related to stock awards	125	93
Provision for loan loss	872	279
Gain on sale of loans	(292)	(802)
Originations of loans held for sale	(15,856)	(43,331)
Proceeds from sale of loans held for sale	19,906	46,881
Loss on sale of other assets	58	126
Gain on sales of securities available for sale	(302)	(598)
Change in other assets and other liabilities, net	(1,381)	(194)
Net cash provided by operating activities	9,575	9,350
<b>Cash Flows from Investing Activities</b>		
Activity in securities:		
Maturities, prepayments and calls	10,850	17,305
Sales	29,290	58,413
Purchases		(83,310)
Proceeds from sale of fixed assets		3
Additions to premises and equipment	(1,972)	(1,300)
Loan originations and principal collections, net	(25,812)	(3,428)
Net cash provided (used in) by investing activities	12,356	(12,317)
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	(15,392)	(15,640)
Net change in short-term debt	310	3,416
Repayments of FHLB advances	(4,500)	(4,500)
Purchase of Treasury Stock	(576)	(77)
Cash dividends paid on common stock	(1,938)	(1,861)

Net cash used in financing activities	(22,096)	(18,662)
<b>Change in Cash and Cash Equivalents</b>	<b>(165)</b>	<b>(21,629)</b>
Cash and cash equivalents - Beginning of year	19,263	44,092
<b>Cash and cash equivalents - End of period</b>	<b>\$ 19,098</b>	<b>\$ 22,463</b>

**Supplemental Information**

Cash paid during the year for:

Interest	\$ 2,015	\$ 2,528
----------	----------	----------

Income taxes	\$ 837	\$ 1,770
--------------	--------	----------

Noncash investing activities:

Transfer of loans to other real estate owned	\$ 139	\$ 175
--	--------	--------

See Notes to Condensed Consolidated Unaudited Financial Statements

**Table of Contents**

## 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, 2014 are not necessarily indicative of the results that are expected for the year ended December 31, 2014. 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, 2013.

## NOTE 2 ASSET PURCHASES

In connection with a December 31, 2007 Knisely acquisition, the Company recognized a core deposit intangible asset of \$1.1 million, which is being amortized on a straight line basis over 7 years, which represents the estimated remaining economic useful life of the deposits.

The Company also recognized core deposit intangible assets of \$1.09 million with the purchase of the Hicksville office on July 9, 2010. These are being amortized over an estimated remaining economic useful life of the deposits of 7 years on a straight line basis.

An office was purchased on December 13, 2013 in Custar, Ohio. Core deposit intangible assets of \$1.17 million were recognized and are being amortized over its remaining economic useful life of the deposits of 7 years on a straight line basis.

The amortization expense for the year ended December 31, 2013 was \$319 thousand. Of the \$480 thousand to be expensed in 2014, \$240 thousand has been expensed as of June 30, 2014.

	(In Thousands)			
	Knisley	Hicksville	Custar	Total
2014	\$ 157	\$ 156	\$ 167	\$ 480
2015		155	167	322
2016		155	167	322
2017		77	167	244
2018			167	167
Thereafter			330	330
	\$ 157	\$ 543	\$ 1,165	\$ 1,865

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES

The amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

	(In Thousands)			
	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 25,950	\$	\$ (619)	\$ 25,331
U.S. Government agency	148,096	911	(1,861)	147,146
Mortgage-backed securities	32,721	607	(146)	33,182
State and local governments	77,591	1,870	(492)	78,969
	\$ 284,358	\$ 3,388	\$ (3,118)	\$ 284,628

	(In Thousands)			
	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 26,067	\$	\$ (795)	\$ 25,272
U.S. Government agency	174,772	1,386	(3,186)	172,972
Mortgage-backed securities	44,638	728	(574)	44,792
State and local governments	79,023	2,909	(459)	81,473
	\$ 324,500	\$ 5,023	\$ (5,014)	\$ 324,509

Investment securities will at times depreciate to an unrealized loss position. The Bank utilizes the following criteria to assess whether impairment is other than temporary. No one item by itself will necessarily signal that a security should be recognized as an other than temporary impairment.

1. The fair value of the security has significantly declined from book value.
2. A downgrade has occurred that lowered 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 new cost basis shall not be changed for subsequent recoveries in fair value. The amount of the write down shall be included in current earnings as a realized loss. The recovery in fair value, if any, shall be recognized in earnings when the security is sold. The table below is presented by category of security and length of time in a continuous loss position. The Bank currently does not hold any securities with other than temporary impairment.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES (Continued)

Information pertaining to securities with gross unrealized losses at June 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

(In Thousands)				
June 30, 2014				
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	\$	\$	\$ (619)	\$ 25,331
U.S. Government agency	(3)	5,529	(1,858)	92,529
Mortgage-backed securities	(1)	4,788	(145)	8,744
State and local governments	(309)	8,899	(183)	10,678
<b>Total available-for-sale securities</b>	<b>\$ (313)</b>	<b>\$ 19,216</b>	<b>\$ (2,805)</b>	<b>\$ 137,282</b>

(In Thousands)				
December 31, 2013				
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	\$ (795)	\$ 25,272	\$	\$
U.S. Government agency	(2,783)	96,241	(403)	4,598
Mortgage-backed securities	(574)	23,171		
State and local governments	(459)	19,594		
<b>Total available-for-sale securities</b>	<b>\$ (4,611)</b>	<b>\$ 164,278</b>	<b>\$ (403)</b>	<b>\$ 4,598</b>

Unrealized losses on securities have not been recognized into income because the issuers' bonds are of high credit quality and the Bank has the intent and ability to hold the securities for the foreseeable future. The fair value is expected to recover as the bonds approach the maturity date.

Below are the gross realized gains and losses as of June 30 for each of the years presented.

(In Thousands)

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

	2014	2013
Gross realized gains	\$ 406	\$ 601
Gross realized losses	(104)	(3)
Net realized gains	\$ 302	\$ 598
Tax expense related to net realized gains	\$ 103	\$ 203

The net realized gain on sales and related tax expense is a reclassification out of accumulated other comprehensive income. The net realized gain is included in net gain on sale of securities available for sale and the related tax expense is included in income tax expense in the condensed consolidated statements of income and comprehensive income (loss).

The amortized cost and fair value of debt securities at June 30, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES (Continued)

	(In Thousands)	
	Amortized Cost	Fair Value
One year or less	\$ 18,997	\$ 19,266
After one year through five years	161,574	161,777
After five years through ten years	62,614	62,281
After ten years	8,452	8,122
<b>Total</b>	<b>\$ 251,637</b>	<b>\$ 251,446</b>
Mortgage-backed securities	32,721	33,182
<b>Total</b>	<b>\$ 284,358</b>	<b>\$ 284,628</b>

Investments with a carrying value and fair value of \$199.1 million at June 30, 2014 and \$205.2 million at December 31, 2013 were pledged to secure public deposits and securities sold under repurchase agreements.

Other securities include Federal Home Loan Bank of Cincinnati and Farmer Mac stock as of June 30, 2014. Federal Home Loan Bank of Indianapolis stock which was acquired in the Knisely acquisition, completely redeemed in early 2013. The stock acquired had a five-year redemption period. The stock is carried at cost, which approximates fair value.

## NOTE 4 LOANS

The Company did not have any loans held for sale as of June 30, 2014 as compared to \$556 thousand in loans held for sale on December 31, 2013. Due to lack of materiality, these loans are included in the Consumer Real Estate loans below.

Loan balances as of June 30, 2014 and December 31, 2013:

	(In Thousands)	
Loans:	June 30, 2014	December 31, 2013
Consumer real estate	\$ 95,863	\$ 92,438
Agricultural real estate	47,745	44,301
Agricultural	63,393	65,449
Commercial real estate	265,902	248,893
Commercial and industrial	98,292	99,498
Consumer	22,801	21,406
Industrial Development Bonds	4,163	4,358



Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

	598,159		576,343
Less: Net deferred loan fees and costs	(320)		(230)
	597,839		576,113
Less: Allowance for loan losses	(5,663)		(5,194)
Loans - Net	\$ 592,176	\$	570,919

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following is a maturity schedule by major category of loans as of June 30, 2014:

	Maturities (In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	\$ 10,419	\$ 19,495	\$ 65,949
Agricultural Real Estate	2,988	14,550	30,207
Agricultural	36,743	22,880	3,770
Commercial Real Estate	44,870	95,279	125,753
Commercial/Industrial	58,309	34,190	5,793
Consumer	5,456	13,167	4,178
Industrial Development Bonds	1,633	529	2,001

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of June 30, 2014. Variable rate loans whose current rates are equal to their floor or ceiling are classified as fixed in this table.

	(In Thousands)	
	Fixed Rate	Variable Rate
Consumer Real Estate	\$ 75,588	\$ 20,275
Agricultural Real Estate	33,573	14,172
Agricultural	58,784	4,609
Commercial Real Estate	170,740	95,162
Commercial/Industrial	70,718	27,574
Consumer	18,317	4,484
Industrial Development Bonds	3,980	183

As of June 30, 2014 and December 31, 2013 one to four family residential mortgage loans amounting to \$22.6 and \$24.2 million, respectively, have been pledged as security for loans the Bank has received from the Federal Home Loan Bank.

