

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
July 31, 2013  
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# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period June 30, 2013

or

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

Commission File Number 0-14492

# FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

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**OHIO**  
(State or other jurisdiction of  
incorporation or organization)

**34-1469491**  
(IRS Employer  
Identification No.)

**307 North Defiance Street, Archbold, Ohio**  
(Address of principal executive offices)

**(419) 446-2501**

**43502**  
(Zip Code)

Registrant's telephone number, including area code

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

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

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicated by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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

Common Stock, No Par Value  
Class

4,679,938  
Outstanding as of July 31, 2013

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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



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ITEM 1 FINANCIAL STATEMENTS  
FARMERS & MERCHANTS BANCORP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands of dollars)

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

Condensed Consolidated Balance Sheets

(in thousands of dollars)

	June 30, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 15,054	\$ 25,620
Interest bearing deposits with banks	6,463	11,941
Federal Funds Sold	946	6,531
<b>Total cash and cash equivalents</b>	<b>22,463</b>	<b>44,092</b>
Securities - available for sale (Note 2)	354,474	355,905
Other Securities, at cost	4,216	4,365
Loans, net (Note 4)	495,777	496,178
Bank premises and equipment	18,287	17,599
Goodwill	4,074	4,074
Mortgage Servicing Rights	2,047	2,063
Other Real Estate Owned	1,754	2,310
Accrued interest and other assets	19,241	20,074
<b>Total Assets</b>	<b>\$ 922,333</b>	<b>\$ 946,660</b>
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest-bearing	\$ 95,442	\$ 103,966
Interest-bearing		
NOW accounts	201,843	196,971
Savings	195,888	192,808
Time	254,439	269,507
<b>Total deposits</b>	<b>747,612</b>	<b>763,252</b>
Federal funds purchased and securities sold under agreement to repurchase	54,728	51,312
FHLB Advances	7,100	11,600
Dividend payable	930	931
Accrued expenses and other liabilities	4,673	9,326
<b>Total liabilities</b>	<b>\$ 815,043</b>	<b>\$ 836,421</b>
<b>Stockholders Equity</b>		
Common stock - No par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares	12,677	12,677
Treasury Stock - 515,902 shares 2013, 515,942 shares 2012	(10,677)	(10,588)

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Unearned Stock Awards - 30,210 shares 2013, 30,670 shares 2012	(572)	(584)
Retained earnings	105,434	102,641
Accumulated other comprehensive income	428	6,093
<b>Total stockholders' equity</b>	<b>107,290</b>	<b>110,239</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 922,333</b>	<b>\$ 946,660</b>

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2012 Balance Sheet has been derived from the audited financial statements of that date.

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FARMERS &amp; MERCHANTS BANCORP, INC.

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

(Unaudited)

(in thousands of dollars, except per share data)

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

## Condensed Consolidated Statement of Income &amp; Comprehensive Income

(in thousands of dollars, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
<b>Interest Income</b>				
Loans, including fees	\$ 6,089	\$ 6,804	\$ 12,167	\$ 13,601
Debt securities:				
U.S. Treasury securities	64	92	125	173
Securities of U.S. Government Agencies	1,016	1,055	2,008	2,080
Municipalities	541	518	1,049	1,028
Dividends	45	46	94	95
Federal funds sold	4	4	11	11
Other	6	6	13	13
Total interest income	7,765	8,525	15,467	17,001
<b>Interest Expense</b>				
Deposits	1,079	1,470	2,206	2,909
Federal funds purchased and securities sold under agreements to repurchase	62	60	122	121
Borrowed funds	43	123	89	247
Total interest expense	1,184	1,653	2,417	3,277
<b>Net Interest Income</b> - Before provision for loan losses	6,581	6,872	13,050	13,724
<b>Provision for Loan Losses</b> (Note 4)	112	78	279	206
<b>Net Interest Income After Provision For Loan Losses</b>	6,469	6,794	12,771	13,518
<b>Noninterest Income</b>				
Customer service fees	1,256	1,245	2,617	2,569
Other service charges and fees	967	860	1,829	1,618
Net gain (loss) on sale of other assets owned	(110)	(210)	(126)	(277)
Net gain on sale of loans	322	622	802	783
Net gain on sale of securities	377		598	169
Total noninterest income	2,812	2,517	5,720	4,862
<b>Noninterest Expenses</b>				
Salaries and Wages	2,260	2,193	4,697	4,479
Pension and other employee benefits	610	744	1,454	1,572
Occupancy expense (net)	288	386	618	791
Furniture and equipment	358	349	707	701
Data processing	300	286	610	551
Franchise taxes	255	236	510	473
FDIC Assessment	141	89	260	219
Mortgage servicing rights amortization	120	178	257	372
Other general and administrative	1,438	1,292	2,783	2,450

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Total Noninterest Expense	5,770	5,753	11,896	11,608
<b>Income Before Federal Income Taxes</b>	<b>3,511</b>	<b>3,558</b>	<b>6,595</b>	<b>6,772</b>
<b>Federal Income Taxes</b>	<b>1,009</b>	<b>1,020</b>	<b>1,941</b>	<b>1,950</b>
<b>Net Income</b>	<b>\$ 2,502</b>	<b>\$ 2,538</b>	<b>\$ 4,654</b>	<b>\$ 4,822</b>
<b>Other Comprehensive Income (Net of Tax):</b>				
Unrealized gains (loss) on securities	\$ (4,916)	\$ 1,159	\$ (5,666)	\$ 6,764
<b>Comprehensive Income</b>	<b>\$ (2,414)</b>	<b>\$ 3,697</b>	<b>\$ (1,012)</b>	<b>\$ 11,586</b>
<b>Net Income Per Share</b>	<b>\$ 0.53</b>	<b>\$ 0.54</b>	<b>\$ 0.99</b>	<b>\$ 1.02</b>
<b>Weighted Average Shares Outstanding</b>	<b>4,679,971</b>	<b>4,695,151</b>	<b>4,681,805</b>	<b>4,704,674</b>
<b>Dividends Declared</b>	<b>\$ 0.20</b>	<b>\$ 0.19</b>	<b>\$ 0.40</b>	<b>\$ 0.38</b>

See Notes to Condensed Consolidated Unaudited Financial Statements



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FARMERS &amp; MERCHANTS BANCORP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands of dollars)

**Farmers & Merchants Bancorp, Inc. and Subsidiary****Condensed Consolidated Statements of Cash Flows****Six Months Ended**

	Six Months Ended	
	June 30, 2013	June 30, 2012
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 4,654	\$ 4,822
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	609	577
Accretion and amortization of securities	1,220	1,587
Amortization of servicing rights	257	372
Amortization of core deposit intangible	156	156
Stock Based Compensation	93	86
Provision for loan loss	279	206
Gain on sale of loans held for sale	(802)	(783)
Originations of loans held for sale	(43,331)	(69,946)
Proceeds from sale of loans held for sale	46,881	71,746
Loss on sale of other assets	126	277
Gain on sales of investment securities	(598)	(169)
Change in operating assets and other liabilities, net	(194)	4,728
Net cash provided by operating activities	9,350	13,659
<b>Cash Flows from Investing Activities</b>		
Activity in securities:		
Maturities, prepayments and calls	17,305	16,428
Securities	58,413	24,584
Purchases	(83,310)	(71,740)
Proceeds from sales of assets	3	2
Additions to premises and equipment	(1,300)	(477)
Loan originations and principal collections, net	(3,428)	5,786
Net cash used in investing activities	(12,317)	(25,417)
<b>Cash Flows from Financing Activities</b>		
Net increase (decrease) in deposits	(15,640)	10,769
Net change in short-term debt	3,416	2,034
Repayments of long-term debt	(4,500)	(34)
Purchase of Treasury Stock	(77)	(683)
Cash dividends paid on common stock	(1,861)	(1,780)
Net cash provided by (used in) financing activities	(18,662)	10,306
Decrease in Cash and Cash Equivalents	(21,629)	(1,452)
Cash and Cash Equivalents - Beginning of Year	44,092	43,143
Cash and Cash Equivalents - End of Period	\$ 22,463	\$ 41,691

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RECONCILIATION OF CASH AND CASH EQUIVALENTS:

Cash and cash due from banks	\$ 15,054	\$ 15,579
Interest bearing deposits with banks	6,463	14,049
Federal funds sold	946	12,063

Cash at end of period	\$ 22,463	\$ 41,691
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**Supplemental Information**

Cash paid during the year for:

Interest	\$ 2,528	\$ 3,295
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Income taxes	\$ 1,770	\$ 2,266
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Noncash investing activities:

Transfer of loans to other real estate owned	\$ 175	\$ 182
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See Notes to Condensed Consolidated Unaudited Financial Statements

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### NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

#### NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2013 are not necessarily indicative of the results that are expected for the year ended December 31, 2013. 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, 2012.

#### 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 estimates.

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

##### Cash and Cash Equivalents

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

##### Securities

Fair values for securities, excluding Federal Home Loan Bank stock, are based on quoted market price, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

##### Other Securities

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

##### Loans

For those variable-rate loans that re-price frequently, and with no significant change in credit risk, fair values are based on carrying values. The fair values of the fixed rate and all other loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality.

##### Deposits - Interest Bearing, Non-interest Bearing and Time

The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed term money market accounts and certificates of deposit approximate their fair value at the reporting date. Fair value for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.



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

## Short-Term Borrowings

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

## FHLB Advances

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

## Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

## Dividends Payable

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

## Off Balance Sheet Financial Instruments

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

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of June 30, 2013 and December 31, 2012 are reflected below.

