FARMERS & MERCHANTS BANCORP INC
Form 10-Q
April 29, 2011

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2011

OR

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

Commission File Number 0-14492

FARMERS & MERCHANTS BANCORP, INC.
(Exact name of registrant as specified in its charter)

OHIO	34-1469491
(State or other jurisdiction of incorporation or organization)	(I.R.S Employer Identification No.)
307-11 North Defiance Street, Archbold, Ohio	43502
(Address of principal executive offices)	(Zip Code)

(419) 446-2501

Registrant s telephone number, including area code

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

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

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

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

Indicate the number of shares of each of the issuers classes of common stock, as of the latest practicable date:

Common Stock, No Par Value	4,688,969

Class	Outstanding as of April 27, 2011

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FORM 10Q
FARMERS & MERCHANTS BANCORP, INC.
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ITEM 1 FINANCIAL STATEMENTS

FARMERS & MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(in thousands of dollars)

	March 31, 2011	December 31, 2010
<S>	<C>	<C>
ASSETS:		
Cash and due from banks	$ 15,964	$ 14,675
Interest bearing deposits with banks	23,077	14,312
Federal funds sold	20,489	14,392
Total cash and cash equivalents	59,530	43,379
Securities available for sale (Note 2)	303,472	287,317
Other Securities, at cost	4,406	4,406
Loans, net (Note 4)	507,505	521,883
Bank premises and equipment	17,101	17,202
Goodwill	4,074	4,074
Mortgage Servicing Rights	2,151	2,178
Other Real Estate Owned	3,989	4,468
Accrued interest and other assets	21,701	21,456
TOTAL ASSETS	$ 923,929	$ 906,363
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES:		
Deposits:		
Noninterest bearing	$ 69,944	$ 70,554
Interest bearing		
NOW accounts	192,196	176,897
Savings	166,607	159,698
Time	311,585	317,364
Total deposits	740,332	724,513
Federal funds purchased and securities sold under agreement to repurchase	52,080	51,241
FHLB Advances	29,820	29,874
Dividend Payable	892	894
Accrued expenses and other liabilities	4,820	5,438
Total Liabilities	827,944	811,960
SHAREHOLDERS EQUITY:		
Common stock, no par value authorized 6,500,000 shares; issued 5,200,000 shares	12,677	12,677

Treasury Stock - 482,106 shares 2011, 477,106 shares 2010		(9,892)		(9,799)
Unearned Stock Awards 28,925 for 2011 and 2010		(580)		(580)
Retained Earnings		92,657		91,567
Accumulated other comprehensive income		1,123		538
Total Shareholders Equity		95,985		94,403
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	923,929	$	906,363

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2010 Balance Sheet has been derived from the audited financial statements of that date.

FARMERS & MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(in thousands of dollars, except per share data)

<Table>

	Three Months Ended	
	March	March 31,
<Caption>	31, 2011	2010
INTEREST INCOME:		
Loans, including fees	$ 8,023	8,482
Debt Securities:		
U.S. Treasury securities	100	26
Securities of U.S. Government agencies	934	1,214
Obligations of states and political subdivisions	532	544
Dividends	49	49
Federal funds sold	6	2
Other	11	8
Total Interest Income	9,655	10,325
INTEREST EXPENSE:		
Deposits	1,883	2,455
Federal Funds purchased and securities sold under agreements to repurchase	75	68
Borrowed funds	263	397
Total Interest Expense	2,221	2,920
NET INTEREST INCOME BEFORE		
PROVISION FOR LOAN LOSSES	7,434	7,405
PROVISION FOR LOAN LOSSES (Note 4)	772	1,690
NET INTEREST INCOME AFTER		
PROVISION FOR LOAN LOSSES	6,662	5,715
NONINTEREST INCOME		
Customer service fees	791	679
Other service charges and fees	776	820
Net gain (loss) on sale of other assets owned	(648)	(16)
Net gain on sale of loans	75	67
Net gain on sale of securities	339	259
Total Noninterest Income	1,333	1,809
NONINTEREST EXPENSE		
Salaries and wages	2,253	2,314
Pension and other employee benefits	815	911
Occupancy expense (net)	313	274
Furniture and Equipment	392	414
Data processing	230	268
Franchise Taxes	218	240
FDIC Assessment	320	259
Mortgage servicing rights amortization	91	103
Other general and administrative	936	1,154

Total Noninterest Expense	5,568	5,937
INCOME BEFORE FEDERAL INCOME TAX	2,427	1,587
FEDERAL INCOME TAXES	446	331
NET INCOME	$ 1,981	$ 1,256
OTHER COMPREHENSIVE INCOME (NET OF TAX):		
Unrealized gains on securities	$ 585	$ (309)
COMPREHENSIVE INCOME	$ 2,566	$ 947
NET INCOME PER SHARE	$ 0.42	$ 0.27
Weighted Average Shares Outstanding 4	693,080	4,734,674
DIVIDENDS DECLARED	$ 0.19	$ 0.18

No disclosure of diluted earnings per share is required as shares are antidilutive as of quarter end.

See Notes to Condensed Consolidated Unaudited Financial Statements.

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

<Table>	Three Months Ended	
<Caption>	March 31, 2011	March 31, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,981	$ 1,256
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Depreciation	338	344
Accretion and amortization of securities	692	275
Amortization of servicing rights	91	103
Amortization of core deposit intangible	78	39
Provision for loan losses	772	1,690
Gain on sale of loans held for sale	(226)	(230)
Originations of loans held for sale	(9,672)	(9,702)
Proceeds from sale of loans held for sale	11,383	9,959
Loss on sale of other assets	648	(16)
Gain on sale of investment securities	(339)	(259)
Change in Operating Assets and Liabilities, net	(1,252)	(1,624)
Net Cash Provided by Operating Activities	4,494	1,835
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in securities:		
Maturities, prepayments and calls	8,848	32,241
Sales	16,361	12,519
Purchases	(40,830)	(60,477)
Proceeds from sale of assets	4	
Additions to premises and equipment	(237)	(266)
Loan originations and principal collections, net	11,894	13,376
Net Cash (Used) in Investing Activities	(3,960)	(2,607)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	15,819	6,856
Net change in short-term debt	839	2,034
Proceeds from issuance of long-term debt		9,000
Repayments of long-term debt	(54)	(66)
Purchase of Treasury stock	(93)	
Cash dividends paid on common stock	(894)	(852)
Net Cash Provided by Financing Activities	15,617	16,972
Net Increase (Decrease) in cash and cash equivalents	16,151	16,200
Cash and cash equivalents Beginning of year	43,379	33,648
Cash and cash equivalents End of period	$ 59,530	$ 49,848

RECONCILIATION OF CASH AND CASH EQUIVALENTS:				
Cash and cash due from banks	$	15,964	$	11,778
Interest bearing deposits with banks		23,077		25,153
Federal funds sold		20,489		12,917
	$	59,530	$	49,848
Supplemental Information				
Cash paid during the period for:				
Interest	$	2,265	$	3,046
Income Taxes	$		$	

<Table>
See Notes to Condensed Consolidated Unaudited Financial Statements.

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 three months ended March 31, 2011 are not necessarily indicative of the results that are expected for the year ended December 31, 2011. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2010.

NOTE 2 FAIR VALUE OF INSTRUMENTS

FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair values of financial instruments are management s estimate of the values at which the instruments could be exchanged in a transaction between willing parties. These estimates are subjective and may vary significantly from amounts that would be realized in actual transactions. In addition, other significant assets are not considered financial assets including deferred tax assets, premises, equipment and intangibles. Further, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered in any of the elements.

