
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period September 30, 2014

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number 0-14492

FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

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)

43502
(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 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 issuers' classes of common stock, as of the latest practicable date:

Common Stock, No Par Value
Class

4,627,848
Outstanding as of October 29, 2014

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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)

Farmers & Merchants Bancorp, Inc. and Subsidiary

	Condensed Consolidated Balance Sheets (in thousands of dollars)	
	September 30, 2014	December 31, 2013
Assets		
Cash and due from banks	\$ 12,058	\$ 15,376
Interest bearing deposits with banks	4,899	2,889
Federal Funds Sold	322	998
Total cash and cash equivalents	17,279	19,263
Securities - available-for-sale	253,119	324,509
Other Securities, at cost	3,717	4,216
Loans, net	602,688	570,919
Bank premises and equipment	20,293	18,709
Goodwill	4,074	4,074
Mortgage Servicing Rights	2,019	2,066
Other Real Estate Owned	1,264	2,091
Accrued interest and other assets	20,788	20,091
Total Assets	\$ 925,241	\$ 965,938
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing	\$ 120,103	\$ 110,452
Interest-bearing		
NOW accounts	204,919	215,185
Savings	214,607	214,467
Time	205,277	236,360
Total deposits	744,906	776,464
Federal funds purchased and securities sold under agreement to repurchase	62,219	69,756
FHLB Advances	—	4,500
Dividend payable	965	967
Accrued expenses and other liabilities	5,129	5,911
Total liabilities	813,219	857,598
Commitments and Contingencies		
Stockholders' Equity		
Common stock - No par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares	12,677	12,677
Treasury Stock - 572,152 shares 2014, 561,562 shares 2013	(11,916)	(11,611)
Unearned Stock Awards - 33,900 shares 2014, 31,530 shares 2013	(772)	(642)
Retained earnings	112,059	107,910
Accumulated other comprehensive income (loss)	(26)	6
Total stockholders' equity	112,022	108,340
Total Liabilities and Stockholders' Equity	\$ 925,241	\$ 965,938

See Notes to Condensed Consolidated Unaudited Financial Statements.

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

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FARMERS & MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED STATEMENT OF INCOME & COMPREHENSIVE INCOME
(Unaudited)

Farmers & Merchants Bancorp, Inc. and Subsidiary

	Condensed Consolidated Statement of Income & Comprehensive Income (in thousands of dollars, except per share data)			
	Three Months Ended		Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Interest Income				
Loans, including fees	\$ 7,108	\$ 6,244	\$ 20,762	\$ 18,411
Debt securities:				
U.S. Treasury securities	64	64	190	189
Securities of U.S. Government Agencies	747	971	2,292	2,979
Municipalities	512	513	1,559	1,562
Dividends	36	47	119	141
Federal funds sold	3	—	4	11
Other	1	5	8	18
Total interest income	8,471	7,844	24,934	23,311
Interest Expense				
Deposits	832	1,023	2,615	3,229
Federal funds purchased and securities sold under agreements to repurchase	63	62	190	184
Borrowed funds	—	44	4	133
Total interest expense	895	1,129	2,809	3,546
Net Interest Income - Before provision for loan losses	7,576	6,715	22,125	19,765
Provision for Loan Losses	282	303	1,154	582
Net Interest Income After Provision For Loan Losses	7,294	6,412	20,971	19,183
Noninterest Income				
Customer service fees	1,317	1,252	3,841	3,869
Other service charges and fees	1,047	995	2,767	2,824
Net gain on sale of loans	205	176	497	978
Net gain on sale of securities - available-for-sale	192	134	494	732
Total noninterest income	2,761	2,557	7,599	8,403
Noninterest Expenses				
Salaries and Wages	2,638	2,460	7,529	7,156
Pension and other employee benefits	927	819	2,492	2,273
Occupancy expense (net)	267	291	842	909
Furniture and equipment	439	350	1,232	1,057
Data processing	305	301	943	911
Franchise taxes	195	255	586	765
Net loss on sale of other assets owned	95	21	153	147
FDIC Assessment	126	146	388	406
Mortgage servicing rights amortization	92	88	258	345
Other general and administrative	1,495	1,382	4,405	4,165
Total Noninterest Expense	6,579	6,113	18,828	18,134
Income Before Federal Income Taxes	3,476	2,856	9,742	9,452
Federal Income Taxes	1,002	791	2,757	2,732
Net Income	2,474	2,065	6,985	6,720
Other Comprehensive Loss (Net of Tax):				
Unrealized loss on securities, net of tax benefit of \$105, \$82, \$16, and \$3,001 respectively	(204)	(159)	(32)	(5,825)
Comprehensive Income	\$ 2,270	\$ 1,906	\$ 6,953	\$ 895
Basic Earnings Per Share	\$ 0.54	\$ 0.45	\$ 1.51	\$ 1.44
Weighted Average Shares Outstanding	4,621,298	4,682,655	4,628,429	4,682,092
Dividends Declared	\$ 0.21	\$ 0.20	\$ 0.63	\$ 0.60

See Notes to Condensed Consolidated Unaudited Financial Statements

[Table of Contents](#)FARMERS & MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)**Farmers & Merchants Bancorp, Inc. and Subsidiary**

	Condensed Consolidated Statements of Cash Flows (in thousands of dollars) Nine Months Ended	
	September 30, 2014	September 30, 2013
Cash Flows from Operating Activities		
Net income	\$ 6,985	\$ 6,720
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,091	916
Amortization of securities, net	1,130	1,714
Amortization of servicing rights	258	345
Amortization of core deposit intangible	360	234
Compensation expense related to stock awards	205	202
Provision for loan loss	1,154	582
Gain on sale of loans	(497)	(978)
Originations of loans held for sale	(26,312)	(54,874)
Proceeds from sale of loans held for sale	30,391	57,957
Loss on sale of other assets	153	147
Gain on sales of securities available for sale	(494)	(732)
Change in other assets and other liabilities, net	(1,369)	(521)
Net cash provided by operating activities	13,055	11,712
Cash Flows from Investing Activities		
Activity in securities:		
Maturities, prepayments and calls	13,281	28,722
Sales	57,928	63,570
Purchases	—	(83,310)
Proceeds from sale of fixed assets	9	35
Additions to premises and equipment	(2,684)	(1,804)
Loan originations and principal collections, net	(36,505)	(25,783)
Net cash provided by (used in) investing activities	32,029	(18,570)
Cash Flows from Financing Activities		
Net increase in deposits	(31,558)	(17,684)
Net change in short-term debt	(7,537)	10,010
Repayments of FHLB advances	(4,500)	(4,500)
Purchase of Treasury Stock	(576)	(734)
Cash dividends paid on common stock	(2,897)	(2,791)
Net cash used in financing activities	(47,068)	(15,699)
Change in Cash and Cash Equivalents	(1,984)	(22,557)
Cash and cash equivalents - Beginning of year	19,263	44,092
Cash and cash equivalents - End of period	\$ 17,279	\$ 21,535
Supplemental Information		
Cash paid during the year for:		
Interest	\$ 2,918	\$ 3,689
Income taxes	\$ 2,137	\$ 2,690
Noncash investing activities:		
Transfer of loans to other real estate owned	\$ 139	\$ 945

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 nine months ended September 30, 2014 are not necessarily indicative of the results that are expected for the year ended December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2013.

NOTE 2 ASSET PURCHASES

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

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

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

The amortization expense for the year ended December 31, 2013 was \$319 thousand. Of the \$480 thousand to be expensed in 2014, \$360 thousand has been expensed as of September 30, 2014.

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

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

NOTE 3 SECURITIES

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

	(In Thousands)			
	September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
U.S. Treasury	\$ 25,892	\$ —	\$ (610)	\$ 25,282
U.S. Government agency	120,245	534	(1,823)	118,956
Mortgage-backed securities	30,773	536	(176)	31,133
State and local governments	76,248	1,864	(364)	77,748
	<u>\$253,158</u>	<u>\$ 2,934</u>	<u>\$ (2,973)</u>	<u>\$253,119</u>

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

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

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

If the impairment is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value, thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The amount of the write down shall be included in current earnings as a realized loss. The recovery in fair value, if any, shall be recognized in earnings when the security is sold. The table below is presented by category of security and length of time in a continuous loss position. The Company currently does not hold any securities with other than temporary impairment.

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

NOTE 3 SECURITIES (Continued)

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

	(In Thousands)			
	September 30, 2014			
	Less Than Twelve Months Gross Unrealized Losses	Fair Value	Twelve Months & Over Gross Unrealized Losses	Fair Value
U.S. Treasury	\$ —	\$ —	\$ (610)	\$ 25,282
U.S. Government agency	(7)	5,488	(1,816)	85,088
Mortgage-backed securities	(10)	4,654	(166)	8,227
State and local governments	(234)	7,866	(130)	9,342
Total available-for-sale securities	\$ (251)	\$ 18,008	\$ (2,722)	\$ 127,939

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

Unrealized losses on securities have not been recognized into income because the issuers' bonds are of high credit quality and the Company has the intent and ability to hold the securities for the foreseeable future. Additionally, the decline in value is primarily due to changes in interest rates since the securities were purchased. The fair value is expected to recover as the bonds approach the maturity date.

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

	(In Thousands)	
	2014	2013
Gross realized gains	\$ 638	\$ 735
Gross realized losses	(144)	(3)
Net realized gains	\$ 494	\$ 732
Tax expense related to net realized gains	\$ 168	\$ 249

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

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

NOTE 3 SECURITIES (Continued)

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

	(In Thousands)	
	Amortized Cost	Fair Value
One year or less	\$ 20,590	\$ 20,827
After one year through five years	146,785	146,351
After five years through ten years	46,793	46,842
After ten years	8,217	7,966
Total	<u>\$222,385</u>	<u>\$221,986</u>
Mortgage-backed securities	30,773	31,133
Total	<u>\$253,158</u>	<u>\$253,119</u>

Investments with a carrying value and fair value of \$176.9 million at September 30, 2014 and \$205.2 million at December 31, 2013 were pledged to secure public deposits and securities sold under repurchase agreements.