	Carrying Amount	Fair Value	(In Thousands)		
			Level 1	Level 2	Level 3
June 2013					
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 22,463	\$ 22,463	\$ 22,463	\$	\$
Securities - available for sale	354,474	354,474	25,479	316,571	12,424
Other Securities	4,216	4,216			4,216
Loans, net	495,777	504,731			504,731
Interest receivable	3,776	3,776			3,776
<b>Total Assets</b>	<b>\$ 880,706</b>	<b>\$ 889,660</b>	<b>\$ 47,942</b>	<b>\$ 316,571</b>	<b>\$ 525,147</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 397,731	\$ 399,483	\$	\$	\$ 399,483
Non-interest bearing Deposits	95,442	96,348		96,348	
Time Deposits	254,439	255,153			255,153
<b>Total Deposits</b>	<b>\$ 747,612</b>	<b>\$ 750,984</b>	<b>\$</b>	<b>\$ 96,348</b>	<b>\$ 654,636</b>
<b>Short-term debt</b>	<b>54,728</b>	<b>54,728</b>			<b>54,728</b>
Federal Home Loan Bank advances	7,100	8,489			8,489
Interest payable	270	270			270
Dividends payable	930	930		930	

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Total Liabilities	\$ 810,640	\$ 815,401	\$	\$ 97,278	\$ 718,123
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FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands) December 2012				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 44,092	\$ 44,092	\$ 44,092	\$	\$
Securities - available for sale	355,905	355,905	10,568	328,929	16,408
Other Securities	4,365	4,365			4,365
Loans, net	496,178	502,125			502,125
Interest receivable	3,603	3,603			3,603
<b>Total Assets</b>	<b>\$ 904,143</b>	<b>\$ 910,090</b>	<b>\$ 54,660</b>	<b>\$ 328,929</b>	<b>\$ 526,501</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 389,779	\$ 390,066	\$	\$	\$ 390,066
Non-interest bearing Deposits	103,966	104,529		104,529	
Time Deposits	269,507	272,591			272,591
<b>Total Deposits</b>	<b>\$ 763,252</b>	<b>\$ 767,186</b>	<b>\$</b>	<b>\$ 104,529</b>	<b>\$ 662,657</b>
Short-term debt	51,312	51,312			51,312
Federal Home Loan Bank advances	11,600	11,012			11,012
Interest payable	288	288			288
Dividends payable	931	931		931	
<b>Total Liabilities</b>	<b>\$ 827,383</b>	<b>\$ 830,729</b>	<b>\$</b>	<b>\$ 105,460</b>	<b>\$ 725,269</b>
<b>Fair Value Measurements</b>					

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

Available-for-sale securities- When quoted prices are available in an active market, securities are valued using the quoted price and are classified as Level 1. The quoted prices are not adjusted.

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

Available-for-sale securities classified as Level 2 are valued using the prices obtained from an independent pricing service. The prices are not adjusted. Securities of obligations of state and political subdivisions are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. Substantially all assumptions used by the independent pricing service are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the market place.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability. Local municipals have been purchased that the Bank evaluates based on the credit strength of the underlying project such as the hospital or retirement home. The fair value is determined by valuing similar credit payment streams at similar rates.

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





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

## Fair Value Measurement (Continued)

The following summarizes financial assets measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, segregated by level or the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured at Fair Value on a Recurring Basis				
(In Thousands)	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)	
June 30, 2013				
Assets-(Securities Available for Sale)				
U.S. Treasury	\$ 25,479	\$	\$	
U.S. Government agency		210,915		
Mortgage-backed securities		45,338		
State and local governments		60,318	12,424	
Total Securities Available for Sale	\$ 25,479	\$ 316,571	\$ 12,424	
(In Thousands)	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)	
December 31, 2012				
Assets-(Securities Available for Sale)				
U.S. Treasury	\$ 10,568	\$	\$	
U.S. Government agency		220,200		
Mortgage-backed securities		53,006		
State and local governments		55,723	16,408	
Total Securities Available for Sale	\$ 10,568	\$ 328,929	\$ 16,408	

Most of the Company's available for sale securities, including any bonds issued by local municipalities, have CUSIP numbers or have similar characteristics of those in the municipal markets, making them marketable and comparable as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At June 30, 2013 and December 31, 2012, such assets consist primarily of impaired loans. Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)

At June 30, 2013 and December 31, 2012, impaired loans categorized as Level 3 were \$4.5 and \$4.6 million, respectively. The specific allocation for impaired loans was \$771 and \$865 thousand as of June 30, 2013 and December 31, 2012, respectively, which are accounted for in the allowance for loan losses (see Note 4).

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

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

The following table presents impaired loans and other real estate owned as recorded at fair value on June 30, 2013 and December 31, 2012:

(\$ in Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2013				Change in fair value for Six-month period ended June 30, 2013
	Balance at June 30, 2013	Markets for Identical sets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Impaired loans	\$ 4,521	\$	\$	\$ 4,521	\$ (3)
Other real estate owned residential mortgages	\$ 609	\$	\$	\$ 609	\$ (16)
Other real estate owned commercial	\$ 1,145	\$	\$	\$ 1,145	\$ (64)
					\$ (83)

(\$ in Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2012				Change in fair value for twelve-month period ended Dec. 31, 2012
	Balance at December 31, 2012	Markets for Identical sets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Impaired loans	\$ 4,591	\$	\$	\$ 4,591	\$ (76)
Other real estate owned residential mortgages	\$ 783	\$	\$	\$ 783	\$ (62)
Other real estate owned commercial	\$ 1,526	\$	\$	\$ 1,526	\$ (214)
					\$ (352)

The Company also has other assets, which under certain conditions, are subject to measurement at fair value. These assets include loans held for sale, bank owned life insurance, and mortgage servicing rights. The Company estimated the fair values of these assets utilizing Level 3 inputs, including, the discounted present value of expected future cash flows. At June 30, 2013 and December 31, 2012, the Company estimates that there is no impairment of these assets, with the exception of mortgage servicing rights. Mortgage servicing rights recognized impairment in one stratum with a charge of \$16 thousand in 2012 to expense. The impairment however was eliminated, as of June 30, 2013. Therefore, no impairment charge to other expense was required to adjust these assets to their estimated fair values.

## NOTE 3 ASSET PURCHASES

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

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

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The amortization expense for the year ended December 31, 2012 was \$312 thousand. Of the \$312 thousand to be expensed in 2013, \$156 thousand has been expensed as of June 30, 2013.

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

## NOTE 3 ASSET PURCHASES (Continued)

	(In Thousands)		
	Knisley	Hicksville	Total
2013	\$ 157	\$ 155	\$ 312
2014	157	155	312
2015		155	155
2016		155	155
2017		79	79
Thereafter			
	\$ 314	\$ 699	\$ 1,013

## NOTE 4 LOANS

The Company had \$565.7 thousand in loans held for sale as of June 30, 2013 as compared to \$2.5 million in loans held for sale on December 31, 2012. Due to lack of materiality, these loans are included in the Consumer Real Estate loans below.

Loan balances as of June 30, 2013 and December 31, 2012:

	(In Thousands)	
Loans:	June 30, 2013	December 31, 2012
Commercial real estate	\$ 215,246	\$ 199,999
Agricultural real estate	35,746	40,143
Consumer real estate	77,948	80,287
Commercial and industrial	93,978	101,624
Agricultural	55,331	57,770
Consumer	19,881	20,413
Industrial Development Bonds	3,102	1,299
	501,232	501,535
Less: Net deferred loan fees and costs	(158)	(133)
	501,074	501,402
Less: Allowance for loan losses	(5,297)	(5,224)
Loans - Net	\$ 495,777	\$ 496,178

The following is a maturity schedule by major category of loans as of June 30, 2013:

	Maturities (In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years

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Commercial Real Estate	\$ 36,770	\$ 103,283	\$ 75,193
Agricultural Real Estate	2,609	9,126	24,011
Consumer Real Estate	11,501	13,082	53,365
Commercial/Industrial	61,597	27,005	5,376
Agricultural	32,792	19,349	3,190
Consumer	5,210	12,573	1,940
Industrial Development Bonds	2,220	490	392

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of June 30, 2013. Variable rate loans whose current rates are equal to their floor or ceiling are classified as fixed in this table.

	(In Thousands)	
	Fixed Rate	Variable Rate
Commercial Real Estate	\$ 127,488	\$ 87,758
Agricultural Real Estate	\$ 25,836	\$ 9,910
Consumer Real Estate	\$ 64,041	\$ 13,907
Commercial/Industrial	\$ 73,134	\$ 20,844
Agricultural	\$ 50,697	\$ 4,634
Consumer	\$ 16,415	\$ 3,308
Industrial Development Bonds	\$ 3,102	\$

As of June 30, 2013 and December 31, 2012 one to four family residential mortgage loans amounting to \$26.8 and \$26.8 million, respectively, have been pledged as security for loans the Bank has received from the Federal Home Loan Bank.

The percentage of delinquent loans has trended downward since the beginning of January 2010 from a high of 2.85% of total loans to a low of .64% as of March 31, 2012. As of June 30, 2013, past dues were 1.07%. These percentages do not include nonaccrual loans which are not past due (nonaccruals are not considered past due if current). 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.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment in past due loans by portfolio segment of loans as of June 30, 2013 and December 31, 2012, net of deferred fees:

June 30, 2013	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Residential	\$ 453	\$ 249	\$ 319	\$ 1,021	\$ 76,927	\$ 77,948	\$
Ag Real Estate	104		88	192	35,554	35,746	
Ag					55,331	55,331	
Commercial Real Estate	501		1,035	1,536	213,710	215,246	
Commercial and Industrial	65		2,552	2,617	94,463	97,080	
Consumer	13	7		20	19,703	19,723	
<b>Total</b>	<b>\$ 1,136</b>	<b>\$ 256</b>	<b>\$ 3,994</b>	<b>\$ 5,386</b>	<b>\$ 495,688</b>	<b>\$ 501,074</b>	<b>\$</b>

December 31, 2012	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Residential	\$ 575	\$	\$ 648	\$ 1,223	\$ 79,064	\$ 80,287	\$
Ag Real Estate					40,143	40,143	
Ag	11			11	57,759	57,770	
Commercial Real Estate			877	877	199,122	199,999	
Commercial and Industrial	78		2,567	2,645	100,278	102,923	
Consumer	65	7		72	20,208	20,280	1
<b>Total</b>	<b>\$ 729</b>	<b>\$ 7</b>	<b>\$ 4,092</b>	<b>\$ 4,828</b>	<b>\$ 496,574</b>	<b>\$ 501,402</b>	<b>\$ 1</b>



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table presents the recorded investment in nonaccrual loans by class of loans as of June 30, 2013 and December 31, 2012:

	(In Thousands)	
	June 30 2013	December 31 2012
Consumer Real Estate	\$ 551	\$ 964
Agricultural Real Estate	88	
Agriculture		
Commercial Real Estate	1,035	877
Commercial and Industrial	2,935	2,987
Consumer		
<b>Total</b>	<b>\$ 4,609</b>	<b>\$ 4,828</b>

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

The risk ratings are described as follows.