The following assumptions and methods were used in estimating the fair value for financial instruments.

Cash and Cash Equivalents

The carrying amounts reported in the balance sheet for cash, cash equivalents and federal funds sold approximate their fair values. Also included in this line item are the carrying amounts of interest-bearing deposits maturing within ninety days which approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Securities and Other Securities

Fair values for securities, excluding Federal Home Loan Bank stock, are based on quoted market price, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

Loans

Most commercial, agricultural and real estate mortgage loans are made on a variable rate basis. For those variable rate loans that re-price frequently, and with no significant change in credit risk, fair values are based on carrying values. The fair values of the fixed rate and all other loans are estimated using discounted cash flow analysis. This is accomplished by using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality.

Deposits

The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed term money market

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

Deposits (Continued)

accounts and certificates of deposit approximate their fair value at the reporting date. Fair value for fixed- rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings

Short-term borrowings are carried at cost that approximates fair value. Other long-term debt was generally valued using a discounted cash flow analysis with a discounted rate based on current incremental borrowing rates for similar types of arrangements, or if not available, based on an approach similar to that used for loans and deposits.

Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

Dividends Payable

The carrying amounts of dividends payable approximate their fair values and are generally paid within forty days of declaration.

Off Balance Sheet Financial Instruments

Fair values for off-balance sheet, credit related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counter- parties credit standing.

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of March 31, 2011 and December 31, 2010 are reflected below.

	(In Thousands)			
	March 31, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and Cash Equivalents	$ 59,530	$ 59,530	$ 43,379	$ 43,379
Securities-available for sale	303,472	303,472	287,317	287,317
Other Securities	4,406	4,406	4,406	4,406
Loans, net	507,505	504,540	521,883	520,766
Accrued Interest Receivable	4,154	4,154	4,036	4,036
Financial Liabilities				
Deposits	$740,332	$742,314	$724,513	$725,270
Short-term Debt				
Repurchase Agreement Sold	52,080	52,080	51,241	51,241
Federal Home Loan Bank advances	29,820	30,712	29,874	30,764
Accrued Interest Payable	427	427	471	471
Dividends Payable	892	892	894	894
Off-Balance Sheet Financial Instruments				
Commitments to extend credit	$	$	$	$
Standby Letters of Credit				

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

Fair Value Measurements

The following tables present information about the Company s assets and liabilities measured at fair value on a recurring basis at March 31, 2011, and the valuation techniques used by the Company to determine those fair values.

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

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Company s assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

Disclosures concerning assets and liabilities measured at fair value are as follows:

Assets and Liabilities Measured at Fair Value on a Recurring Basis

($ in Thousands) 3/31/2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets Securities Available for Sale			
U.S. Treasury	$ 32,235		
U.S. Government agency	$ 175,463		
Mortgage-backed securities	$ 30,016		
State and local governments	$ 0	$ 53,303	$ 12,455
Total Securities Available for Sale	$ 237,714	$ 53,303	$ 12,455
Liabilities	$ 0	$ 0	$ 0
12/31/2010	Assets (Level 1)	(Level 2)	(Level 3)
Assets Securities Available for Sale			
U.S. Treasury	$ 32,279		
U.S. Government agency	$ 165,703		
Mortgage-backed securities	$ 24,531		
State and local governments	$ 0	$ 53,502	$ 11,302
Total Securities Available for Sale	$ 222,513	$ 53,502	$ 11,302
Liabilities	$ 0	$ 0	$ 0

The Company did have assets measured at fair value that were categorized as Level 3 during the period. The Company s available for sale securities includes bonds issued by local municipalities. Those municipal bonds that did not have CUSIP or credit ratings numbers were treated as Level 3. Those bonds, including municipalities, that did have CUSIP numbers or have similar characteristics of those in like markets, were considered comparable and marketable and reported as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At March 31, 2011, such assets consist primarily of impaired loans and other real estate. The Company has established the fair values of these assets using Level 3 inputs, each individually described below.

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management s best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)

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

Other real estate is reported at either the fair value of the real estate minus the estimated costs to sell the asset or the cost of the asset. The determination of fair value of the real estate relies primarily on appraisals from third parties. If the fair value of the real estate, minus the estimated costs to sell the asset, is less than the asset s cost, the deficiency is recognized as a valuation allowance against the asset through a charge to expense.

Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2011

($ in Thousands)	Balance at 3/31/11	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Change in fair value for three-month period ended March 31, 2011
Impaired loans	$ 3,636			$ 3,636	$ (197)
Other real estate owned residential mortgages	$ 1,679			$ 1,679	$ (59)
Other real estate owned-commercial	$ 2,290			$ 2,290	$ (385)
Total change in fair value					$ (641)

Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2010

($ in Thousands)	Balance at 3/31/10	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Change in fair value for three-month period ended March 31, 2010
Impaired loans	$ 13,442			$ 13,442	$ (2,006)
Other real estate owned residential mortgages	$ 845			$ 845	$
Other real estate owned-commercial	$ 339			$ 339	$
Total change in fair value					$ (2,006)

NOTE 3 ASSET PURCHASE

On July 9, 2010, the Bank completed its purchase of a branch office in Hicksville, Ohio from First Place Bank. Deposits of close to $28 million and loans of $14 million were included in the purchase. The new office is located within the Bank s current market area, shortening the distance between offices in the Ohio and Indiana market area. The following table summarizes the estimated values of the assets acquired and the liabilities assumed:

(Dollars in Thousands)	
Cash	$ 114
Loans, Net of Discount	13,792
Accrued Interest on Loans	64
Premises and Equipment	1,803
Core Deposit Intangible	1,087
Other Assets	11
Total Assets Acquired	$ 16,871
Deposits	$ 27,749
Accrued Interest on Deposits	13
Other Liabilities	10
Total Liabilities Assumed	27,772
Net Liabilities Assumed	$ 10,901

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

In connection with the purchase, the Bank recognized an addition to core deposit intangible by $1.1 million, which is being amortized on a straight line basis over the estimated remaining economic life of the deposits of 7 years. Amortization of these core deposit intangibles is scheduled to be as follows:

	(In Thousands)
2011	$ 234
2012	312
2013	312
2014	312
2015	155
Thereafter	235
	$ 1560

NOTE 4 LOANS

Loan balances as of March 31, 2011 and December 31, 2010.

	(In Thousands)	
	March 31, 2011	December 31, 2010
Commercial Real Estate	$ 195,754	$ 194,268
Agricultural Real Estate	31,948	33,650
Consumer Real Estate	83,115	86,036
Commercial/Industrial	113,415	117,344
Agricultural	60,508	65,400
Consumer	26,674	29,008
Industrial Development Bonds	1,965	1,965
	513,379	527,671
Less: Net deferred loan fees and costs	(122)	(82)
	513,257	527,589
Less: Allowance for loan losses	(5,752)	(5,706)
Loans Net	$ 507,505	$ 521,883

The following is a maturity schedule by major category of loans as of March 31, 2011:

	Maturities (In Thousands)			
	Within One Year	After One Year Within Five Years	After Five Years	Total
Commercial Real Estate	$28,942	$120,602	$46,210	$195,754
Agricultural Real Estate	2,978	12,356	16,614	31,948
Consumer Real Estate	6,153	16,128	60,834	83,115
Commercial/Industrial	80,013	29,097	4,305	113,415

Agricultural	42,665	15,248	2,595	60,508
Consumer	5,164	19,253	2,135	26,552
Industrial Development Bonds	556	446	963	1,965

The distribution of fixed rate loans and variable loans by major loan category is as follows as of March 31, 2011:

	(In Thousands)	
	Fixed Rate	Variable Rate
Commercial Real Estate	$74,417	$121,337
Agricultural Real Estate	18,611	13,337
Consumer Real Estate	70,944	12,171
Commercial/Industrial	81,628	31,787
Agricultural	55,735	4,773
Consumer	22,188	4,364
Industrial Development Bonds	1,965	

As of March 31, 2011 and 2010 one to four family residential mortgage loans amounting to $72.7 million and $75.3 million, respectively, have been pledged as security for loans the Bank has received from the Federal Home Loan Bank.

