

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
April 26, 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 ended March 31, 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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|  |   |
|--|---|
| <b>OHIO</b><br>(State or other jurisdiction of<br>incorporation or organization)             | <b>34-1469491</b><br>(I.R.S Employer<br>Identification No.) |
| <b>307 North Defiance Street, Archbold, Ohio</b><br>(Address of principal executive offices) | <b>43502</b><br>(Zip Code)                                  |

**(419) 446-2501**

**Registrant's telephone number, including area code**

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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

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

|  |   |
|--|---|
| <b>Common Stock, No Par Value</b><br>Class | <b>4,679,938</b><br><b>Outstanding as of April 25, 2013</b> |
|--|---|

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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 &amp; MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands of dollars)

|   | March 31, 2013    | December 31, 2012 |
|---|-------------------|-------------------|
| <b>ASSETS:</b>  |                   |                   |
| Cash and due from banks   | \$ 12,404         | \$ 25,620         |
| Interest bearing deposits with banks  | 11,323            | 11,941            |
| Federal funds sold  | 33,802            | 6,531             |
| <b>Total cash and cash equivalents</b>  | <b>57,529</b>     | <b>44,092</b>     |
| Securities - available for sale (Note 2)  | 360,821           | 355,905           |
| Other Securities, at cost   | 4,216             | 4,365             |
| Loans, net (Note 4)   | 479,484           | 496,178           |
| Bank premises and equipment   | 17,722            | 17,599            |
| Goodwill  | 4,074             | 4,074             |
| Mortgage Servicing Rights, net  | 2,042             | 2,047             |
| Other Real Estate Owned   | 2,226             | 2,310             |
| Accrued interest and other assets   | 21,046            | 20,090            |
| <b>TOTAL ASSETS</b>   | <b>\$ 949,160</b> | <b>\$ 946,660</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                   |                   |
| <b>LIABILITIES:</b>   |                   |                   |
| <b>Deposits:</b>  |                   |                   |
| Noninterest bearing   | \$ 99,027         | \$ 103,966        |
| <b>Interest bearing</b>   |                   |                   |
| NOW accounts  | 213,376           | 196,971           |
| Savings   | 198,188           | 192,808           |
| Time  | 261,855           | 269,507           |
| <b>Total deposits</b>   | <b>772,446</b>    | <b>763,252</b>    |
| Federal funds purchased and securities sold under agreement to repurchase                       | 49,087            | 51,312            |
| FHLB Advances   | 7,100             | 11,600            |
| Dividend Payable  | 931               | 931               |
| Accrued expenses and other liabilities  | 8,963             | 9,326             |
| <b>Total Liabilities</b>  | <b>838,527</b>    | <b>836,421</b>    |
| <b>SHAREHOLDERS EQUITY:</b>   |                   |                   |
| Common stock, no par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares | 12,677            | 12,677            |
| Treasury Stock - 519,902 shares 2013, 515,942 shares 2012                                       | (10,674)          | (10,588)          |
| Unearned Stock Awards 30,210 shares 2013, 30,670 shares 2012                                    | (575)             | (584)             |
| Retained Earnings   | 103,862           | 102,641           |
| Accumulated other comprehensive income  | 5,343             | 6,093             |

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|   |            |            |
|---|------------|------------|
| Total Shareholders Equity                 | 110,633    | 110,239    |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 949,160 | \$ 946,660 |

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)

|  | Three Months Ended |                |
|--|--------------------|----------------|
|  | March 31, 2013     | March 31, 2012 |
| <b>INTEREST INCOME:</b>  |                    |                |
| Loans, including fees  | \$ 6,078           | \$ 6,797       |
| <b>Debt Securities:</b>  |                    |                |
| U.S. Treasury securities   | 61                 | 81             |
| Securities of U.S. Government Agencies                                     | 992                | 1,025          |
| Municipalities   | 508                | 510            |
| Dividends  | 49                 | 49             |
| Federal funds sold   | 7                  | 7              |
| Other  | 7                  | 7              |
| <b>Total Interest Income</b>   | <b>7,702</b>       | <b>8,476</b>   |
| <b>INTEREST EXPENSE:</b>   |                    |                |
| Deposits   | 1,127              | 1,439          |
| Federal Funds purchased and securities sold under agreements to repurchase | 60                 | 61             |
| Borrowed funds   | 46                 | 124            |
| <b>Total Interest Expense</b>  | <b>1,233</b>       | <b>1,624</b>   |
| <b>NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES</b>                | <b>6,469</b>       | <b>6,852</b>   |
| <b>PROVISION FOR LOAN LOSSES (Note 4)</b>                                  | <b>167</b>         | <b>128</b>     |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>                 | <b>6,302</b>       | <b>6,724</b>   |
| <b>NONINTEREST INCOME</b>  |                    |                |
| Customer service fees  | 1,361              | 1,324          |
| Other service charges and fees   | 862                | 758            |
| Net gain (loss) on sale of other assets owned                              | (16)               | (67)           |
| Net gain on sale of loans  | 480                | 161            |
| Net gain on sale of securities   | 221                | 169            |
| <b>Total Noninterest Income</b>  | <b>2,908</b>       | <b>2,345</b>   |
| <b>NONINTEREST EXPENSE</b>   |                    |                |
| Salaries and wages   | 2,437              | 2,286          |
| Pension and other employee benefits  | 844                | 828            |
| Occupancy expense (net)  | 330                | 405            |
| Furniture and Equipment  | 349                | 352            |
| Data processing  | 310                | 265            |
| Franchise Taxes  | 255                | 237            |
| FDIC Assessment  | 119                | 130            |
| Mortgage servicing rights amortization                                     | 137                | 194            |
| Other general and administrative   | 1,345              | 1,158          |
| <b>Total Noninterest Expense</b>   | <b>6,126</b>       | <b>5,855</b>   |
| <b>INCOME BEFORE FEDERAL INCOME TAX</b>                                    | <b>3,084</b>       | <b>3,214</b>   |