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

NOTE 4 LOANS

The Company had \$678 thousand in consumer real estate loans held for sale as of September 30, 2014 as compared to \$556 thousand in loans held for sale on December 31, 2013. Due to lack of materiality, these loans are included in the Consumer Real Estate loans below.

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

Loans:	(In Thousands)	
	September 30, 2014	December 31, 2013
Consumer real estate	\$ 97,651	\$ 92,438
Agricultural real estate	48,812	44,301
Agricultural	67,221	65,449
Commercial real estate	274,074	248,893
Commercial and industrial	92,926	99,498
Consumer	23,455	21,406
Industrial Development Bonds	4,854	4,358
	<u>608,993</u>	<u>576,343</u>
Less: Net deferred loan fees and costs	(389)	(230)
	<u>608,604</u>	<u>576,113</u>
Less: Allowance for loan losses	(5,916)	(5,194)
Loans - Net	<u>\$ 602,688</u>	<u>\$ 570,919</u>

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

NOTE 4 LOANS (Continued)

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

	Maturities (In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	\$10,820	\$ 19,204	\$ 67,627
Agricultural Real Estate	3,558	14,253	31,001
Agricultural	39,834	23,228	4,159
Commercial Real Estate	43,036	92,764	138,274
Commercial/Industrial	55,248	31,686	5,992
Consumer	5,307	14,137	4,011
Industrial Development Bonds	2,363	340	2,151

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

	(In Thousands)	
	Fixed Rate	Variable Rate
Consumer Real Estate	\$ 77,757	\$19,894
Agricultural Real Estate	34,129	14,683
Agricultural	62,153	5,068
Commercial Real Estate	175,742	98,332
Commercial/Industrial	69,495	23,431
Consumer	19,191	4,264
Industrial Development Bonds	4,685	169

As of September 30, 2014 and December 31, 2013 one to four family residential mortgage loans amounting to \$22.0 and \$24.2 million, respectively, have been pledged as security for loans the Bank has received from the Federal Home Loan Bank.

Unless listed separately, 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 September 30, 2014 and December 31, 2013, net of deferred fees:

	(In Thousands)						
	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
September 30, 2014							
Consumer Real Estate	\$ 576	\$ 150	\$ 489	\$ 1,215	\$ 96,436	\$ 97,651	\$ —
Agricultural Real Estate	25	—	—	25	48,787	48,812	—
Agricultural	—	—	—	—	67,221	67,221	—
Commercial Real Estate	56	709	—	765	273,309	274,074	—
Commercial and Industrial	—	—	—	—	97,780	97,780	—
Consumer	60	18	5	83	22,983	23,066	—
Total	<u>\$ 717</u>	<u>\$ 877</u>	<u>\$ 494</u>	<u>\$ 2,088</u>	<u>\$606,516</u>	<u>\$ 608,604</u>	<u>\$ —</u>
December 31, 2013							
Consumer Real Estate	\$ 778	\$ —	\$ 234	\$ 1,012	\$ 91,426	\$ 92,438	\$ —
Agricultural Real Estate	—	—	—	—	44,301	44,301	—
Agricultural	—	—	—	—	65,449	65,449	—
Commercial Real Estate	—	—	373	373	248,520	248,893	—
Commercial and Industrial	—	—	26	26	103,830	103,856	—
Consumer	28	2	—	30	21,146	21,176	—
Total	<u>\$ 806</u>	<u>\$ 2</u>	<u>\$ 633</u>	<u>\$ 1,441</u>	<u>\$574,672</u>	<u>\$ 576,113</u>	<u>\$ —</u>

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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 September 30, 2014 and December 31, 2013:

	(In Thousands)	
	September 30 2014	December 31 2013
Consumer Real Estate	\$ 568	\$ 483
Agricultural Real Estate	—	—
Agricultural	2	—
Commercial Real Estate	709	2,436
Commercial and Industrial	350	410
Consumer	5	—
Total	<u>\$ 1,634</u>	<u>\$ 3,329</u>

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

The risk ratings are described as follows.

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

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

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

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

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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.

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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 class based on the most recent analysis performed as of September 30, 2014 and December 31, 2013:

	(In Thousands)				
	<u>Agricultural Real Estate</u>	<u>Agricultural</u>	<u>Commercial Real Estate</u>	<u>Commercial and Industrial</u>	<u>Industrial Development Bonds</u>
September 30, 2014					
1-2	\$ 3,961	\$ 7,964	\$ 1,250	\$ 212	\$ —
3	14,844	23,115	51,943	22,552	4,392
4	29,512	36,142	216,262	67,672	462
5	276	—	1,828	2,085	—
6	219	—	2,791	174	—
7	—	—	—	231	—
8	—	—	—	—	—
Total	<u>\$ 48,812</u>	<u>\$ 67,221</u>	<u>\$ 274,074</u>	<u>\$ 92,926</u>	<u>\$ 4,854</u>
December 31, 2013					
1-2	\$ 3,764	\$ 9,263	\$ 1,104	\$ 2,525	\$ —
3	14,588	27,212	55,060	21,610	3,869
4	25,186	28,974	182,277	72,059	489
5	729	—	4,987	2,119	—
6	34	—	5,092	758	—
7	—	—	373	427	—
8	—	—	—	—	—
Total	<u>\$ 44,301</u>	<u>\$ 65,449</u>	<u>\$ 248,893</u>	<u>\$ 99,498</u>	<u>\$ 4,358</u>

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

NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of September 30, 2014 and December 31, 2013.

Grade	(In Thousands)	
	Consumer Real Estate September 30 2014	Consumer Real Estate December 31 2013
Pass	\$ 96,961	\$ 92,226
Special Mention (5)	—	—
Substandard (6)	552	18
Doubtful (7)	138	194
Total	<u>\$ 97,651</u>	<u>\$ 92,438</u>

	(In Thousands)			
	Consumer - Credit		Consumer - Other	
	September 30 2014	December 31 2013	September 30 2014	December 31 2013
Performing	\$ 3,618	\$ 3,721	\$ 19,421	\$ 17,425
Nonperforming	—	—	27	30
Total	<u>\$ 3,618</u>	<u>\$ 3,721</u>	<u>\$ 19,448</u>	<u>\$ 17,455</u>

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

	September 30, 2014	December 31, 2013	September 30, 2013
Impaired loans without a valuation allowance	\$ 1,209	\$ 924	\$ 253
Impaired loans with a valuation allowance	477	1,516	1,308
Total impaired loans	<u>\$ 1,686</u>	<u>\$ 2,440</u>	<u>\$ 1,561</u>
Valuation allowance related to impaired loans	\$ 252	\$ 516	\$ 423
Total non-accrual loans	\$ 1,634	\$ 3,329	\$ 2,908
Total loans past-due ninety days or more and still accruing	\$ —	\$ —	\$ —
Quarter ended average investment in impaired loans	\$ 1,788	\$ 2,532	\$ 1,879
Year to date average investment in impaired loans	\$ 1,989	\$ 3,274	\$ 3,521

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

The Bank had approximately \$824.4 thousand of its impaired loans classified as troubled debt restructured as of September 30, 2014, \$861.2 thousand as of December 31, 2013 and \$378.0 thousand as of September 30, 2013.

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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 nine months ended September 30, 2014.

Three Months September 30, 2014 Troubled Debt Restructurings	Number of Contracts Modified in the Last 3 Months	(In Thousands)		Nine Months September 30, 2014 Troubled Debt Restructurings	Number of Contracts Modified in the Last 9 Months	(In Thousands)	
		Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment			Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Ag Real Estate	—	\$ —	\$ —	Ag Real Estate	2	\$ 153	\$ 141

The following table represents three months and nine months ended September 30, 2013.

Three Months September 30, 2013 Troubled Debt Restructurings	Number of Contracts Modified in the Last 3 Months	(In Thousands)		Nine Months September 30, 2013 Troubled Debt Restructurings	Number of Contracts Modified in the Last 9 Months	(In Thousands)	
		Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment			Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Commercial and Industrial		\$ —	\$ —	Commercial and Industrial	1	\$ 81	\$ 43

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

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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 September 30, 2014 and September 30, 2013.

	(In Thousands)				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Three Months Ended September 30, 2014					
With no related allowance recorded:					
Consumer real estate	\$ 26	\$ 26	\$ —	\$ 26	\$ —
Agricultural real estate	—	—	—	94	7
Agricultural	—	—	—	—	—
Commercial real estate	709	709	—	739	—
Commercial and industrial	474	474	—	476	7
Consumer	—	—	—	—	—
With a specific allowance recorded:					
Consumer real estate	139	139	49	112	1
Agricultural real estate	—	—	—	—	—
Agricultural	—	—	—	—	—
Commercial real estate	—	—	—	—	—
Commercial and industrial	338	338	203	341	—
Consumer	—	—	—	—	—
Totals:					
Consumer real estate	<u>\$ 165</u>	<u>\$ 165</u>	<u>\$ 49</u>	<u>\$ 138</u>	<u>\$ 1</u>
Agricultural real estate	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 94</u>	<u>\$ 7</u>
Agricultural	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Commercial real estate	<u>\$ 709</u>	<u>\$ 709</u>	<u>\$ —</u>	<u>\$ 739</u>	<u>\$ —</u>
Commercial and industrial	<u>\$ 812</u>	<u>\$ 812</u>	<u>\$ 203</u>	<u>\$ 817</u>	<u>\$ 7</u>
Consumer	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

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

NOTE 4 LOANS (Continued)

	(In Thousands)				
Three Months Ended September 30, 2013	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	\$ 152	\$ 224	\$ —	\$ 224	\$ 6
Agricultural real estate	—	—	—	—	—
Agricultural	—	—	—	—	—
Commercial real estate	101	101	—	364	—
Commercial and industrial	—	—	—	—	—
Consumer	—	—	—	—	—
With a specific allowance recorded:					
Consumer real estate	372	372	114	273	1
Agricultural real estate	88	88	9	88	—
Agricultural	—	—	—	—	—
Commercial real estate	470	717	219	514	—
Commercial and industrial	378	378	81	416	—
Consumer	—	—	—	—	—
Totals:					
Consumer real estate	<u>\$ 524</u>	<u>\$ 596</u>	<u>\$ 114</u>	<u>\$ 497</u>	<u>\$ 7</u>
Agricultural real estate	<u>\$ 88</u>	<u>\$ 88</u>	<u>\$ 9</u>	<u>\$ 88</u>	<u>\$ —</u>
Agricultural	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Commercial real estate	<u>\$ 571</u>	<u>\$ 818</u>	<u>\$ 219</u>	<u>\$ 878</u>	<u>\$ —</u>
Commercial and industrial	<u>\$ 378</u>	<u>\$ 378</u>	<u>\$ 81</u>	<u>\$ 416</u>	<u>\$ —</u>
Consumer	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

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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 nine months ended September 30, 2014 and September 30, 2013.