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

The percentage of delinquent loans has trended downward since the beginning of 2010 from a high of 2.85% of total loans in January to a low of .76% as of the end of March 2011. These percentages do not include nonaccrual loans which are not past due. This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, and the writing down of uncollectable credits in a timely manner. Industrial Development Bonds are included in the commercial and industrial category for the remainder of the tables in this Note 4.

The following table represents the contractual aging of the recorded investment in past due loans by class or loans as of March 31, 2011 and December 31, 2010 (in thousands):

March 31, 2011	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Consumer real estate	$ 349	$ 56	$ 162	$ 567	$ 82,549	$ 83,115	$
Agricultural real estate				$	31,948	31,948	
Agricultural			14	$ 14	60,494	60,508	
Commercial Real Estate	244		347	$ 591	195,163	195,754	
Commercial and Industrial	736	110	997	$ 1,843	113,537	115,380	31
Consumer				$	26,674	26,674	
Total	$ 1,329	$ 166	$ 1,520	$ 3,015	$ 510,365	$ 513,379	$ 31

December 31, 2010	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Consumer real estate	$ 610	$ 29	$ 169	$ 808	$ 94,463	$ 95,271	$
Agricultural real estate					33,650	33,650	
Agricultural			1,474	1,474	63,926	65,400	
Commercial Real Estate	548		445	993	184,040	185,033	
Commercial and Industrial	957	52	831	1,840	117,469	119,309	15

Consumer	147	6	33	186	28,822	29,008	33
Total	$ 2,262	$ 87	$ 2,952	$ 5,301	$ 522,370	$ 527,671	$ 48

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

	(In thousands)	
	March 31 2011	December 31 2010
Consumer real estate	$ 803	$ 587
Agricultural real estate	44	531
Agricultural	14	1,474
Commercial Real Estate	591	1,705
Commercial and Industrial	1,693	1,543
Consumer	4	4
Total	$ 3,149	$ 5,844

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.

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

2. One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of RMA ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank s loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.

3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50, and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.

4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans that are meeting the terms of repayment.

   Loans may be graded 3 when there is no recent information on which to base a current risk evaluation and the following conditions apply:

   At inception, the loan was properly underwritten and did not possess an unwarranted level of credit risk

   a. At inception, the loan was secured with collateral possessing a loan value adequate to protect the Bank from loss;

   b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;

   c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.

5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.

6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key

distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential , versus defined , impairments to the primary source of loan repayment and collateral.

7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
   a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.

   b. Loans are inadequately protected by the current net worth and paying capacity of the borrower c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.

   d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.

   e. Unusual courses of action are needed to maintain a high probability of repayment. Unusual courses of action are needed to maintain a high probability of repayment.

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

f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.

g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.

h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.

i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.

j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:

a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.

b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.

c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.

9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution s financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

The following table represents the risk category of loans by class based on the most recent analysis performed as of March 31, 2011 and December 31, 2010 (in thousands):

					Industrial
	Agriculture		Commercial	Commercial	Development
				and	
March 31, 2011	Real Estate	Agriculture	Real Estate	Industrial	Bonds
1-2	$ 520	$ 107	$	$ 19	$ 275
3	11,638	24,721	22,274	18,573	733
4	18,483	35,474	161,451	84,620	957
5	190	168	6,229	2,286	
6	1,096	14	5,745	6,657	
7	21	24	55	1,260	
8					
Total	$31,948	$60,508	$195,754	$113,415	$1,965

					Industrial
	Agriculture		Commercial	Commercial	Development
				and	
December 31, 2010	Real Estate	Agriculture	Real Estate	Industrial	Bonds
1-2	$ 484	$ 109	$	$ 341	$ 275
3	12,216	27,964	23,017	14,026	733
4	19,624	35,655	148,481	92,066	957
5	208	173	6,765	3,388	
6	1,097	1,474	6,319	6,688	
7	21	25	451	835	
8					
Total	$33,650	$65,400	$185,033	$117,344	$1,965

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

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned grading as of March 31, 2011 and December 31, 2010.

	Consumer Real Estate March 31 2011	Consumer Real Estate December 31 2010
Grade		
Pass	$82,714	$84,723
Special Mention (5)		387
Substandard (6)	211	639
Doubtful (7)	190	287
Total	$83,115	$86,036

	Consumer Credit March 31 2011	Consumer Credit December 31 2010	Consumer Other March 31 2011	Consumer Other December 31 2010
Performing	$3,322	$3,553	$23,211	$25,405
Nonperforming	14	6	5	44
Total	$3,336	$3,559	$23,216	$25,449

Information about impaired loans as of March 31, 2011 and December 31, 2010 follows:

	(In Thousands)	
	3/31/2011	12/31/2010
Impaired loans without a valuation allowance	$ 1,761	$ 2,849
Impaired loans with a valuation allowance	1,875	1,520
Total impaired loans	$ 3,636	$ 4,369
Valuation allowance related to impaired loans	$ 575	$ 632
Total non-accrual loans	$ 3,149	$ 5,844
Total loans past-due ninety days or more and still accruing	$ 31	$ 48

	(In Thousands)	
	Quarter ended March 31 2011	Year ended December 31 2010

Average investment in impaired loans	$3,872	$10,136
Interest income recognized on impaired loans	$ 651	$ 61
Interest income recognized on a cash basis on impaired loans	$ 645	$ 41

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

The Bank did classify approximately $3.5 million of its impaired loans as troubled debt restructured during 2010 and this balance decreased to $3.3 million as of March 31, 2011.

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)
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 of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the collateral value used.