Industrial Development Bonds are included in the commercial and industrial category for the remainder of the tables in this Note 4.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment in past due loans by portfolio segment of loans as of June 30, 2014 and December 31, 2013, net of deferred fees:

(In Thousands)							
	30-59 Day Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
June 30, 2014							
Consumer Real Estate	\$ 970	\$ 256	\$ 54	\$ 1,280	\$ 94,583	\$ 95,863	\$
Agricultural Real Estate					47,745	47,745	
Agricultural	14			14	63,379	63,393	
Commercial Real Estate	12			12	265,890	265,902	
Commercial and Industrial					102,455	102,455	
Consumer	2			2	22,479	22,481	
<b>Total</b>	<b>\$ 998</b>	<b>\$ 256</b>	<b>\$ 54</b>	<b>\$ 1,308</b>	<b>\$ 596,531</b>	<b>\$ 597,839</b>	<b>\$</b>
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
December 31, 2013							
Consumer Real Estate	\$ 778	\$	\$ 234	\$ 1,012	\$ 91,426	\$ 92,438	\$
Agricultural Real Estate					44,301	44,301	
Agricultural					65,449	65,449	
Commercial Real Estate			373	373	248,520	248,893	
Commercial and Industrial			26	26	103,830	103,856	
Consumer	28	2		30	21,146	21,176	
<b>Total</b>	<b>\$ 806</b>	<b>\$ 2</b>	<b>\$ 633</b>	<b>\$ 1,441</b>	<b>\$ 574,672</b>	<b>\$ 576,113</b>	<b>\$</b>

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table presents the recorded investment in nonaccrual loans by class of loans as of June 30, 2014 and December 31, 2013:

	(In Thousands)	
	June 30 2014	December 31 2013
Consumer Real Estate	\$ 173	\$ 483
Commercial Real Estate	799	2,436
Commercial and Industrial	355	410
Total	\$ 1,327	\$ 3,329

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.
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 Risk Management Association 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. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.
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

**Table of Contents**

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

NOTE 4 LOANS (Continued)

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.
  - 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.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by class based on the most recent analysis performed as of June 30, 2014 and December 31, 2013:

	(In Thousands)				
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>June 30, 2014</b>					
1-2	\$ 4,497	\$ 7,029	\$ 1,295	\$ 365	\$
3	15,265	22,954	52,072	24,343	3,687
4	27,648	33,410	205,801	70,439	476
5	114		1,871	2,081	
6	221		4,863	673	
7				391	
8					
<b>Total</b>	<b>\$ 47,745</b>	<b>\$ 63,393</b>	<b>\$ 265,902</b>	<b>\$ 98,292</b>	<b>\$ 4,163</b>

	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>December 31, 2013</b>					
1-2	\$ 3,764	\$ 9,263	\$ 1,104	\$ 2,525	\$
3	14,588	27,212	55,060	21,610	3,869
4	25,186	28,974	182,277	72,059	489
5	729		4,987	2,119	
6	34		5,092	758	
7			373	427	
8					
<b>Total</b>	<b>\$ 44,301</b>	<b>\$ 65,449</b>	<b>\$ 248,893</b>	<b>\$ 99,498</b>	<b>\$ 4,358</b>



**Table of Contents**

## 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 risk grading as of June 30, 2014 and December 31, 2013.

Grade	(In Thousands)	
	Consumer Real Estate June 30 2014	Consumer Real Estate December 31 2013
Pass	\$ 95,553	\$ 92,226
Special Mention (5)		
Substandard (6)	310	18
Doubtful (7)		194
Total	\$ 95,863	\$ 92,438

	(In Thousands)			
	Consumer - Credit June		Consumer - Other	
	30 2014	December 31 2013	June 30 2014	December 31 2013
Performing	\$ 3,574	\$ 3,721	\$ 18,882	\$ 17,425
Nonperforming			25	30
Total	\$ 3,574	\$ 3,721	\$ 18,907	\$ 17,455

Information about impaired loans as of June 30, 2014, December 31, 2013 and June 30, 2013 are as follows:

	June 30, 2014	December 31, 2013	June 30, 2013
Impaired loans without a valuation allowance	\$ 1,444	\$ 924	\$ 1,703
Impaired loans with a valuation allowance	345	1,516	2,818

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Total impaired loans	\$ 1,789	\$ 2,440	\$ 4,521
Valuation allowance related to impaired loans	\$ 202	\$ 516	\$ 771
Total non-accrual loans	\$ 1,327	\$ 3,329	\$ 4,609
Total loans past-due ninety days or more and still accruing	\$	\$	\$
Quarter ended average investment in impaired loans	\$ 1,928	\$ 2,532	\$ 4,363
Year to date average investment in impaired loans	\$ 2,090	\$ 3,274	\$ 4,342

No additional funds are committed to be advanced in connection with impaired loans.

The Bank had approximately \$964 thousand of its impaired loans classified as troubled debt restructured as of June 30, 2014, \$861.2 thousand as of December 31, 2013 and \$2.9 million as of June 30, 2013.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents three months and six months ended June 30, 2014.

				(In Thousands)	
Three Months			Pre-	Post-	
June 30, 2014	Number of		Modification	Modification	
	Contracts		Outstanding	Outstanding	
	Modified in the		Recorded	Recorded	
	Last 3		Investment	Investment	
	Months		\$	\$	
Troubled Debt Restructurings					
Ag Real Estate					
				(In Thousands)	
Six Months			Pre-	Post-	
June 30, 2014	Number of		Modification	Modification	
	Contracts		Outstanding	Outstanding	
	Modified in the		Recorded	Recorded	
	Last 6		Investment	Investment	
	Months		\$	\$	
Ag Real Estate	2		\$ 153	\$	141

The following table represents three months and six months ended June 30, 2013.

				(In Thousands)	
Three Months			Pre-	Post-	
June 30, 2013	Number of		Modification	Modification	
	Contracts		Outstanding	Outstanding	
	Modified in the		Recorded	Recorded	
	Last 3		Investment	Investment	
	Months		\$	\$	
Commercial and Industrial	3		\$ 2,251	\$	2,251
				(In Thousands)	
Six Months			Pre-	Post-	
June 30, 2013	Number of		Modification	Modification	
	Contracts		Outstanding	Outstanding	
	Modified in the		Recorded	Recorded	
	Last 6		Investment	Investment	
	Months		\$	\$	

Commercial and Industrial	4	\$ 2,294	\$ 2,332
---------------------------	---	----------	----------

For the three and six month periods ended June 30, 2014 and 2013, there were no TDRs that subsequently defaulted after modification.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

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 for 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-off 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.

The following table presents loans individually evaluated for impairment by class of loans for three months ended June 30, 2014 and June 30, 2013.

	(In Thousands)				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Three Months Ended June 30, 2014					
With no related allowance recorded:					
Consumer real estate	\$ 26	\$ 26	\$	\$ 23	\$ 1
Agricultural real estate	141	141		141	
Agricultural					
Commercial real estate	1,277	1,277		845	14
Commercial and industrial				354	14
Consumer					
With a specific allowance recorded:					
Consumer real estate				55	1
Agricultural real estate					
Agricultural					
Commercial real estate					
Commercial and industrial	345	345	202	510	2
Consumer					
Totals:					

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Consumer real estate	\$ 26	\$ 26	\$	\$ 78	\$ 2
Agricultural real estate	\$ 141	\$ 141	\$	\$ 141	\$
Agricultural	\$	\$	\$	\$	\$
Commercial real estate	\$ 1,277	\$ 1,277	\$	\$ 845	\$ 14
Commercial and industrial	\$ 345	\$ 345	\$ 202	\$ 864	\$ 16
Consumer	\$	\$	\$	\$	\$

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

Three Months Ended June 30, 2013	(In Thousands)				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	\$ 359	\$ 431	\$	\$ 202	\$
Agricultural real estate					
Agricultural					
Commercial real estate	1,035	1,459		1,038	
Commercial and industrial	309	309		309	
Consumer		3			
With a specific allowance recorded:					
Consumer real estate	111	111	38	111	
Agricultural real estate	88	88	15	111	
Agricultural					
Commercial real estate				15	
Commercial and industrial	2,619	2,619	718	2,659	
Consumer					
<b>Totals:</b>					
Consumer real estate	\$ 470	\$ 542	\$ 38	\$ 313	\$
Agricultural real estate	\$ 88	\$ 88	\$ 15	\$ 111	\$
Agricultural	\$	\$	\$	\$	\$
Commercial real estate	\$ 1,035	\$ 1,459	\$	\$ 1,053	\$
Commercial and industrial	\$ 2,928	\$ 2,928	\$ 718	\$ 2,968	\$
Consumer	\$	\$ 3	\$	\$	\$

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans for six months ended June 30, 2014 and June 30, 2013.

Six Months Ended June 30, 2014	(In Thousands)				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance recorded:</b>					
Consumer real estate	\$ 26	\$ 26	\$	\$ 44	\$ 1
Agricultural real estate	141	141		141	
Agricultural					
Commercial real estate	1,277	1,277		874	28
Commercial and industrial				181	40
Consumer					
<b>With a specific allowance recorded:</b>					
Consumer real estate				127	2
Agricultural real estate					
Agricultural					
Commercial real estate				47	
Commercial and industrial	345	345	202	676	5
Consumer					
<b>Totals:</b>					
Consumer real estate	\$ 26	\$ 26	\$	\$ 171	\$ 3
Agricultural real estate	\$ 141	\$ 141	\$	\$ 141	\$
Agricultural	\$	\$	\$	\$	\$
Commercial real estate	\$ 1,277	\$ 1,277	\$	\$ 921	\$ 28
Commercial and industrial	\$ 345	\$ 345	\$ 202	\$ 857	\$ 45
Consumer	\$	\$	\$	\$	\$



**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

Six Months Ended June 30, 2013	(In Thousands)				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	\$ 359	\$ 431	\$	\$ 131	\$
Agricultural real estate					
Agricultural					
Commercial real estate	1,035	1,459		622	
Commercial and industrial	309	309		297	
Consumer		3			
With a specific allowance recorded:					
Consumer real estate	111	111	38	121	
Agricultural real estate	88	88	15	55	
Agricultural					
Commercial real estate				332	
Commercial and industrial	2,619	2,619	718	2,701	
Consumer					
Totals:					
Consumer real estate	\$ 470	\$ 542	\$ 38	\$ 252	\$
Agricultural real estate	\$ 88	\$ 88	\$ 15	\$ 55	\$
Agricultural	\$	\$	\$	\$	\$
Commercial real estate	\$ 1,035	\$ 1,459	\$	\$ 954	\$
Commercial and industrial	\$ 2,928	\$ 2,928	\$ 718	\$ 2,998	\$
Consumer	\$	\$ 3	\$	\$	\$

**Table of Contents**

## 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)	
	Six Months Ended June 30, 2014	Twelve Months Ended December 31, 2013
<b>Allowance for Loan &amp; Lease Losses</b>		
Balance at beginning of year	\$ 5,194	\$ 5,224
Provision for loan loss	872	858
Loans charged off	(534)	(1,262)
Recoveries	131	374
Allowance for Loan & Lease Losses	\$ 5,663	\$ 5,194
<b>Allowance for Unfunded Loan Commitments &amp; Letters of Credit</b>		
	\$ 186	\$ 163
Total Allowance for Credit Losses	\$ 5,849	\$ 5,357

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.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table breaks down the activity within ACL 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 for three months ended June 30, 2014 and June 30, 2013 is as follows:

	(In Thousands)									
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated		Total
<b>Three Months Ended June 30, 2014</b>										
<b>ALLOWANCE FOR CREDIT LOSSES:</b>										
Beginning balance	\$ 402	\$ 131	\$ 323	\$ 1,959	\$ 1,330	\$ 270	\$ 180	\$ 910	\$	\$ 5,505
Charge Offs	(66)			(28)		(74)			\$	(168)
Recoveries	7		3		5	47			\$	62
Provision (Credit)	226	(6)	(9)	(44)	134	47		96	\$	444
Other Non-interest expense related to unfunded							6		\$	6
Ending Balance	\$ 569	\$ 125	\$ 317	\$ 1,887	\$ 1,469	\$ 290	\$ 186	\$ 1,006	\$	5,849
Ending balance: individually evaluated for impairment	\$	\$	\$	\$	\$ 202	\$	\$	\$	\$	202
Ending balance: collectively evaluated for impairment	\$ 569	\$ 125	\$ 317	\$ 1,887	\$ 1,267	\$ 290	\$ 186	\$ 1,006	\$	5,647
	\$ 2	\$	\$	\$	\$	\$	\$	\$	\$	2