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|  |           |           |
|--|-----------|-----------|
| FEDERAL INCOME TAXES                     | 932       | 930       |
| NET INCOME                               | \$ 2,152  | \$ 2,284  |
| OTHER COMPREHENSIVE INCOME (NET OF TAX): |           |           |
| Unrealized gains (loss) on securities    | \$ (750)  | \$ 5,605  |
| COMPREHENSIVE INCOME                     | \$ 1,402  | \$ 7,889  |
| NET INCOME PER SHARE                     | \$ 0.46   | \$ 0.48   |
| Weighted Average Shares Outstanding      | 4,683,659 | 4,714,197 |
| DIVIDENDS DECLARED                       | \$ 0.20   | \$ 0.19   |

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)

|   | Three Months Ended |                |
|---|--------------------|----------------|
|   | March 31, 2013     | March 31, 2012 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                    |                |
| Net income  | \$ 2,152           | \$ 2,284       |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                    |                |
| Depreciation  | 304                | 289            |
| Accretion and amortization of securities  | 635                | 785            |
| Amortization of servicing rights  | 137                | 194            |
| Amortization of core deposit intangible   | 78                 | 78             |
| Stock Based Compensation  | 46                 | 45             |
| Provision for loan losses   | 167                | 128            |
| Gain on sale of loans held for sale   | (480)              | (161)          |
| Originations of loans held for sale   | (24,051)           | (27,634)       |
| Proceeds from sale of loans held for sale   | 27,412             | 29,920         |
| Loss on sale of other assets  | 16                 | 67             |
| Gain on sale of investment securities   | (221)              | (169)          |
| Change in Operating Assets and Liabilities, net                                   | (641)              | (1,794)        |
| Net Cash Provided by Operating Activities   | 5,554              | 4,032          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                    |                |
| Activity in securities:   |                    |                |
| Maturities, prepayments and calls   | 13,402             | 12,614         |
| Sales   | 35,131             | 24,584         |
| Purchases   | (54,850)           | (56,500)       |
| Proceeds from sale of assets  |                    |                |
| Additions to premises and equipment   | (427)              | (188)          |
| Loan originations and principal collections, net                                  | 13,166             | 10,620         |
| Net Cash (Used) in Investing Activities   | 6,422              | (8,870)        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                    |                |
| Net increase (decrease) in deposits   | 9,194              | 24,439         |
| Net change in short-term debt   | (2,225)            | (2,367)        |
| Repayments of long-term debt  | (4,500)            | (17)           |
| Purchase of Treasury stock  | (77)               | (233)          |
| Cash dividends paid on common stock   | (931)              | (890)          |
| Net Cash Provided (Used) by Financing Activities                                  | 1,461              | 20,932         |
| Net (Decrease) in cash and cash equivalents                                       | 13,437             | 16,094         |
| Cash and cash equivalents - Beginning of year                                     | 44,092             | 37,026         |
| Cash and cash equivalents - End of period   | \$ 57,529          | \$ 59,237      |
| <b>RECONCILIATION OF CASH AND CASH EQUIVALENTS:</b>                               |                    |                |
| Cash and cash due from banks  | \$ 12,404          | \$ 12,060      |
| Interest bearing deposits with banks  | 11,323             | 16,121         |



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|  |           |           |
|--|-----------|-----------|
| Federal funds sold                           | 33,802    | 31,056    |
| Cash at end of period                        | \$ 57,529 | \$ 59,237 |
| <b>Supplemental Information</b>              |           |           |
| Cash paid during the period for:             |           |           |
| Interest                                     | \$ 1,212  | \$ 1,632  |
| Income Taxes                                 | \$        | \$ 426    |
| Noncash investing activities:                |           |           |
| Transfer of loans to other real estate owned | \$ 75     | \$ 150    |

See Notes to Condensed Consolidated Unaudited Financial Statements.

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### ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

#### NOTE 1 BASIS OF PRESENTATION

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

##### Short-Term Borrowings

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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.