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

The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2011 and December 31, 2010 (in thousands):

March 31, 2011

		Unpaid		Average	Interest
	Recorded	Principal	Related	Recorded	Income
	Investment	Balance	Allowance	Investment	Recognized
With no related allowance recorded:					
Consumer real estate	$ 239	$ 239	$	$ 126	$
Agriculture real estate	219	219		205	
Agriculture				480	641
Commercial real estate	1,047	1,224		1,339	4
Commercial and industrial		365			
Consumer					
With a specific allowance recorded:					
Consumer real estate	446	411	51	576	3
Agriculture real estate					
Agriculture					
Commercial real estate	230	230	54	132	1
Commercial and industrial	1,455	1,455	470	1,015	2
Consumer					
Totals:					
Consumer real estate	$ 685	$ 650	$ 51	$ 702	$ 3
Agriculture real estate	$ 219	$ 219	$ 0	$ 205	$ 0
Agriculture	$ 0	$ 0	$ 0	$ 480	$ 641
Commercial real estate	$ 1,277	$ 1,454	$ 54	$ 1,471	$ 5

Commercial and industrial	$ 1,455	$ 1,820	$ 470	$ 1,015	$ 2
Consumer	$	$	$	$	$

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

December 31, 2010	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	$	$	$	$	$
Agriculture real estate	219	219		119	31
Agriculture	1,397	1,397		2,786	
Commercial real estate	849	1,699		2,209	26
Commercial and industrial				2,221	2
Consumer					
With a specific allowance recorded:					
Consumer real estate	671	701	66	1,375	
Agriculture real estate					
Agriculture				5	1
Commercial real estate	476	476	73	296	1
Commercial and industrial	757	757	493	1,125	
Consumer					
Totals:					
Consumer real estate	$ 671	$ 701	$ 66	$ 1,375	$
Agriculture real estate	$ 219	$ 219	$ 0	$ 119	$ 31
Agriculture	$ 1,397	$ 1,397	$ 0	$ 2,791	$ 1
Commercial real estate	$ 1,325	$ 2,175	$ 73	$ 2,505	$ 27
Commercial and industrial	$ 757	$ 757	$ 493	$ 3,346	$ 2
Consumer	$	$	$	$	$

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)	
	March 31 2011	December 31 2010
Allowance for Loan Losses		
Balance at beginning of year	$5,706	$ 6,008
Provision for loan loss	772	5,325
Loans charged off	(792)	(6,422)
Recoveries	66	795

Allowance for Loan & Leases Losses	$5,752	$ 5,706
Allowance for Unfunded Loan Commitments & Letters of Credit	$ 152	$ 153
Total Allowance for Credit Losses	$5,904	$ 5,859

The Company segregates its Allowance for Loan and Lease Losses (ALLL) into two reserves: The ALLL and the Allowance for Unfunded Loan Commitments and Letters of Credit (AULC). When combined, these reserves constitute the total Allowance for Credit Losses (ACL).

The AULC is reported within other liabilities on the balance sheet while the ALLL is netted within the loans, net asset line. The ACL presented above represents the full amount of reserves available to absorb possible credit losses. The next table breaks down the activity within ALLL for each loan portfolio segment and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs.

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

Additional analysis related to the allowance for credit losses (in thousands) as of March 31, 2011 and December 31, 2010 is as follows:

	Consumer	Agriculture		Commercial		Consumer (incl.	Unfunded Loan Commitment & Letters of		
March 31, 2011	Real Estate	Real Estate	Agriculture	Real Estate	Commercial	Credit Cards)	Credit	Unallocated	Total
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	$ 258	$ 122	$ 327	$ 1,868	$ 2,354	$ 380	$ 153	$ 397	$ 5,859
Charge Offs	(85)		(24)	(89)	(479)	(115)			($792)
Recoveries	2		3	17	5	39			$ 66
Provision	91	32	6	354	640	28		(379)	$ 772
Other Non-interest expense related to unfunded	$						(1)		($1)
Ending Balance	$ 266	$ 154	$ 312	$ 2,150	$ 2,520	$ 332	$ 152	$ 18	$ 5,904
Ending balance: individually evaluated for impairment	$ 51			$ 54	$ 470				$ 575
Ending balance: collectively evaluated for impairment	$ 215	$ 154	$ 312	$ 2,096	$ 2,050	$ 332	$ 152	$ 18	$ 5,329
Ending balance: loans acquired with deteriorated credit quality	2					2			4
FINANCING RECEIVABLES:									
Ending balance	$ 74,075	$ 32,363	$ 60,096	$ 204,954	$ 115,518	$ 26,373			$ 513,379
Ending balance: individually evaluated for impairment	$ 685	$ 219	$	$ 1,277	$ 1,455				$ 3,636

Ending balance: collectively evaluated for impairment	$ 73,390	$ 32,144	$ 60,096	$ 203,677	$ 114,063	$ 26,373			$ 509,743
Ending balance: loans acquired with deteriorated credit quality	$ 984	$	$	$	$	$ 235			$ 1,219

							Unfunded		
							Loan		
						Consumer	Commitment		
	Consumer	Agriculture		Commercial		(incl.	&		
							Letters		
	Real	Real		Real		Credit	of		
December 31, 2010	Estate	Estate	Agriculture	Estate	Commercial	Cards)	Credit	Unallocated	Total
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	$ 439	$ 120	$ 647	$ 1,810	$ 2,494	$ 497	$ 227	$ 1	$ 6,235
Charge Offs	(507)		(136)	(1,147)	(4,188)	(444)			(6,422)
Recoveries	55		17	52	515	156			795
Provision	271	2	(201)	1,153	3,533	171		396	5,325
Other Non-interest expense related to unfunded							(74)		(74)
Ending Balance	$ 258	$ 122	$ 327	$ 1,868	$ 2,354	$ 380	$ 153	$ 397	$ 5,859
Ending balance: individually evaluated for impairment	$ 66			$ 73	$ 493				$ 632
Ending balance: collectively evaluated for impairment	$ 190	$ 122	$ 327	$ 1,795	$ 1,861	$ 380	$ 153	$ 397	$ 5,226
Ending balance: loans acquired with deteriorated credit quality	$ 2					2			$ 4
FINANCING RECEIVABLES:									
Ending balance	$ 75,785	$ 34,446	$ 65,400	$ 204,327	$ 119,262	$ 28,451			$ 527,671

Ending balance: individually evaluated for impairment	$ 671	$ 219	$ 1,397	$ 1,325	$ 757		$ 4,369
Ending balance: collectively evaluated for impairment	$ 75,114	$ 34,227	$ 64,003	$ 203,002	$ 118,505	$ 28,451	$ 523,302
Ending balance: loans acquired with deteriorated credit quality	$ 987					156	$ 1,143

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

INTRODUCTION

Farmers & Merchants Bancorp, Inc. (the Company) was incorporated on February 25, 1985, under the laws of the State of Ohio. Farmers & Merchants Bancorp, Inc., and its subsidiary The Farmers & Merchants State Bank (the Bank) are engaged in commercial banking. The executive offices of the Company are located at 307 North Defiance Street, Archbold 43502.

The Farmers & Merchants State Bank engages in general commercial banking and savings business. Their activities include commercial, agricultural and residential mortgage, consumer and credit card lending activities. Because the Bank s offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such things as farm land, farm equipment, livestock and general operation loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for such items as autos, trucks, recreational vehicles, motorcycles, etc.

The Bank s underwriting policies exercised through established procedures facilitates operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank s practice has been not to promote innovative, unproven credit products which will not be in the best interest of the Bank or its customers. The Bank does offer a hybrid loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years they automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank s adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer Mac and Small Business Lending programs. The Bank does also retain the servicing on these partially or 100% sold loans. In order for the customer to participate in these programs they must meet the requirements established by these agencies.

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

Following are the characteristics and underwriting criteria for each major type of loan the Bank offers:

Commercial Real Estate Construction, purchase, and refinance of business purpose real estate. Risks include loan amount in relation to construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower s ability to repay in orderly fashion, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer s ability to repay in a changing rate environment before granting loan approval.

Agricultural Real Estate Purchase of farm real estate or for permanent improvements to the farm real estate. Cash flow from the farm operation is the repayment source and is therefore subject to the financial success of the farm operation.

Consumer Real Estate Purchase, refinance, or equity financing of one to four family owner occupied dwelling. Success in repayment is subject to borrower s income, debt level, character in fulfilling payment obligations, employment, and others.