Ending balance:  
loans acquired with  
deteriorated credit  
quality

**FINANCING  
RECEIVABLES:**

Ending balance	\$ 95,863	\$ 47,745	\$ 63,393	\$ 265,902	\$ 102,455	\$ 22,481	\$	\$	\$ 597,839
----------------	-----------	-----------	-----------	------------	------------	-----------	----	----	------------

Ending balance:  
individually  
evaluated for  
impairment

\$ 26	\$ 141	\$	\$ 1,277	\$ 345	\$	\$	\$	\$ 1,789
-------	--------	----	----------	--------	----	----	----	----------

Ending balance:  
collectively  
evaluated for  
impairment

\$ 95,837	\$ 47,604	\$ 63,393	\$ 264,625	\$ 102,110	\$ 22,481	\$	\$	\$ 596,050
-----------	-----------	-----------	------------	------------	-----------	----	----	------------

Ending balance:  
loans acquired with  
deteriorated credit  
quality

\$ 532	\$	\$	\$	\$	\$	\$	\$	\$ 532
--------	----	----	----	----	----	----	----	--------

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	(In Thousands)							Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer				
<b>Three Months Ended June 30, 2013</b>										
<b>ALLOWANCE FOR CREDIT LOSSES:</b>										
Beginning balance	\$ 463	\$ 105	\$ 260	\$ 1,566	\$ 1,972	\$ 256	\$ 172	\$ 722	\$ 5,516	
Charge Offs	(89)			(44)		(112)			\$ (245)	
Recoveries	4		3		41	38			\$ 86	
Provision (Credit)	(17)	10	14	(62)	125	84		(42)	\$ 112	
Other Non-interest expense related to unfunded							15		\$ 15	
Ending Balance	\$ 361	\$ 115	\$ 277	\$ 1,460	\$ 2,138	\$ 266	\$ 187	\$ 680	\$ 5,484	
Ending balance: individually evaluated for impairment	\$ 38	\$ 15	\$	\$	\$ 718	\$	\$	\$	\$ 771	
Ending balance: collectively evaluated for impairment	\$ 323	\$ 100	\$ 277	\$ 1,460	\$ 1,420	\$ 266	\$ 187	\$ 680	\$ 4,713	
Ending balance: loans acquired with deteriorated credit quality	\$ 2	\$	\$	\$	\$	\$	\$	\$	\$ 2	
<b>FINANCING RECEIVABLES:</b>										
Ending balance	\$ 77,948	\$ 35,746	\$ 55,331	\$ 215,246	\$ 97,080	\$ 19,723	\$	\$	\$ 501,074	

Ending balance: individually evaluated for impairment	\$ 470	\$ 88	\$ 1,035	\$ 2,928	\$	\$	\$ 4,521
Ending balance: collectively evaluated for impairment	\$ 77,478	\$ 35,658	\$ 55,331	\$ 214,211	\$ 94,152	\$ 19,723	\$ 496,553
Ending balance: loans acquired with deteriorated credit quality	\$ 549	\$	\$	\$	\$	\$	\$ 549

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

Additional analysis related to the allowance for credit losses for six months ended June 30, 2014 and June 30, 2013 is as follows:

	(In Thousands)									
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total	
<b>Six Months Ended</b>										
<b>June 30, 2014</b>										
<b>ALLOWANCE</b>										
<b>FOR CREDIT</b>										
<b>LOSSES:</b>										
Beginning balance	\$ 257	\$ 131	\$ 326	\$ 2,107	\$ 1,359	\$ 292	\$ 163	\$ 722	\$ 5,357	
Charge Offs	(131)			(229)		(174)			(534)	
Recoveries	17		3	3	10	98			131	
Provision (Credit)	426	(6)	(13)	6	99	74		286	872	
Other Non-interest expense related to unfunded							23		23	
Ending Balance	\$ 569	\$ 125	\$ 316	\$ 1,887	\$ 1,468	\$ 290	\$ 186	\$ 1,008	\$ 5,849	
Ending balance: individually evaluated for impairment	\$	\$	\$	\$	\$ 202	\$	\$	\$	\$ 202	
Ending balance: collectively evaluated for impairment	\$ 569	\$ 125	\$ 316	\$ 1,887	\$ 1,266	\$ 290	\$ 186	\$ 1,008	\$ 5,647	
Ending balance: loans acquired with deteriorated credit quality	\$ 2	\$	\$	\$	\$	\$	\$	\$	\$ 2	

**FINANCING  
RECEIVABLES:**

Ending balance	\$ 95,863	\$ 47,745	\$ 63,393	\$ 265,902	\$ 102,455	\$ 22,481	\$	\$	\$ 597,839
----------------	-----------	-----------	-----------	------------	------------	-----------	----	----	------------

Ending balance:

individually evaluated for impairment	\$ 26	\$ 141	\$	\$ 1,277	\$ 345	\$	\$	\$	\$ 1,789
---	-------	--------	----	----------	--------	----	----	----	----------

Ending balance:

collectively evaluated for impairment	\$ 95,837	\$ 47,604	\$ 63,393	\$ 264,625	\$ 102,110	\$ 22,481	\$	\$	\$ 596,050
---	-----------	-----------	-----------	------------	------------	-----------	----	----	------------

Ending balance:

loans acquired with deteriorated credit quality	\$ 532	\$	\$	\$	\$	\$	\$	\$	\$ 532
---	--------	----	----	----	----	----	----	----	--------



**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	(In Thousands)							Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer				
<b>Six Months Ended June 30, 2013</b>										
<b>ALLOWANCE FOR CREDIT LOSSES:</b>										
Beginning balance	\$ 368	\$ 113	\$ 290	\$ 1,749	\$ 2,183	\$ 268	\$ 162	\$ 253	\$ 5,386	
Charge Offs	(100)			(64)		(198)			\$ (362)	
Recoveries	9		4		56	87			\$ 156	
Provision (Credit)	84	2	(17)	(225)	(101)	109		427	\$ 279	
Other Non-interest expense related to unfunded							25		\$ 25	
Ending Balance	\$ 361	\$ 115	\$ 277	\$ 1,460	\$ 2,138	\$ 266	\$ 187	\$ 680	\$ 5,484	
Ending balance: individually evaluated for impairment	\$ 38	\$ 15	\$	\$	\$ 718	\$	\$	\$	\$ 771	
Ending balance: collectively evaluated for impairment	\$ 323	\$ 100	\$ 277	\$ 1,460	\$ 1,420	\$ 266	\$ 187	\$ 680	\$ 4,713	
Ending balance: loans acquired with deteriorated credit quality	\$ 2	\$	\$	\$	\$	\$	\$	\$	\$ 2	
<b>FINANCING RECEIVABLES:</b>										
Ending balance	\$ 77,948	\$ 35,746	\$ 55,331	\$ 215,246	\$ 97,080	\$ 19,723	\$	\$	\$ 501,074	
	\$ 470	\$ 88	\$	\$ 1,035	\$ 2,928	\$	\$	\$	\$ 4,521	

Ending balance:  
individually  
evaluated for  
impairment

Ending balance:  
collectively  
evaluated for  
impairment

\$ 77,478	\$ 35,658	\$ 55,331	\$ 214,211	\$ 94,152	\$ 19,723	\$	\$	\$ 496,553
-----------	-----------	-----------	------------	-----------	-----------	----	----	------------

Ending balance:  
loans acquired with  
deteriorated credit  
quality

\$ 549	\$	\$	\$	\$	\$	\$	\$	\$ 549
--------	----	----	----	----	----	----	----	--------

**Table of Contents**

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

NOTE 5 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 estimates.

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

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.

Other Securities

The carrying value of Federal Home Loan Bank stock, listed as other securities, approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

Loans

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, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality.

Deposits - Interest Bearing, Non-interest Bearing and Time

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 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.

### Short-Term Borrowings

The carrying value of short-term borrowings approximates fair values.

### FHLB Advances

Fair values of FHLB advances are estimated using discounted cash flow analysis based on the Company's current incremental borrowing rates for similar types or borrowing arrangements.

### Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## 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, 2014 and December 31, 2013 are reflected below.

	Carrying Amount	Fair Value	(In Thousands)		
			Level 1	Level 2	Level 3
			June 2014		
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 19,098	\$ 19,098	\$ 19,098	\$	\$
Securities - available for sale	284,628	284,628	25,331	251,222	8,074
Other Securities	3,717	3,717			3,717
Loans, net	592,176	602,149			602,149
Interest receivable	3,659	3,659			359
<b>Total Assets</b>	<b>\$ 903,278</b>	<b>\$ 913,251</b>	<b>\$ 44,429</b>	<b>\$ 251,222</b>	<b>\$ 614,299</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 427,881	\$ 429,276	\$	\$	\$ 429,276
Non-interest bearing Deposits	115,371	115,371		115,371	
Time Deposits	217,820	217,498			217,498
<b>Total Deposits</b>	<b>\$ 761,072</b>	<b>\$ 762,145</b>	<b>\$</b>	<b>\$ 115,371</b>	<b>\$ 646,774</b>
Short-term debt	70,066	70,066			70,066
Interest payable	205	205			205
Dividends payable	963	963		963	
<b>Total Liabilities</b>	<b>\$ 832,306</b>	<b>\$ 833,379</b>	<b>\$</b>	<b>\$ 116,334</b>	<b>\$ 717,045</b>



**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	Carrying Amount	Fair Value	(In Thousands) December 2013		
			Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 19,263	\$ 19,263	\$ 19,263	\$	\$
Securities - available for sale	324,509	324,509	25,272	288,891	10,346
Other Securities	4,216	4,216			4,216
Loans, net	570,919	579,992			579,992
Interest receivable	3,694	3,694			3,694
<b>Total Assets</b>	<b>\$ 922,601</b>	<b>\$ 931,674</b>	<b>\$ 44,535</b>	<b>\$ 288,891</b>	<b>\$ 598,248</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 429,652	\$ 429,750	\$	\$	\$ 429,750
Non-interest bearing Deposits	110,452	110,452		110,452	
Time Deposits	236,360	236,027			236,027
<b>Total Deposits</b>	<b>\$ 776,464</b>	<b>\$ 776,229</b>	<b>\$</b>	<b>\$ 110,452</b>	<b>\$ 665,777</b>
Short-term debt	69,756	69,756			69,756
Federal Home Loan Bank advances	4,500	4,570			4,570
Interest payable	223	223			223
Dividends payable	967	967		967	
<b>Total Liabilities</b>	<b>\$ 851,910</b>	<b>\$ 851,745</b>	<b>\$</b>	<b>\$ 111,419</b>	<b>\$ 740,326</b>

## Fair Value Measurements

In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities in active markets that the Company has the ability to access.