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

## FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

## Dividends Payable

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

## Off Balance Sheet Financial Instruments

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

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

|                                 | Carrying<br>Amount | Fair<br>Value     | (In Thousands)   |                   |                   |
|---------------------------------|--------------------|-------------------|------------------|-------------------|-------------------|
|                                 |                    |                   | March 2013       |                   |                   |
|                                 |                    |                   | Level 1          | Level 2           | Level 3           |
| <b>Financial Assets:</b>        |                    |                   |                  |                   |                   |
| Cash and Cash Equivalents       | \$ 57,529          | \$ 57,529         | \$ 57,529        | \$                | \$                |
| Securities - available for sale | 360,821            | 360,821           | 26,239           | 323,333           | 11,249            |
| Other Securities                | 4,216              | 4,216             |                  |                   | 4,216             |
| Loans, net                      | 479,484            | 486,768           |                  |                   | 486,768           |
| Interest receivable             | 4,322              | 4,322             |                  |                   | 4,322             |
| <b>Total Assets</b>             | <b>\$ 906,372</b>  | <b>\$ 913,656</b> | <b>\$ 83,768</b> | <b>\$ 323,333</b> | <b>\$ 506,555</b> |
| <b>Financial Liabilities:</b>   |                    |                   |                  |                   |                   |
| Interest bearing Deposits       | \$ 411,564         | \$ 412,512        | \$               | \$                | \$ 412,512        |
| Non-interest bearing Deposits   | 99,027             | 99,662            |                  | 99,662            |                   |
| Time Deposits                   | 261,855            | 263,574           |                  |                   | 263,574           |
| <b>Total Deposits</b>           | <b>\$ 772,446</b>  | <b>\$ 775,748</b> | <b>\$</b>        | <b>\$ 99,662</b>  | <b>\$ 676,086</b> |
| Short-term debt                 | 49,087             | 49,087            |                  |                   | 49,087            |
| Federal Home Loan Bank advances | 7,100              | 6,610             |                  |                   | 6,610             |
| Interest payable                | 287                | 287               |                  |                   | 287               |
| Dividends payable               | 931                | 931               |                  | 931               |                   |
| <b>Total Liabilities</b>        | <b>\$ 829,851</b>  | <b>\$ 832,663</b> | <b>\$</b>        | <b>\$ 100,593</b> | <b>\$ 732,070</b> |

(In Thousands)  
December 2012

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|                                 | Carrying<br>Amount | Fair<br>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            | 501,160           |                  |                   | 501,160           |
| Interest receivable             | 3,603              | 3,603             |                  |                   | 3,603             |
| <b>Total Assets</b>             | <b>\$ 904,143</b>  | <b>\$ 909,125</b> | <b>\$ 54,660</b> | <b>\$ 328,929</b> | <b>\$ 525,536</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> |

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

## FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Fair Value Measurements

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

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

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

| (In Thousands)                              | Assets and Liabilities Measured at Fair Value on a Recurring Basis |   |   |
|---|--|---|---|
|   | Quoted Prices in Active Markets for Identical Assets (Level 1)     | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| March 31, 2013                              |  |   |   |
| <b>Assets-Securities Available for Sale</b> |  |   |   |
| U.S. Treasury                               | \$ 26,239  | \$                                      | \$  |
| U.S. Government agency                      |  | 216,549                                 |   |
| Mortgage-backed securities                  |  | 49,696                                  |   |
| State and local governments                 |  | 57,088                                  | \$ 11,249                                 |
| <b>Total Securities Available for Sale</b>  | <b>\$ 26,239</b>   | <b>\$ 323,333</b>                       | <b>\$ 11,249</b>                          |

(In Thousands)

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| December 31, 2012                           | Quoted Prices in Active<br>Markets for<br>Identical<br>Assets (Level 1) | Significant<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|---|---|---|---|
| <b>Assets-Securities Available for Sale</b> |   |   |   |
| U.S. Treasury                               | \$ 10,568   | \$  | \$  |
| U.S. Government agency                      |   | 220,200                                       |   |
| Mortgage-backed securities                  |   | 53,006  |   |
| State and local governments                 |   | 55,723  | 16,408  |
| <b>Total Securities Available for Sale</b>  | <b>\$ 10,568</b>  | <b>\$ 328,929</b>                             | <b>\$ 16,408</b>                                |

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 March 31, 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 March 31, 2013 and December 31, 2012, impaired loans categorized as Level 3 were \$4.1 and \$4.6 million, respectively.

The specific allocation for impaired loans was \$860 and \$865 thousand as of March 31, 2013 and December 31, 2012, respectively, which are accounted for in the allowance for loan losses (see Note 4).

Other real estate is reported at either the lower of the fair value of the real estate minus the estimated costs to sell the asset or the cost of the asset. The determination of fair value of the real estate relies primarily on appraisals from

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

## FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Fair Value Measurements (Continued)

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.