1. Zero (0) Unclassified. Any loan which has not been assigned a classification.
2. One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of Risk Management Association ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank's loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.
3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50, and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.
4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans that are meeting the terms of repayment.

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

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

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- a. At inception, the loan was secured with collateral possessing a loan value adequate to protect the Bank from loss;
  - b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;
  - c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.
5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.

6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential, versus defined, impairments to the primary source of loan repayment and collateral.
7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
  - a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
  - b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.
  - c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
  - d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
  - e. Unusual courses of action are needed to maintain a high probability of repayment.
  - f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.
  - g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.
  - h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.
  - i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.
  - j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:
- a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.
  - b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.
  - c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.
9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by class based on the most recent analysis performed as of June 30, 2013 and December 31, 2012:

(in Thousands)	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>June 30, 2013</b>					
1-2	\$ 3,258	\$ 5,014	\$ 2,573	\$ 605	\$
3	12,953	21,695	53,936	23,894	2,758
4	18,625	28,588	147,286	63,047	344
5	786	34	5,283	2,245	
6	36		6,168	1,517	
7	88			2,670	
8					
<b>Total</b>	<b>\$ 35,746</b>	<b>\$ 55,331</b>	<b>\$ 215,246</b>	<b>\$ 93,978</b>	<b>\$ 3,102</b>

	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>December 31, 2012</b>					
1-2	\$ 2,719	\$ 5,022	\$ 4,046	\$ 750	\$ 97
3	15,111	23,525	42,467	21,750	859
4	21,481	29,188	137,537	71,228	343
5	794	35	8,984	3,385	
6	38		6,295	2,202	
7			670	2,309	
8					
<b>Total</b>	<b>\$ 40,143</b>	<b>\$ 57,770</b>	<b>\$ 199,999</b>	<b>\$ 101,624</b>	<b>\$ 1,299</b>

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of June 30, 2013 and December 31, 2012.

	(In Thousands)	
	Consumer Real Estate	Consumer Real Estate
	June 30 2013	December 31 2012
Grade		
Pass	\$ 77,531	\$ 79,766
Special Mention (5)		
Substandard (6)	393	110
Doubtful (7)	24	411
Total	\$ 77,948	\$ 80,287

	(In Thousands)			
	Consumer - Credit		Consumer - Other	
	June 30 2013	December 31 2012	June 30 2013	December 31 2012
Performing	\$ 3,498	\$ 3,470	\$ 16,225	\$ 16,775
Nonperforming		3		32
Total	\$ 3,498	\$ 3,473	\$ 16,225	\$ 16,807

Information about impaired loans as of June 30, 2013, December 31, 2012 and June 30, 2012 are as follows:

	(In Thousands)		
	June 30, 2013	December 31, 2012	June 30, 2012
Impaired loans without a valuation allowance	\$ 1,703	\$ 730	\$ 806
Impaired loans with a valuation allowance	2,818	3,861	3,548
Total impaired loans	\$ 4,521	\$ 4,591	\$ 4,354
Valuation allowance related to impaired loans	\$ 771	\$ 865	\$ 557
Total non-accrual loans	\$ 4,609	\$ 4,828	\$ 4,893
Total loans past-due ninety days or more and still accruing	\$	\$ 1	\$
Three months ended average investment in impaired loans	\$ 4,363	\$ 4,468	\$ 2,772

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Six months ended average investment in impaired loans	\$	4,342	\$	4,508	\$	2,363
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No additional funds are committed to be advanced in connection with impaired loans.

The Bank had approximately \$2.9 million of its impaired loans classified as troubled debt restructured as of June 30, 2013, \$627.3 thousand as of December 31, 2012 and \$207 thousand as of June 30, 2012.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

Three Months	Number of			Six Months	Number of		
June 30, 2013	Contracts	Modification	Modification	June 30, 2013	Contracts	Modification	Modification
	Modified in the	Outstanding	Outstanding		Modified in the	Outstanding	Outstanding
	Last 3	Recorded	Recorded		Last 3	Recorded	Recorded
Troubled Debt Restructurings	Months	Investment	Investment	Troubled Debt Restructurings	Months	Investment	Investment
Commercial Real Estate		\$	\$	Commercial Real Estate		\$	\$
Ag Real Estate		\$	\$	Ag Real Estate		\$	\$
Commercial and Industrial	3	\$ 2,251	\$ 2,251	Commercial and Industrial	4	\$ 2,294	\$ 2,332

Troubled Debt Restructurings	Number of		Troubled Debt Restructurings	Number of	
That Subsequently Defaulted	Contracts	Recorded	That Subsequently Defaulted	Contracts	Recorded
	Modified in the	Investment		Modified in the	Investment
	Last 3 Months			Last 3 Months	
Commercial Real Estate		\$	Commercial Real Estate		\$
Ag Real Estate		\$	Ag Real Estate		\$
Commercial and Industrial		\$	Commercial and Industrial		\$

The following table represents three months and six months ended June 30, 2012.

Three Months	Number of			Six Months	Number of		
June 30, 2012	Contracts	Pre-	Post-	June 30, 2012	Contracts	Pre-	Post-
	Modified in the	Modification	Modification		Modified in the	Modification	Modification
	Last 6	Outstanding	Outstanding		Last 6	Outstanding	Outstanding
Troubled Debt Restructurings	Months	Recorded	Recorded	Troubled Debt Restructurings	Months	Recorded	Recorded
		Investment	Investment			Investment	Investment
Commercial Real Estate	1	\$ 1,937	\$ 1,937	Commercial Real Estate	1	\$ 1,937	\$ 1,937
Ag Real Estate		\$	\$	Ag Real Estate		\$	\$
Commercial and Industrial		\$	\$	Commercial and Industrial		\$	\$

Troubled Debt Restructurings	Number of		Troubled Debt Restructurings	Number of	
That Subsequently Defaulted	Contracts	Recorded	That Subsequently Defaulted	Contracts	Recorded
	Modified in the	Investment		Modified in the	Investment
	Last 6 Months			Last 6 Months	
Commercial Real Estate		\$	Commercial Real Estate		\$
Ag Real Estate		\$	Ag Real Estate		\$
Commercial and Industrial		\$	Commercial and Industrial		\$



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

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

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

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



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

Three Months Ended June 30, 2012

(in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance recorded:</b>					
Consumer real estate	\$ 340	\$ 355	\$	\$ 213	\$
<b>Agriculture real estate</b>					
<b>Agriculture</b>					
Commercial real estate	207	384		207	
Commercial and industrial	364	364		122	
Consumer		10			
<b>With a specific allowance recorded:</b>					
Consumer real estate	398	425	139	400	
<b>Agriculture real estate</b>					
<b>Agriculture</b>					
Commercial real estate	600	847		664	
Commercial and industrial	2,441	2,441	417	1,162	1
Consumer	4	4	1	4	
<b>Totals:</b>					
Consumer real estate	\$ 738	\$ 780	\$ 139	\$ 613	\$
<b>Agriculture real estate</b>					
Agriculture	\$	\$	\$	\$	\$
Commercial real estate	\$ 807	\$ 1,231	\$	\$ 871	\$
Commercial and industrial	\$ 2,805	\$ 2,805	\$ 417	\$ 1,284	\$ 1
Consumer	\$ 4	\$ 14	\$ 1	\$ 4	\$

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

Six Months Ended June 30, 2013 (in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance recorded:</b>					
Consumer Real Estate	\$ 359	\$ 431	\$	\$ 131	\$
Agriculture Real Estate					
Agriculture					
Commercial Real Estate	1,035	1,459		622	
Commercial and Industrial	309	309		297	
Consumer		3			
<b>With a specific allowance recorded:</b>					
Consumer Real Estate	111	111	38	121	
Agriculture Real Estate	88	88	15	55	
Agriculture					
Commercial Real Estate				332	
Commercial and Industrial	2,619	2,619	718	2,701	
Consumer					
<b>Totals:</b>					
Consumer Real Estate	\$ 470	\$ 542	\$ 38	\$ 252	\$
Agriculture Real Estate	\$ 88	\$ 88	\$ 15	\$ 55	\$
Agriculture	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 1,035	\$ 1,459	\$	\$ 954	\$
Commercial and Industrial	\$ 2,928	\$ 2,928	\$ 718	\$ 2,998	\$
Consumer	\$	\$ 3	\$	\$	\$

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

## NOTE 4 LOANS (Continued)

Six Months Ended June 30, 2012 (in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance recorded:</b>					
Consumer Real Estate	\$ 340	\$ 355	\$	\$ 185	\$
<b>Agriculture Real Estate</b>					
<b>Agriculture</b>					
Commercial Real Estate	207	384		207	
Commercial and Industrial	364	364		61	
Consumer		10			
<b>With a specific allowance recorded:</b>					
Consumer Real Estate	398	425	139	395	5
<b>Agriculture Real Estate</b>					
<b>Agriculture</b>					
Commercial Real Estate	600	847		683	
Commercial and Industrial	2,441	2,441	417	827	2
Consumer	4	4	1	4	
<b>Totals:</b>					
Consumer Real Estate	\$ 738	\$ 780	\$ 139	\$ 580	\$ 5
<b>Agriculture Real Estate</b>					
<b>Agriculture</b>					
Commercial Real Estate	\$ 807	\$ 1,231	\$	\$ 890	\$
Commercial and Industrial	\$ 2,805	\$ 2,805	\$ 417	\$ 888	\$ 2
Consumer	\$ 4	\$ 14	\$ 1	\$ 4	\$

The ALLL has a direct impact on the provision expense. An increase in the ALLL is funded through recoveries and provision expense. The following tables summarize the activities in the allowance for credit losses.