Commercial/Industrial Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of profit projections, financial leverage, economic trends, management ability, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer s ability to repay in a changing rate environment before granting loan approval.

Agricultural Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re- finance of capital assets such as machinery and equipment, and livestock. The production of crops and livestock is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmers ability to hedge their position by using the future contracts. The risk related to weather is often mitigated by requiring federal crop insurance.

Consumer Funding for individual and family purposes. Success in repayment is subject to borrower s income, debt level, character in fulfilling payment obligations, employment, and others.

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

INTRODUCTION (Continued)

Industrial Development Bonds Funds for public improvements in the Bank s service area. Repayment ability is based on the continuance of the taxation revenue as the source of repayment.

All loan requests are reviewed as to credit worthiness and are subject to the Bank s underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on collateral types as set forth in the Bank s Loan Policy. In addition, credit scores of principal borrowers are reviewed and an approved exception from an additional officer is required should a credit score not meet the Bank s Loan Policy guidelines.

Consumer Loans:

Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect. Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage periods of lost wages or death. Boats, campers, motorcycles, RV s and Motor Coaches range from 80%-90% based on age of vehicle. 1st or 2nd mortgages on 1-4 family homes range from 75%-90% with in-house first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV. Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

Commercial/Agriculture:

Real Estate:

Maximum LTVs range from 70%-80% depending on type.

Accounts Receivable:

Up to 80% LTV

Inventory:

Agriculture:

Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%

Commercial:

Maximum LTV of 50% on raw and finished goods

Used vehicles, new recreational vehicles and manufactured homes not to exceed (NTE) 80% LTV

Equipment:

New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value

Restaurant equipment up to 35% of market value

Heavy trucks, titled trailers and NTE 75% LTV and aircraft up to 75% of appraised value

Risks are mitigated through an adherence to Loan Policy with any exception being recorded and approved by Senior Management or committees comprised of Senior Management. Loan Policy defines parameters to essential underwriting guidelines such as loan-to-value ratio, cash flow and debt-to-income ratio, loan requirements and covenants, financial information tracking, collection practice and others. Limitation to any one borrower is defined by the Bank s legal lending limits and is stated in policy. On a broader basis, the Bank restricts total aggregate funding in comparison to Bank capital to any one business and agricultural sector by an approved sector percentage to capital limitation.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition ATM s (automated teller machines) are provided at most branch locations along with other independent locations such as major employers and hospitals in the market area. The Bank has custodial services for IRA s (Individual Retirement Accounts) and HSA s (Health Savings Accounts).

F&M Investment Services, the brokerage department of the Bank, opened for business in April, 1999. Securities are offered through Raymond James Financial Services Inc.

The Bank s primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Williams and Wood and in the Indiana counties of DeKalb and Steuben. The commercial banking business in this market are highly competitive with approximately 17 other depository institutions doing business in the Bank s primary market. The Bank competes directly with other commercial banks, credit unions and farm credit services and savings and loan institutions in each of their operating localities. In a number of locations, the Bank competes against institutions which are much larger.

The Company s common stock is not listed on any exchange or the NASDAQ Stock Market. The stock is currently quoted in over-the-counter markets.

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

2011 IN REVIEW

The impact of new legislation, such as Health Care and Dodd-Frank Financial Reform (collectively, Financial Reform legislation), weighs heavily on the minds of bankers along with their customers during its implementation. The primary concerns at this point are the impact on future revenues and expenses and how quickly it will be felt.

Short-term rates remain low and are expected to remain low throughout 2011. This has enabled the Company to continue to sell investment securities and recognize a gain without compromising the yield while modestly increasing the duration of the investment portfolio. In first quarter 2010, the favorable gain produced from the sale of securities was $259 thousand. Most of the securities sold were agencies maturing in a shorter time period than the securities that were purchased to replace them. For first quarter 2011, the favorable gain was higher at $339 thousand and the securities sold were out of state municipals and agencies. The Bank was able to continue to capitalize on the steepness of the yield curve.

During the first quarter of 2011, the Bank received a payoff on a large nonaccrual loan. The collection of which included over $600 thousand of interest and a reimbursement of over $300 thousand in legal fees. The collection process took almost three years to complete. This boost to revenue is evident throughout from net interest margin, improved asset quality to lower non-interest expense for the quarter. It also offsets the concerns of a tightening margin due to soft loan demand and high liquidity caused from deposit growth.

A large amount of write-downs and losses on the sale of other real estate owned (ORE) hampered the first quarter of 2011 as compared to the same quarter 2010. The number of properties held decreased during 2011 and the balance is almost $4 million as of March 31, 2011, $2.8 million higher than March 31, 2010. Even so, net noninterest expense was only slightly higher by $107 thousand than first quarter 2010. Keeping noninterest expense lower than peer has long been a strength of the Company.

The Bank s local service area has experienced a very slight improvement in employment rates in mid year 2010 through first quarter 2011. The improvement is not considered significant at this time as unemployment remains in double digits in most of the company s market areas. 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 remains at lower levels, consumer sensitive industries and the retail sector may continue to experience pressures as well.

On July 9, 2010, the Bank completed its purchase of a branch office in Hicksville, Ohio from First Place Bank, a savings association with its main office in Warren, OH. Deposits of close to $28 million and loans of $14 million were included in the purchase. The new office is located within the Bank s current market area, shortening the distance between offices in the Ohio and Indiana market area. The transaction has been accretive to earnings within the first nine months of operation.

Asset quality continued to improve and the Company remains strong, stable and well capitalized. The Company has the capacity to continue to cover the increased costs of doing business in a tough economy and is seeking good loans to improve profitability.

CRITICAL ACCOUNTING POLICY AND ESTIMATES

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the industries in which it operates. At times the application of these principles requires Management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.

Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL) and the valuation of its Mortgage Servicing Rights as the accounting areas that requires the most subjective or complex judgments, and as such have the highest possibility of being subject to revision as new information becomes available.

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

CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)

The ALLL represents management s estimate of credit losses inherent in the Bank s loan portfolio at the report date. The estimate is a composite of a variety of factors including past experience, collateral value and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion.

The Bank s ALLL methodology captures trends in leading, current, and lagging indicators which will have a direct affect on the Bank s allocation amount. Trends in such leading indicators as delinquency, unemployment, changes in the Bank s service area, experience and ability of staff, regulatory trends, and credit concentrations are referenced. A current indicator such as the total Watch List loan amount to Capital, and a lagging indicator such as the charge off amount are referenced as well. A matrix is formed by loan type from these indicators that is responsive in making ALLL adjustments.

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest expense in proportion to, and over the period of, the estimated future servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to the amortized cost. Impairment is deter- mined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum. Fees received for servicing loans owned by investors are based on a percentage of the outstanding monthly principal balance of such loans and are included in operating income as loan payments are received. Costs of servicing loans are charged to expense as incurred. The Bank utilizes a third party vendor to estimate the fair value of their mortgage servicing rights which utilizes national prepayment speeds in its calculations.

MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

In comparing the balance sheet of March 31, 2011 to that of December 31, 2010, the liquidity of the Bank has increased and remains strong with additional funds being placed in Federal Funds Sold and interest bearing deposits with banks. The Bank has taken advantage of the Federal Reserve s payment of interest and also placed funds in term deposits at a correspondent bank. The Bank monitors the rate paid by the Federal Reserve versus the Federal Funds Sold rate and other deposit rates offered through correspondent banks.