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

| (in Thousands)                                  | Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2013 |  |   |   |  |
|---|---|--|---|---|--|
|   | Balance at March 31, 2013   | Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Change in fair value for three-month period ended March 31, 2013 |
| Impaired loans                                  | \$ 4,144  | \$                                     | \$                                      | \$ 4,144                                  | \$ (20)  |
| Other real estate owned - residential mortgages | \$ 817  | \$                                     | \$                                      | \$ 817                                    | \$   |
| Other real estate owned - commercial            | \$ 1,409  | \$                                     | \$                                      | \$ 1,409                                  | \$   |
|   |   |  |   |   | \$ (20)  |

| (in Thousands)                                  | Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2012 |  |   |   |  |
|---|--|--|---|---|--|
|   | Balance at December 31, 2012   | Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Change in fair value for twelve-month period ended Dec. 31, 2012 |
| 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 March 31, 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 with the impairment remaining, however unchanged, as of March 31, 2013. Therefore, no impairment charge to other expense was required to adjust these assets to their estimated fair values.



NOTE 3 ASSET PURCHASE

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.

The amortization expense for the year ended December 31, 2012 was \$312 thousand. Of the \$313 thousand to be expensed in 2013, \$78 thousand has been expensed as of March 31, 2013.

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|            | (In Thousands) |            | Total    |
|------------|----------------|------------|----------|
|            | Knisely        | Hicksville |          |
| 2013       | \$ 157         | \$ 156     | \$ 313   |
| 2014       | 157            | 156        | 313      |
| 2015       |                | 155        | 155      |
| 2016       |                | 155        | 155      |
| 2017       |                | 77         | 77       |
| Thereafter |                |            |          |
|            | \$ 314         | \$ 699     | \$ 1,013 |

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

## NOTE 4 LOANS

## NOTE 4 LOANS

The Company had \$350.9 thousand in loans held for sale as of March 31, 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 March 31, 2013 and December 31, 2012:

| Loans:                                 | (In Thousands) |                   |
|--|----------------|-------------------|
|  | March 31, 2013 | December 31, 2012 |
| Commercial real estate                 | \$ 209,601     | \$ 199,999        |
| Agricultural real estate               | 35,898         | 40,143            |
| Consumer real estate                   | 77,160         | 80,287            |
| Commercial and industrial              | 89,779         | 101,624           |
| Agricultural                           | 51,896         | 57,770            |
| Consumer                               | 19,489         | 20,413            |
| Industrial Development Bonds           | 1,202          | 1,299             |
|  | \$ 485,025     | \$ 501,535        |
| Less: Net deferred loan fees and costs | (197)          | (133)             |
|  | 484,828        | 501,402           |
| Less: Allowance for loan losses        | (5,344)        | (5,224)           |
| Loans - Net                            | \$ 479,484     | \$ 496,178        |

The following is a maturity schedule by major category of loans as of March 31, 2013:

|                              | (In Thousands)  |                                  |                  |
|------------------------------|-----------------|----------------------------------|------------------|
|                              | Within One Year | After One Year Within Five Years | After Five Years |
| Commercial Real Estate       | \$ 44,598       | \$ 98,274                        | \$ 66,729        |
| Agricultural Real Estate     | 2,499           | 9,169                            | 24,230           |
| Consumer Real Estate         | 9,244           | 14,815                           | 53,101           |
| Commercial/Industrial        | 61,763          | 24,744                           | 3,272            |
| Agricultural                 | 30,669          | 18,996                           | 2,231            |
| Consumer                     | 4,898           | 12,602                           | 1,792            |
| Industrial Development Bonds | 320             | 490                              | 392              |

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of March 31, 2013. Variable rate loans whose current rates are equal to their floor or ceiling are classified as fixed in this table.

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|                              | (In Thousands) |                  |
|------------------------------|----------------|------------------|
|                              | Fixed<br>Rate  | Variable<br>Rate |
| Commercial Real Estate       | \$ 114,221     | \$ 95,380        |
| Agricultural Real Estate     | 26,672         | 9,226            |
| Consumer Real Estate         | 62,672         | 14,488           |
| Commercial/Industrial        | 67,170         | 22,609           |
| Agricultural                 | 48,375         | 3,521            |
| Consumer                     | 15,206         | 4,086            |
| Industrial Development Bonds | 1,202          |                  |

As of March 31, 2013 and December 31, 2012 one to four family residential mortgage loans amounting to \$25.6 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 March 31, 2013, past dues were 1.21%. 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.

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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 March 31, 2013 and December 31, 2012, net of deferred fees:

|                           | (In Thousands)      |                     |                               |                 |                   |                             | Recorded Investment > 90 Days and Accruing |
|---------------------------|---------------------|---------------------|-------------------------------|-----------------|-------------------|-----------------------------|--|
|                           | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days Past Due | Total Past Due  | Current           | Total Financing Receivables |  |
| March 31, 2013            |                     |                     |                               |                 |                   |                             |  |
| Consumer real estate      | \$ 613              | \$                  | \$ 310                        | \$ 923          | \$ 76,237         | \$ 77,160                   | \$   |
| Agricultural real estate  |                     |                     |                               |                 | 35,898            | 35,898                      |  |
| Agricultural              | 9                   |                     |                               | 9               | 51,887            | 51,896                      |  |
| Commercial Real Estate    | 1,228               | 139                 | 845                           | 2,212           | 207,389           | 209,601                     |  |
| Commercial and Industrial | 154                 | 27                  | 2,528                         | 2,709           | 88,272            | 90,981                      |  |
| Consumer                  | 27                  | 18                  | 3                             | 48              | 19,244            | 19,292                      | 3  |
| <b>Total</b>              | <b>\$ 2,031</b>     | <b>\$ 184</b>       | <b>\$ 3,686</b>               | <b>\$ 5,901</b> | <b>\$ 478,927</b> | <b>\$ 484,828</b>           | <b>\$ 3</b>                                |

