FARMERS & MERCHANTS BANCORP INC
Form 10-Q
July 28, 2014
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period June 30, 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	**34-1469491**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
307 North Defiance Street, Archbold, Ohio	**43502**
(Address of principal executive offices)	**(Zip Code)**

(419) 446-2501

Registrant s telephone number, including area code

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 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 x 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 x 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	x
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 x

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

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

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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

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

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

Total liabilities		837,695		857,598
Stockholders Equity				
Common stock - No par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares		12,677		12,677
Treasury Stock - 585,292 shares 2014, 561,562 shares 2013		(12,190)		(11,611)
Unearned Stock Awards - 30,805 shares 2014, 31,530 shares 2013		(621)		(642)
Retained earnings		110,489		107,910
Accumulated other comprehensive income		178		6
Total stockholders equity		110,533		108,340
Total Liabilities and Stockholders Equity	$	948,228	$	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		Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Interest Income				
Loans, including fees	$ 6,977	$ 6,089	$ 13,654	$ 12,167
Debt securities:				
U.S. Treasury securities	63	64	126	125
Securities of U.S. Government Agencies	696	1,016	1,545	2,008
Municipalities	522	541	1,047	1,049
Dividends	40	45	83	94
Federal funds sold	1	4	1	11
Other	4	6	7	13
Total interest income	8,303	7,765	16,463	15,467
Interest Expense				
Deposits	905	1,079	1,783	2,206
Federal funds purchased and securities sold under agreements to repurchase	65	62	127	122
Borrowed funds		43	4	89
Total interest expense	970	1,184	1,914	2,417
Net Interest Income - Before provision for loan losses	7,333	6,581	14,549	13,050
Provision for Loan Losses (Note 4)	444	112	872	279
Net Interest Income After Provision For Loan Losses	6,889	6,469	13,677	12,771
Noninterest Income				
Customer service fees	1,278	1,256	2,524	2,617
Other service charges and fees	928	967	1,720	1,829
Net loss on sale of other assets owned	(19)	(110)	(58)	(126)
Net gain on sale of loans	203	322	292	802
Net gain on sale of securities - available for sale	180	377	302	598
Total noninterest income	2,570	2,812	4,780	5,720

Noninterest Expenses				
Salaries and Wages	2,456	2,260	4,891	4,697
Pension and other employee benefits	720	610	1,565	1,454
Occupancy expense (net)	271	288	575	618
Furniture and equipment	399	358	793	707
Data processing	324	300	638	610
Franchise taxes	195	255	391	510
FDIC Assessment	130	141	262	260
Mortgage servicing rights amortization	84	120	166	257
Other general and administrative	1,444	1,438	2,910	2,783
Total Noninterest Expense	6,023	5,770	12,191	11,896
Income Before Federal Income Taxes	3,436	3,511	6,266	6,595
Federal Income Taxes	882	1,009	1,755	1,941
Net Income	2,554	2,502	4,511	4,654
Other Comprehensive Income (Loss) (Net of Tax):				
Unrealized gain (loss) on securities, net of tax benefit (expense) of ($437), $2,532, ($89), and $2,918 respectively	847	(4,916)	172	(5,666)
Comprehensive Income (Loss)	$ 3,401	$ (2,414)	$ 4,683	$ (1,012)
Basic Earnings Per Share	$ 0.55	$ 0.53	$ 0.97	$ 0.99
Weighted Average Shares Outstanding	4,626,309	4,679,971	4,632,054	4,681,805
Dividends Declared	$ 0.21	$ 0.20	$ 0.42	$ 0.40

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

Net cash used in financing activities		(22,096)		(18,662)
Change in Cash and Cash Equivalents		(165)		(21,629)
Cash and cash equivalents - Beginning of year		19,263		44,092
Cash and cash equivalents - End of period	$	19,098	$	22,463
Supplemental Information				
Cash paid during the year for:				
Interest	$	2,015	$	2,528
Income taxes	$	837	$	1,770
Noncash investing activities:				
Transfer of loans to other real estate owned	$	139	$	175

See Notes to Condensed Consolidated Unaudited Financial Statements

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

NOTE 2 ASSET PURCHASES

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

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

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

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

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

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

	(In Thousands) December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
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
	$ 324,500	$ 5,023	$ (5,014)	$ 324,509

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

1. The fair value of the security has significantly declined from book value.

2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB by Standard and Poors.)