Available-for-sale securities, when quoted prices are available in an active market, securities are valued using the quoted price and are classified as Level 1.

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.

Available-for-sale securities classified as Level 2 are valued using the prices obtained from an independent pricing service. The prices are not adjusted. Securities of obligations of state and political subdivisions are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating.

Substantially all assumptions used by the independent pricing service are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the market place.

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. The Bank holds some local municipals that the Bank evaluates based on the credit strength of the underlying project such as hospital or retirement housing. The fair value is determined by valuing similar credit payment streams at similar rates.

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.



**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Fair Value Measurements (Continued)

The following summarizes financial assets measured at fair value on a recurring basis as of June 30, 2014 and December 31, 2013, segregated by level or the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured at Fair Value on a Recurring Basis (In Thousands)			
	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
June 30, 2014			
Assets-(Securities Available for Sale)			
U.S. Treasury	\$ 25,331	\$	\$
U.S. Government agency		147,146	
Mortgage-backed securities		33,182	
State and local governments		70,895	8,074
Total Securities Available for Sale	\$ 25,331	\$ 251,223	\$ 8,074
	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
December 31, 2013			
Assets-(Securities Available for Sale)			
U.S. Treasury	\$ 25,272	\$	\$
U.S. Government agency		172,972	
Mortgage-backed securities		44,792	
State and local governments		71,127	10,346
Total Securities Available for Sale	\$ 25,272	\$ 288,891	\$ 10,346

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table represents the changes in the Level 3 fair-value category of which unobservable inputs are relied upon as of June 30, 2014 and June 30, 2013.

	(In Thousands)		
	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	State and Local Governments	State and Local Governments	State and Local Governments
	Tax-Exempt	Taxable	Total
Balance at January 1, 2014	\$ 8,802	\$ 1,544	\$ 10,346
Change in Market Value	(1,093)	(359)	(1,452)
Payments & Maturities	(820)		(820)
Balance at June 30, 2014	\$ 6,889	\$ 1,185	\$ 8,074

	(In Thousands)		
	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	State and Local Governments	State and Local Governments	State and Local Governments
	Tax-Exempt	Taxable	Total
Balance at January 1, 2013	\$ 14,863	\$ 1,545	\$ 16,408
Change in Market Value	(116)	1	(115)
Purchases	519		519
Payments & Maturities	(4,388)		(4,388)
Balance at June 30, 2013	\$ 10,878	\$ 1,546	\$ 12,424

Most of the Company's available for sale securities, including any bonds issued by local municipalities, have CUSIP numbers or have similar characteristics of those in the municipal markets, making them marketable and comparable 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, 2014 and December 31, 2013, such assets consist primarily of impaired loans. 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.)

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements:

	Fair Value at June 30, 2014	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and political subdivision securities	\$ 8,074	Discounted cash flow	Credit strength of underlying project or entity / Discount rate	0-5%
Impaired Loans			Discount to reflect current market conditions and ultimate collectability	
	\$ 1,587	Collateral based measurements		0-50%
Other real estate owned - residential	\$ 734	Appraisals	Discount to reflect current market	0-20%
Other real estate owned - commercial	\$ 807	Appraisals	Discount to reflect current market	0-20%

	Fair Value at December 31, 2013	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and political subdivision securities	\$ 10,346	Discounted cash flow	Credit strength of underlying project or entity / Discount rate	0-5%
Impaired Loans			Discount to reflect current market conditions and ultimate collectability	
	\$ 1,924	Collateral based measurements		0-50%
Other real estate owned - residential	\$ 964	Appraisals	Discount to reflect current market	0-20%
Other real estate owned - commercial	\$ 1,127	Appraisals	Discount to reflect current market	0-20%

At June 30, 2014 and December 31, 2013, impaired loans categorized as Level 3 were \$1.8 and \$1.9 million, respectively. The specific allocation for impaired loans was \$202 and \$516 thousand as of June 30, 2014 and December 31, 2013, respectively, which are accounted for in the allowance for loan losses (see Note 4).

Other real estate is reported at either the lower of 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. The valuation

allowance is therefore increased or decreased, through charges or credits to expense, for changes in the asset's fair value or estimated selling costs.

**Table of Contents**

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents impaired loans and other real estate owned as recorded at fair value on June 30, 2014 and December 31, 2013:

(In Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2014			
	Balance at June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 1,587	\$	\$	\$ 1,587
Other real estate owned residential mortgages	\$ 734	\$	\$	\$ 734
Other real estate owned commercial	\$ 807	\$	\$	\$ 807

(In Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2013			
	Balance at December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 1,924	\$	\$	\$ 1,924
Other real estate owned residential mortgages	\$ 964	\$	\$	\$ 964
Other real estate owned commercial	\$ 1,127	\$	\$	\$ 1,127

The Company also has other assets, which under certain conditions, are subject to measurement at fair value. These assets include loans held for sale, bank owned life insurance, and mortgage servicing rights. The Company estimated the fair values of these assets utilizing Level 3 inputs, including, the discounted present value of expected future cash flows. At June 30, 2014 and December 31, 2013, the Company estimates that there is no impairment of these assets.

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

## INTRODUCTION

### NATURE OF ACTIVITIES

Farmers & Merchants Bancorp, Inc. (Company) is a bank holding company incorporated under the laws of Ohio in 1985. Our subsidiary, The Farmers & Merchants State Bank (Bank) is a community bank operating in Northwest Ohio since 1897. We report our financial condition and net income on a consolidated basis and we report only one segment.

Our executive offices are located at 307 North Defiance Street, Archbold, Ohio 43502, and our telephone number is (419) 446-2501.

For a discussion of the general development of the Company's business throughout 2014, please see the portion of Management's Discussion and Analysis of Financial Condition and Results of Operations captioned "2014 in Review".

---

**Table of Contents**

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

The U.S. economy continues to strengthen, but at a slow pace. After a sluggish first quarter in 2014, the economy has picked up in the second quarter. Inclement weather was believed to have contributed to the slowness of the first quarter.

The Bank's primary service area, Northwest Ohio and Northeast Indiana, continue to exhibit a downward trend in unemployment rates at both a local and national level. The agricultural industry continued its strong performance in 2013 as evidenced by strengthened financial statements. The automotive sector showed improvement with car dealers in our marketing area ending with more profitable numbers than in recent years. Overall, business profits are improving. Loan growth occurred during the fourth quarter of 2013 and has continued through second quarter 2014 and the Bank finally surpassed the loan balances of 2012, along with second quarter 2013 and 2013. Overall, net loan growth is \$21.3 million or 3.7% over yearend end 2013. New 1-4 family residential and construction remains weak and refinancing activity are also below the level of same period 2013.

The Bank acquired its 21st office during the fourth quarter of 2013. The office is located in Custar, Ohio, and was a natural extension of the Bank's market area. The office provides the full range of services discussed below. Growth in 2014 is anticipated in Sylvania, Ohio, where the Bank recently purchased a building and is in the process of remodeling for a full-service branch office. Expected occupancy is in the third quarter of 2014.

The Farmers & Merchants State Bank engages in general commercial banking and savings business including 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 items as farm land, farm equipment, livestock and operating loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for the purchase of autos, trucks, recreational vehicles, motorcycles, and other consumer goods.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition ATMs (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 IRAs (Individual Retirement Accounts) and HSAs (Health Savings Accounts). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and ACH (Automated Clearing House) file transmittal. In addition, the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Mobile banking was added in 2012 and has been widely accepted and used by consumers. An upgrade to the Bank's bill pay program along with additional electronic services being offered occurred during second quarter. Changes in billing will take place during the third quarter. The Bank is also restructuring a portion of its checking portfolio with the introduction of two new offerings, Secure and Pure checking through the remainder of 2014. Some of the Bank's older checking products will be discontinued. Secure checking incorporates identity theft protection and monitoring, Pure checking enables the depositor to offset fees by utilizing on-line statements and either of conducting debit card activity or maintaining an overall deposit relationship.

The Bank has established underwriting policies and procedures which facilitate 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 mortgage loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years 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 also normally retains the servicing rights 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. In addition, the Bank does sell some of its longer term fixed rate agricultural mortgages into the secondary market with the aid of a broker.

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
NATURE OF ACTIVITIES (Continued)

The Bank does not have a program to fund sub-prime loans. Sub-prime loans are characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers.

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 and 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 farmer's ability to hedge their position by the use of 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 wage 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.

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
NATURE OF ACTIVITIES (Continued)

Consumer Loans (continued)

The Bank will only make Qualified Mortgages as defined by the Truth in Lending Act and Regulation Z.

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 up to NTE 75% LTV and aircraft up to 75% of appraised value.

We also provide checking account services, as well as savings and time deposit services such as certificates of deposits. In addition, ATMs are provided at all of our Ohio and Indiana banking offices. Two ATM's are located at Sauder Woodworking Co., Inc., a major employer in Archbold. Additional locations in Ohio are at Northwest State Community College, Archbold; Community Hospitals of Williams County, Bryan; Fairlawn Haven Wyse Commons, Archbold; R&H Restaurant, Fayette; Delta Eagles, Sauder Village, Archbold; Fulton County Health Center, Wauseon; downtown Defiance; and a mobile trailer ATM. In Indiana, four additional remote ATM's are located in the town of St. Joe; at Kaiser's Supermarket and Therma-Tru in Butler; and at DeKalb Memorial Hospital in Auburn.

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 Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956. Our subsidiary bank is in turn regulated and examined by the Ohio Division of Financial Institutions, and the Federal Deposit Insurance Corporation. The activities of our bank subsidiary are also subject to other federal and state laws and regulations.

The Bank's primary market includes smaller communities located in the Ohio counties of Defiance, Fulton, Henry, Lucas, Williams and Wood and in the Indiana counties of DeKalb and Steuben. The commercial banking business in this market is highly competitive with approximately 17 other depository institutions currently doing business in the Bank's primary market. In our banking activities, we compete 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, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of service provided. On December 31, 2007, the Bank acquired the Knisely Bank of Indiana, expanding its market with the addition of offices in Butler and Auburn, Indiana, both located in DeKalb County. An additional office was opened in the summer of 2008 in Angola, Indiana, located in Steuben County. On July 9, 2010 the Bank purchased a branch office in Hicksville, Ohio shortening the distance between our Ohio and Indiana offices. The Bank opened an office in Waterville, Lucas County, Ohio in second quarter 2013 providing growth opportunity and extension of the market area. An additional office in Wood County was opened in fourth quarter 2013. The office was added through a single office acquisition and is located in Custar, Ohio. The Bank has acquired an office location in Sylvania, Ohio with a proposed opening date during the third quarter of 2014. Remodeling, begun during the second quarter, continues.