	(In Thousands)				
Nine Months Ended September 30, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	\$ 26	\$ 26	\$ —	\$ 38	\$ 1
Agricultural real estate	—	—	—	125	8
Agricultural	—	—	—	—	—
Commercial real estate	709	709	—	829	9
Commercial and industrial	474	474	—	279	7
Consumer	—	—	—	—	—
With a specific allowance recorded:					
Consumer real estate	139	139	49	122	24
Agricultural real estate	—	—	—	—	—
Agricultural	—	—	—	—	—
Commercial real estate	—	—	—	32	—
Commercial and industrial	338	338	203	564	—
Consumer	—	—	—	—	—
Totals:					
Consumer real estate	<u>\$ 165</u>	<u>\$ 165</u>	<u>\$ 49</u>	<u>\$ 160</u>	<u>\$ 25</u>
Agricultural real estate	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 125</u>	<u>\$ 8</u>
Agricultural	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Commercial real estate	<u>\$ 709</u>	<u>\$ 709</u>	<u>\$ —</u>	<u>\$ 861</u>	<u>\$ 9</u>
Commercial and industrial	<u>\$ 812</u>	<u>\$ 812</u>	<u>\$ 203</u>	<u>\$ 843</u>	<u>\$ 7</u>
Consumer	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

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

NOTE 4 LOANS (Continued)

Nine Months Ended September 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	\$ 152	\$ 224	\$ —	\$ 162	\$ 7
Agricultural real estate	—	—	—	—	—
Agricultural	—	—	—	—	—
Commercial real estate	101	101	—	536	—
Commercial and industrial	—	—	—	198	—
Consumer	—	—	—	—	—
With a specific allowance recorded:					
Consumer real estate	372	372	114	172	4
Agricultural real estate	88	88	9	66	—
Agricultural	—	—	—	—	—
Commercial real estate	470	717	219	393	—
Commercial and industrial	378	378	81	1,940	1
Consumer	—	—	—	—	—
Totals:					
Consumer real estate	\$ 524	\$ 596	\$ 114	\$ 334	\$ 11
Agricultural real estate	\$ 88	\$ 88	\$ 9	\$ 66	\$ —
Agricultural	\$ —	\$ —	\$ —	\$ —	\$ —
Commercial real estate	\$ 571	\$ 818	\$ 219	\$ 929	\$ —
Commercial and industrial	\$ 378	\$ 378	\$ 81	\$ 2,138	\$ 1
Consumer	\$ —	\$ —	\$ —	\$ —	\$ —

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

NOTE 4 LOANS (Continued)

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

	(In Thousands)	
	Nine Months Ended September 30, 2014	Twelve Months Ended December 31, 2013
Allowance for Loan & Lease Losses		
Balance at beginning of year	\$ 5,194	\$ 5,224
Provision for loan loss	1,154	858
Loans charged off	(630)	(1,262)
Recoveries	198	374
Allowance for Loan & Lease Losses	<u>\$ 5,916</u>	<u>\$ 5,194</u>
Allowance for Unfunded Loan Commitments & Letters of Credit	\$ 196	\$ 163
Total Allowance for Credit Losses	<u>\$ 6,112</u>	<u>\$ 5,357</u>

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.

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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 September 30, 2014 and September 30, 2013 is as follows:

	(In Thousands)								
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
Three Months Ended September 30, 2014									
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	\$ 569	\$ 125	\$ 317	\$ 1,886	\$ 1,469	\$ 290	\$ 186	\$ 1,007	\$ 5,849
Charge Offs	—	—	—	—	—	(95)	—	—	\$ (95)
Recoveries	11	—	1	—	5	49	—	—	\$ 66
Provision (Credit)	218	3	18	(54)	(149)	57	—	189	\$ 282
Other Non-interest expense related to unfunded	—	—	—	—	—	—	10	—	\$ 10
Ending Balance	<u>\$ 798</u>	<u>\$ 128</u>	<u>\$ 336</u>	<u>\$ 1,832</u>	<u>\$ 1,325</u>	<u>\$ 301</u>	<u>\$ 196</u>	<u>\$ 1,196</u>	<u>\$ 6,112</u>
Ending balance: individually evaluated for impairment	\$ 49	\$ —	\$ —	\$ —	\$ 203	\$ —	\$ —	\$ —	\$ 252
Ending balance: collectively evaluated for impairment	<u>\$ 749</u>	<u>\$ 128</u>	<u>\$ 336</u>	<u>\$ 1,832</u>	<u>\$ 1,122</u>	<u>\$ 301</u>	<u>\$ 196</u>	<u>\$ 1,196</u>	<u>\$ 5,860</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2</u>
FINANCING RECEIVABLES:									
Ending balance	<u>\$97,651</u>	<u>\$ 48,812</u>	<u>\$ 67,221</u>	<u>\$ 274,074</u>	<u>\$ 97,780</u>	<u>\$23,066</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$608,604</u>
Ending balance: individually evaluated for impairment	\$ 165	\$ —	\$ —	\$ 709	\$ 812	\$ —	\$ —	\$ —	\$ 1,686
Ending balance: collectively evaluated for impairment	<u>\$97,486</u>	<u>\$ 48,812</u>	<u>\$ 67,221</u>	<u>\$ 273,365</u>	<u>\$ 96,968</u>	<u>\$23,066</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$606,918</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 527</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 527</u>

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

NOTE 4 LOANS (Continued)

	(In Thousands)								
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
Three Months Ended September 30, 2013									
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	\$ 361	\$ 115	\$ 277	\$ 1,460	\$ 2,138	\$ 266	\$ 187	\$ 680	\$ 5,484
Charge Offs	(12)	—	—	—	(513)	(122)	—	—	\$ (647)
Recoveries	6	—	1	—	17	53	—	—	\$ 77
Provision (Credit)	52	(1)	4	523	(313)	76	—	(38)	\$ 303
Other Non-interest expense related to unfunded	—	—	—	—	—	—	(18)	—	\$ (18)
Ending Balance	<u>\$ 407</u>	<u>\$ 114</u>	<u>\$ 282</u>	<u>\$ 1,983</u>	<u>\$ 1,329</u>	<u>\$ 273</u>	<u>\$ 169</u>	<u>\$ 642</u>	<u>\$ 5,199</u>
Ending balance: individually evaluated for impairment	\$ 114	\$ 9	\$ —	\$ 219	\$ 80	\$ —	\$ —	\$ —	\$ 422
Ending balance: collectively evaluated for impairment	<u>\$ 293</u>	<u>\$ 105</u>	<u>\$ 282</u>	<u>\$ 1,764</u>	<u>\$ 1,249</u>	<u>\$ 273</u>	<u>\$ 169</u>	<u>\$ 642</u>	<u>\$ 4,777</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2</u>
FINANCING RECEIVABLES:									
Ending balance	<u>\$79,268</u>	<u>\$ 37,758</u>	<u>\$ 56,752</u>	<u>\$ 232,104</u>	<u>\$ 96,643</u>	<u>\$20,801</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$523,326</u>
Ending balance: individually evaluated for impairment	\$ 524	\$ 88	\$ —	\$ 571	\$ 378	\$ —	\$ —	\$ —	\$ 1,561
Ending balance: collectively evaluated for impairment	<u>\$78,744</u>	<u>\$ 37,670</u>	<u>\$ 56,752</u>	<u>\$ 231,533</u>	<u>\$ 96,265</u>	<u>\$20,801</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$521,765</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 539</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 539</u>

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

NOTE 4 LOANS (Continued)

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

	(In Thousands)								
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
Nine Months Ended September 30, 2014									
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	\$ 257	\$ 131	\$ 326	\$ 2,107	\$ 1,359	\$ 292	\$ 163	\$ 722	\$ 5,357
Charge Offs	(130)	—	—	(230)	—	(270)	—	—	\$ (630)
Recoveries	28	—	4	3	15	148	—	—	\$ 198
Provision (Credit)	643	(3)	6	(48)	(49)	131	—	474	\$ 1,154
Other Non-interest expense related to unfunded	—	—	—	—	—	—	33	—	\$ 33
Ending Balance	<u>\$ 798</u>	<u>\$ 128</u>	<u>\$ 336</u>	<u>\$ 1,832</u>	<u>\$ 1,325</u>	<u>\$ 301</u>	<u>\$ 196</u>	<u>\$ 1,196</u>	<u>\$ 6,112</u>
Ending balance: individually evaluated for impairment	\$ 49	\$ —	\$ —	\$ —	\$ 203	\$ —	\$ —	\$ —	\$ 252
Ending balance: collectively evaluated for impairment	<u>\$ 749</u>	<u>\$ 128</u>	<u>\$ 336</u>	<u>\$ 1,832</u>	<u>\$ 1,122</u>	<u>\$ 301</u>	<u>\$ 196</u>	<u>\$ 1,196</u>	<u>\$ 5,860</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2</u>
FINANCING RECEIVABLES:									
Ending balance	<u>\$97,651</u>	<u>\$ 48,812</u>	<u>\$ 67,221</u>	<u>\$ 274,074</u>	<u>\$ 97,780</u>	<u>\$23,066</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$608,604</u>
Ending balance: individually evaluated for impairment	\$ 165	\$ —	\$ —	\$ 709	\$ 812	\$ —	\$ —	\$ —	\$ 1,686
Ending balance: collectively evaluated for impairment	<u>\$97,486</u>	<u>\$ 48,812</u>	<u>\$ 67,221</u>	<u>\$ 273,365</u>	<u>\$ 96,968</u>	<u>\$23,066</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$606,918</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 527</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 527</u>