	(In Thousands)	
	Six Months Ended June 30, 2013	Twelve Months Ended December 31, 2012
<b>Allowance for Loan Losses</b>		
Balance at beginning of year	\$ 5,224	\$ 5,091
Provision for loan loss	279	738
Loans charged off	(362)	(891)
Recoveries	156	286
Allowance for Loan & Leases Losses	\$ 5,297	\$ 5,224
<b>Allowance for Unfunded Loan Commitments &amp; Letters of Credit</b>		
	\$ 187	\$ 162

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Total Allowance for Credit Losses	\$ 5,484	\$	5,386
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The Company segregates its Allowance for Loan and Lease Losses (ALLL) into two reserves: The ALLL and the Allowance for Unfunded Loan Commitments and Letters of Credit (AULC). When combined, these reserves constitute the total Allowance for Credit Losses (ACL).

The AULC is reported within other liabilities on the balance sheet while the ALLL is netted within the loans, net asset line. The ACL presented above represents the full amount of reserves available to absorb possible credit losses.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table breaks down the activity within ACL for each loan portfolio segment and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs.

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

(in thousands)	Consumer Real Estate	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit allocated	Total	
<b>Three Months Ended June 30, 2013</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 463	\$ 105	\$ 260	\$ 1,566	\$ 1,972	\$ 256	\$ 172	\$ 722	\$ 5,516
Charge Offs	(89)			(44)		(112)			\$ (245)
Recoveries	4		3		41	38			\$ 86
Provision	(17)	10	14	(62)	125	84		(42)	\$ 112
Other Non-interest expense related to unfunded							15		\$ 15
Ending Balance	\$ 361	\$ 115	\$ 277	\$ 1,460	\$ 2,138	\$ 266	\$ 187	\$ 680	\$ 5,484
Ending balance: individually evaluated for impairment	\$ 38	\$ 15	\$	\$	\$ 718	\$	\$	\$	\$ 771
Ending balance: collectively evaluated for impairment	\$ 323	\$ 100	\$ 277	\$ 1,460	\$ 1,420	\$ 266	\$ 187	\$ 680	\$ 4,713
Ending balance: loans acquired with deteriorated credit quality	\$ 2	\$	\$	\$	\$	\$	\$	\$	\$ 2
<b>FINANCING RECEIVABLES:</b>									
Ending balance	\$ 77,948	\$ 35,746	\$ 55,331	\$ 215,246	\$ 97,080	\$ 19,723	\$	\$	\$ 501,074
Ending balance: individually evaluated for impairment	\$ 470	\$ 88	\$	\$ 1,035	\$ 2,928	\$	\$	\$	\$ 4,521
Ending balance: collectively evaluated for impairment	\$ 77,478	\$ 35,658	\$ 55,331	\$ 214,211	\$ 94,152	\$ 19,723	\$	\$	\$ 496,553
Ending balance: loans acquired with deteriorated credit quality	\$ 549	\$	\$	\$	\$	\$	\$	\$	\$ 549

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

	Consumer Real Estate	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
(in thousands)									
<b>Three Months Ended June 30, 2012</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 433	\$ 90	\$ 272	\$ 1,569	\$ 1,859	\$ 293	\$ 140	\$ 636	\$ 5,292
Charge Offs	(53)			(97)		(121)			(271)
Recoveries	25		3	1	4	45			78
Provision	55	2		249	(7)	66		(288)	77
Other Non-interest expense related to unfunded							1		1
Ending Balance	\$ 460	\$ 92	\$ 275	\$ 1,722	\$ 1,856	\$ 283	\$ 141	\$ 348	\$ 5,177
Ending balance: individually evaluated for impairment	\$ 139	\$	\$	\$	\$ 417	\$ 1	\$	\$	\$ 557
Ending balance: collectively evaluated for impairment	\$ 321	\$ 92	\$ 275	\$ 1,722	\$ 1,439	\$ 282	\$ 141	\$ 348	\$ 4,620
Ending balance: loans acquired with deteriorated credit quality	\$ 1	\$	\$	\$	\$	\$	\$	\$	\$ 1
<b>FINANCING RECEIVABLES:</b>									
Ending balance	\$ 81,252	\$ 32,408	\$ 54,808	\$ 202,900	\$ 105,423	\$ 21,577	\$	\$	\$ 498,368
Ending balance: individually evaluated for impairment	\$ 738	\$	\$	\$ 807	\$ 2,805	\$ 4	\$	\$	\$ 4,354
Ending balance: collectively evaluated for impairment	\$ 80,514	\$ 32,408	\$ 54,808	\$ 202,093	\$ 102,618	\$ 21,573	\$	\$	\$ 494,014
Ending balance: loans acquired with deteriorated credit quality	\$ 547	\$	\$	\$	\$	\$	\$	\$	\$ 547



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

	Consumer Real Estate	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Unfunded Loan Commitment & Consumer Letters of Credit inallocated			Total
(in thousands)									
<b>Six Months Ended June 30, 2013</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 368	\$ 113	\$ 290	\$ 1,749	\$ 2,183	\$ 268	\$ 162	\$ 253	\$ 5,386
Charge Offs	(100)			(64)		(198)			\$ (362)
Recoveries	9		4		56	87			\$ 156
Provision	84	2	(17)	(225)	(101)	109		427	\$ 279
Other Non-interest expense related to unfunded							25		\$ 25
Ending Balance	\$ 361	\$ 115	\$ 277	\$ 1,460	\$ 2,138	\$ 266	\$ 187	\$ 680	\$ 5,484
Ending balance: individually evaluated for impairment	\$ 38	\$ 15	\$	\$	\$ 718	\$	\$	\$	\$ 771
Ending balance: collectively evaluated for impairment	\$ 323	\$ 100	\$ 277	\$ 1,460	\$ 1,420	\$ 266	\$ 187	\$ 680	\$ 4,713
Ending balance: loans acquired with deteriorated credit quality	\$ 2	\$	\$	\$	\$	\$	\$	\$	\$ 2
<b>FINANCING RECEIVABLES:</b>									
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Ending balance: individually evaluated for impairment	\$ 470	\$ 88	\$	\$ 1,035	\$ 2,928	\$	\$	\$	\$ 4,521
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Ending balance: loans acquired with deteriorated credit quality	\$ 549	\$	\$	\$	\$	\$	\$	\$	\$ 549

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

	Consumer Real Estate	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Unfunded Loan Commitment & Letters of Credit allocated	Consumer	Total	
(in thousands)									
<b>Six Months Ended June 30, 2012</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 261	\$ 140	\$ 266	\$ 2,088	\$ 1,947	\$ 315	\$ 130	\$ 74	\$ 5,221
Charge Offs	93			(97)		(208)			(398)
Recoveries	30		10	2	19	76			137
Provision	262	(48)	(1)	(271)	(110)	100		274	206
Other Non-interest expense related to unfunded							11		11
Ending Balance	\$ 460	\$ 92	\$ 275	\$ 1,722	\$ 1,856	\$ 283	\$ 141	\$ 348	\$ 5,177
Ending balance: individually evaluated for impairment	\$ 139	\$	\$	\$	\$ 417	\$ 1	\$	\$	\$ 557
Ending balance: collectively evaluated for impairment	\$ 321	\$ 92	\$ 275	\$ 1,722	\$ 1,439	\$ 282	\$ 141	\$ 348	\$ 4,620
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Ending balance: loans acquired with deteriorated credit quality	\$ 547	\$	\$	\$	\$	\$	\$	\$	\$ 547

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

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

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

For a discussion of the general development of the Company's business throughout 2013, please see the portion of Management's Discussion and Analysis of Financial Condition and Results of Operations captioned "2013 in Review".

#### NATURE OF ACTIVITIES

The Bank's primary service area, Northwest Ohio and Northeast Indiana, continue to experience a higher level of unemployment as compared to the national average. All averages both local and national however, show a slight downward trend. The agricultural industry continued its strong performance in 2013 as evidenced by strengthened financial statements. Wet, stormy weather has delayed the wheat harvest and yields appear to be running slightly lower than previous years. Automotive showed improvement with car dealers in our marketing area ending with more profitable numbers than in recent years. Overall, business profits are improving however borrowing activity remains sluggish, and the loan balances remain below yearend 2012. New 1-4 family residential and construction remain weak and refinancing activity is also below the level of first half 2012.

The Bank opened its 20<sup>th</sup> office during the second quarter. The office is located in Waterville, Ohio and was a natural extension of the Bank's market area. The office provides the full range of services discussed below.

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 operating 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 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). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and ACH file transmittal. In addition the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Mobile banking was added in 2012 and has been widely accepted and used by consumers.

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 mortgage loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank's adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer Mac and Small Business Lending programs. The Bank 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. In addition, the Bank does sell some of its longer term fixed rate agricultural mortgages into the secondary market with the aid of a broker.

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

The Bank does not have a program to fund sub-prime loans. Sub-prime loans are characterized as a lending program or strategy that 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 farmer's ability to hedge their position by the use of the future contracts. The risk related to weather is often mitigated by requiring federal crop insurance.

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

**Industrial Development Bonds** Funds for public improvements in the Bank's service area. Repayment ability is usually 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 in the event of wage loss resulting from disability 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.