At June 30, 2014, we had 255 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be excellent.

---

**Table of Contents**

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**2014 IN REVIEW Second Quarter**

Loan growth continued in the second quarter of 2014 following a first quarter of growth even with the expected pay down of seasonal borrowings after yearend. This loan growth was preceded by a strong fourth quarter which included an office acquisition and increased borrowings in the commercial and agricultural real estate portfolios. This growth is important to the Company as a step in the right direction to improve its net interest income and margin.

Net interest income improved during the second quarter of 2014 as compared to the second quarter of 2013 by \$752 thousand. This was accomplished due to increased loan balances and lower borrowing levels for the quarter. Loan income was up \$888 thousand and total interest expense down \$214 thousand. As the Bank continues its strategy to fund loan growth with security sales and runoff, interest income from securities was down \$350 thousand.

Offsetting the improvement in net interest income was a decrease in noninterest income. Loan sales in both the agricultural and 1-4 family portfolios decreased significantly in comparison to previous year, down almost \$27 million. Net gain on sales of loans was therefore also down \$510 thousand year-to-date of which \$119 thousand of the decrease was attributed to second quarter activity. In fact, in comparing second quarter 2014 to second quarter 2013, 2013 outperformed 2014 in the areas of noninterest income, ending the quarter with a total difference of \$242 thousand. An area of improvement in the quarter comparison in noninterest income was net loss on sale of other assets owned, which was lower by \$91 thousand from second quarter 2014. This is due to lower holdings of Other Real Estate Owned, OREO and fewer evaluation write-downs from updated appraisals, a positive influence from both scenarios. This was not an unexpected turn of events and is why loan growth is so vital to the Company going forward.

Total allowance provision for loan losses was \$332 thousand higher for the second quarter 2014 as compared to same quarter 2013. Loan growth and charge-offs warranted additional provision expense be taken in the second quarter. Impaired loans decreased \$651 thousand from December 31, 2013 levels and down \$2.7 million from June 30, 2013. The same comparison applied for nonaccrual loans, showing an improvement in lower balances by \$2.0 million than December 31, 2013 and \$3.6 million than June 30, 2013. Three loans were categorized trouble debt restructured TDR in the second quarter of 2013 totaling under \$2.3 million compared to no additions during second quarter 2014. Past due loans decreased by \$133 thousand in comparing June 30, 2014 to December 31, 2013 balances, with the majority in decrease in the greater than 90 days. Overall past dues remain at historically low levels. In 2014, the Company continues to work on the collection of these loans and looks forward to maintaining the low exposure during 2014.

All rates remain low and are expected to remain low throughout 2014. This has enabled the Company to continue to sell investment securities and recognize a gain without compromising the yield. In 2013, the transactions had modestly extended the duration of the investment portfolio. Sales in 2014 have so far been used to fund loan growth and reinvestment into securities has not been necessary. For all of 2013, the recognized gain was \$775 thousand, of which \$377 thousand was recognized in the second quarter. For second quarter 2014, the Company has recognized gains of \$180 thousand for a year-to-date total of \$302 thousand. Most of the securities sold were agencies maturing in a short time period. The Bank was able to continue to capitalize on the steepness of the yield curve and the unrealized market gain position the last three years. Additional sales throughout 2014 may be executed as needed to fund loan growth, which management expects to continue. The market value of the security portfolio has leveled off as evidenced by the high other comprehensive loss reported on the income statement and statement of comprehensive income 2013. Additional opportunity to sell investment securities for a gain may be limited for the remainder of 2014.

The majority of the Bank's commercial borrowers have experienced slight improvement, although a few still lag. As the economic recovery remains fragile and consumer confidence still remains at lower levels, consumer sensitive industries and the retail sector may continue to experience pressures as well. The Company has seen improvement in unemployment levels throughout its market area. Announcement of employment expansions by local businesses have also improved the outlook for 2014.

Agriculture remained strong in 2013 and farmers have protected their revenues for 2014 through hedges and the purchase of crop insurance. Prices have come down in commodities and farmers work to structure inputs to offset.

**Table of Contents**

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**2014 IN REVIEW Second Quarter (Continued)**

Overall, crops are looking healthy through our market area. This is always subject to change due to the effects of weather which is why crop insurance is utilized.

Overall, profitability in the second quarter of 2014 was up slightly as compared to the same quarter last year. In comparisons, net income is up 2% or \$52 thousand. Net interest income was up 11.4% over the same period in 2013. The Company has done an exceptional job of growing loans while keeping past dues low. 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 while seeking good loans to improve profitability. The Company continues to look for new opportunities to generate and protect revenue and provide additional channels through which to serve our customers and maintain our high level of customer satisfaction.

The Bank has been attentive to the significant final mortgage rules and additional guidance issued by the Consumer Financial Protection Bureau to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions. Effective in January 2014, these rules are a game-changer which impacts the entire mortgage lending industry, as well as the Bank's perspective on its mortgage lending business. The Bank continues to work toward fulfillment of applicable requirements for these new mortgage rules, as it gains further understanding of the complexities and inter-related nature of these rules while making strategic decisions, and addressing key considerations necessary for implementation of each rule. The Company is also preparing for the implementation of Basel III capital rules which will begin phase in for the Company on January 1, 2015. These rules may impact the ability of some financial institutions to pay dividends, though the Company believes itself to be able to maintain its strong capital position and not be limited in that regard. Larger institutions, which the rule was designed for, were required to begin reporting as of January 1, 2014.

**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 financial services industry 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 and accompanying notes.

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.

These policies, along with the disclosures presented in the notes to the condensed consolidated financial statements and in the management discussion and analysis of the financial condition and results of operations, provide information on how significant assets and liabilities are valued and how those values are determined for the financial statements. 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 and OREO as the accounting areas that require the most subjective or complex judgments, and as such could be the most subject to revision as new information becomes available.

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell.

Foreclosed real estate for sale is carried at the lower of fair value minus estimated costs to sell, or cost. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and a write-down is recorded by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to

**Table of Contents**

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)**

sell. Foreclosed real estate is classified as OREO. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At June 30, 2014, holdings were \$1.5 million and were \$2.1 million as of December 31, 2013 and \$1.8 million as of June 30, 2013.

The ALLL represents management's estimate of probable credit losses inherent in the Bank's loan portfolio, unfunded loan commitments, and letters of credit at the report date. The ALLL methodology is regularly reviewed for its appropriateness and is approved annually by the Board of Directors. This written methodology is consistent with Generally Accepted Accounting Principles which provides for a consistently applied analysis.

The Bank's methodology provides an estimate of the probable credit losses either by calculating a specific loss per credit or by applying a composite of historical factors over a relevant period of time with current internal and external factors which may affect credit collectability. Such factors which may influence estimated losses are the conditions of the local and national economy, local unemployment trends, abilities of lending staff, valuation trends of fixed assets, and trends in credit delinquency, classified credits, and credit losses.

Inherent in most estimates is imprecision. The Bank's ALLL provides a margin for imprecision with an unallocated amount.

Bank regulatory agencies and external auditors periodically review the Bank's methodology and adequacy of the ALLL. Any required changes in the ALLL or loan charge-offs by these agencies or auditors may have a material effect on the ALLL.

The Company is required to estimate the value of its Mortgage Servicing Rights. The Company recognizes as separate assets rights to service fixed rate single-family mortgage loans that it has sold without recourse but services for others for a fee. Mortgage servicing assets are initially recorded at cost, based upon pricing multiples as determined by the purchaser, when the loans are sold. Mortgage servicing assets are carried at the lower of the initial carrying value, adjusted for amortization, or estimated fair value. Amortization is determined in proportion to and over the period of estimated net servicing income using the level yield method. For purposes of determining impairment, the mortgage servicing assets are stratified into like groups based on loan type, term, new versus seasoned and interest rate. The valuation is completed by an independent third party.

The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced.

The Company's mortgage servicing rights relating to loans serviced for others represent an asset of the company. This asset is initially capitalized and included in other assets on the Company's consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights. There are a number of factors, however, that can effect the ultimate value of the mortgage servicing rights to the Company, including the estimated prepayment speed of the loan and the discount rate used to present value the servicing right. For example, if the mortgage loan is prepaid, the Company will receive fewer servicing fees, meaning that the present value of the mortgage servicing

rights is less than the carrying value of those rights on the Company's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Company of the mortgage servicing rights, the Company receives a valuation of its mortgage servicing rights from an independent third party. The independent third party's valuation of the mortgage servicing rights is based on relevant characteristics of the Company's loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as current national market interest rate levels, market forecasts and other economic conditions. Management, with the advice from its third party valuation firm, reviewed the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter's analysis related to the mortgage servicing asset. In addition, based upon the independent third party's valuation of the Company's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Company. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Company's net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on

**Table of Contents**

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)**

market conditions. The accuracy of these estimates and assumptions by management and its third party valuation specialist can be directly tied back to the fact that management has only been required to record minor valuation allowances through its income statement over time based upon the valuation of each stratum of servicing rights. For more information regarding the estimates and calculations used to establish the ALLL and the value of Mortgage Servicing Rights, please see Note 1 to the consolidated financial statements provided herewith.

**MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES**

In comparing the balance sheet of June 30, 2014 to that of December 31, 2013, the cash equivalent liquidity of the Bank has remained at the same level and is considered strong. The stability in liquidity was facilitated by the office acquisition in the fourth quarter of 2013 of which deposits account for \$29.5 million and loans only \$11.4 million. During the six months of 2014, net loans have increased \$21.3 million even with a \$10 million decrease stemming from the repayment on a line of credit by a single borrowing relationship which was expected and which happens each year at this time. The fact that loan levels increased in light of the anticipated yearly reduction is a positive factor towards future improvement to profitability.

The Company's decrease in total assets of \$17.7 million was due to lower balances within the securities portfolio of \$39.9 million and FHLB borrowings of \$4.5 million. This was partially offset by an increase in loans of \$21.2 million. The Company has an unsecured borrowing capacity of \$106.5 million through correspondent banks and over \$85.5 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.

A large fluctuation in the market value of the securities occurred during the second quarter of 2013 causing the unrealized gain position to decrease significantly. Management recognized the change in the market early and was quick to capture a portion of the gain before it fluctuated to an unrealized loss position. Currently the security portfolio is in a net unrealized gain position of \$270 thousand. Management feels confident that liquidity needs can easily be funded from an orderly runoff of the investment portfolio, along with other sources of funding.