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

NOTE 4 LOANS (Continued)

	(In Thousands)								
	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
Nine Months Ended September 30, 2013									
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	\$ 368	\$ 113	\$ 290	\$ 1,749	\$ 2,183	\$ 268	\$ 162	\$ 253	\$ 5,386
Charge Offs	(112)	—	—	(64)	(513)	(319)	—	—	\$ (1,008)
Recoveries	15	—	5	1	73	139	—	—	\$ 233
Provision (Credit)	136	1	(13)	297	(414)	185	—	389	\$ 581
Other Non-interest expense related to unfunded	—	—	—	—	—	—	7	—	\$ 7
Ending Balance	<u>\$ 407</u>	<u>\$ 114</u>	<u>\$ 282</u>	<u>\$ 1,983</u>	<u>\$ 1,329</u>	<u>\$ 273</u>	<u>\$ 169</u>	<u>\$ 642</u>	<u>\$ 5,199</u>
Ending balance: individually evaluated for impairment	\$ 114	\$ 9	\$ —	\$ 219	\$ 80	\$ —	\$ —	\$ —	\$ 422
Ending balance: collectively evaluated for impairment	<u>\$ 293</u>	<u>\$ 105</u>	<u>\$ 282</u>	<u>\$ 1,764</u>	<u>\$ 1,249</u>	<u>\$ 273</u>	<u>\$ 169</u>	<u>\$ 642</u>	<u>\$ 4,777</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 2</u>
FINANCING RECEIVABLES:									
Ending balance	<u>\$79,268</u>	<u>\$ 37,758</u>	<u>\$ 56,752</u>	<u>\$ 232,104</u>	<u>\$ 96,643</u>	<u>\$20,801</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$523,326</u>
Ending balance: individually evaluated for impairment	\$ 524	\$ 88	\$ —	\$ 571	\$ 378	\$ —	\$ —	\$ —	\$ 1,561
Ending balance: collectively evaluated for impairment	<u>\$78,744</u>	<u>\$ 37,670</u>	<u>\$ 56,752</u>	<u>\$ 231,533</u>	<u>\$ 96,265</u>	<u>\$20,801</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$521,765</u>
Ending balance: loans acquired with deteriorated credit quality	<u>\$ 539</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 539</u>

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

NOTE 5 FAIR VALUE OF INSTRUMENTS

FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

Cash and Cash Equivalents

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

Securities

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

Other Securities – Available-for-sale

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, net

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

Deposits - Interest Bearing, Non-interest Bearing and Time

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

Short-Term Borrowings

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

FHLB Advances

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

Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

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

NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Dividends Payable

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

Off Balance Sheet Financial Instruments

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

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of September 30, 2014 and December 31, 2013 are reflected below.

	(In Thousands)				
	September 30, 2014				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial Assets:					
Cash and Cash Equivalents	\$ 17,279	\$ 17,279	\$17,279	\$ —	\$ —
Securities - available-for-sale	253,119	253,119	25,282	219,930	7,907
Other Securities	3,717	3,717	—	—	3,717
Loans, net	602,688	619,041	—	—	619,041
Interest receivable	4,210	4,210	—	—	4,210
Total Assets	<u>\$881,013</u>	<u>\$897,366</u>	<u>\$42,561</u>	<u>\$219,930</u>	<u>\$634,875</u>
Financial Liabilities:					
Interest bearing Deposits	\$419,526	\$419,499	\$ —	\$ —	\$419,499
Non-interest bearing Deposits	120,103	120,103	—	120,103	—
Time Deposits	205,277	206,950	—	—	204,492
Total Deposits	<u>\$744,906</u>	<u>\$746,552</u>	<u>\$ —</u>	<u>\$120,103</u>	<u>\$623,991</u>
Short-term borrowings	62,219	62,219	—	—	62,219
Interest payable	197	197	—	—	197
Dividends payable	965	965	—	965	—
Total Liabilities	<u>\$808,287</u>	<u>\$809,933</u>	<u>\$ —</u>	<u>\$121,068</u>	<u>\$686,407</u>

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

NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands)				
	December 31, 2013				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial Assets:					
Cash and Cash Equivalents	\$ 19,263	\$ 19,263	\$19,263	\$ —	\$ —
Securities - available-for-sale	324,509	324,509	25,272	288,891	10,346
Other Securities	4,216	4,216	—	—	4,216
Loans, net	570,919	579,992	—	—	579,992
Interest receivable	3,694	3,694	—	—	3,694
Total Assets	\$922,601	\$931,674	\$44,535	\$288,891	\$598,248
Financial Liabilities:					
Interest bearing Deposits	\$429,652	\$429,750	\$ —	\$ —	\$429,750
Non-interest bearing Deposits	110,452	110,452	—	110,452	—
Time Deposits	236,360	236,027	—	—	236,027
Total Deposits	\$776,464	\$776,229	\$ —	\$110,452	\$665,777
Short-term borrowings	69,756	69,756	—	—	69,756
Federal Home Loan Bank advances	4,500	4,570	—	—	4,570
Interest payable	223	223	—	—	223
Dividends payable	967	967	—	967	—
Total Liabilities	\$851,910	\$851,745	\$ —	\$111,419	\$740,326

Fair Value Measurements

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

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

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

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

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

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

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

NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Fair Value Measurements (Continued)

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

	Assets and Liabilities Measured at Fair Value on a Recurring Basis (In Thousands)		
	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
<u>September 30, 2014</u>			
<u>Assets-(Securities Available for Sale)</u>			
U.S. Treasury	\$ 25,282	\$ —	\$ —
U.S. Government agency		118,956	—
Mortgage-backed securities		31,133	—
State and local governments	—	69,841	7,907
Total Securities Available for Sale	<u>\$ 25,282</u>	<u>\$ 219,930</u>	<u>\$ 7,907</u>
	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
<u>December 31, 2013</u>			
<u>Assets-(Securities Available for Sale)</u>			
U.S. Treasury	\$ 25,272	\$ —	\$ —
U.S. Government agency	—	172,972	—
Mortgage-backed securities	—	44,792	—
State and local governments	—	71,127	10,346
Total Securities Available for Sale	<u>\$ 25,272</u>	<u>\$ 288,891</u>	<u>\$ 10,346</u>

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

NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	(In Thousands)		
	Fair Value Measurements Using Significant		
	Unobservable Inputs (Level 3)		
	State and Local Governments Tax-Exempt	State and Local Governments Taxable	State and Local Governments Total
Balance at January 1, 2014	\$ 8,802	\$ 1,544	\$ 10,346
Change in Market Value	(1,262)	(357)	(1,619)
Payments & Maturities	(820)	—	(820)
Balance at September 30, 2014	<u>\$ 6,720</u>	<u>\$ 1,187</u>	<u>\$ 7,907</u>

	(In Thousands)		
	Fair Value Measurements Using Significant		
	Unobservable Inputs (Level 3)		
	State and Local Governments Tax-Exempt	State and Local Governments Taxable	State and Local Governments Total
Balance at January 1, 2013	\$ 14,863	\$ 1,545	\$ 16,408
Change in Market Value	(497)	—	(497)
Purchases	519	—	519
Payments & Maturities	(4,388)	—	(4,388)
Balance at September 30, 2013	<u>\$ 10,497</u>	<u>\$ 1,545</u>	<u>\$ 12,042</u>

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 September 30, 2014 and December 31, 2013, such assets consist primarily of impaired loans. Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)

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

NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	Fair Value at September 30, 2014	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and political subdivision securities	\$ 7,907	Discounted cash flow	Credit strength of underlying project or entity / Discount rate	0-5%
Impaired Loans				
	\$ 1,434	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%
Other real estate owned - residential	\$ 618	Appraisals	Discount to reflect current market	0-20%
Other real estate owned - commercial	\$ 646	Appraisals	Discount to reflect current market	0-20%
	Fair Value at December 31, 2013	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and political subdivision securities	\$ 10,346	Discounted cash flow	Credit strength of underlying project or entity / Discount rate	0-5%
Impaired Loans				
	\$ 1,924	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%
Other real estate - owned residential	\$ 964	Appraisals	Discount to reflect current market	0-20%
Other real estate - owned commercial	\$ 1,127	Appraisals	Discount to reflect current market	0-20%

At September 30, 2014 and December 31, 2013, impaired loans categorized as Level 3 were \$1.4 and \$1.9 million, respectively. The specific allocation for impaired loans was \$256 and \$516 thousand as of September 30, 2014 and December 31, 2013, respectively, which are accounted for in the allowance for loan losses (see Note 4).

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

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

NOTE 5 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

(In Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2014			
	Balance at September 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 1,434	\$ —	\$ —	\$ 1,434
Other real estate owned residential mortgages	\$ 618	\$ —	\$ —	\$ 618
Other real estate owned commercial	\$ 646	\$ —	\$ —	\$ 646

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

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

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

INTRODUCTION

NATURE OF ACTIVITIES

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

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

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

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

NATURE OF ACTIVITIES (Continued)

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

The Bank's primary service area, Northwest Ohio and Northeast Indiana, continue to exhibit a downward trend in unemployment rates at both a local and national level. The agricultural industry is faced with lower prices and possibly lower yields. Rain was scattered in our market area during the growing season and harvest is being hampered by heavier fall rains. Strong financial performance in the previous years will aid in any possible shortfalls this year. The automotive sector showed improvement with car dealers in our marketing area presenting more profitable numbers than in prior years. Overall, business profits are improving. Loan growth occurred during the fourth quarter of 2013 and has continued through third quarter 2014 and the Bank finally surpassed the loan balances of 2012. Overall, net loan growth is \$31.8 million or 5.6% over since the year ended December 31, 2013. New 1-4 family residential and construction remains weak and refinancing activity are also below the level of same period 2013.