Overall, cash and cash equivalents increased over $16.2 million and securities increased an additional $16.2 million. The Company s increased liquidity came from a decrease of almost $14.3 million in the Bank s loan portfolio and deposit growth of $15.8 million. Liquidity remains high with the Bank also having access to $27 million of unsecured borrowings through correspondent banks and $76 million of unpledged securities which may be sold or used as collateral. The strength of the security portfolio is shown in the tables to follow. With the exception of stock, all of the Bank s security portfolio is categorized as available for sale and as such is recorded at market value. The charts which follow do not include stock.

Investment securities will at times depreciate to an unrealized loss position. The Bank utilizes the following criteria to assess whether or not an impaired security is other than temporary. No one item by itself will necessarily signal that a security should be recognized as other than temporary impairment.

1. The fair value of the security has significantly declined from book value.
2. A down grade has occurred that lowers the credit rating to below investment grade (below Baa3 by Moody and BBB- by Standard and Poors).
3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.
4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.
5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

If the impairment is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value, thereby establishing a new cost basis. The amount of the write down shall be included in earnings as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value. The recovery in fair value shall be recognized in earnings when the security is sold. The first table is presented by category of security and length of time in a continuous loss position. Municipalities may be more likely to be in a loss position greater than 12 months due to their length to maturity and are not indicative of an issue with safety and soundness of the municipality. The Bank currently does not hold any securities with other than temporary impairment.

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

March 31, 2011	Less Than Twelve Months (In Thousands)		Twelve Months & Over (In Thousands)	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ (365)	$32,236	$	$
U.S. Government agency	(1,202)	92,242		
Mortgage-backed securities	(7)	5,021		
State and local governments	(189)	9,471	(88)	11,281

The following chart shows the breakdown of the unrealized gain or loss associated within each category of the investment portfolio as of March 31, 2011.

	March 31, 2011		(In Thousands)	
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
Available-for-Sale:				
U.S. Treasury	$ 32,600	$	$ (365)	$ 32,235
U.S. Government agency	175,535	1,130	(1,202)	175,463
Mortgage-backed securities	28,935	1,088	(7)	30,016
State and local governments	64,700	1,335	(277)	65,758
	$ 301,770	$ 3,553	$ (1,851)	$ 303,472

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

	March 31, 2011	(In Thousands)
	Amortized Cost	Fair Value
One year or less	$ 2,064	$ 2,082
After one year through five years	205,476	205,480
After five years through ten years	49,359	49,869
After ten years	15,936	16,025
Subtotal	$272,835	$273,456
Mortgage Backed Securities	28,935	30,016
Total	$301,770	$303,472

Net loans show a decrease of $14.3 million for the three months ended March 31, 2011. $792 thousand was charged-off during the three month period. While over $7 million came off the watch list during the first quarter, it was not all due to having been charged-off. A portion of the decrease is positive in that troubled loans were either paid off or were refinanced elsewhere. Overall, total assets of the Company increased $17.6 million from December 31, 2010 to March 31, 2011.

Following is a breakdown of the allowance for credit losses by category of loan as of March 31st for 2009, 2010 and 2011.

		(In Thousands)	
	March-2011 Amount (000 s)	March-2010 Amount (000 s)	March-2009 Amount (000 s)
Balance at End of Period Applicable To:			
Commercial Real Estate	$2,150	$2,638	$1,752
Ag Real Estate	154	109	72
Consumer Real Estate	266	466	439
Commercial and Industrial	2,520	3,569	2,547
Agricultural	312	288	703
Consumer, Overdrafts and other loans	350	401	419
Unallocated			
Allowance for Loan & Lease Losses	$5,752	$7,471	$5,932
Off Balance Sheet Commitments	152	221	203
Total Allowance for Credit Losses	$5,904	$7,692	$6,135

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

MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES (Continued)

The chart below shows the breakdown of the loan portfolio by category less deferred loan fees and costs.

		(In Thousands)	
	March-2011 Amount (000 s)	March-2010 Amount (000 s)	March-2009 Amount (000 s)
Commercial Real Estate	$195,754	$225,351	$219,880
Ag Real Estate	31,948	40,599	45,181
Consumer Real Estate	83,115	82,112	89,493
Commercial and Industrial	113,415	118,920	111,482
Agricultural	60,508	55,697	53,300
Consumer, Overdrafts and other loans	26,552	31,163	28,875
Industrial Development Bonds	1,965	2,506	7,499
Total Loans	$513,257	$556,348	$555,710

Deposits increased $15.8 million in total from December 31, 2010. The mix of the portfolio continued to transition to a higher level of core deposits as a result primarily of the Bank s offering of a high interest bearing transaction account along with an increase in health savings accounts. The success of this product is also the reason for the continued movement of deposits out of Certificates of Deposit to interest bearing transaction accounts. In 2010, the Bank strengthened its line of deposit products by adding additional products which added additional options to its already highly successful Reward Checking, which was renamed KASASA Cash. The additional options include KASASA Saver, KASASA Giver and KASASA ITunes. KASASA Saver is the reason behind the increase in savings. These continue to be the deposit of choice and attract not only new money from existing customers but new customers to the Bank also.

The Certificate of Deposit (COD) portfolio has decreased $5.8 million during the first three months of 2011 which is helping to decrease the cost of funds, as demonstrated below in the section of this MD&A captioned MATERIAL CHANGES IN RESULTS OF OPERATION Interest Expense .

Capital increased approximately $1.6 million from year-end during the three months of 2011. Positive earnings and an increase in accumulated other comprehensive income are the factors behind the increase. Comprehensive income increased $0.6 million even with the shift of $339 thousand from unrealized gain to realized gain with the sale of securities. Dividends remained stable during the period.

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

Primary Ratio	10.46%
Tier I Leverage Ratio	9.81%
Risk Based Capital Tier I	14.38%
Total Risk Based Capital	15.34%
Stockholders Equity/Total Assets	10.39%

MATERIAL CHANGES IN RESULTS OF OPERATIONS

Interest Income

Annualized interest income and yield on earning assets is down in 2011 as compared to March 31, 2010. While total assets were higher than year end, the decrease resulted primarily from the transition of the Company s earning assets from high yield to lower yield assets. As the table that follows confirms, the shift of funds within the interest earning portfolios caused a lower yield thereby causing lower interest income even though assets increased. The largest change in yield came in the additions to the taxable security portfolio as the Bank sought to keep the growth in shorter periods for liquidity. The portfolio was also impacted by calls due to the low rate environment.

The Bank worked to minimize the impact of the low rate environment on its loan portfolio with the use of floors on renewed and new loans. 2011 loan yield was positively impacted by the collection of nonaccrual interest and adjustments to the Farmer Mac portfolio, which is a loan participation program that generated additional interest income in first quarter 2010. To protect the yield, the Bank is working to add spread to the margin on the variable rate loans so that when prime does adjust up, the Bank s rate also adjusts up over the floor. Overall, interest income from loans was down $459 thousand in comparing the three months ended March 31, 2011 to same period for 2010.

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)
MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)
Interest Income (Continued)

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

Total interest income was down almost $670 thousand in comparing the first three month of 2011 to the first nine months of 2010. Loans were the only earning asset that decreased in volume which emphasizes the importance of growing loans as it is the highest yielding earning asset. The overall asset yield also decreased 63 basis points between the two periods.