As previously stated, net loans show an increase for the six months ended June 30, 2014, which reverses the trend in declining loan balances which the Bank had experienced all throughout fiscal year 2012 and up through the second quarter 2013. Growth occurred across the board on all real estate related portfolios along with the non-real estate consumer portfolio. The remaining portfolios showed a decrease as compared to yearend 2013. The balance of the decrease in the other loan portfolios was due to the pay down, payoff or refinancing of loans. Loan sales into the secondary market have also impacted the consumer and agricultural real estate portfolios though on a much smaller basis than in 2013. Year to date, the Bank has sold approximately \$19.9 million of loans into the secondary market, while originating only \$15.9 million of the loans during the same six-month period as demonstrated in the cash flow statement for the period. The majority of the activity stemmed from within the 1-4 family portfolio. The trend of decreasing loan balances is reversing, as the following chart shows increases in 2013 and a strong upswing in 2014. The Bank is also starting to generate a positive trend of increasing loan balances after our second quarter activity when comparing to yearend. The Bank's pipeline of loans remains strong, driven by opportunities for new relationships as business activity begins to reflect a more optimistic opinion of the economy and large financial

institutions downsize certain portfolios. The Bank has also been able to further deepen our relationships and increase the dealings with some of our newer customers.

**Table of Contents**

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

The chart below shows the breakdown of the loan portfolio by category as of June 30 for the last three years.

	(In Thousands)		
	June-14 Amount	June-13 Amount	June-12 Amount
Consumer Real Estate	\$ 95,863	\$ 77,948	\$ 81,252
Agricultural Real Estate	47,745	35,746	32,408
Agricultural	63,393	55,331	54,808
Commercial Real Estate	265,902	215,246	202,900
Commercial and Industrial	98,292	93,978	104,224
Consumer, Overdrafts and other loans	22,481	19,723	21,577
Industrial Development Bonds	4,163	3,102	1,199
Total Loans	\$ 597,839	\$ 501,074	\$ 498,368

On a year to year comparison basis, the Commercial real estate portfolio shows the largest increase of \$50.7 million in balance as of June 30, 2014 compared to June 30, 2013. Agricultural real estate shows an increase of \$12.0 million. Consumer real estate showed the largest improvement in the consumer portfolios of \$17.9 million. Overall, all categories of loans increased. Loans increased \$96.8 million as compared to the same period last year and increased \$99.5 million as compared to June 30, 2012.

Overall, total assets of the Company decreased \$17.7 million from December 31, 2013 to June 30, 2014.

Deposits decreased \$15.4 million from yearend 2013 which correlated to the maturing and leaving of time deposits. Time deposits decreased \$18.5 million during the first six months of 2014. The Bank budgeted for this occurrence, choosing to fund loan growth with core deposit growth and investment security runoff and sales. The time deposit shrinkage helped to improve the Bank's cost of funds.

The Bank paid off \$4.5 million in FHLB advances which had matured during 2014. This too should lower the cost of funds. Securities sold under agreement to repurchase held steady during the first six months of 2014 as compared to yearend.

Capital increased \$2.2 million during the first six months of 2014. Positive earnings aided by an increase in accumulated other comprehensive income offset a dividend declaration. Accumulated other comprehensive income increased \$172 thousand which encompassed the shift of \$302 thousand from unrealized gain to realized gain with the sale of securities. Dividends paid year-to-date were \$77 thousand higher than the same period last year with a one cent increase per share per quarter being the reason.

The Company continues to be well-capitalized in accordance with Federal regulatory capital requirements as the capital ratios below show:

Primary Ratio	11.55%
Tier I Leverage Ratio	11.01%
Risk Based Capital Tier I	15.62%
Total Risk Based Capital	16.50%
Stockholders Equity/Total Assets	11.66%

**Table of Contents**

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**MATERIAL CHANGES IN RESULTS OF OPERATIONS**

Comparison of Results of Operation for six month periods ended June 30, 2014 and 2013.

Improvement in net interest income of \$1.5 million occurred for the first half 2014 over the same period 2013, with improvement seen in both parts of the equation, interest income up \$996 thousand over June 30, 2013 and interest expense down \$503 thousand. The higher balance in interest and fees from loans was generated from the increase loan balances of fourth quarter 2013 and first half 2014. The reverse was seen in the noninterest arena where noninterest income was lower by \$940 thousand in first half 2014 as compared to first half 2013 and noninterest expense was \$295 higher. Noninterest income for 2014 was impacted in all areas driven primarily by (i) a decrease in the gain on sale of securities of \$296 thousand, (ii) a \$510 thousand decrease on gain of sale of loans and (iii) lower levels of collection of customer service fees and charges by \$202 thousand.

Net interest income after the provision for loan expense for the six months ended June 30, 2014 was up \$906 thousand from the six-month period ended June 30, 2013. The provision for loan loss expense was approximately \$593 thousand higher than same period 2013. The provision was needed for loan growth and replacement for the net charge-offs of \$403 thousand that occurred during the period and was based on Management's quarterly analysis of the adequacy of the allowance for loan losses.

Noninterest expense was higher by \$295 thousand in comparison largely due to the addition of the Waterville and Custar offices. In addition, a location was purchased in Sylvania, Ohio and is in the process of remodeling. An opening date in the third quarter is expected. The number of full time equivalent employees was 251 as of June 30, 2013 compared to 255 as of June 30, 2014.

The low balances in past dues, nonaccruals, OREO and troubled loans, all contributed to lower levels of expense in legal fees as relate to collections along with appraisal expense. A change to the calculation of Ohio state tax was also favorable for the Company in 2014.

Overall, the performance for the year-to-date comparison had lower bottom line income of \$143 thousand caused by the reduced level of noninterest income generation and a slightly higher noninterest expense. It is a lower decrease than the first quarter comparison by \$51 thousand.

The Company predicted the lower noninterest income position and is focused on continuing to strengthen our core earnings through loan growth and improvement to the net interest margin. New products and services are being introduced in 2014 to create additional revenue opportunities. As mentioned previously, deposit services have been the focus with updates and new services being offered with bill pay to form FM eXpress. This bundle will include an enhanced bill payment product, CheckFree, Popmoney (an online payment service that allows the customer to send and receive payments from F&M online Mobile Banking service), A2A (allows a customer to transfer money between a F&M account and accounts at other financial institutions), Messenger (notifies the customer when designated events take place in their account), and Mobile Capture (allows the customer to make deposits using their smart phone camera). Two new checking products, Secure and Pure have begun to be introduced with a few older products being discontinued.

Interest Income



Annualized interest income and yield on earning assets is up 17 basis points in 2014 as compared to June 30, 2013. While the average total earning assets were only higher by 1% or \$10.3 million than the prior year, the increase in interest income resulted primarily from the increased growth of the Company's earning assets, specifically loans. As the table that follows confirms, the increase in the amount of the interest earning portfolios from loans caused a higher June 2014 earnings in loans, than the decrease in securities and caused higher combined yields. The increased volume in the loan portfolio also offset the loss in interest income due to rate changes. The security portfolio will continue to be utilized to fund loan growth. Prepayment speeds remain high on mortgage-backed securities, though these may slow as the Bank's refinancing activity has slowed and long term rates inch higher.

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
 MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Rates on the loan portfolio are lower as compared to the previous year due to the change in the composition of the overall portfolio. An emphasis on building spreads and margins on existing loans remains intact. Funding the loans with excess security holdings has been beneficial in the second quarter of 2014. Overall loans are up on average \$90.6 million and the security portfolio down \$62.9 million on average from the previous year. Deposit generation in the two new offices are the factors behind the discrepancy of balances.

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 to follow.

	(In Thousands)		Yield/Rate	
	Average Balance	Interest/Dividends	June 30, 2014	June 30, 2013
Interest Earning Assets:				
Loans	\$ 580,469	\$ 13,654	4.71%	4.97%
Taxable Investment Securities	231,290	1,877	1.62%	1.58%
Tax-exempt Investment Securities	68,371	923	4.09%	4.34%
Fed Funds Sold & Interest Bearing Deposits	7,876	9	0.23%	0.19%
<b>Total Interest Earning Assets</b>	<b>\$ 888,006</b>	<b>\$ 16,463</b>	<b>3.82%</b>	<b>3.65%</b>

**Change in June 30, 2014 Interest Income Compared to June 30, 2013**

Interest Earning Assets:	Change	Due to	
		Volume	Due to Rate
Loans	\$ 1,487	\$ 2,134	\$ (647)
Taxable Investment Securities	(489)	(549)	61
Tax-exempt Investment Securities	12	98	(86)
Fed Funds Sold & Interest Bearing Deposits	(14)	(21)	6
<b>Total Interest Earning Assets</b>	<b>\$ 996</b>	<b>\$ 1,662</b>	<b>\$ (666)</b>

Interest Expense

Interest expense continued to be lower than the comparable six months of 2013. Interest expense related to deposits was down \$423 thousand while the average interest-bearing deposit balance increased by \$1.6 million in comparing the balances of each six month period. 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 thirty-six months. However, depositors continue to place more funds in shorter term deposits while they wait for rates to rise or move funds

elsewhere. KASASA Cash and Saver along with HSA s helped to increase the savings average deposit balances by \$37.5 million.

Interest on borrowed funds was \$85 thousand lower for the six month period ended June 30, 2014 than 2013. More borrowings from Federal Home Loan Bank were paid off during 2013 and 2014, making the average balance in other borrowed money considerably lower by \$7.2 million in 2014 in comparison. Thus the largest decrease in cost of funds for other borrowed money was due to the decreased volume which also impacted the rate of the remaining borrowings portfolio. During the first quarter of 2014, all borrowings from the FHLB were paid off. Fed Funds Purchased and Securities Sold under Agreement to Repurchase had a larger average balance in 2014 of \$10.5 million of whose cost was offset by lower rates making the fluctuation cost a minimal \$4 thousand.

Asset yield increased 17 basis points while cost of funds decreased 14 basis points. The main focus is to continue to increase asset yield by using excess cash and the liquidation of lower yielding investments to fund loan growth. Borrowings may be utilized if the cost thereof is lower than cost of new deposit generation or the loss on sales of securities.

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

	(In Thousands)		Yield/Rate	
	Average Balance	Interest/Dividends	June 30, 2014	June 30, 2013
Interest Bearing Liabilities:				
Savings Deposits	\$ 436,411	\$ 720	0.33%	0.38%
Other Time Deposits	225,354	1,063	0.94%	1.10%
Other Borrowed Money	290	4	2.76%	2.39%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	62,040	127	0.41%	0.47%
<b>Total Interest Bearing Liabilities</b>	<b>\$ 724,095</b>	<b>\$ 1,914</b>	<b>0.53%</b>	<b>0.67%</b>

**Change in June 30, 2014 Interest Expense Compared to June 30, 2013**

Interest Bearing Liabilities:	Change	Due to	
		Volume	Due to Rate
Savings Deposits	\$ (46)	\$ 62	\$ (108)
Other Time Deposits	(377)	(168)	(209)
Other Borrowed Money	(85)	(99)	14
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	5	21	(16)
<b>Total Interest Bearing Liabilities</b>	<b>\$ (503)</b>	<b>\$ (184)</b>	<b>\$ (319)</b>

**Net Interest Income**

Net interest income is higher in the six month comparison, which is the opposite position as yearend 2013's comparison to yearend 2012. The issue of earning less per earning asset dollar was reversed as evidenced by a 29 basis point higher net interest margin ratio when comparing year-to-date 2014 to 2013. The tables above demonstrate that the improvements in net interest income are primarily a result of a continued shift in balance sheet composition, with the benefits of the shift to higher yielding assets continuing to be hampered by the extended low rate environment.