3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.

4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.

5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

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

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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 June 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

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

	(In Thousands) December 31, 2013			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ (795)	$ 25,272	$	$
U.S. Government agency	(2,783)	96,241	(403)	4,598
Mortgage-backed securities	(574)	23,171		
State and local governments	(459)	19,594		
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 Bank has the intent and ability to hold the securities for the foreseeable future. The fair value is expected to recover as the bonds approach the maturity date.

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

(In Thousands)

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

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

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

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

NOTE 3 SECURITIES (Continued)

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

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

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

NOTE 4 LOANS

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

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

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

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

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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 June 30, 2014:

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

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

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

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

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

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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 June 30, 2014 and December 31, 2013, net of deferred fees:

(In Thousands)

June 30, 2014	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
Consumer Real Estate	$ 970	$ 256	$ 54	$ 1,280	$ 94,583	$ 95,863	$
Agricultural Real Estate					47,745	47,745	
Agricultural	14			14	63,379	63,393	
Commercial Real Estate	12			12	265,890	265,902	
Commercial and Industrial					102,455	102,455	
Consumer	2			2	22,479	22,481	
Total	$ 998	$ 256	$ 54	$ 1,308	$ 596,531	$ 597,839	$

December 31, 2013	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
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	$ 806	$ 2	$ 633	$ 1,441	$ 574,672	$ 576,113	$

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

NOTE 4 LOANS (Continued)

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

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

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

The risk ratings are described as follows.

1. Zero (0) Unclassified. Any loan which has not been assigned a classification.

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

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

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

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

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

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

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

c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.

5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or

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 June 30, 2014 and December 31, 2013:

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

	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
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	$ 44,301	$ 65,449	$ 248,893	$ 99,498	$ 4,358

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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 June 30, 2014 and December 31, 2013.

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

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

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

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

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

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

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

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

NOTE 4 LOANS (Continued)

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

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

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

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

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

Six Months June 30, 2013 Troubled Debt Restructurings	Number of Contracts Modified in the Last 6 Months	(In Thousands) Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment

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

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

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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 June 30, 2014 and June 30, 2013.

	(In Thousands)				
Three Months Ended June 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	$	$ 23	$ 1
Agricultural real estate	141	141		141	
Agricultural					
Commercial real estate	1,277	1,277		845	14
Commercial and industrial				354	14
Consumer					
With a specific allowance recorded:					
Consumer real estate				55	1
Agricultural real estate					
Agricultural					
Commercial real estate					
Commercial and industrial	345	345	202	510	2
Consumer					
Totals:					

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

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

NOTE 4 LOANS (Continued)

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

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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 six months ended June 30, 2014 and June 30, 2013.

	(In Thousands)				
Six Months Ended June 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	$	$ 44	$ 1
Agricultural real estate	141	141		141	
Agricultural					
Commercial real estate	1,277	1,277		874	28
Commercial and industrial				181	40
Consumer					
With a specific allowance recorded:					
Consumer real estate				127	2
Agricultural real estate					
Agricultural					
Commercial real estate				47	
Commercial and industrial	345	345	202	676	5
Consumer					
Totals:					
Consumer real estate	$ 26	$ 26	$	$ 171	$ 3
Agricultural real estate	$ 141	$ 141	$	$ 141	$
Agricultural	$	$	$	$	$
Commercial real estate	$ 1,277	$ 1,277	$	$ 921	$ 28
Commercial and industrial	$ 345	$ 345	$ 202	$ 857	$ 45
Consumer	$	$	$	$	$

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

NOTE 4 LOANS (Continued)

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

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

NOTE 4 LOANS (Continued)

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

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

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

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

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

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