		(In Thousands) March 31, 2011		March 31, 2010
	Average Balance	Interest/Dividends	Yield/Rate	Yield/Rate
Interest Earning Assets:				
Loans	$513,208	$ 8,023	6.29%	6.07%
Taxable Investment Securities	237,316	1,105	1.86%	3.36%
Tax-exempt Investment Securities	61,466	510	5.03%	5.45%
Fed Funds Sold & Interest Bearing Deposits	42,499	17	0.16%	0.14%
Total Interest Earning Assets	$854,489	$ 9,655	4.66%	5.29%

Change in March 31, 2011 Interest Income (In Thousands) Compared to March 31, 2010

	Change	Due to Volume	Due to Rate
Interest Earning Assets:			
Loans	$ (459)	$ (762)	$ 303
Taxable Investment Securities	(205)	378	(583)
Tax-exempt Investment Securities	(13)	41	(54)
Fed Funds Sold & Interest Bearing Deposits	7	6	1
Total Interest Earning Assets	$ (670)	$ (337)	$ (333)

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

Interest Expense

Interest expense continued to be lower than the comparable three months from 2010. Interest expense related to deposits was down $572 thousand while the deposit balance increased by $57.8 million in comparing the ending balances of each first three months. Approximately $28 million of the growth came through the purchase of the Hicksville office. Time deposits continue to reprice down and the Bank continues to try and lengthen the duration of the portfolio with specials offered in terms longer than 12 months. However, depositors continue to place more funds in shorter term deposits or move elsewhere. KASASA Cash and Saver helped to increase the savings deposit balances as seen in the increase due to volume.

Interest on borrowed funds was $134 thousand lower for the three month periods ended March 31, 2011 and 2010. While additional borrowings from Federal Home Loan Bank in the amount of $9 million were taken in the first quarter of 2010, the rates on those borrowings were lower than those paid off during 2009. Over $13 million of borrowings were paid off in 2010 causing the decreased cost shown in the table. Rates paid on the daily repurchase agreements, used by the Bank to offset commercial sweep accounts, were also lower in 2011 than the corresponding rate paid in 2010 though only slightly.

The decrease in interest expense did not outpace the decrease in interest income as it did last year and remains a focus for improvement in 2011. The main focus is to increase asset yield by using excess cash and investments to fund loan growth.

		(In Thousands) March 31, 2011		March 31, 2010
	Average Balance	Interest/Dividends	Yield/Rate	Yield/Rate
Interest Bearing Liabilities:				
Savings Deposits	$ 341,092	$ 562	0.66%	0.67%
Other Time Deposits	311,280	1,321	1.70%	2.47%
Other Borrowed Money	29,855	263	3.52%	5.89%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	50,180	75	0.60%	0.62%
Total Interest Bearing Liabilities	$ 732,407	$ 2,221	1.21%	1.80%

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ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)
MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)
Interest Expense (Continued)

Change in March 31, 2011 Interest Expense (In Thousands) Compared to March 31, 2010

	Change	Due to Volume	Due to Rate
Interest Bearing Liabilities:			
Savings Deposits	$ 79	$ 90	$ (11)
Other Time Deposits	(652)	(34)	(618)
Other Borrowed Money	(312)	(81)	(231)
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	7	9	(2)
Total Interest Bearing Liabilities	$ (878)	$ (16)	$ (862)

Net Interest Income

Net interest income is higher in three month comparisons, with improvement primarily due to the ability of the Bank to decrease its cost of funds by lowering rates on interest bearing liabilities and the collection of nonaccrual interest of over $600 thousand. This decrease offset the loss of interest income due to lower overall rates on earning assets.

Net interest income should continue to increase as the Bank continues to work to increase interest income by reducing the amount of nonaccrual loans and attempting to add spread on renewing loans. Interest expense on time deposits should also continue to show a decrease until depositors begin to transition back into longer-term deposits. If and when rates begin to rise, the challenge will be to delay the pricing up of deposits.

Provision Expense

Provision for loan loss was almost $1 million lower for the three months ended March 31, 2011 as compared to the same 2010 period. The decrease of a large balance in nonaccrual loans, along with improving asset quality and low loan growth warranted the lower provision to the loan loss reserve. Non-accruals decreased $2.7 million during the first three months of 2011 and past dues over 30 days decreased to 2.16% of total loans as of March 31, 2011 from 2.47% at March 31, 2010. The Bank continues to work on these accounts, with its focus primarily on the commercial and commercial real estate portfolios. As charts below will show for 2011, a large portion of the provision was also to replace the reserve balance depleted from net charge-offs during the period. The longer the economy struggles, the more likely additional credits may encounter cash flow problems and the Bank remains diligent in providing funds to offset future losses.

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

Looking at the balance in impaired loans, it shows the Bank has finally had some movement of loans out of this classification, $6.26 million when looking at average investment of 2010 compared to first quarter 2011. The decrease was due mainly to the collection of principal from the sale of collateral from one borrower and the remainder from charge-off activity within this classification of loans.

The following table tracks the change in impaired loans and their valuation allowance along with nonaccrual balances as of year end 2010 and the quarter ending March 31, 2011 and December 31, 2010.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Provision Expense (Continued)

	(In Thousands)	
	Quarter ended March 31, 2011	Year ended December 31, 2010
Impaired loans without a valuation allowance	$ 1,761	$ 2,849
Impaired loans with a valuation allowance	1,875	1,520
Total impaired loans	$ 3,636	$ 4,369
Valuation allowance related to impaired loans	$ 575	$ 632
Total non-accrual loans	$ 3,149	$ 5,844
Total loans past-due ninety days or more and still accruing	$ 31	$ 48
Average investment in impaired loans	$ 3,872	$ 10,136

The Bank did classify almost $3.3 million of its impaired loans as troubled debt restructured during the first quarter of 2011, down from $3.5 million at December 31, 2010.

In determining the allocation for impaired loans the Bank applies the observable market price of the collateral securing the asset, reduced by applying a discount for estimated costs of collateral liquidation. In some instances where the discounted market value is less than the loan amount, a specific impairment allocation is assigned, which may be 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 discloses how much of ALLL is attributed to each segment of the loan portfolio, as well as the percent that each particular segment of the loan portfolio represents to the entire loan portfolio in the aggregate. As was mentioned in previous discussion, the commercial and commercial real estate portfolios are having a major impact on the ALLL and the provision expense.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Provision Expense (Continued)

	(In Thousands)		
	Mar-11	Mar-10	Mar-09
Loans	$ 513,257	$ 556,348	$ 555,710
Daily average of outstanding loans	$ 513,208	$ 561,650	$ 558,968
Allowance for Loan Losses-Jan 1	$ 5,706	$ 6,008	$ 5,497
Loans Charged off:			
Commercial Real Estate	88		
Ag Real Estate			
Consumer Real Estate	94	36	163
Commercial and Industrial	471	49	
Agricultural	24	100	
Consumer & other loans	115	81	109
	792	266	272
Loan Recoveries:			
Commercial Real Estate	1		
Ag Real Estate			
Consumer Real Estate	18	2	1
Commercial and Industrial	5	2	3
Agricultural	3	1	
Consumer & other loans	39	34	44
	66	39	48
Net Charge Offs	726	227	224
Provision for loan loss	772	1,690	659
Acquisition provision for loan loss			
Allowance for Loan & Lease Losses Mar 31	$ 5,752	$ 7,471	$ 5,932
Allowance for Unfunded Loan Commitments & Letters of Credit Mar 31	152	221	203
Total Allowance for Credit Losses Mar 31	$ 5,904	$ 7,692	$ 6,135
Ratio of net charge-offs to average Loans outstanding	0.14%	0.04%	0.04%
Ratio of the Allowance for Loan Loss to Nonperforming Loans	182.70%	48.85%	38.36%