Management expects the current interest rate environment to continue to further hamper the Company's progress on improving interest margins throughout the remainder of the fiscal year. As a result, interest income, in comparison to 2013, should increase throughout the year assuming the continuing generation of loan growth. The Bank continues to attempt to add spread on renewing loans while loan growth is needed to improve the overall numbers. Interest expense on time deposits may start to show an increase as depositors begin to transition back into longer-term deposits. The portfolio has very limited potential for large fluctuations in rates due to the duration of this low rate environment. Should rates begin to rise; the challenge will be to delay the upward pricing of deposits in order to allow the Bank to generate a greater spread from the increased yield on its earning assets.

	June 30, 2014	June 30, 2013
Interest/Dividend income/yield	3.82%	3.65%
Interest Expense / yield	0.53%	0.67%
Net Interest Spread	3.29%	2.98%
Net Interest Margin	3.39%	3.10%

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Provision Expense

Provision for loan loss was \$593 thousand higher for the six months ended June 30, 2014 as compared to the same 2013 period. A higher net charge-off position of \$197 thousand in 2014 than in 2013 along with fourth quarter 2013 and 2014 first half loan growth warranted the increased provision to the loan loss reserve. The balance in nonaccrual loans decreased \$3.3 million along with a decrease of \$2.7 million in impaired loan balances as of June 30, 2014 as compared to the balances as of June 30, 2013. Provision expense related to those increased balances in 2013 was recognized in the later time periods of 2012. The overall loan portfolio was also \$96.8 million higher as of June 30, 2014 compared to June 30, 2013. The Bank continues to focus on the commercial and commercial real estate portfolios for both asset quality and growth. As the charts further below will show for 2013 and 2012, a large portion of the provision was also to replace the reserve balance depleted from the net charge-offs during the period and 2014 had a larger net charge-off position than 2013.

Should the recovery stop or continue to slow even further, it is more likely additional credits may encounter cash flow problems and the Bank remains diligent in providing funds to offset future losses. In the immediate future, the Bank would expect to fund the loan loss reserve for any loan growth that may occur.

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.

The Bank has recognized a significant decrease in the overall balance of impaired loans when looking at June 2014 compared to June 2013. A positive factor can also be seen in the decrease in the current average balance for the six months during 2014 as compared to same period 2013. This is due mainly to the collection of principal from the sale of collateral from borrowers and continual collection of payments on these borrowers classified as impaired.

The Bank had \$964 thousand of its impaired loans classified as TDR as of June 30, 2014. One new TDR impaired relationship with two individual loans was added during the first quarter and not any in the second quarter. When combined with pay downs, the change resulted in \$651 thousand less in impaired balances and the specific allocation balance was decreased by \$314 thousand as compared to yearend 2013.

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 reduced or 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

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
 MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

discloses how much of the 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. Commercial real estate loans accounted for the largest component of charge-offs and consumer loan activity has accounted for the largest component of recoveries in second quarter 2014 as compared to 2013. As was mentioned in previous discussion, the commercial real estate portfolio is currently having a major impact on the ALLL, both through charge-off activity and due to growth of balances.

The following table presents activities for the allowance for loan losses by loan type for three months ended June 30, 2014, 2013, and 2012.

	(In Thousands)		
	Three Months Ended June-14	Three Months Ended June-13	Three Months Ended June-12
Loans	\$ 597,839	\$ 501,074	\$ 498,368
Daily average of outstanding loans	\$ 591,732	\$ 495,014	\$ 500,515
Allowance for Loan & Lease Losses - April 1	\$ 5,325	\$ 5,344	\$ 5,151
Loans Charged off:			
Consumer Real Estate	66	89	53
Agricultural Real Estate			
Agricultural			
Commercial Real Estate	28	44	96
Commercial and Industrial			
Consumer & other loans	74	112	122
	168	245	271
Loan Recoveries			
Consumer Real Estate	7	4	24
Agricultural Real Estate			
Agricultural	3	3	3
Commercial Real Estate			1
Commercial and Industrial	5	41	4
Consumer & other loans	47	38	46
	62	86	78



Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Net Charge Offs	106	159	193
Provision for loan loss	444	112	78
Allowance for Loan & Lease Losses - June 30	\$ 5,663	\$ 5,297	\$ 5,036
Allowance for Unfunded Loan Commitments & Letters of Credit - June 30	186	187	141
Total Allowance for Credit Losses - June 30	\$ 5,849	\$ 5,484	\$ 5,177
Ratio of net charge-offs to average Loans outstanding	0.02%	0.03%	0.04%
Ratio of Allowance for Loan Loss to Nonperforming Loans	426.89%	114.93%	102.93%

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

The following table presents activities for the allowance for loan losses by loan type for six months ended June 30, 2014, 2013, and 2012.

	(In Thousands)		
	Six Months Ended June-14	Six Months Ended June-13	Six Months Ended June-12
Loans	\$ 597,839	\$ 501,074	\$ 498,368
Daily average of outstanding loans	\$ 580,469	\$ 489,831	\$ 496,242
Allowance for Loan & Lease Losses - January 1	\$ 5,194	\$ 5,224	\$ 5,091
Loans Charged off:			
Consumer Real Estate	130	100	93
Agricultural Real Estate			
Agricultural			
Commercial Real Estate	229	64	97
Commercial and Industrial			
Consumer & other loans	175	198	208
	534	362	398
Loan Recoveries			
Consumer Real Estate	17	9	30
Agricultural Real Estate			
Agricultural	3	4	10
Commercial Real Estate	3		2
Commercial and Industrial	10	56	18
Consumer & other loans	98	87	77
	131	156	137
Net Charge Offs	403	206	261
Provision for loan loss	872	279	206
Allowance for Loan & Lease Losses - June 30	\$ 5,663	\$ 5,297	\$ 5,036
Allowance for Unfunded Loan Commitments & Letters of Credit - June 30	186	187	141

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Total Allowance for Credit Losses - June 30	\$ 5,849	\$ 5,484	\$ 5,177
Ratio of net charge-offs to average Loans outstanding	0.07%	0.04%	0.05%
Ratio of Allowance for Loan Loss to Nonperforming Loans	426.85%	114.93%	102.93%

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
 MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

The following table presents the balances for allowance of loan losses by loan type for six months ended June 30, 2014 and June 30, 2013.

	(In Thousands) June-2014		(In Thousands) June-2013	
	Amount	% of Portfolio	Amount	% of Portfolio
<b>Balance at End of Period Applicable To:</b>				
Consumer Real Estate	\$ 569	16.03	\$ 361	15.56
Agricultural Real Estate	125	7.99	115	7.13
Agricultural	316	10.60	277	11.04
Commercial Real Estate	1,887	44.48	1,460	42.95
Commercial and Industrial	1,468	16.44	2,138	18.76
Consumer, Overdrafts and other loans	290	3.76	266	3.94
Unallocated	1,008	0.70	680	0.62
Allowance for Loan & Lease Losses	5,663		5,297	
Off Balance Sheet Commitments	186		187	
<b>Total Allowance for Credit Losses</b>	<b>\$ 5,849</b>		<b>\$ 5,484</b>	

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 0.22% currently. June 2014 decreased slightly to the new low though any percentage under 1% is considered 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, growth of the last year the write down of uncollectable credits in a timely manner and the new loan.

#### Non-interest Income

Overall, noninterest income for first half 2014 was \$940 thousand below the same time period of 2013. As has been expected, revenue from gains on sales of loans, investment securities and other assets owned diminished compared to prior periods. The Bank was able to capitalize on those opportunities; however, current increases in the long term market rates has slowed the progress. All categories of noninterest income decreased as compared to first half 2013. The Bank does not expect a significant change in the opportunity for gains for the remainder of 2014.

\$29.3 million in sales of investment securities were conducted in the first half 2014 to fund loan growth and capture some additional revenue. The sales resulted in a gain of \$302 thousand. First half 2013 had sales of \$38.4 million resulting in gains of \$598 thousand. The difference between 2014 and 2013 sales was the utilization of the funds. 2014 went to fund loan growth while 2013 was reinvested in securities.

This does not mean that some avenues were not available for improvement. With the percentage of core deposits, specifically checking accounts, increasing throughout the Bank's market area, debit card usage was higher. Corresponding interchange income increased to over \$500 thousand for the quarter, outperforming second quarter 2013 by \$128 thousand.

Overdraft and return check fees were lower by \$108.6 thousand in comparing the periods, even though the number of accounts increased by almost 2 thousand.

The Bank is in the early stages of implementing new (while revamping older) products and services to capture additional revenue. More importantly, to also add value to our customer experience and meet new service demands.

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
 MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

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. The capitalization runs through non-interest income while the amortization thereof is included in non-interest expense. For 2014, mortgage servicing rights caused a net \$27 thousand more in expense than for first half 2013. The carrying value is well below the market value of \$3.2 million which indicates any large expense to fund the valuation allowance to be unlikely in 2014.

	(In Thousands)	
	2014	2013
Beginning Balance, January 1	\$ 2,066	\$ 2,063
Capitalized Additions	123	241
Amortization	(166)	(257)
Ending Balance, June 30	2,023	2,047
Valuation Allowance		
Mortgage Servicing Rights, net June 30	\$ 2,023	\$ 2,047

Loss on sale of other assets owned was lower by \$68 thousand as of second quarter end 2014 as compared to same period 2013. This represents a lower expense or an improvement in non-interest income for the period. This line item includes losses from sales of assets, losses from write-downs to the Bank's OREO and losses resulting from the loss or disposal of fixed assets, though the fixed asset impact is inconsequential. Holdings in ORE decreased to \$1.5 million as of June 30, 2014 compared to holdings of \$1.8 million as of June 30, 2013. Activity on sales of ORE has been strong in 2014 with eleven sales compared to the same number of sales in first half 2013 and the Bank expects this to continue throughout the remainder of 2014. The volume of the sales was higher during 2014 than 2013 by \$251 thousand. The Bank also wrote down the value on four properties due to updated appraisals and expects holdings to decrease even further.

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 loss.

The following chart presents other comprehensive income for the three months ending June 30, 2014 and June 30, 2013.