|                           | (In Thousands)      |                     |                               |                 |                   |                             | Recorded Investment > 90 Days and Accruing |
|---------------------------|---------------------|---------------------|-------------------------------|-----------------|-------------------|-----------------------------|--|
|                           | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days Past Due | Total Past Due  | Current           | Total Financing Receivables |  |
| December 31, 2012         |                     |                     |                               |                 |                   |                             |  |
| Consumer real estate      | \$ 575              | \$                  | \$ 648                        | \$ 1,223        | \$ 79,064         | \$ 80,287                   | \$   |
| Agricultural real estate  |                     |                     |                               |                 | 40,143            | 40,143                      |  |
| Agricultural              | 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>                                |

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

|                           | (In Thousands) |                  |
|---------------------------|----------------|------------------|
|                           | March 31 2013  | December 31 2012 |
| Consumer real estate      | \$ 689         | \$ 964           |
| Agricultural real estate  |                |                  |
| Agricultural              |                | 0                |
| Commercial Real Estate    | 944            | 877              |
| Commercial and Industrial | 2,949          | 2,987            |
| Consumer                  |                |                  |

|       |          |          |
|-------|----------|----------|
| Total | \$ 4,582 | \$ 4,828 |
|-------|----------|----------|

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.

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

NOTE 4 LOANS (Continued)

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

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

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

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

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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.



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

## NOTE 4 LOANS (Continued)

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

| (in Thousands)        | Agriculture<br>Real<br>Estate | Agriculture      | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Industrial<br>Development<br>Bonds |
|-----------------------|-------------------------------|------------------|---------------------------|---------------------------------|------------------------------------|
| <b>March 31, 2013</b> |                               |                  |                           |                                 |                                    |
| 1-2                   | \$ 2,255                      | \$ 2,883         | \$ 3,264                  | \$ 57                           | \$                                 |
| 3                     | 13,837                        | 16,509           | 52,354                    | 22,021                          | 858                                |
| 4                     | 18,979                        | 32,469           | 139,030                   | 60,990                          | 344                                |
| 5                     | 790                           | 35               | 8,672                     | 2,404                           |                                    |
| 6                     | 37                            |                  | 6,237                     | 1,600                           |                                    |
| 7                     |                               |                  | 44                        | 2,707                           |                                    |
| 8                     |                               |                  |                           |                                 |                                    |
| <b>Total</b>          | <b>\$ 35,898</b>              | <b>\$ 51,896</b> | <b>\$ 209,601</b>         | <b>\$ 89,779</b>                | <b>\$ 1,202</b>                    |

|                          | Agriculture<br>Real<br>Estate | Agriculture      | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Industrial<br>Development<br>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>                    |

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 March 31, 2013 and December 31, 2012.

| Grade | (In Thousands)                              |  |
|-------|---|--|
|       | Consumer<br>Real Estate<br>March 31<br>2013 | Consumer<br>Real Estate<br>December 31<br>2012 |
|       | Pass  | \$ 76,850                                      |

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|                     |           |           |
|---------------------|-----------|-----------|
| Special Mention (5) |           |           |
| Substandard (6)     | 33        | 110       |
| Doubtful (7)        | 277       | 411       |
| Total               | \$ 77,160 | \$ 80,287 |

|               | (In Thousands)    |                     |                  |                     |
|---------------|-------------------|---------------------|------------------|---------------------|
|               | Consumer - Credit |                     | Consumer - Other |                     |
|               | March 31<br>2013  | December 31<br>2012 | March 31<br>2013 | December 31<br>2012 |
| Performing    | \$ 3,340          | \$ 3,470            | \$ 15,931        | \$ 16,775           |
| Nonperforming |                   | 3                   | 21               | 32                  |
| Total         | \$ 3,340          | \$ 3,473            | \$ 15,952        | \$ 16,807           |

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

NOTE 4 LOANS (Continued)

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

|   | March 31,<br>2013 | (In Thousands)<br>December 31,<br>2012 | March 31,<br>2012 |
|---|-------------------|--|-------------------|
| Impaired loans without a valuation allowance                | \$ 1,119          | \$ 730                                 | \$ 362            |
| Impaired loans with a valuation allowance                   | 3,025             | 3,861                                  | 1,505             |
| <b>Total impaired loans</b>                                 | <b>\$ 4,144</b>   | <b>\$ 4,591</b>                        | <b>\$ 1,867</b>   |
| Valuation allowance related to impaired loans               | \$ 860            | \$ 865                                 | \$ 191            |
| <b>Total non-accrual loans</b>                              | <b>\$ 4,582</b>   | <b>\$ 4,828</b>                        | <b>\$ 2,923</b>   |
| Total loans past-due ninety days or more and still accruing | \$ 3              | \$ 1                                   | \$                |
| <b>For three months ended:</b>                              |                   |  |                   |
| Average investment in impaired loans                        | \$ 4,321          | \$ 4,468                               | \$ 1,954          |

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

The Bank had approximately \$670 thousand of its impaired loans classified as troubled debt restructured as of March 31, 2013 and \$207 thousand as of March 31, 2012.