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

	March 2011 Amount (000 s)	% of Portfolio	March 2010 Amount (000 s)	% of Portfolio
Balance at End of Period Applicable To:				
Commercial Real Estate	$ 2,150	36.41	$ 2,638	38.11
Ag Real Estate	154	6.22	109	7.30
Consumer Real Estate	266	17.92	466	17.16
Commercial and Industrial	2,520	22.10	3,569	21.38
Agricultural	312	11.79	288	10.01
Consumer, Overdrafts and other loans	350	5.56	401	6.05
Unallocated				
Allowance for Loan & Lease Losses	5,752	100	7,471	100
Off Balance Sheet Commitments	152		221	
Total Allowance for Credit Losses	$ 5,904		$ 7,692	

The percentage of delinquent loans has trended downward since the beginning of 2010 from a high of 2.85% of total loans in January to a low of .76% as of the end of March 2011. These percentages do not include nonaccrual loans which are not past due. This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, and the writing down of uncollectable credits in a timely manner.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Non-interest Income

Non-interest income was lower for the three months ended March 31, 2011 as compared to same period in March 31, 2010. It is surprising; because it is the same comparison of the first quarter 2010 to the first quarter of 2009. First quarter 2009 performance was exceptional with the addition of revenue coming from the mortgage financing activity and sale of consumer real estate loans into the secondary market. First quarter 2011 performance was hurt by the loss on other assets owned of $648 thousand. Some what offsetting the impact of the loss of mortgage financing revenue was the gain on sale of securities which was $80 thousand higher than the three month period ended March 31, 2010. The increase in the checking and savings portfolios in terms of number of accounts in 2011 as compared to 2010 has been the main factor behind the additional collection of fees. Overall, non-interest income decreased and ended $476 thousand lower for the first three months of operations in 2011 as compared to 2010.

The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights which is reported as an other asset on the balance sheet. The capitalization runs through non-interest income while the amortization thereof is included in non-interest expense. A slight impairment in the valuation of the ten year segment occurred in 2011.

(In Thousands)	2011	2010
Beginning Balance, January 1	$ 2,178	$ 2,177
Capitalized Additions	66	82
Amortizations	(91)	(103)
Valuation Allowance	(2)	0
Ending Balance, March 31	$ 2,151	$ 2,156

Of concern for the remainder of the year is the impact of recently amended Federal Reserve Regulation E on overdraft revenue and the cost of compliance. Regulation E continues to be modified and costs are being incurred to reduce revenue. At this point in time, the Bank is also concerned with changes to interchange fees and the possible loss of revenue.

As long as the opportunity exists for gains to be recognized from the sale of securities without impacting yield and extending the maturity duration too long, the Bank will continue to take advantage of it. This provides an opportunity for the Bank to offset the loss of noninterest income. The gain booked in 2010 was based on security sales of $55.7 million while 2011 s gain was based on security sales of $17.5 million. There were not any securities sold at a loss in either period.

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

	(In Thousands)	
	Three Months	Three Months Ended

	Ended March 31, 2011	March 31, 2010
Net Unrealized gain (loss) on available-for-sale securities	$ 1,226	$ (209)
Reclassification adjustment for gain (loss) on sale of available-for-sale securities	(339)	(259)
Net unrealized gains (loss)	887	(468)
Tax Effect	(302)	159
Other comprehensive income (expense)	$ 585	$ (309)

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Non-Interest Expense

Non-interest expense for the quarter ended March 31, 2011 was $369 thousand lower than for the same period of 2010. Salaries and wages were lower by $61 thousand during the quarter which was unexpected with the addition of the Hicksville office. The larger decrease was in other operating expenses, driven primarily by lower loan collection expenses of which $300 thousand was reimbursement of collection fees on one loan.

With respect to FDIC assessments, the expense is still high in 2011, though changes to the assessment calculation may decrease it the reminder of 2011. FDIC expense was approximately $61 thousand higher year to date than 2010.

Continuing on the positive side, a smaller decrease of $22 thousand in comparing March 31, 2011 to March 31, 2010 was derived from a change in service bureaus for the Bank s core operating system. This change occurred in late first quarter of 2010 so the Bank would expect this lower cost to stabilize throughout 2010. The improvement continued even with the addition of the new branch office in Hicksville, Ohio in July 2010.

Occupancy expense was higher by $39 thousand in the three months comparison of 2011 to 2010. The increase is partly attributed to the increase in the number of offices.

Net Income

Overall, net income was up $725 thousand for the three months ended March 31, 2011, compared to the same period of 2010. The improvement in asset quality that has occurred over the last half of 2010 and the first three months of 2011 enabled the Company to have almost $1 million less in provision expense in first quarter 2011 as compared to 2010. This coupled with the collection of nonaccrual interest income and reimbursement of collection costs offset the increased cost of ORE write-downs and losses. The gain on sale of investments obviously plays a role in the improvement and the Company is fortunate that the opportunity existed to capture income that has been used to offset the provision expense of the last two years. The improvement in net interest income for the quarter and also in the net noninterest position of the Company bodes well for continued improvement in profitability through 2011.

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

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

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

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

Interest Rate Shock on Net Interest Margin			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
2.93%	-6.15%	Rising	3.00%	25,197	-5.61%
3.01%	-3.70%	Rising	2.00%	25,753	-3.53%
3.07%	-1.70%	Rising	1.00%	26,236	-1.72%
3.12%	0.00%	Flat	0.00%	26,696	0.00%
3.08%	-1.33%	Falling	-1.00%	26,568	-0.48%
2.91%	-6.97%	Falling	-2.00%	25,460	-4.63%
2.72%	-12.91%	Falling	-3.00%	24,280	-9.05%

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

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

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

ITEM 4 CONTROLS AND PROCEDURES

As of March 31, 2011, an evaluation was performed under the supervision and with the participation of the Company s management including the CEO and CFO, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. Based on that evaluation, the Company s management, including the CEO and CFO, concluded that the Company s disclosure controls and procedures were effective as of March 31, 2011. There have been no significant changes in the Company s internal control over financial reporting that occurred during the quarter ended March 31, 2011.

PART II

ITEM 1 LEGAL PROCEEDINGS

None

ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2010.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

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
1/1/2011 to 1/31/2011				200,000
2/1/2011 to 2/28/2011				200,000
3/1/2011 to 3/31/2011	5,000	$ 18.65	5,000	195,000
Total	5,000	$ 18.65	5,000(1)	195,000

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

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 REMOVED AND RESERVED

ITEM 5 OTHER INFOROMATION

ITEM 6 EXHIBITS

3.1 Amended Articles of Incorporation of the Registrant (incorporated by reference to Registrant s Quarterly Report on Form 10-Q filed with the Commission on August 1, 2006)

3.2 Code of Regulations of the Registrant (incorporated by reference to Registrant s Quarterly Report on Form 10-Q filed with the Commission on May 10, 2004)

31.1 Rule 13-a-14(a) Certification -CEO

31.2 Rule 13-a-14(a) Certification -CFO

32.1	Section 1350 Certification	CEO
32.2	Section 1350 Certification	CFO

SIGNATURES

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

Farmers & Merchants Bancorp, Inc.,

Date: April 27, 2011

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

Date: April 27, 2011

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