The Bank acquired its 21st office during the fourth quarter of 2013. The office is located in Custer, Ohio, and was a natural extension of the Bank's market area. The office provides the full range of services discussed below. Growth for the remainder of 2014 is expected in Sylvania, Ohio, where the Bank recently opened its 22nd full-service branch office.

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

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

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

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

NATURE OF ACTIVITIES (Continued)

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

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

Commercial Real Estate – Construction, purchase, and refinance of business purpose real estate. Risks include loan amount in relation to construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower's ability to repay in a timely fashion, and others before granting loan approval. 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.

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

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

Commercial and Industrial – Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of profit projections, financial leverage, economic trends, management ability, and others.

The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

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

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

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

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

Consumer Loans:

- Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect.
- Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage periods of wage or death.
- Boats, campers, motorcycles, RV's and Motor Coaches range from 80%-90% based on age of vehicle.
- 1st or 2nd mortgages on 1-4 family homes range from 75%-90% with "in-house" first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV.

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

NATURE OF ACTIVITIES (Continued)

Consumer Loans (continued)

- The Bank will only make Qualified Mortgages as defined by the Truth in Lending Act and Regulation Z.
- Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

Commercial/Agriculture/Real Estate:

- Maximum LTVs range from 70%-80% depending on type.
- Accounts Receivable:
- Up to 80% LTV.

Inventory:

- Agriculture:
Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%.
- Commercial:
Maximum LTV of 50% on raw and finished goods.
- Used vehicles, new recreational vehicles and manufactured homes not to exceed (NTE) 80% LTV.

Equipment:

- New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value.
- Restaurant equipment up to 35% of market value.
- Heavy trucks, titled trailers up to NTE 75% LTV and aircraft up to 75% of appraised value.

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

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

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

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

At September 30, 2014, we had 253 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.

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

2014 IN REVIEW Third Quarter Performance

Loan growth continued in the third quarter of 2014 and the loan portfolio attained a new high of over \$600 million. This loan growth was preceded by a strong fourth quarter 2013 which included an office acquisition and increased borrowings in the commercial and agricultural real estate portfolios. This growth is important to the Company as a step in the right direction to improve its net interest income and margin.

The year of consistent loan growth spurred improvement in interest income. Interest income from loans was higher by \$864 thousand when comparing third quarter 2014 to 2013. Given that the strategy was to fund loan growth from the sales of securities, interest income from the securities portfolio was down \$225 thousand from the same time periods. Overall, improvement in total interest income was \$627 thousand for the third quarter ending September 30, 2014 compared to third quarter ending September 30, 2013.

Expanding on the positive improvement of interest income was the decrease in cost of funds during the third quarter. Third quarter 2014 was lower by \$234 thousand than third quarter 2013. The Company funded its assets with deposits, federal funds purchased and securities sold under agreements to repurchase exclusively. Third quarter 2013 in comparison also utilized borrowings from the Federal Home Loan Bank. A significant decrease in time deposit balances also contributed to the third quarter 2014 lower cost of funds.

Combining the improvements in both interest income and interest expense, net interest income was up \$861 thousand in 2014 as compared to 2013 for the third quarter. The benefit of the Company's strategy of repositioning the balance sheet and shrinking holdings was very evident in the results of the comparison of third quarter activity on net interest income.

Total allowance provision for loan losses was \$21 thousand lower for the third quarter 2014 as compared to same quarter 2013. Loan growth warranted provision expense be taken in the third quarter 2014 as net charge-offs, excluding overdraft activity, were in a net recovery position. Charge-offs due to overdraft loans was \$82 thousand with recoveries of \$27 thousand for three months ended September 30, 2014. This compared to a net charge-off provision of \$498 thousand, again excluding overdraft activity, for third quarter 2013. \$92 thousand of charge-offs and \$20 thousand of recoveries related to overdraft products in the same three months of 2013. In addition, overall past dues remain at historically low levels.

Adding to the improvement in net interest income was an increase in noninterest income. Gains on sales in the agricultural portfolio increased slightly in comparison to same quarter previous year, while gains on sales from the 1-4 family portfolio was down slightly. Net gain on sales of loans was therefore up \$29 thousand in third quarter comparison. In fact, in comparing third quarter 2014 to third quarter 2013, 2014 outperformed 2013 in all areas of noninterest income by a total of \$204 thousand. Customer service fees were positively impacted by the structural changes made to the Bank's bill pay program. Additional services were added and the new bundle was marketed as FMeXpress. Fees were collected during each of the three months of third quarter 2014. Fees applied to both the retail and business customers of the Bank. Service charges were impacted by just one month of revenue from "Secure" and "Pure" checking in the third quarter 2014 and represented only our first conversion and consolidation of checking products. Two more waves will take place in the fourth quarter.

All rates remain low and are expected to remain low throughout 2014. In addition, economists' predictions have extended the duration of the low rate market to exist until fourth quarter 2015. This has enabled the Company to continue to sell investment securities and recognize a gain without compromising the yield. For third quarter 2013, the recognized gain was \$134 thousand. For third quarter 2014 it was \$192 thousand. Most of the securities sold were agencies maturing in a short time period. Additional sales throughout 2014 may be executed as needed to fund loan growth, which management expects to continue. The market value of the security portfolio has leveled off as evidenced by the other comprehensive loss reported on the statement of income and comprehensive income for third quarter ended September 30, 2013 and 2014 on sales of securities. Additional opportunity to sell investment securities for a gain may be limited for the remainder of 2014.

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

2014 IN REVIEW Third Quarter Performance (Continued)

For the third quarter ended September 30th, noninterest expenses were \$466 thousand higher in 2014 than for 2013. An additional office was opened in Sylvania impacting salaries and furniture and equipment. Salaries and wages were also higher by \$178 thousand in 2014 than 2013 due to the increase in the incentive accrual. A stronger performance in the ROA (Return On Assets) financial measure, on which the largest portion of the incentive is based, correlated to a higher provision. Health care costs continue to increase on a per employee basis as the number of full-time equivalent employees was 253 at quarter-end 2014, up from 249 at the same time for 2013. An area of disappointment in the quarter comparison in noninterest expense was net loss on sale of other assets owned, which was higher by \$74 thousand from third quarter 2013. This was due to sales and write downs on Other Real Estate Owned, "OREO".

Overall, profitability in the third quarter of 2014 was up significantly as compared to the same quarter last year. In comparisons, net income is up 20% or \$409 thousand. Net interest income was up 13% over the same period in 2013. The Company has done an exceptional job of growing loans while keeping past dues low. The Company remains strong, stable, and well capitalized and has the capacity to continue 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. The Bank continues to work toward fulfillment of applicable requirements for these new mortgage rules, as it gains further understanding of the complexities and inter-related nature of these rules while making strategic decisions, and addressing key considerations necessary for implementation of each rule. The Company is also preparing for the implementation of Basel III capital rules which will begin phase in for the Company on January 1, 2015. These rules may impact the ability of some financial institutions to pay dividends, though the Company believes itself to be able to maintain its strong capital position and not be limited in that regard. Larger institutions, which the rule was designed for, were required to begin reporting as of January 1, 2014.

CRITICAL ACCOUNTING POLICY AND ESTIMATES

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

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

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

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

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

CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)

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 OREO. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At September 30, 2014, holdings were \$1.3 million and were \$2.1 million as of December 31, 2013 and \$2.4 million as of September 30, 2013.

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

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

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

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

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

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

The Company's mortgage servicing rights relating to loans serviced for others represent an asset of the company. This asset is initially capitalized and included in other assets on the Company's consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights. There are a number of factors, however, that can effect the ultimate value of the mortgage servicing rights to the Company, including the estimated prepayment speed of the loan and the discount rate used to present value the servicing right. For example, if the mortgage loan is prepaid, the Company will receive fewer servicing fees, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Company's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Company of the mortgage servicing rights, the Company receives a valuation of its mortgage servicing rights from an independent third party. The independent third party's valuation of the mortgage servicing rights is based on relevant characteristics of the Company's loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as current national market interest rate levels, market forecasts and other economic conditions. Management, with the advice from its third party valuation firm, reviewed the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter's analysis related to the mortgage servicing asset. In addition, based upon the independent third party's valuation of the Company's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to

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

CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)

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 minor valuation allowances through its income statement over time based upon the valuation of each stratum of servicing rights. For more information regarding the estimates and calculations used to establish the ALLL and the value of Mortgage Servicing Rights, please see Note 1 to the consolidated financial statements provided herewith.

MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

In comparing the balance sheet of September 30, 2014 to that of December 31, 2013, the cash equivalent liquidity of the Bank has decreased by \$2 million; however it is still considered strong. The stability in liquidity was facilitated by the office acquisition in the fourth quarter of 2013 of which deposits account for \$29.5 million and loans only \$11.4 million. During the first nine months of 2014, net loans have increased \$31.8 million even with a \$10 million decrease stemming from the repayment on a line of credit by a single borrowing relationship which was expected and which happens each year at this time. The fact that loan levels increased in light of the anticipated yearly reduction is a positive factor towards future improvement to profitability.

The Company's decrease in total assets of \$40.7 million was due to lower balances within the securities portfolio of \$71.4 million and FHLB borrowings of \$4.5 million. This was partially offset by the increase in loans mentioned above. The Company has an unsecured borrowing capacity of \$105.5 million through correspondent banks and over \$75.4 million of unpledged securities which may be sold or used as collateral. With the exception of stock, all of the Bank's security portfolio is categorized as available for sale and as such is recorded at market value.