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

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

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

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

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

The Bank's primary market includes 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 is highly competitive with approximately 17 other depository institutions currently doing business in the Bank's primary market. In our banking activities, we compete directly with other commercial banks, credit unions and farm credit services and savings and loan institutions in each of their operating localities. In a number of locations, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of service provided. On December 31, 2007, the Bank acquired the Knisely Bank of Indiana, expanding

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its market with the addition of offices in Butler and Auburn, Indiana, both located in DeKalb County. An additional office was opened in the summer of 2008 in Angola, Indiana, located in Steuben County. On July 9, 2010 the Bank purchased a branch office in Hicksville, Ohio shortening the distance between our Ohio and Indiana offices. During 2012, the Bank purchased land in Waterville, Lucas County, Ohio, and began construction of an office. The office was opened in second quarter 2013 providing growth opportunity and extension of the market area.

At June 30, 2013, we had 251 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be excellent.

2013 IN REVIEW

Non-interest income bolstered the second quarter and first half results of 2013 while net interest income decreased as compared to second quarter 2012 and first half. During the 1<sup>st</sup> quarter, the largest improvement in the non-interest

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

income arena was the net gain on sale of loans; sales of 1-4 family and agricultural real estate were an extension of 2012's heightened activity level. Due to the continued low rate environment, the Company's customers were able to refinance their loans and lower their payments and/or reduce the term of the loan. During the second quarter, gain on sale of securities bolstered the noninterest income and was the largest improvement in the quarter.

The trend of declining net interest income continued through the second quarter 2013 as evidenced by the lower net interest income on the income statement. Lack of significant loan growth was a contributing factor along with loss on yield from investments due to maturities and calls and lower reinvestment rate opportunities.

Total allowance provision for loan losses remained constant and was just slightly higher than 2012. Due to lack of loan growth and a low net charge-off position, the allowance for loan loss did not require a large influx of funds to provide more than an adequate level of protection. Impaired loans decreased from December 31, 2012 levels. They increased by just \$166 thousand over June 30, 2012 levels. The same comparison changed slightly for nonaccrual loans, showing an improvement in lower balances than December 31, 2012 as compared to same time period last year. One commercial loan was added to nonaccrual and impaired status during the second half 2012 is behind the increase in comparing second quarter balances. Overall, the Company continues to work on the collection of these loans and looks forward to continuing to decrease the exposure during 2013.

All rates remain low and are expected to remain low throughout 2013. This has enabled the Company to continue to sell investment securities and recognize a gain without compromising the yield. The transactions have modestly extended the duration of the investment portfolio. For all of 2012, the recognized gain was \$852 thousand, of which \$169 thousand was recognized in the second quarter. For second quarter 2013, the Company has recognized gains of \$377 thousand bringing the total for 2013 to \$598 thousand. Most of the securities sold were agencies maturing in a shorter time period than the securities that were purchased to replace them. The Bank was able to continue to capitalize on the steepness of the yield curve and the unrealized market gain position the last three years. The market value of the security portfolio has declined as evidenced by the high negative comprehensive income reported on the income statement. Additional opportunity to sell investment securities for a gain is limited for the remainder of 2013.

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, while is improving, still remains at lower levels, consumer sensitive industries and the retail sector may continue to experience pressures as well. Drought conditions existed in the majority of the market area we service during 2012 and 2013 has brought increased moisture and storms. Crop insurance and two previous years of strong yields lessened any negative impact on our agricultural portfolio. Though yields in 2012 were down, prices were higher than a year earlier which helped lessen the financial impact. Though water levels have not yet returned to pre-drought levels, the outlook remains optimistic for 2013 agricultural activity.

Overall, profitability in the second quarter of 2013 was bolstered from the improvement in noninterest income. Noninterest income was up 17.7% over first half 2012. The Company has done an exceptional job of recognizing opportunities to provide services and products that the low rate environment made possible. These opportunities are further discussed in the Material Changes in Results of Operations. The Company remains strong, stable, and well capitalized and has the capacity to continue to cover the increased costs of doing business in a tough economy while seeking good loans to improve profitability. The Company continues to look for new opportunities to generate and protect revenue and provide additional channels through which to serve our customers and maintain our high level of customer satisfaction.

The Bank has been attentive to the significant final mortgage rules and additional guidance issued by the Consumer Financial Protection Bureau to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions. Effective in January 2014, these rules are a game-changer which impacts the entire mortgage lending industry, as well as the Bank's perspective on its mortgage lending business. The Bank continues to work toward fulfillment of applicable requirements for these new mortgage rules, as it gains further understanding of the complexities and inter-related nature of these rules, makes strategic decisions, and addresses key considerations necessary for implementation of each rule.



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

CRITICAL ACCOUNTING POLICY AND ESTIMATES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the financial services industry in which it operates. At times the application of these principles requires management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements and accompanying notes.

These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.

These policies, along with the disclosures presented in the notes to the consolidated financial statements and in the management discussion and analysis of the financial condition and results of operations, provide information on how significant assets and liabilities are valued and how those values are determined for the financial statements. Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL) and the valuation of its Mortgage Servicing Rights and Other Real Estate Owned (OREO) as the accounting areas that require the most subjective or complex judgments, and as such could be the most subject to revision as new information becomes available.

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

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 collection and ultimate recovery of the book value of the collateral, in most cases, is beyond our control.

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

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

The Company's mortgage servicing rights relating to loans serviced for others represent an asset of the company. This asset is initially capitalized and included in other assets on the Company's consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Company, including the estimated prepayment speed of the loan and the discount rate used to present value the servicing right. For example, if the mortgage loan is prepaid, the Company will receive fewer servicing fees, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Company's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Company of the mortgage servicing rights, the Company receives a valuation of its mortgage servicing rights from an independent third party. The independent third party's valuation of the mortgage servicing rights is based on relevant characteristics of the Company's loan servicing



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CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)**

portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as current national market interest rate levels, market forecasts and other economic conditions. Management, with the advice from its third party valuation firm reviewed the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter's analysis related to the mortgage servicing asset. In addition, based upon the independent third party's valuation of the Company's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Company. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Company's net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on market conditions. The accuracy of these estimates and assumptions by management and its third party valuation specialist can be directly tied back to the fact that management has only been required to record a minor valuation allowance through its income statement based upon the valuation of each stratum of servicing rights. For more information regarding the estimates and calculations used to establish the ALLL and the value of Mortgage Servicing Rights, please see Note 1 to the consolidated financial statements provided herewith.

Foreclosed real estate for sale is carried at the lower of fair value minus estimated costs to sell, or cost. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and a write-down is recorded by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell. Foreclosed real estate is classified as other real estate owned. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At June 30, 2013, holdings were \$1.8 million and were \$2.3 million as of December 31, 2012 and \$3.3 million as of June 30, 2012.

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

In comparing the balance sheet of June 30, 2013 to that of December 31, 2012, the liquidity of the Bank has decreased by approximately \$21.6 million and still remains strong. The size of the Bank is smaller by a similar amount. The decrease in liquidity also corresponds to a lower balance in the lowest interest yielding category. During the six months of 2013, net loans have decreased just \$401 thousand of which a \$10 million decrease was expected and happens each year at this time as a result of line of credit utilization by a single relationship. The fact that loan levels remained steady in light of the anticipated yearly reduction is a positive factor towards future improvement to profitability.

The Company's decrease in size was due to lower liability balances within deposits and FHLB borrowings. The Company has an unsecured borrowing capacity of \$95.3 million through correspondent banks and over \$153.6 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 that 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's impairment 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

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

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.

As the chart below shows, there were only minor amounts of securities in a loss position as of June 30, 2013.

June 30, 2013	(In Thousands)			
	Less Than Twelve Months Gross Unrealized Losses	Fair Value	Twelve Months & Over Gross Unrealized Losses	(In Thousands) Fair Value
U.S. Treasury	\$ (704)	\$ 25,479	\$	\$
U.S. Government agency	(3,513)	118,150		
Mortgage-backed securities	(290)	14,275		
State and local governments	(373)	12,930		

A large fluctuation in the market value of the securities occurred during the second quarter causing the unrealized gain position to decrease significantly. Management recognized the change in the market early and was quick to capture the gain before it fluctuated to an unrealized loss position. Management feels confident that liquidity needs can easily be funded from an orderly runoff of the investment portfolio.

The following chart shows the breakdown of the unrealized gain or loss associated within each category of the investment portfolio as of June 30, 2013.

	(In Thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 26,183	\$	\$ (704)	\$ 25,479
U.S. Government agency	212,713	1,715	(3,513)	210,915
Mortgage-backed securities	44,835	793	(290)	45,338
State and local governments	70,095	3,020	(373)	72,742
	\$ 353,826	\$ 5,528	\$ (4,880)	\$ 354,474

The following table shows the maturity schedule of the security portfolio as of June 30, 2013

	(In Thousands) June 30, 2013	
	Amortized Cost	Fair Value
One year or less	\$ 13,903	\$ 14,008
After one year through five years	168,149	169,545

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After five years through ten years	116,226	113,720
After ten years	10,713	11,863
<b>Subtotal</b>	<b>\$ 308,991</b>	<b>\$ 309,136</b>
Mortgage Backed Securities	44,835	45,338
<b>Total</b>	<b>\$ 353,826</b>	<b>\$ 354,474</b>

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As previously stated, net loans show only a slight decrease of \$401 thousand for the six months ended June 30, 2013. \$362 thousand was charged-off during the six month period indicating the total decrease was not due to charge-offs. The balance of the decrease in loans was due to the pay down, payoff or refinancing of loans. Loan sales into the secondary market have also impacted the consumer and agricultural real estate portfolios. During the year almost \$46.9 million of these sales occurred with only \$43.3 million of the loans originated in the same period as shown in the cash flow statement for the period. Agricultural real estate accounted for just over one eighth of the activity with 1-4 family representing the majority. Both portfolios include a large portion of refinancing. The trend of decreasing loan balances is not unique to this year as the chart to follow shows the trend during the last three years and shows an uptick for June 2013 as compared to June 2012. The Bank is however, closer to reversing the trend after our second quarter activity when comparing to yearend. The Bank's pipeline of loans has increased, driven by opportunities for new relationships as national banks downsize certain portfolios and an overall more optimistic opinion of the economy by businesses.