The following table represents three months ended March 31, 2013.

|                              | Number<br>of<br>Contracts<br>Modified in the<br>Last<br>3<br>Months | March 31, 2013<br>Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
|------------------------------|---|---|--|
| Troubled Debt Restructurings |   |   |  |
| Commercial Real Estate       |   | \$  | \$   |
| Ag Real Estate               |   |   |  |
| Commercial and Industrial    | 1   | 81  | 43   |

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

The following table represents three months ended March 31, 2012.

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|                              | March 31, 2012   |   |  |
|------------------------------|--|---|--|
|                              | Number of<br>Contracts<br>Modified in the<br>Last<br>3<br>Months | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment |
| Troubled Debt Restructurings |  |   |  |
| Commercial Real Estate       |  | \$  | \$   |
| Ag Real Estate               |  |   |  |
| Commercial and Industrial    |  |   |  |

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

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

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

## NOTE 4 LOANS (Continued)

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 March 31, 2013.

Three Months Ended March 31, 2013

|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|--|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| <b>With no related allowance recorded:</b> |                        |                                |                      |                                   |                                  |
| Consumer real estate                       | \$ 33                  | \$ 33                          | \$                   | \$ 60                             | \$ 1                             |
| Agriculture real estate                    |                        |                                |                      |                                   |                                  |
| Agriculture                                |                        |                                |                      |                                   |                                  |
| Commercial real estate                     | 801                    | 1,225                          |                      | 207                               |                                  |
| Commercial and industrial                  | 285                    | 285                            |                      | 286                               |                                  |
| Consumer                                   |                        |                                |                      |                                   |                                  |
| <b>With a specific allowance recorded:</b> |                        |                                |                      |                                   |                                  |
| Consumer real estate                       | 277                    | 349                            | 79                   | 131                               | 3                                |
| Agriculture real estate                    |                        |                                |                      |                                   |                                  |
| Agriculture                                |                        |                                |                      |                                   |                                  |
| Commercial real estate                     | 44                     | 64                             | 29                   | 6,250                             |                                  |
| Commercial and industrial                  | 2,704                  | 2,704                          | 751                  | 2,743                             |                                  |
| Consumer                                   |                        |                                |                      |                                   |                                  |
| <b>Totals:</b>                             |                        |                                |                      |                                   |                                  |
| Consumer real estate                       | \$ 310                 | \$ 382                         | \$ 79                | \$ 191                            | \$ 4                             |
| Agriculture real estate                    | \$                     | \$                             | \$                   | \$                                | \$                               |
| Agriculture                                | \$                     | \$                             | \$                   | \$                                | \$                               |
| Commercial real estate                     | \$ 845                 | \$ 1,289                       | \$ 29                | \$ 6,457                          | \$                               |
| Commercial and industrial                  | \$ 2,989               | \$ 2,989                       | \$ 751               | \$ 3,029                          | \$                               |
| Consumer                                   | \$                     | \$                             | \$                   | \$                                | \$                               |

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Three Months Ended March 31, 2012

|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|--|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| <b>With no related allowance recorded:</b> |                        |                                |                      |                                   |                                  |
| Consumer real estate                       | \$ 155                 | \$ 155                         | \$                   | \$ 158                            | \$ 3                             |
| <b>Agriculture real estate</b>             |                        |                                |                      |                                   |                                  |
| <b>Agriculture</b>                         |                        |                                |                      |                                   |                                  |
| Commercial real estate                     | 207                    | 384                            |                      | 207                               |                                  |
| <b>Commercial and industrial</b>           |                        |                                |                      |                                   |                                  |
| <b>Consumer</b>                            |                        |                                |                      |                                   |                                  |
| <b>With a specific allowance recorded:</b> |                        |                                |                      |                                   |                                  |
| Consumer real estate                       | 312                    | 312                            | 65                   | 390                               | 3                                |
| <b>Agriculture real estate</b>             |                        |                                |                      |                                   |                                  |
| <b>Agriculture</b>                         |                        |                                |                      |                                   |                                  |
| Commercial real estate                     | 696                    | 846                            | 22                   | 702                               |                                  |
| Commercial and industrial                  | 493                    | 493                            | 104                  | 493                               |                                  |
| Consumer                                   | 4                      | 4                              |                      | 4                                 | 2                                |
| <b>Totals:</b>                             |                        |                                |                      |                                   |                                  |
| Consumer real estate                       | \$ 467                 | \$ 467                         | \$ 65                | \$ 548                            | \$ 6                             |
| <b>Agriculture real estate</b>             |                        |                                |                      |                                   |                                  |
| <b>Agriculture</b>                         |                        |                                |                      |                                   |                                  |
| Commercial real estate                     | \$ 903                 | \$ 1,230                       | \$ 22                | \$ 909                            | \$                               |
| Commercial and industrial                  | \$ 493                 | \$ 493                         | \$ 104               | \$ 493                            | \$                               |
| Consumer                                   | \$ 4                   | \$ 4                           | \$                   | \$ 4                              | \$ 2                             |