(In Thousands)

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013
Net Unrealized gain (loss) on available-for-sale securities	\$ 1,464	\$ (8,267)
Less reclassification adjustment for gain on sale of available-for-sale securities	180	(819)
Net Unrealized gain (loss)	1,284	(7,448)
Tax Effect	(437)	2,532
Other comprehensive income (loss)	\$ 847	\$ (4,916)

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
 MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

The following chart presents other comprehensive income for the six months ending June 30, 2014 and June 30, 2013.

	(In Thousands)	
	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net Unrealized gain (loss) on available-for-sale securities	\$ 563	\$ (9,182)
Less reclassification adjustment for gain on sale of available-for-sale securities	302	(598)
Net Unrealized gain (loss) on Tax Effect	261 (89)	(8,584) 2,918
Other comprehensive income (loss)	\$ 172	\$ (5,666)

#### Non-Interest Expense

Non-interest expense for the six months ended June 30, 2014 was \$295 thousand higher than for the same period of 2013. Salaries and wages were \$194 thousand higher 2014 compared to 2013 for the same six month time frame. The number of full time equivalent employees increased from 251 as of June 30, 2013 to 255 as of June 30, 2014. 2014's numbers include the addition of two offices.

Medical costs show only a \$14.5 thousand decrease in comparing year-to-date 2014 to 2013. The Bank instituted a change to how a HSA contribution per employee was given. Instead of depositing all at once at the start of the year as was done in 2013, the contribution is distributed through the year. The Bank also switched medical providers at yearend 2013, which resulted in claims which would have normally been covered in 2014 being expensed in 2013. Health insurance costs have increased for the Bank in 2014, though it is not clearly evident in looking at the line items.

The incentive accrual for 2014 and 2013 is almost equivalent, differing by less than \$500. This is due to the net incomes of the Bank for the periods on which the incentive is calculated are almost equivalent, differing by under \$150 thousand. The Bank continues to reward employees for performance and the accrual reflects this.

A decrease occurred of \$91 thousand in the amortization expense of mortgage servicing rights. When a mortgage is refinanced, any unamortized servicing right is fully expensed and therefore, drives the amortization expense higher within that period. Of the sales and originations shown in the cash flow, \$12.4 million were originated and \$13.0 million sold from the 1-4 family portfolio which had mortgage servicing rights attached. These were down from \$29.8 million in originations and \$31.6 million in sales from the same portfolio as of second quarter 2013. Therefore,



amortization expense from refinancing activity would be expected to be lower, which it is.

Other general and administrative expenses were higher during the six months for 2014 by \$127 thousand; as compared to the same six months 2013. The amortization expense of the core deposit intangible was \$83.7 thousand higher in 2014 than in 2013 due to the Custar office acquisition in December 2013. General legal fees were \$54.2 thousand higher in first half 2014 as compared to same time frame of 2013. Legal fees as related to collection of problem loans were down \$121.2 thousand in the same comparison. Improvement in past dues, nonaccruals, ORE and troubled loans were behind the lower expense. Other expenses related to these areas were also down \$168. thousand from the previous year.

Additional decreases in general and administrative noninterest expense were lower taxes for the State of Ohio as a revised tax code became effective in 2014, resulting in a Company savings of \$119.6 thousand for the first half on a consolidated basis. An adjustment for force placed property insurance that was over expensed resulted in a one-time decrease for general insurance expense in 2014.

**Table of Contents**

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Another increase in the line item general and administrative expense is in NSF checks and other losses stemming from the Bank's deposit accounts. In comparing the second quarter of 2014 to 2013, the increase amounted to \$61.4 thousand more expense in 2014. This represents an area of great concern to the Bank as the failures of other organizations to protect customer's information hurts the Bank's bottom line. This exposure to risk continues to increase as our society adopts and utilizes more technology than ever before.

Overall non-interest expense was \$295 thousand higher in 2014 than in 2013. The Company continues to monitor costs to safeguard profitability.

Net Income

Overall, net income was down \$143 thousand for the six months ended June 30, 2014, compared to the same period of 2013. The improvement in asset quality that has occurred over the last two years along with lower loan balances enabled the Company to have low levels of provision expense until third quarter 2013. Provision was increased during the quarter due to charge-offs and loan growth and was \$593 thousand higher than 2013 on a comparable year-to-date. This coupled with the decreases in both gains on sale of investments; and gains on sales of loans are the largest factors behind the decrease.

The importance of a higher loan to asset percentage was evidenced by the improvement in interest income and yield. With the decrease in noninterest income, it becomes essential that the Bank continue to build on the growth in loans the last half of 2014. The ability to fund that loan growth with a growth in core deposits is another strength of the Company which should continue with the addition of new offices.

The Bank also has the ability to borrow funds or sell securities and best of all, the option to choose which source correlates to be the most profitable.

The Company is positioned for improvement in the net interest margin while rates remain low, provided there is an increase in loan demand. 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 and adjustable rate loans. As with the rest of the banking 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 2014 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.

Overall, the Bank is working to offset the probable loss of noninterest income streaming from sales by increasing the loan balances. Possible improvement in the net interest margin appears attainable with the loan increases shown in the quarterly comparisons.

Comparison of Results of Operations for the quarters ended June 30, 2014 and June 30, 2013.

The largest fluctuations in the balance sheet for the second quarter 2014 from first quarter 2014 were caused by the changes in the asset structure. Cash balances and the investment portfolio decreased by \$31.6 million as they were used to fund net loan growth of \$14.6 million and replace deposit run-off of \$29.2 million. The same change in composition exists in comparing June 30, 2014 to June 30, 2013 with larger differences: Cash and securities down \$73.2 million, net loans up \$96.4 million. Deposits are up \$13.5 million in 2014 due to the addition of the two offices in second half 2013.

The increase in average loan balances in second quarter 2014 as compared to second quarter 2013 correlates to the increase of \$888 thousand in loan interest income for the same quarter comparison. Taking into account the lower average balances of securities and therefore lower interest income from those, overall interest income remained higher by \$538 thousand in quarter comparisons. Though the average deposit balances were higher in second quarter 2014, interest expense was lower by \$174 thousand. Overall net interest income for the quarter was \$752 thousand higher than the same quarter last year.

**Table of Contents**

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

The improvement in net interest income for second quarter 2014 as compared to second quarter 2013 was sufficient enough to offset the decrease in noninterest income and the increase in noninterest expense to compile a \$52 thousand improvement in net income for 2014. The improvement in net interest income offset a larger loan provision expense of \$332 thousand, a decrease of \$242 thousand in noninterest income and an increase of \$253 thousand in noninterest expense. The loan provision expense for the quarter ended June 30, 2014 was to fund a higher ALLL for the loan growth that also occurred during the period. Net charge-offs for second quarter 2014 were lower by \$37.5 thousand than second quarter 2013's \$104.7 thousand.

Two additional offices were operating during the second quarter of 2014 as compared to second quarter 2013. One office was accretive to earnings as it was an acquisition in fourth quarter 2013 and the other was close to breakeven after a year of operation. Continued growth in these offices will benefit the Bank's bottom line through the remainder of 2014. As loan growth continues, the small increase in net income for this quarter comparison should expand and bring the year-to-date comparison of 2014 closer to or surpass 2013. However, the second half of 2014 will be impacted by the addition of another brick and mortar office. The increased profitability due to loan growth will be tempered by the expense of the additional office.

**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, estimated, and 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 is interest rate risk. The majority of our interest rate risk arises from the instruments, positions and transactions entered into for purposes, other than trading such as loans, available for sale securities, interest bearing deposits, short term borrowings and long term borrowings. Interest rate risk occurs when interest bearing assets and liabilities re-price 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. 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. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.

**Table of Contents****ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)**

The Company also reviews shocks with a 4.0% fluctuation with a delayed time frame of 10 months. The shocks presented below assume an immediate change of rate in the percentages and directions shown covering a twelve month period:

Interest Rate Shock on Net Interest Margin			Interest Rate Shock on Net Interest Income		
Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total (\$000)	% Change to Flat Rate
3.52%	6.45%	Rising	3.00%	32,187	7.34%
3.49%	5.80%	Rising	2.00%	31,710	5.75%
3.39%	2.53%	Rising	1.00%	30,676	2.30%
3.30%	0.00%	Flat	0.00%	29,986	0.00%
3.01%	-8.76%	Falling	-1.00%	27,540	-8.16%
2.79%	-15.63%	Falling	-2.00%	25,704	-14.28%
2.53%	-23.40%	Falling	-3.00%	23,665	-21.08%

The net interest margin represents the forecasted twelve month margin. The Company also reviews a 24 month forecast period. It also shows what effect rate changes will have on both the margin and 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 since 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. What the Bank has experienced is a decrease in the time balances of our deposit portfolio, therefore a loss of term funding. Over the last three years, other borrowings that had matured were not replaced which thus eliminated a category of what historically was longer term liability. A high level of liquidity negated the need to re-borrow.

The shock chart currently shows a tightening in net interest margin over the next twelve months in a decreasing rate environment while an improvement is forecasted in a rising rate environment. Due to the length and existence of such a low rate environment, the model does not predict expansion of net income margin in any falling category. Cost of funds are below 0.75% so at even the lowest shock of 100 basis points, the Bank cannot take full advantage and reprice funds to match the level of shock. The positive impact in a rising rate environment is partially caused by a large core deposit base that should not reprice as quickly as the assets. The average duration of the majority of the assets is outside the 12 month shock period. The Bank enhanced its use of the software model during 2012 by including decay rates and key rate ties on certain deposit accounts and continues to review and modify those rates as updated data is compiled. Both enhancements were based on historical performance data of the Bank. Both directional changes are within risk exposure guidelines at the 200 basis point level. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

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, 2014, 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, 2014. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

**Table of Contents**

## PART II OTHER INFORMATION

## 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, 2013.

## ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Treasury stock repurchase for quarter ended June 30, 2014.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	(d) Maximum Number of Shares that may yet be purchased under the Plans or Programs
4/1/2014 to 4/30/2014				195,930
5/1/2014 to 5/31/2014	15,000	\$ 24.45	15,000	180,930
6/1/2014 to 6/30/2014	4,500	\$ 24.75	4,500	176,430
Total	19,500	\$ 24.52	19,500	176,430

- (1) The Company purchased shares in the market pursuant to a stock repurchase program publicly announced on January 18, 2014. On that date, the Board of Directors authorized the repurchase of 200,000 common shares between January 18, 2014 and December 31, 2014.

## ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

## ITEM 4 MINE SAFETY DISCLOSURES

Not applicable



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
- 101.INS XBRL Instance Document (1)
- 101.SCH XBRL Taxonomy Extension Schema Document (1)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document (1)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document (1)
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document (1)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document (1)

**Table of Contents**

SIGNATURES

**SIGNATURES**

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

Farmers & Merchants Bancorp, Inc.,

Date: July 28, 2014

By: /s/ Paul S. Siebenmorgen  
Paul S. Siebenmorgen  
President and CEO

Date: July 28, 2014

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