The chart below shows the breakdown of the loan portfolio by category less deferred loan fees and costs as of June 30 for the last three years.

	(In Thousands)		
	June 2013 Amount	June 2012 Amount	June 2011 Amount
Commercial Real Estate	\$ 215,246	\$ 202,900	\$ 193,993
Agricultural Real Estate	35,746	32,408	32,228
Consumer Real Estate	77,948	81,252	81,557
Commercial and Industrial	93,978	104,224	113,947
Agricultural	55,331	54,808	57,221
Consumer, Overdrafts and other loans	19,723	21,577	25,249
Industrial Development Bonds	3,102	1,199	1,965
<b>Total Loans</b>	<b>\$ 501,074</b>	<b>\$ 498,368</b>	<b>\$ 506,160</b>

The Commercial and Industrial portfolio shows the largest decrease of \$10.2 million in balance as of June 30, 2013 compared to June 30, 2012. Agricultural real estate shows an increase of \$3.3 million which may switch positions next quarter as additional sales may occur. Commercial real estate showed the largest improvement in balances of \$12.3 million which was higher than the previous quarter's comparison increase of \$8.7 million. Overall, loans increased \$2.7 million as compared to the same period last year and decreased \$5.1 million as compared to June 30, 2011.

Overall, total assets of the Company decreased \$24.3 million from December 31, 2012 to June 30, 2013.

Deposits decreased \$15.6 million with the largest decrease of \$15.1 million in the time deposits. The largest increase in the deposit portfolio of \$4.9 million was in the NOW portfolio due to the continuing popularity of the KASASA program. 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. 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, whose product utilizes a higher yielding rate than the Bank's regular saving account, is the reason behind the retention and increase of dollars in savings. These continue to be the deposits of choice and attract not only new money from existing customers but new customers to the Bank.

The Certificate of Deposit (COD) portfolio has decreased \$15.1 million during the first six months of 2013, which is part of the reason why the Bank continues to decrease the cost of funds. Through its pricing, the Bank has limited its attractiveness to short-term rate shoppers and foresees continuing this strategy throughout 2013. This is demonstrated below in the section of this MD&A captioned MATERIAL CHANGES IN RESULTS OF OPERATION - Interest Expense .





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The Bank paid off \$5.1 million in FHLB advances which had matured during 2012 and made principal payments and payoffs totaling \$4.5 million so far in 2013. This too should lower the cost of funds. Securities sold under agreement to repurchase increased \$3.4 million during the first six months of 2013 as compared to yearend.

Capital decreased a modest \$2.9 million from year-end during the six months of 2013. Positive earnings and a significant decrease in accumulated other comprehensive income are the factors behind the decrease. Comprehensive income decreased \$5.7 million which encompassed the shift of \$598 thousand from unrealized gain to realized gain with the sale of securities. Dividends paid were \$81 thousand higher the same period last year. Dividends declared increased approximately \$40 thousand as compared to June 2012 while comparable to December 2012.

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

Primary Ratio	11.50%
Tier I Leverage Ratio	10.97%
Risk Based Capital Tier I	17.06%
Total Risk Based Capital	17.98%
Stockholders' Equity/Total Assets	11.63%

**MATERIAL CHANGES IN RESULTS OF OPERATIONS**

Comparison of Results of Operation for six month periods ended June 30, 2013 and 2012.

The improvement in noninterest income for the first half 2013, was not high enough to offset the loss of interest income. As a result, net income was \$168 thousand lower than 2012's first half. The \$858 thousand increase in noninterest income was driven primarily by (i) an increase in the gain on sale of securities of \$429 thousand, and (ii) smaller improvements in the remainder of categories in the range of \$19 to \$211 thousand. The increase in the aggregate number of checking and savings accounts has been the principal factor behind the increase in customer service fees for the two periods.

Net interest income after the provision for loan expense for the quarter ended June 30, 2013 was down \$747 thousand from the six-month period ended June 30, 2012. The decrease in total interest income for the comparison of the two periods was \$674 thousand less than the decrease in total interest expense, making it the principal driver behind the overall decrease. The provision for loan loss expense was approximately \$73 thousand higher than same period 2012.

Noninterest expense was higher in comparison due to the addition of the Waterville office. The number of full time equivalent employees was 245 as of June 30, 2012 compared to 251 as of June 30, 2013.

Overall, the performance for the first half comparison was favorable and continues to showcase the issue with decreasing interest income being offset by strong noninterest revenue.

**Interest Income**

Annualized interest income and yield on earning assets is down 34 basis points in 2013 as compared to June 30, 2012. While the average total earning assets were only slightly higher by less than 1% for \$5.4 million than the prior year, the decrease in interest income resulted primarily from the decreased yields of the Company's earning assets. As the table that follows confirms, the decrease in the rate of the interest earning portfolios from loans to investments caused a lower June 2013 yield in loans and securities thereby causing lower interest income. The increased volume in the security portfolio did not offset the loss in interest income due to rate changes. However, the portfolio continues to have calls due to the low rate environment. Prepayment speeds remain high on mortgage-backed securities. These may slow as the Bank's refinancing activity has and long term rates inch higher.



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Overall, interest income from loans was down \$1.4 million in comparing the six months ended June 30, 2013 to same period 2012 which accounts for the majority of the overall drop in interest income. This emphasizes the impact of declining or stagnant loan balances and the need to find good loans with which to rebuild the portfolio. The overall asset yield decreased 34 basis points between the two periods.

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

Interest Earning Assets:	(In Thousands)		Yield/Rate	
	Average Balance June 30, 2013	Interest/Dividends June 30, 2013	June 30, 2013	June 30, 2012
Loans	\$ 489,831	\$ 12,167	5.01%	5.52%
Taxable Investment Securities	299,045	2,365	1.58%	1.70%
Tax-exempt Investment Securities	63,560	911	4.34%	4.44%
Fed Funds Sold & Interest Bearing Deposits	25,270	24	0.19%	0.14%
Total Interest Earning Assets	\$ 877,706	\$ 15,467	3.65%	3.99%

**Change in June 30, 2013 Interest Income Compared to June 30, 2012**

Interest Earning Assets:	Change	Due to Volume	Due to Rate
Loans	\$ (1,434)	\$ (160)	\$ (1,274)
Taxable Investment Securities	(70)	96	(166)
Tax-exempt Investment Securities	(30)	(14)	(16)
Fed Funds Sold & Interest Bearing Deposits		(8)	8
Total Interest Earning Assets	\$ (1,534)	\$ (86)	\$ (1,448)

**Interest Expense**

Interest expense continued to be lower than the comparable six months of 2012. Interest expense related to deposits was down \$703 thousand while the average interest-bearing deposit balance increased by \$14.5 million in comparing the balances of each six month period. Time deposits continue to reprice down and the Bank continues to try and lengthen the duration of the portfolio with specials offered in terms longer than thirty-six months. However, depositors continue to place more funds in shorter term deposits while they wait for rates to rise or move funds elsewhere. KASASA Cash and Saver along with HSA's helped to increase the savings average deposit balances by \$26 million.

Interest on borrowed funds was \$158 thousand lower for the six month period ended June 30, 2013 than 2012. More borrowings from Federal Home Loan Bank were paid off during 2012 and 2013, making the balance in other borrowed money considerably lower in 2013 in comparison. Thus the largest decrease in cost of funds for other borrowed money was due to the decreased volume which also impacted the rate of the remaining borrowings portfolio. Fed Funds Purchased and Securities Sold under Agreement to Repurchase had similar balances in 2013 and 2012 making the fluctuation cost a minimal \$1 thousand.

For the same comparison as last year, the decrease in interest expense did not outpace the decrease in interest income. It remains a focus for improvement in 2013. Asset yield decreased 34 basis points while cost of funds decreased 22 basis points. The main focus is to increase asset yield by using excess cash and investments to fund loan growth.



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Interest Bearing Liabilities:	(In Thousands)		Yield/Rate	
	Average Balance	Interest/Dividends	June 30, 2013	June 30, 2012
Savings Deposits	\$ 398,942	\$ 766	0.38%	0.58%
Other Time Deposits	261,209	1,440	1.10%	1.25%
Other Borrowed Money	7,439	89	2.39%	2.97%
Fed Funds Purchased & Securities Sold under Agreement to Repurch	51,556	122	0.47%	0.48%
<b>Total Interest Bearing Liabilities</b>	<b>\$ 719,146</b>	<b>\$ 2,417</b>	<b>0.67%</b>	<b>0.89%</b>

**Change in June 30, 2013 Interest Expense Compared to June 30, 2012**

Interest Bearing Liabilities:	Change	Due to Volume	Due to Rate
Savings Deposits	\$ (309)	\$ 51	\$ (360)
Other Time Deposits	(394)	(180)	(214)
Other Borrowed Money	(158)	(110)	(48)
Fed Funds Purchased & Securities Sold under Agreement to Repurch	1	2	(1)
<b>Total Interest Bearing Liabilities</b>	<b>\$ (860)</b>	<b>\$ (237)</b>	<b>\$ (623)</b>

## Net Interest Income

Net interest income is lower in the six month comparison, which is the same position as yearend 2012's comparison to yearend 2011. The issue of earning less per earning asset dollar still remains as evidenced by the lower net interest margin ratio. The tables above demonstrate that the decline in net interest income is primarily a result of continued interest rate compression that results from falling rates impacting yields on assets more dramatically than rates paid on liabilities.