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

## NOTE 4 LOANS (Continued)

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

|  | (In Thousands)                          |   |
|--|---|---|
|  | Three Months Ended<br>March 31,<br>2013 | Twelve Months Ended<br>December 31,<br>2012 |
| <b>Allowance for Loan Losses</b>                                       |   |   |
| Balance at beginning of year   | \$ 5,224                                | \$ 5,091                                    |
| Provision for loan loss  | 167                                     | 738   |
| Loans charged off  | (116)                                   | (891)                                       |
| Recoveries   | 69                                      | 286   |
| <br>   |   |   |
| Allowance for Loan & Leases Losses                                     | \$ 5,344                                | \$ 5,224                                    |
| <br>   |   |   |
| <b>Allowance for Unfunded Loan Commitments &amp; Letters of Credit</b> |   |   |
|  | \$ 172                                  | \$ 162                                      |
| <br>   |   |   |
| Total Allowance for Credit Losses                                      | \$ 5,516                                | \$ 5,386                                    |

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

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

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

Additional analysis related to the allowance for credit losses for three months ended March 31, 2013 is as follows (in thousands):

|  | Consumer       |                | Agriculture | Commercial  |            | Consumer<br>(incl.<br>Credit<br>Cards) | Unfunded<br>Loan<br>Commitment<br>&<br>Letters<br>of<br>Credit |             | Unallocated | Total |
|--|----------------|----------------|-------------|-------------|------------|--|--|-------------|-------------|-------|
|  | Real<br>Estate | Real<br>Estate |             | Real Estate | Commercial |  | Credit   | Unallocated |             |       |
| <b>Three Months Ended March 31, 2013</b> |                |                |             |             |            |  |  |             |             |       |
| <b>ALLOWANCE FOR CREDIT LOSSES:</b>      |                |                |             |             |            |  |  |             |             |       |
| Beginning balance                        | \$ 368         | \$ 113         | \$ 290      | \$ 1,749    | \$ 2,183   | \$ 268                                 | \$ 162   | \$ 253      | \$ 5,386    |       |
| Charge Offs                              | (10)           |                |             | (20)        |            | (86)                                   |  |             | (116)       |       |
| Recoveries                               | 4              |                | 1           |             | 15         | 49                                     |  |             | 69          |       |
| Provision                                | 101            | (8)            | (31)        | (163)       | (226)      | 25                                     |  | 469         | 167         |       |
|  |                |                |             |             |            |  | 10   |             | 10          |       |

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Other Non-interest expense related to unfunded

|                |    |     |    |     |    |     |    |       |    |       |    |     |    |     |    |     |    |       |
|----------------|----|-----|----|-----|----|-----|----|-------|----|-------|----|-----|----|-----|----|-----|----|-------|
| Ending Balance | \$ | 463 | \$ | 105 | \$ | 260 | \$ | 1,566 | \$ | 1,972 | \$ | 256 | \$ | 172 | \$ | 722 | \$ | 5,516 |
|----------------|----|-----|----|-----|----|-----|----|-------|----|-------|----|-----|----|-----|----|-----|----|-------|

|   |    |    |    |  |    |    |    |     |    |  |    |  |    |  |    |  |    |     |
|---|----|----|----|--|----|----|----|-----|----|--|----|--|----|--|----|--|----|-----|
| Ending balance: individually evaluated for impairment | \$ | 79 | \$ |  | \$ | 29 | \$ | 752 | \$ |  | \$ |  | \$ |  | \$ |  | \$ | 860 |
|---|----|----|----|--|----|----|----|-----|----|--|----|--|----|--|----|--|----|-----|

|   |    |     |    |     |    |     |    |       |    |       |    |     |    |     |    |     |    |       |
|---|----|-----|----|-----|----|-----|----|-------|----|-------|----|-----|----|-----|----|-----|----|-------|
| Ending balance: collectively evaluated for impairment | \$ | 384 | \$ | 105 | \$ | 260 | \$ | 1,537 | \$ | 1,220 | \$ | 256 | \$ | 172 | \$ | 722 | \$ | 4,656 |
|---|----|-----|----|-----|----|-----|----|-------|----|-------|----|-----|----|-----|----|-----|----|-------|

|   |    |   |    |  |    |  |    |  |    |  |    |  |    |  |    |  |    |   |
|---|----|---|----|--|----|--|----|--|----|--|----|--|----|--|----|--|----|---|
| Ending balance: loans acquired with deteriorated credit quality | \$ | 1 | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  | \$ | 1 |
|---|----|---|----|--|----|--|----|--|----|--|----|--|----|--|----|--|----|---|