A large fluctuation in the market value of the securities occurred during the second quarter of 2013 causing the unrealized gain position to decrease significantly. Management recognized the change in the market early and was quick to capture a portion of the gain before it fluctuated to an unrealized loss position. Currently the security portfolio is in a net unrealized loss position of \$26 thousand. Management feels confident that liquidity needs can easily be funded from an orderly runoff of the investment portfolio, along with other sources of funding.

As previously stated, net loans show an increase for the nine months ended September 30, 2014, which reverses the trend in declining loan balances which the Bank had experienced all throughout fiscal year 2012 and up through the third quarter 2013. Growth occurred across the board on all loan portfolios as compared to September 30, 2013. Loan sales into the secondary market have also impacted the consumer and agricultural real estate portfolios though on a much smaller basis than in 2013. Year to date, the Bank has sold approximately \$30.4 million of loans into the secondary market, while originating only \$26.3 million of the loans during the same nine-month period as demonstrated in the cash flow statement for the period. The majority of the activity stemmed from within the 1-4 family portfolio. The trend of decreasing loan balances is reversed, as the following chart shows increases in 2013 and a strong upswing in 2014. The Bank is also starting to generate a positive trend of increasing loan balances after our third quarter activity when comparing to yearend. The Bank's pipeline of loans remains strong, driven by opportunities for new relationships as business activity begins to reflect a more optimistic opinion of the economy and large financial institutions downsize certain portfolios. The Bank has also been able to further deepen our relationships and increase the dealings with some of our newer customers.

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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)

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

	(In Thousands)		
	September-14 Amount	September-13 Amount	September-12 Amount
Consumer Real Estate	\$ 97,651	\$ 79,268	\$ 81,041
Agricultural Real Estate	48,812	37,758	32,221
Agricultural	67,221	56,752	56,581
Commercial Real Estate	274,074	232,104	198,856
Commercial and Industrial	92,926	92,340	100,126
Consumer, Overdrafts and other loans	23,066	20,801	21,052
Industrial Development Bonds	4,854	4,303	1,427
Total Loans	<u>\$ 608,604</u>	<u>\$ 523,326</u>	<u>\$ 491,304</u>

On a year to year comparison basis, the Commercial real estate portfolio shows the largest increase of \$42.0 million in balance as of September 30, 2014 compared to September 30, 2013. Agricultural real estate shows an increase of \$11.1 million. Consumer real estate showed the largest improvement in the consumer portfolios of \$18.4 million. Loans increased \$85.3 million as compared to the same period last year and increased \$117.3 million as compared to September 30, 2012.

Overall, total assets of the Company decreased \$40.7 million from December 31, 2013 to September 30, 2014.

Deposits decreased \$31.6 million from yearend 2013 which correlated to the maturing and leaving of time deposits. Time deposits decreased \$31.1 million during the first nine months of 2014. The Bank budgeted for this occurrence, choosing to fund loan growth with core deposit growth and investment security runoff and sales. The time deposit shrinkage helped to reduce the Bank's cost of funds, as these are typically the most expensive type of deposit account for the Bank.

The Bank paid off \$4.5 million in FHLB advances which had matured during 2014. This too has lowered the cost of funds. Securities sold under agreement to repurchase decreased \$14.5 million during the first nine months of 2014 as compared to yearend.

Capital increased \$3.7 million during the first nine months of 2014, as earnings exceeded dividend declarations. Accumulated other comprehensive income (loss) decreased \$32 thousand which encompassed the shift of \$494 thousand from unrealized gain to realized gain with the sale of securities. Dividends paid year-to-date were \$106 thousand higher than the same period last year with a one cent increase per share per quarter being the reason.

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

Primary Ratio	12.00%
Tier I Leverage Ratio	11.43%
Risk Based Capital Tier I	15.80%
Total Risk Based Capital	16.68%
Stockholders' Equity/Total Assets	12.11%

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS

Comparison of Results of Operation for nine month periods ended September 30, 2014 and 2013.

Improvement in net interest income of \$2.3 million occurred for the first three quarters 2014 over the same period 2013, with improvement seen in both parts of the equation, with interest income up \$1.6 million over September 30, 2013 and interest expense down \$737 thousand. The higher balance in interest and fees from loans was generated from the increase loan balances of fourth quarter 2013 and each of the first three quarter 2014. The reverse was seen in the noninterest arena where noninterest income was lower by \$810 thousand in the first nine months of 2014 as compared to the first nine months of 2013 and noninterest expense was \$688 thousand higher. Noninterest income for 2014 was impacted in all areas driven primarily by (i) a decrease in the gain on sale of securities of \$421 thousand, (ii) a \$481 thousand decrease on gain of sale of loans and (iii) lower levels of collection of other service charge and fees by \$57 thousand.

Net interest income after the provision for loan loss expense for the nine months ended September 30, 2014 was up \$1.8 million from the nine month period ended September 30, 2013. The provision for loan loss expense was approximately \$572 thousand higher than same period 2013. The provision was needed for loan growth and replacement for the net charge-offs of \$299.8 thousand that occurred during the period and was based on Management's quarterly analysis of the adequacy of the allowance for loan losses.

Noninterest expense was higher by \$694 thousand in comparison largely due to the addition of the Waterville and Custar offices in late 2013. In addition, an office located in Sylvania, Ohio was opened during the third quarter 2014. The number of full time equivalent employees was 249 as of September 30, 2013 compared to 253 as of September 30, 2014.

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

Overall, the performance for the year-to-date comparison had a higher bottom line income of \$265 thousand caused by the increased net interest income. It is a reversal of the previous quarter of 2014 when it was lower on the same time periods of year-to-date 2013.

The Company predicted the lower noninterest income position and is focused on continuing to strengthen our core earnings through loan growth and improvement to the net interest margin. New products and services are being introduced in 2014 to create additional revenue opportunities. As mentioned previously, deposit services have been the focus with updates and new services being offered with bill pay to form "FM eXpress". Two new checking products, "Secure" and "Pure" have begun to be introduced with a few older products being discontinued.

Interest Income

Annualized interest income and yield on earning assets is up 30 basis points in 2014 as compared to September 30, 2013. While the average total earning assets were lower by 1% or \$11.2 million than the prior year, the increase in interest income resulted primarily from the increased growth of the Company's loan portfolios, up \$92.4 million in average balances. As the table that follows confirms, the increase in the amount of the interest earning portfolios from loans caused a higher September 2014 earnings in loans, than the decrease in securities and caused higher combined yields. The increased volume in the loan portfolio also offset the loss in interest income due to rate changes. The security portfolio will continue to be utilized to fund loan growth. Prepayment speeds remain high on mortgage-backed securities, though these may slow as the Bank's refinancing activity has slowed and long term rates inch higher.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Rates on the loan portfolio are lower as compared to the previous year due to the change in the composition of the overall portfolio. An emphasis on building spreads and margins on existing loans remains intact. Funding the loans with excess security holdings has been beneficial in the third quarter of 2014. Overall loans are up on average \$92.4 million and the security portfolio down \$91.5 million on average from the previous year.

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	
	September 30, 2014		September 30, 2014	September 30, 2013
	Average Balance	Interest/Dividends		
Loans	\$ 587,049	\$ 20,762	4.72%	5.00%
Taxable Investment Securities	199,936	2,786	1.86%	1.58%
Tax-exempt Investment Securities	67,376	1,374	4.12%	4.35%
Fed Funds Sold & Interest Bearing Deposits	7,378	12	0.22%	0.19%
Total Interest Earning Assets	\$ 861,739	\$ 24,934	3.97%	3.69%

Change in September 30, 2014 Interest Income Compared to September 30, 2013

Interest Earning Assets:	Change	Due to Volume	Due to Rate
Loans	\$2,351	\$ 3,272	\$ (921)
Taxable Investment Securities	(725)	(1,333)	608
Tax-exempt Investment Securities	12	129	(117)
Fed Funds Sold & Interest Bearing Deposits	(15)	(20)	5
Total Interest Earning Assets	\$1,623	\$ 2,048	\$ (425)

Interest Expense

Interest expense continued to be lower than the comparable nine months of 2013. Interest expense related to deposits was down \$614 thousand while the average interest-bearing deposit balance decreased by \$1.7 million in comparing the balances of each nine 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-nine 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 \$34.3 million.

Interest on borrowed funds was \$129 thousand lower for the nine month period ended September 30, 2014 than 2013. All borrowings from Federal Home Loan Bank were paid off during 2013 and 2014, making the average balance in other borrowed money considerably lower by \$7.1 million in 2014 in comparison. Thus the largest decrease in cost of funds for other borrowed money was due to the decreased volume which also impacted the rate of the remaining borrowings portfolio. During the first quarter of 2014, all borrowings from the FHLB were paid off. Fed Funds Purchased and Securities Sold under Agreement to Repurchase had a larger average balance in 2014 of \$8.8 million of whose cost was offset by lower rates making the fluctuation cost a minimal \$6 thousand.

Asset yield increased 30 basis points while cost of funds decreased 14 basis points. The main focus is to continue to increase asset yield by using excess cash and the liquidation of lower yielding investments to fund loan growth. Borrowings may be utilized if the cost thereof is lower than cost of new deposit generation or the loss on sales of securities.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Interest Bearing Liabilities:	(In Thousands)		Yield/Rate	
	September 30, 2014		September 30, 2014	September 30, 2013
	Average Balance	Interest/Dividends		
Savings Deposits	\$ 431,948	\$ 1,082	0.33%	0.38%
Other Time Deposits	219,986	1,533	0.93%	1.10%
Other Borrowed Money	194	4	2.75%	2.42%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	61,405	190	0.41%	0.46%
Total Interest Bearing Liabilities	\$ 713,533	\$ 2,809	0.52%	0.66%

Change in September 30, 2014 Interest Expense Compared to September 30, 2013

Interest Bearing Liabilities:	Change	Due to Volume	Due to Rate
Savings Deposits	\$ (36)	\$ 86	\$ (122)
Other Time Deposits	(578)	(251)	(327)
Other Borrowed Money	(129)	(147)	18
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	6	27	(21)
Total Interest Bearing Liabilities	\$ (737)	\$ (285)	\$ (452)

Net Interest Income

Net interest income is higher in the nine month comparison, which is the opposite position as yearend 2013's comparison to yearend 2012. The issue of earning less per earning asset dollar was reversed as evidenced by a 40 basis point higher net interest margin ratio when comparing year-to-date 2014 to 2013. The tables above demonstrate that the improvements in net interest income are primarily a result of a continued shift in balance sheet composition, with the benefits of the shift to higher yielding assets continuing to be hampered by the extended low rate environment.