Management expects the current interest rate environment to continue to further compress the Company's interest margins throughout the remainder of the fiscal year. As a result, interest income, in comparison to 2012, may remain behind throughout the year if a higher level of loan growth does not occur. The Bank continues to attempt to add spread on renewing loans while loan growth is needed to improve the overall numbers. Interest expense on time deposits should also continue to show a decrease until depositors begin to transition back into longer-term deposits. Should rates begin to rise, the challenge will be to delay the pricing up of deposits in order to allow the Bank to generate a greater spread from the increased yield on its earning assets.

## Provision Expense

Provision for loan loss was \$73 thousand higher for the six months ended June 30, 2013 as compared to the same 2012 period. The decrease in the average balance in nonaccrual loans, along with improving asset quality and low loan growth, as compared to yearend 2012, warranted the low provision to the loan loss reserve. The balance in nonaccrual loans decreased \$219 thousand along with a decrease of \$70 thousand in impaired loan balances as of June 30, 2013 as compared to the balances as of December 31, 2012. In comparing to June 30, 2012, nonaccrual balances decreased \$284 thousand and impaired loan balances increased \$167 thousand. Provision expense related to those increased balances was recognized in the later time periods of 2012. The overall loan portfolio was also \$2.7 million higher as of June 30, 2013 compared to June 30, 2012. The Bank continues to focus on the commercial and commercial real estate portfolios for both asset quality and growth. As the charts below will show for 2013 and 2012, a large portion of the provision was also to replace the reserve balance depleted from the net charge-offs during the period and 2013 had a smaller net charge-off position than 2012. Should the recovery stop or continue to slow even further, it is more likely additional credits may encounter cash flow problems and the Bank remains diligent in providing funds to offset future losses. In the immediate future, the Bank would expect to fund the loan loss reserve for any loan growth that may occur.



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Provision Expense (Continued)

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

Looking at the balance in impaired loans, it shows the Bank has recognized a slight increase in the overall balance of impaired loans when looking at June 2013 compared to June 2012. However, a positive factor can also be seen. A decrease in the current average balance during 2013 as compared to yearend December 2012. This is due mainly to the collection of principal from the sale of collateral from borrowers and continual collection of payments on these borrowers classified as impaired.

Increase in the impaired loans with a valuation allowance occurred during the second quarter 2012 relates to two relationships of \$2.4 million, one comprising \$2.3 million. In addition, during the second and third quarter, one relationship previously declared impaired had a decrease in the allocation amount of \$5 thousand. In the future, a collection of the collateral may have a larger short fall.

The Bank had \$2.9 million of its impaired loans classified as troubled debt restructured as of June 30, 2013, of which \$207 thousand was classified the same as at June 30, 2012. Four new impaired relationships were added during the second quarter and two were removed. The change resulted in \$503 thousand less in impaired balances; however the new relationship added \$30 thousand to the specific allocation balances.

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 the ALLL is attributed to each segment of the loan portfolio, as well as the percent that each particular segment of the loan portfolio represents to the entire loan portfolio in the aggregate. Consumer activity has accounted for the largest component of charge-offs and recoveries in second quarter 2013 as compared to 2012. As was mentioned in previous discussion, the commercial and commercial real estate portfolios are having a major impact on the ALLL.

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The following table presents activities for the allowance for loan losses by loan type for three months ended June 30, 2013, 2012, and 2011.

	(In Thousands)		
	Three Months Ended June-13	Three Months Ended June-12	Three Months Ended June-11
Loans	\$ 501,074	\$ 498,368	\$ 506,160
Daily average of outstanding loans	\$ 495,014	\$ 500,515	\$ 505,960
Allowance for Loan Losses - April 1	\$ 5,344	\$ 5,151	\$ 5,752
Loans Charged off:			
Commercial Real Estate	44	96	66
Ag Real Estate			
Consumer Real Estate	89	53	97
Commercial and Industrial			845
Agricultural			
Consumer & other loans	112	122	53
	245	271	1,061
Loan Recoveries			
Commercial Real Estate		1	29
Ag Real Estate			
Consumer Real Estate	4	24	5
Commercial and Industrial	41	4	1
Agricultural	3	3	62
Consumer & other loans	38	46	48
	86	78	145
Net Charge Offs	159	193	916
Provision for loan loss	112	78	653
Acquisition provision for loan loss			
Allowance for Loan & Lease Losses - June 30	\$ 5,297	\$ 5,036	\$ 5,489
Allowance for Unfunded Loan Commitments & Letters of Credit June 30	187	141	144
Total Allowance for Credit Losses - June 30	\$ 5,484	\$ 5,177	\$ 5,633
Ratio of net charge-offs to average Loans outstanding	0.03%	0.04%	0.18%
Ratio of Allowance for Loan Loss to Nonperforming Loans	114.93%	102.93%	61.90%





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The following table presents activities for the allowance for loan losses by loan type for six months ended June 30, 2013, 2012, and 2011.

	(In Thousands)		
	Six Months Ended June-13	Six Months Ended June-12	Six Months Ended June-11
Loans	\$ 501,074	\$ 498,368	\$ 506,160
Daily average of outstanding loans	\$ 489,831	\$ 496,242	\$ 509,564
Allowance for Loan Losses - January 1	\$ 5,224	\$ 5,091	\$ 5,706
Loans Charged off:			
Commercial Real Estate	64	97	155
Ag Real Estate			
Consumer Real Estate	100	93	190
Commercial and Industrial			1,316
Agricultural			24
Consumer & other loans	198	208	169
	362	398	1,854
Loan Recoveries			
Commercial Real Estate		2	29
Ag Real Estate			
Consumer Real Estate	9	30	23
Commercial and Industrial	56	18	6
Agricultural	4	10	65
Consumer & other loans	87	77	85
	156	137	208
Net Charge Offs	206	261	1,646
Provision for loan loss	279	206	1,429
Acquisition provision for loan loss			
Allowance for Loan & Lease Losses - June 30	\$ 5,297	\$ 5,036	\$ 5,489
Allowance for Unfunded Loan Commitments & Letters of Credit June 30	187	141	144
Total Allowance for Credit Losses - June 30	\$ 5,484	\$ 5,177	\$ 5,633
Ratio of net charge-offs to average Loans outstanding	0.04%	0.05%	0.32%
Ratio of Allowance for Loan Loss to Nonperforming Loans	114.93%	102.93%	61.90%



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

	Amount (000 s)	% of Portfolio	Amount (000 s)	% of Portfolio
<b>Balance at End of Period Applicable To:</b>				
Commercial Real Estate	\$ 1,460	42.95	\$ 1,722	38.33
Ag Real Estate	115	7.13	92	6.37
Consumer Real Estate	361	15.56	460	16.11
Commercial and Industrial	2,138	18.76	1,856	22.51
Agricultural	277	11.04	275	11.30
Consumer, Overdrafts and other loans	266	3.94	283	4.99
Unallocated	680	0.62	348	0.39
<b>Allowance for Loan &amp; Lease Losses</b>	<b>\$ 5,297</b>		<b>\$ 5,036</b>	
Off Balance Sheet Commitments	187		141	
<b>Total Allowance for Credit Losses</b>	<b>\$ 5,484</b>		<b>\$ 5,177</b>	

The percentage of delinquent loans has trended downward since the beginning of 2010 from a high of 2.85% of total loans in January to .64% as of the end of June 2012. June 2013 remained low at 1.07%. 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 write down of uncollectable credits in a timely manner.

**Non-interest Income**

Non-interest income was higher for the six months ended June 30, 2013 as compared to same period in June 30, 2012. Improvement in non-interest income was reached in all categories from customer service fees to net gain on sale of securities. The increase in the checking and savings portfolios in terms of number of accounts in 2013 as compared to 2012 has been one of the main factors behind the maintaining of and additional collection of fees. Increases came from debit card usage for the first six months of 2013 being approximately \$195 thousand higher in revenue than for the first six months 2012. This revenue stream is very important to the Bank and its ability to offer free checking accounts to our customers.

Net gain on sale of securities represented the largest improvement in noninterest income, up \$429 thousand as of second quarter end 2013 compared to second quarter end 2012. As the market rates for long term assets began to rise, the Bank began to see the unrealized gain on the market value of securities erode. At the end of May and beginning of June, the Bank decided to capture some of the gain before the opportunity evaporated. \$377 thousand was recognized in the second quarter 2013.

The Bank was able to continue to take advantage of the opportunity to recognize gains from the sales of securities without impacting the yield of the investment portfolio by marginally extending the maturity duration. The gain in 2013 was based on security sales of \$37.6 million.

The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights. The capitalization runs through non-interest income while the amortization thereof is included in non-interest expense. A slight impairment in the valuation of the thirty year segment occurred in the fourth quarter of 2012 and was reversed in the second quarter of 2013, eliminating all impairment.

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	(In Thousands)	
	2013	2012
Beginning Balance, January 1	\$ 2,063	\$ 2,071
Capitalized Additions	241	384
Amortization	(257)	(372)
Ending Balance, June 30	2,047	2,083
Valuation Allowance		
Mortgage Servicing Rights, net June 30	\$ 2,047	\$ 2,083

Loss on sale of assets was lower by \$151 thousand as of first half 2013 as compared to same period 2012. This represents an improvement in non-interest income for the period. This line item includes losses from sales of assets, losses from write-downs to the Bank's Other Real Estate Owned (ORE) and losses resulting from the loss or disposal of fixed assets, though the fixed asset sales are inconsequential. Holdings in ORE decreased to \$1.8 million as of June 30, 2013 compared to holdings of \$3.3 million as of June 30, 2012. Activity on sales of ORE has increased in 2013 and the Bank expects this to continue throughout the remainder of 2013 and decrease the holdings even further.

Overall non-interest income improved \$858 thousand for the six months of operations in 2013 as compared to 2012. It is expected to continue through 2013, specifically in the area of loss on sale of other assets owned.

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.