**FINANCING RECEIVABLES:**

|                |    |        |    |        |    |        |    |         |    |        |    |        |    |  |    |  |    |         |
|----------------|----|--------|----|--------|----|--------|----|---------|----|--------|----|--------|----|--|----|--|----|---------|
| Ending balance | \$ | 77,160 | \$ | 35,898 | \$ | 51,896 | \$ | 209,601 | \$ | 90,981 | \$ | 19,292 | \$ |  | \$ |  | \$ | 484,828 |
|----------------|----|--------|----|--------|----|--------|----|---------|----|--------|----|--------|----|--|----|--|----|---------|

|   |    |     |    |  |    |     |    |       |    |  |    |  |    |  |    |  |    |       |
|---|----|-----|----|--|----|-----|----|-------|----|--|----|--|----|--|----|--|----|-------|
| Ending balance: individually evaluated for impairment | \$ | 310 | \$ |  | \$ | 845 | \$ | 2,990 | \$ |  | \$ |  | \$ |  | \$ |  | \$ | 4,145 |
|---|----|-----|----|--|----|-----|----|-------|----|--|----|--|----|--|----|--|----|-------|

|   |    |        |    |        |    |        |    |         |    |        |    |        |    |  |    |  |    |         |
|---|----|--------|----|--------|----|--------|----|---------|----|--------|----|--------|----|--|----|--|----|---------|
| Ending balance: collectively evaluated for impairment | \$ | 76,850 | \$ | 35,898 | \$ | 51,896 | \$ | 208,756 | \$ | 87,991 | \$ | 19,292 | \$ |  | \$ |  | \$ | 480,683 |
|---|----|--------|----|--------|----|--------|----|---------|----|--------|----|--------|----|--|----|--|----|---------|

|   |    |     |    |  |    |  |    |  |    |  |    |  |    |  |    |  |    |     |
|---|----|-----|----|--|----|--|----|--|----|--|----|--|----|--|----|--|----|-----|
| Ending balance: loans acquired with deteriorated credit quality | \$ | 556 | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  | \$ | 556 |
|---|----|-----|----|--|----|--|----|--|----|--|----|--|----|--|----|--|----|-----|



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

## NOTE 4 LOANS (Continued)

|  | Consumer<br>Real<br>Estate | Agriculture<br>Real<br>Estate | Agriculture | Commercial<br>Real Estate | Commercial | Consumer<br>(incl.<br>Credit<br>Cards) | Unfunded<br>Loan<br>Commitment<br>&<br>Letters<br>of<br>Credit | Unallocated | Total      |
|--|----------------------------|-------------------------------|-------------|---------------------------|------------|--|--|-------------|------------|
| Three Months Ended March 31,<br>2012                               |                            |                               |             |                           |            |  |  |             |            |
| <b>ALLOWANCE FOR CREDIT LOSSES:</b>                                |                            |                               |             |                           |            |  |  |             |            |
| Beginning balance  | \$ 261                     | \$ 140                        | \$ 266      | \$ 2,088                  | \$ 1,947   | \$ 315                                 | \$ 130   | \$ 74       | \$ 5,221   |
| Charge Offs  | (40)                       |                               | \$          |                           |            | (86)                                   |  |             | \$ (126)   |
| Recoveries   | 3                          |                               | 7           | 4                         | 15         | 30                                     |  |             | \$ 59      |
| Provision  | 209                        | (51)                          | (1)         | (522)                     | (103)      | 34                                     |  | 562         | \$ 128     |
| Other Non-interest expense related<br>to unfunded                  |                            |                               |             |                           |            |  | 10   |             | \$ 10      |
| Ending Balance   | \$ 433                     | \$ 89                         | \$ 272      | \$ 1,570                  | \$ 1,859   | \$ 293                                 | \$ 140   | \$ 636      | \$ 5,292   |
| Ending balance: individually<br>evaluated for impairment           | \$ 65                      | \$                            | \$          | \$ 22                     | \$ 104     | \$                                     | \$   | \$          | \$ 191     |
| Ending balance: collectively<br>evaluated for impairment           | \$ 368                     | \$ 89                         | \$ 272      | \$ 1,548                  | \$ 1,755   | \$ 293                                 | \$ 140   | \$ 636      | \$ 5,101   |
| Ending balance: loans acquired with<br>deteriorated credit quality | \$ 2                       | \$                            | \$          | \$                        | \$         | \$                                     | \$   | \$          | \$ 2       |
| <b>FINANCING RECEIVABLES:</b>                                      |                            |                               |             |                           |            |  |  |             |            |
| Ending balance   | \$ 79,716                  | \$ 31,814                     | \$ 54,084   | \$ 200,865                | \$ 105,111 | \$ 21,652                              | \$   | \$          | \$ 493,242 |
| Ending balance: individually<br>evaluated for impairment           | \$ 467                     | \$                            | \$          | \$ 903                    | \$ 493     | \$ 4                                   | \$   | \$          | \$ 1,867   |
| Ending balance: collectively<br>evaluated for impairment           | \$ 79,249                  | \$ 31,814                     | \$ 54,084   | \$ 199,962                | \$ 104,618 | \$ 21,648                              | \$   | \$          | \$ 491,375 |
| Ending balance: loans acquired with<br>deteriorated credit quality | \$ 709                     | \$                            | \$          | \$                        | \$         | \$                                     | \$   | \$          | \$ 709     |