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

	September 30, 2014	September 30, 2013
Interest/Dividend income/yield	3.97%	3.69%
Interest Expense / yield	0.52%	0.66%
Net Interest Spread	3.45%	3.03%
Net Interest Margin	3.53%	3.13%

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Provision Expense

Provision expense taken for loan loss was \$572 thousand higher for the nine months ended September 30, 2014 as compared to the same 2013 period. Loan growth throughout 2014 warranted the increased provision to the loan loss reserve. With an over 16% loan growth rate the last twelve months, the Company recognizes some time will need to pass for these loans to season. The prudent action was to reserve for growth, which is higher than any of the historical periods used in the ALLL calculations. The balance in nonaccrual loans decreased \$1.3 million along with a slight increase of \$125 thousand in impaired loan balances as of September 30, 2014 as compared to the balances as of September 30, 2013. The overall loan portfolio was also \$85.3 million higher as of September 30, 2014 compared to September 30, 2013. The Bank continues to focus on the commercial and commercial real estate portfolios for both asset quality and growth. As the charts on the following page 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. The first three quarters of 2014 had a larger net charge-off position than compared to the same period for fiscal year 2012, although net charge-offs were lower than in the same period in 2013.

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

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

The Bank has recognized a slight increase in the overall balance of impaired loans when looking at September 2014 compared to September 2013. A positive factor can be seen in the decrease in the current average balance for the nine months during 2014 as compared to same period 2013 of \$1.5 million. This is due mainly to the collection of principal from the sale of collateral from borrowers and continual collection of payments on these borrowers classified as impaired.

The Bank had \$824.4 thousand of its impaired loans classified as TDR as of September 30, 2014. One new TDR impaired relationship with two individual loans was added during the first quarter without any additional in the second and third quarter. When combined with pay downs, the change resulted in \$754 thousand less in impaired balances and the specific allocation balance was decreased by \$264 thousand as compared to yearend 2013.

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

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

The ALLL has a direct impact on the provision expense. The increase in the ALLL is funded through recoveries and provision expense. The following tables both deal with the allowance for credit losses. The first table breaks down the activity within ALLL for each loan portfolio segment and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

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

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

	(In Thousands)		
	Three Months Ended September-14	Three Months Ended September-13	Three Months Ended September-12
Loans	\$ 608,604	\$ 523,326	\$ 491,304
Daily average of outstanding loans	\$ 599,995	\$ 504,063	\$ 492,125
Allowance for Loan & Lease Losses - July 1	\$ 5,663	\$ 5,297	\$ 5,036
Loans Charged off:			
Consumer Real Estate	—	12	92
Agricultural Real Estate	—	—	—
Agricultural	—	—	6
Commercial Real Estate	—	—	—
Commercial and Industrial	—	513	—
Consumer & other loans	95	122	142
	<u>95</u>	<u>647</u>	<u>240</u>
Loan Recoveries			
Consumer Real Estate	11	5	23
Agricultural Real Estate	—	1	—
Agricultural	1	1	1
Commercial Real Estate	—	—	3
Commercial and Industrial	5	17	5
Consumer & other loans	49	53	71
	<u>66</u>	<u>77</u>	<u>103</u>
Net Charge Offs	29	570	137
Provision for loan loss	282	303	235
Allowance for Loan & Lease Losses - September 30	\$ 5,916	\$ 5,030	\$ 5,134
Allowance for Unfunded Loan Commitments & Letters of Credit - September 30	196	169	149
Total Allowance for Credit Losses - September 30	\$ 6,112	\$ 5,199	\$ 5,283
Ratio of net charge-offs to average Loans outstanding	0.00%	0.11%	0.03%
Ratio of Allowance for Loan Loss to Nonperforming Loans	<u>362.07%</u>	<u>173.00%</u>	<u>97.62%</u>

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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)

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

	Nine Months Ended September-14	Nine Months Ended September-13	Nine Months Ended September-12
Loans	<u>\$ 608,604</u>	<u>\$ 523,326</u>	<u>\$ 491,304</u>
Daily average of outstanding loans	<u>\$ 587,049</u>	<u>\$ 494,627</u>	<u>\$ 494,860</u>
Allowance for Loan & Lease Losses - January 1			
Loans Charged off:	\$ 5,194	\$ 5,224	\$ 5,091
Consumer Real Estate	130	112	185
Agricultural Real Estate	—	—	—
Agricultural	—	—	6
Commercial Real Estate	230	64	—
Commercial and Industrial	—	512	97
Consumer & other loans	270	320	351
Loan Recoveries	<u>\$ 630</u>	<u>\$ 1,008</u>	<u>\$ 639</u>
Consumer Real Estate	28	15	53
Agricultural Real Estate	—	—	—
Agricultural	4	5	11
Commercial Real Estate	3	1	5
Commercial and Industrial	15	71	23
Consumer & other loans	148	140	148
	<u>\$ 198</u>	<u>\$ 232</u>	<u>\$ 240</u>
Net Charge Offs	<u>\$ 432</u>	<u>\$ 776</u>	<u>\$ 399</u>
Provision for loan loss	<u>\$ 1,154</u>	<u>\$ 582</u>	<u>\$ 442</u>
Acquisition provision for loan loss	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Allowance for Loan & Lease Losses - September 30	<u>\$ 5,916</u>	<u>\$ 5,030</u>	<u>\$ 5,134</u>
Allowance for Unfunded Loan Commitments & Letters of Credit - September 30	<u>\$ 196</u>	<u>\$ 169</u>	<u>\$ 149</u>
Total Allowance for Credit Losses - September 30	<u>\$ 6,112</u>	<u>\$ 5,199</u>	<u>\$ 5,283</u>
Ratio of net charge-offs to average Loans outstanding	<u>0.07%</u>	<u>0.16%</u>	<u>0.08%</u>
Ratio of the Allowance for Loan Loss to Nonperforming Loans*	<u>362.07%</u>	<u>173.00%</u>	<u>97.61%</u>

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

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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)

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

Balance at End of Period Applicable To:	(In Thousands) September-2014		(In Thousands) September-2013	
	Amount	% of Loan Category	Amount	% of Loan Category
Consumer Real Estate	\$ 798	0.82	\$ 407	0.51
Agricultural Real Estate	128	0.26	114	0.30
Agricultural	336	0.50	282	0.50
Commercial Real Estate	1,832	0.67	1,983	0.85
Commercial and Industrial	1,325	1.43	1,329	1.44
Consumer, Overdrafts and other loans	301	1.30	273	1.31
Unallocated	1,196	0.20	642	0.12
Allowance for Loan & Lease Losses	5,916		5,030	
Off Balance Sheet Commitments	196		169	
Total Allowance for Credit Losses	\$ 6,112		\$ 5,199	

The percentage of delinquent loans has trended downward since the beginning of 2010 from a high of 2.85% of total loans in January to 0.22% which was a new low as of June 30, 2014. September 2014 increased slightly to 0.34% though any percentage under 1% is considered low. These percentages do not include nonaccrual loans which are not past due. This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, growth of the last year the write down of uncollectable credits in a timely manner and the new loan.

Non-interest Income

Overall, noninterest income for nine months 2014 was \$804 thousand below the same time period of 2013. As has been expected, revenue from gains on sales of loans and investment securities diminished compared to prior periods. The Bank was able to capitalize on those opportunities; however, current increases in the long term market rates has slowed the progress. All categories of noninterest income decreased as compared to year-to-date 2013. The Bank does not expect a significant change in the opportunity for gains for the remainder of 2014.

\$57.9 million in sales of investment securities were conducted so far in 2014 to fund loan growth and capture some additional revenue. The sales resulted in a gain of \$494 thousand. The same time period 2013 had sales of \$63.6 million resulting in gains of \$732 thousand. The difference between 2014 and 2013 sales was the utilization of the funds. 2014 went to fund loan growth while 2013 was reinvested in securities.

This does not mean that some avenues were not available for improvement. With the percentage of core deposits, specifically checking accounts, increasing throughout the Bank's market area, debit card usage was higher. Corresponding interchange income increased to over \$588 thousand for the quarter, outperforming year-to-date 2013 by \$194 thousand.

Overdraft and return check fees were lower by \$76 thousand in comparing the periods, even though the number of accounts has increased.

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

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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)

The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights. The capitalization runs through non-interest income while the amortization thereof is included in non-interest expense. For 2014, mortgage servicing rights caused a net \$68 thousand more in expense than for nine months 2013. The carrying value is well below the market value of \$3.1 million which indicates any large expense to fund the valuation allowance to be unlikely in 2014.

	(In Thousands)	
	2014	2013
Beginning Balance, January 1	\$2,066	\$2,063
Capitalized Additions	211	366
Amortization	(258)	(345)
Ending Balance, September 30	2,019	2,084
Valuation Allowance	—	—
Mortgage Servicing Rights, net September 30	<u>\$2,019</u>	<u>\$2,084</u>

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

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

	(In Thousands)	
	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013
Net Unrealized loss on available-for-sale securities	\$ (117)	\$ (107)
Less reclassification adjustment for gain on sale of available-for-sale securities	192	134
Net Unrealized loss	(309)	(241)
Tax Effect	105	82
Other comprehensive income (loss)	<u>\$ (204)</u>	<u>\$ (159)</u>

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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)

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

	(In Thousands)	
	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Net Unrealized gain (loss) on available-for-sale securities	\$ 446	\$ (8,094)
Less reclassification adjustment for gain on sale of available-for-sale securities	494	732
Net Unrealized gain (loss) on	(48)	(8,826)
Tax Effect	16	3,001
Other comprehensive income (loss)	<u>\$ (32)</u>	<u>\$ (5,825)</u>

Non-Interest Expense

Non-interest expense for the nine months ended September 30, 2014 was \$694 thousand higher than for the same period of 2013. Salaries and wages were \$373 thousand higher 2014 compared to 2013 for the same nine month time frame. The number of full time equivalent employees increased from 249 as of September 30, 2013 to 253 as of September 30, 2014. 2014's numbers include the addition of three offices.