	(In Thousands)	
	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Net Unrealized gain (loss) on available-for-sale securities	\$ (7,986)	\$ 750
Reclassification adjustment for gain on sale of available-for-sale securities	\$ (598)	\$ (169)
Net unrealized gains (losses)	\$ (8,584)	\$ 581
Tax Effect	\$ 2,918	\$ (197)
Other comprehensive income (loss)	\$ (5,666)	\$ 384

**Non-Interest Expense**

Non-interest expense for the six months ended June 30, 2013 was only \$288 thousand higher than for the same period of 2012. The largest individual increase in expense is related to the salaries and wages. Salaries and wages were higher by \$218 thousand during the six months as compared to the same time frame of 2012. Base pay was higher by 3.7% or \$84.4 thousand in 2013 than 2012 with the number of full time equivalent employees having increased from 246 as of June 30, 2012 to 251 as of June 30, 2013. This percentage is in line with the small increases that were authorized to be implemented throughout the organization for higher performing employees. Pension and other employee benefits decreased by \$118 thousand in the same time period. Medical costs increased by \$69.5 thousand for the six months ended June 30, 2013 as compared to June 30, 2012. This was due to a higher level of claims accompanied by higher insurance premiums for plan year 2013. Occupancy expense decreased \$173 thousand as compared to 2012.



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MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Non-Interest Expense (Continued)

A decrease occurred of \$115 thousand in the amortization expense of mortgage servicing rights. When a mortgage is refinanced, any unamortized servicing right is fully expensed and therefore, drives the amortization expense higher within that period. Of the sales and originations shown in the cash flow, \$29.7 million were originated and \$31.7 million sold from the 1-4 family portfolio which had mortgage servicing rights attached. These were down from \$44.8 million in originations and \$46.3 million in sales from the same portfolio in second quarter 2012. Therefore, amortization expense from refinancing activity would be expected to be lower, which it is.

Other general and administrative expenses were higher during the six months for 2013 by \$333 thousand; as compared to the same six months 2012. Almost one fourth; \$77.1 thousand, of the increase is attributed to loan collection fees, including legal. Overall non-interest expense was just \$288 thousand higher in 2013 than in 2012. The Company continues to monitor costs to safeguard profitability.

Net Income

Overall, net income was down \$168 thousand for the six months ended June 30, 2013, compared to the same period of 2012. The improvement in asset quality that has occurred over the last two years along with lower loan balances enabled the Company to have low levels of provision expense. This coupled with the decrease on ORE write-down and losses summarized in gain/loss on sale of other assets owned of \$151 thousand less in 2013 than in 2012, increased gain on sale of investments of \$429 thousand in 2013 over 2012, are the largest factors behind the decrease not being larger. Obviously, the gain on sale of securities plays a role in the improvement and the Company is fortunate that the opportunity existed to capture income that has been used to improve profitability the last two years. The decrease in net interest income for the quarter is proof of the importance of the effect of balance sheet mix as the low loan balances continues to impact overall asset yield.

The Company is positioned for improvement in the net interest margin while rates remain low, provided there is an increase in loan demand. It will be a challenge to maintain the margin once short term rates begin to rise. However, the Bank remains focused on improving the asset yield through improved asset quality and added spread to prime on variable and adjustable rate loans. As with the rest of the banking industry, the Company is also limited from achieving higher profitability by the cost of increased regulatory requirements such as Regulation E, Dodd-Frank Wall Street Reform and Consumer Protection Act and any other additional regulations that may be enacted during 2013 and their corresponding cost of compliance. The Company will continue to seek to enhance existing products and services to increase revenue, improve efficiency and increase customer satisfaction.

Comparison of Results of Operations for the quarters ended June 30, 2013 and June 30, 2012.

In comparing changes in the balance sheet composition from first quarter to second quarter-end 2013, the two most important ones are the net loans from the asset side and accumulated comprehensive income from the capital section. This statement would also hold true when comparing the June 30<sup>th</sup> balances of 2012 to 2013.

Net loans show an increase in both circumstances, which is a step in the desired direction. The increase is minor at less than half a million in year to year comparison, but is an increase in comparing 2013 quarter-end balances of \$16.3 million. The operative word in both instances is increase. The Bank is anticipating it may be the start of a new trend that will help to bolster long-term profitability.

Accumulated comprehensive income has experienced the opposite and is significantly lower at June 30, 2013 by \$6.3 million compared to June 30, 2012 and by \$4.9 million compared to March 31, 2013. This basically signifies that only a small opportunity or not one at all, exists to recognize additional income from gain on sale of investments, especially, if future income is not to be jeopardized by the sale. As the income statement has shown, this has been a portion of non-interest income for many recent years. This fluctuation also stresses the importance of why community banks did not want it to be a part of the Basel III capital rules to be implemented in the coming years: it can be a very volatile portion of capital and play havoc with meeting regulatory guidelines without much warning.





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

In comparing June quarterly results for 2012 and 2013, interest income is lower in 2013 by \$760 thousand. 94% of the decrease is from lower earnings on loans. While the balances were similar, the decrease was due to rate. Interest expense was lower by \$469 thousand with 83% due to the rate on deposits and lower time deposit balances. The net of these two amounted to net interest income being lower in second quarter 2013 than second quarter 2012 by \$291 thousand.

The largest differences in quarter comparisons within noninterest income were an increase in 2013 by the gain on sale of securities of \$377 thousand, and a decrease of \$300 thousand in 2013 from gain on sale of loans. Overall, noninterest income improved by \$295 thousand for second quarter 2013 compared to same time period 2012.

Noninterest expense was separated by only \$17 thousand in comparing the two periods. Second quarter 2013 was higher than 2012. Fluctuation by category was limited with the largest being \$146 thousand in other general and administrative. The difference in year-to-date expenses was due more to the first quarter activity.

For second quarter comparison, net income as down only \$36 thousand in 2013 as compared to 2012. Earnings per share and dividends declared were different by one cent. As discussed previously, the largest fluctuation in the quarter comparison relates to other comprehensive income, a loss of \$6.1 million in the market value of securities for 3 months ended June 30, 2013 and June 30, 2012.

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

**FORWARD LOOKING STATEMENTS**

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

**ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of the our interest rate risk arises from the instruments, positions and transactions entered into for purposes, other than trading such as loans, available for sale securities, interest bearing deposits, short term borrowings and long term borrowings. Interest rate risk occurs when interest bearing assets and liabilities re-price at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.



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## ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)

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

Interest Rate Shock on Net Interest Margin	Interest Rate Shock on Net Interest Income				
	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total (\$000)	% Change to Flat Rate
Net Interest Margin (Ratio)					
2.87%	2.44%	Rising	3.00%	25,850	0.12%
2.90%	1.45%	Rising	2.00%	25,824	0.22%
2.86%	2.77%	Rising	1.00%	25,393	1.88%
2.94%	0.00%	Flat	0.00%	25,880	0.00%
2.68%	9.00%	Falling	1.00%	23,779	8.12%
2.52%	14.35%	Falling	2.00%	22,435	13.31%
2.31%	21.31%	Falling	3.00%	20,771	19.74%

The net interest margin represents the forecasted twelve month margin. It also shows what effect rate changes will have on both the margin and net interest income. The goal of the Company is to lengthen some of the liabilities or sources of funds to decrease the exposure to a rising rate environment. The Bank has offered higher rates on certificates of deposits for longer periods since 2011. Of course, customer desires also drive the ability to capture longer term deposits. Currently, the customer looks for terms twelve months and under while the Bank would prefer 24 months and longer. It is often a meeting in the middle that satisfies both. What the Bank has experienced is a decrease in the time balances of our deposit portfolio, therefore a loss of term funding. Over the last two years, other borrowings that had matured were not replaced which thus eliminated a category of what historically was longer term liability. A high level of liquidity negated the need to re-borrow.

The shock chart currently shows a tightening in net interest margin over the next twelve months in both a rising and decreasing rate environment. Due to the length of and existence of such a low rate environment, the model does not predict expansion of net income margin at any level. Cost of funds are below 1% so at even the lowest shock of 100 basis points, the Bank cannot take full advantage and reprice funds to match the level of shock. The negative impact in a rising rate environment is partially caused by a timing issue on the ability to reprice assets as immediately as the liabilities. The average duration of the majority of the assets is outside the 12 month shock period. The Bank enhanced its use of the software model during 2012 by including decay rates and key rate ties on certain deposit accounts. Both enhancements were based on historical performance data of the Bank. Both directional changes are within risk exposure guidelines at the 200 basis point level. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

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

## ITEM 4 CONTROLS AND PROCEDURES

As of June 30, 2013, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2013. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2013 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

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## PART II OTHER INFORMATION

## ITEM 1 LEGAL PROCEEDINGS

None

## ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2012.

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

Treasury stock repurchase for quarter ended June 30, 2013

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	(d) Maximum Number of Shares that may yet be purchased under the Plans or Programs
4/1/2013 to 4/30/2013				196,500
5/1/2013 to 5/31/2013				196,500
6/1/2013 to 6/30/2013				196,500
Total				196,500

- (1) The Company purchased shares in the market pursuant to a stock repurchase program publicly announced on January 18, 2013. On that date, the Board of Directors authorized the repurchase of 200,000 common shares between January 18, 2013 and December 31, 2013.

## ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

## ITEM 4 MINE SAFETY DISCLOSURES

Not applicable

## ITEM 5 OTHER INFORMATION

## ITEM 6 EXHIBITS

3.1

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

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

3.2	Code of Regulations of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on May 10, 2004)
31.1	Rule 13-a-14(a) Certification - CEO
31.2	Rule 13-a-14(a) Certification - CFO
32.1	Section 1350 Certification - CEO
32.2	Section 1350 Certification - CFO
101.INS	XBRL Instance Document (1)
101.SCH	XBRL Taxonomy Extension Schema Document (1)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (1)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (1)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (1)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (1)

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SIGNATURES

**SIGNATURES**

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

Farmers & Merchants Bancorp, Inc.,

Date: July 31, 2013

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

Date: July 31, 2013

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

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