Medical costs show only an \$86 thousand increase in comparing year-to-date 2014 to 2013. The Bank instituted a change to how a HSA contribution per employee was given. Instead of depositing all at once at the start of the year as was done in 2013, the contribution is distributed through the year. The Bank also switched medical providers at yearend 2013, which resulted in claims which would have normally been covered in 2014 being expensed in 2013. Health insurance costs have increased for the Bank in 2014, more than is evident in looking at the line items.

The incentive accrual for 2014 and 2013 differs by \$121.8 thousand. This is due to the net income of the Bank for the periods on which the incentive is calculated are almost equivalent, differing by \$265 thousand. 2014 is higher in net income, number of employees and incentive expense. The Bank continues to reward employees for performance and the accrual reflects this.

Loss on sale of other assets owned was higher by \$6 thousand as of third quarter end 2014 as compared to same period 2013. This line item includes losses from sales of assets, losses from write-downs to the Bank's OREO and losses resulting from the loss or disposal of fixed assets, though the fixed asset impact is inconsequential. Holdings in OREO decreased to \$1.3 million as of September 30, 2014 compared to holdings of \$2.4 million as of September 30, 2013. Activity on sales of OREO has been strong in 2014 with thirteen sales, matching the same number of sales in nine months 2013 and the Bank expects this to continue throughout the remainder of 2014. The volume of the sales was higher during 2014 than 2013 by \$365 thousand. The Bank also wrote down the value on eight properties due to updated appraisals and expects holdings to decrease even further.

A decrease occurred of \$87 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, \$21.4 million were originated and \$21.3 million sold from the 1-4 family portfolio which had mortgage servicing rights attached. These were down from \$40.5 million in originations and \$42.2 million in sales from the same portfolio as of third quarter 2013. Therefore, amortization expense from refinancing activity would be expected to be lower, which it is.

Other general and administrative expenses were higher during the nine months for 2014 by \$240 thousand; as compared to the same nine months 2013. The amortization expense of the core deposit intangible was \$126 thousand higher in 2014 than in 2013 due to the Custar office acquisition in December 2013. Legal fees as related to collection of problem loans were down \$174.7 thousand in the same comparison. Improvement in past dues, nonaccruals, ORE and troubled loans were behind the lower expense. Other expenses related to these areas were also down \$93 thousand from the previous year. Consulting fees were up \$84 thousand as additional vendors were utilized in the new product projects.

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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)

Losses caused by the security breaches and misuse of checking products were \$72.8 thousand higher in the three quarters of 2014 as compared to three quarters of 2013. This represents an area of great concern to the Bank as the failures of other organizations to protect customer's information hurts the Bank's bottom line. This exposure to risk continues to increase as our society adopts and utilizes more technology than ever before.

Additional decreases in general and administrative noninterest expense were lower taxes for the State of Ohio as a revised tax code became effective in 2014, resulting in a Company savings of \$179.5 thousand for the year-to-date on a consolidated basis. An adjustment for force placed property insurance that was over expensed resulted in a one-time decrease for general insurance expense in 2014.

Overall non-interest expense was \$694 thousand higher in 2014 than in 2013. The Company continues to monitor costs to safeguard profitability.

Net Income

Overall, net income was up \$265 thousand for the nine months ended September 30, 2014, compared to the same period of 2013. The importance of a higher loan to asset percentage was evidenced by the improvement in interest income and yield. With the decrease in noninterest income, it becomes essential that the Bank continue to build on the growth in loans. The ability to fund that loan growth with a growth in core deposits is another strength of the Company which should continue with the addition of new offices.

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

The Company is positioned for improvement in the net interest margin while rates remain low, provided there is an increase in loan demand. It will be a challenge to maintain the margin once short term rates begin to rise. However, the Bank remains focused on improving the asset yield through improved asset quality and added spread to prime on variable and adjustable rate loans. As with the rest of the banking industry, the Company is also limited from achieving higher profitability by the cost of increased regulatory requirements such as Regulation E, Dodd-Frank Wall Street Reform and Consumer Protection Act and any other additional regulations that may be enacted going forward 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. The Company expects the newer offices to stimulate additional growth and profitability.

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. The addition of new deposit products will help to increase the service charge revenue and/or interchange revenue from increased debit card transactions.

FORWARD LOOKING STATEMENTS

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

ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest rate risk is managed within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates.

Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.

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

Net Interest Margin (Ratio)	Interest Rate Shock on Net Interest Margin		Rate Direction	Rate Changes by	Interest Rate Shock on Net Interest Income	
	% Change to Flat Rate				Cumulative Total (\$000)	% Change to Flat Rate
3.62%	9.73%		Rising	3.00%	33,286	10.65%
3.57%	8.15%		Rising	2.00%	32,525	8.13%
3.43%	4.00%		Rising	1.00%	31,183	3.66%
3.30%	0.00%		Flat	0.00%	30,081	0.00%
3.02%	-8.60%		Falling	-1.00%	27,507	-8.57%
2.79%	-15.40%		Falling	-2.00%	25,589	-14.93%
2.55%	-22.72%		Falling	-3.00%	23,558	-21.69%

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

The shock chart currently shows a tightening in net interest margin over the next twelve months in a decreasing rate environment while an improvement is forecasted in a rising rate environment. Due to the length and existence of such a low rate environment, the model does not predict expansion of net income margin in any falling category. Cost of funds are below 0.50% so at even the lowest shock of 100 basis points, the Bank cannot take full advantage and reprice funds to match the level of shock. The positive impact in a rising rate environment is partially caused by a large core deposit base that should not reprice as quickly as the assets. The average duration of the majority of the assets is outside the 12 month shock period. The Bank enhanced its use of the software model during 2012 by including decay rates and key rate ties on certain deposit accounts and continues to review and modify those rates as updated data is compiled. Both enhancements were based on historical performance data of the Bank. Both directional changes are within risk exposure guidelines at the 200 basis point level. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

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

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ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2014, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2014. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

None

ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2013.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Treasury stock repurchase for quarter ended September 30, 2014 (1).

<u>Period</u>	<u>(a) Total Number of Shares Purchased</u>	<u>(b) Average Price Paid per Share</u>	<u>(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs</u>	<u>(d) Maximum Number of Shares that may yet be purchased under the Plans or Programs</u>
7/1/2014 to 7/31/2014	—	—	—	176,430
8/1/2014 to 8/31/2014	—	—	—	176,430
9/1/2014 to 9/30/2014	—	—	—	176,430
Total	—	—	—	176,430

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

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable

ITEM 5 OTHER INFORMATION

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PART II OTHER INFORMATION (Continued)

ITEM 6 EXHIBITS

3.1	Amended Articles of Incorporation of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on August 1, 2006)
3.2	Code of Regulations of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on May 10, 2004)
31.1	Rule 13-a-14(a) Certification -CEO
31.2	Rule 13-a-14(a) Certification -CFO
32.1	Section 1350 Certification - CEO
32.2	Section 1350 Certification - CFO
101.INS	XBRL Instance Document (1)
101.SCH	XBRL Taxonomy Extension Schema Document (1)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (1)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (1)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (1)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (1)

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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.

Date: October 29, 2014

Farmers & Merchants Bancorp, Inc.,

By: /s/ Paul S. Siebenmorgen

Paul S. Siebenmorgen
President and CEO

Date: October 29, 2014

By: /s/ Barbara J. Britenriker

Barbara J. Britenriker
Exec. Vice-President and CFO

CERTIFICATIONS

I, Paul S. Siebenmorgen, President and CEO of Farmers & Merchants Bancorp, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Farmers & Merchants Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Acts Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 29, 2014

/s/ Paul S. Siebenmorgen

Paul S. Siebenmorgen
President and Chief Executive Officer

CERTIFICATIONS

I, Barbara J. Britenriker, Executive Vice-President and CFO of Farmers & Merchants Bancorp, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Farmers & Merchants Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Acts Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 29, 2014

/s/ Barbara J. Britenriker

Barbara J Britenriker

Executive Vice President and Chief Financial Officer

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Quarterly Report of Farmers & Merchants Bancorp, Inc. on Form 10-Q for the period ending September 30, 2014 as filed with the Securities and Exchange Commission (“the report”), I, Paul S. Siebenmorgen, President and Chief Executive Officer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Farmers & Merchants Bancorp, Inc. as of the dates and for the periods expressed in the Report.

Date: October 29, 2014

/s/ Paul S. Siebenmorgen

Paul S. Siebenmorgen, President and Chief Executive Officer

A signed original of this written statement required by Section 906 has been provided to Farmers & Merchants Bancorp, Inc. and will be retained by Farmers & Merchants Bancorp, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350**

In connection with the Quarterly Report of Farmers & Merchants Bancorp, Inc. on Form 10-Q for the period ending September 30, 2014, as filed with the Securities and Exchange Commission ("the report"), I, Barbara J. Britenriker, Exec. Vice-President and Chief Financial Officer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Farmers & Merchants Bancorp, Inc. as of the dates and for the periods expressed in the Report.

Date: October 29, 2014

/s/ Barbara J. Britenriker

Barbara J. Britenriker, Exec. Vice President and Chief Financial
Officer

A signed original of this written statement required by Section 906 has been provided to Farmers & Merchants Bancorp, Inc. and will be retained by Farmers & Merchants Bancorp, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.