

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
October 26, 2016  
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**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, 2016**

**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)**  
**(419) 446-2501**

**43502**  
**(Zip Code)**

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

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

Common Stock, No Par Value  
Class

4,620,725  
Outstanding as of October 24, 2016

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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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)

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

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## ITEM 1 FINANCIAL STATEMENTS

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

	(in thousands of dollars)	
	September 30, 2016	December 31, 2015
	(Unaudited)	
<b>Assets</b>		
Cash and due from banks	\$ 30,896	\$ 21,333
Federal funds sold	602	685
Total cash and cash equivalents	31,498	22,018
Interest-bearing time deposits	1,915	
Securities - available-for-sale	224,473	235,115
Other securities, at cost	3,717	3,717
Loans, net	732,070	679,821
Premises and equipment	21,356	20,587
Goodwill	4,074	4,074
Mortgage servicing rights	2,143	2,056
Other real estate owned	1,412	1,175
Other assets	21,789	20,505
<b>Total Assets</b>	<b>\$ 1,044,447</b>	<b>\$ 989,068</b>
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest-bearing	\$ 176,180	\$ 171,112
Interest-bearing		
NOW accounts	209,264	190,890
Savings	240,615	225,052
Time	212,042	184,285
Total deposits	838,101	771,339
Federal Funds purchased and securities sold under agreements to repurchase	59,487	78,815
Federal Home Loan Bank (FHLB) advances	10,000	10,000
Dividend payable	1,053	1,007
Accrued expenses and other liabilities	8,863	7,810
Total liabilities	917,504	868,971
<b>Commitments and Contingencies</b>		
<b>Stockholders Equity</b>		
Common shares - no par value - 6,500,000 shares 12/31/15		

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Common shares - no par value - 10,000,000 shares 9/30/16 authorized, 5,200,000 shares issued and outstanding	11,841	12,086
Treasury Stock - 578,705 shares 2016, 587,466 shares 2015	(12,251)	(12,389)
Retained earnings	125,723	120,188
Accumulated other comprehensive income	1,630	212
Total stockholders equity	126,943	120,097
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 1,044,447</b>	<b>\$ 989,068</b>

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2015, Condensed Consolidated Balance Sheet has been derived from the audited Consolidated Balance Sheet as of that date.

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## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

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

(Unaudited)

	(in thousands of dollars, except per share data)			
	Three Months Ended		Nine Months Ended	
	September 30, 2015	September 30, 2014	September 30, 2014	September 30, 2013
<b>Interest Income</b>				
Loans, including fees	\$ 8,629	\$ 7,341	\$ 24,997	\$ 21,598
Debt securities:				
U.S. Treasury and government agencies	559	603	1,734	1,819
Municipalities	344	456	1,093	1,361
Dividends	36	37	111	111
Federal funds sold	7	2	9	7
Other	15	5	37	21
<b>Total interest income</b>	<b>9,590</b>	<b>8,444</b>	<b>27,981</b>	<b>24,917</b>
<b>Interest Expense</b>				
Deposits	947	841	2,686	2,446
Federal funds purchased and securities sold under agreements to repurchase	115	94	346	218
Borrowed funds	37		110	
<b>Total interest expense</b>	<b>1,099</b>	<b>935</b>	<b>3,142</b>	<b>2,664</b>
<b>Net Interest Income - Before Provision for Loan Losses</b>				
	8,491	7,509	24,839	22,253
<b>Provision for Loan Losses</b>	<b>308</b>	<b>243</b>	<b>924</b>	<b>540</b>
<b>Net Interest Income After Provision For Loan Losses</b>				
	8,183	7,266	23,915	21,713
<b>Noninterest Income</b>				
Customer service fees	1,711	1,388	4,497	4,171
Other service charges and fees	941	1,084	2,850	2,963
Net gain on sale of loans	216	183	619	531
Net gain on sale of available for sale securities	47	172	503	418
<b>Total noninterest income</b>	<b>2,915</b>	<b>2,827</b>	<b>8,469</b>	<b>8,083</b>
<b>Noninterest Expense</b>				
Salaries and Wages	2,981	2,714	8,661	8,083
Employee benefits	849	804	2,426	2,555
Net occupancy expense	359	289	1,083	1,012
Furniture and equipment	438	475	1,293	1,324

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Data processing	360	318	1,132	967
Franchise taxes	219	186	658	560
Net (gain) loss on sale of other assets owned	(6)	32	39	43
FDIC Assessment	126	126	368	364
Mortgage servicing rights amortization	123	93	311	276
Other general and administrative	1,473	1,475	4,594	4,274
<b>Total noninterest expenses</b>	<b>6,922</b>	<b>6,512</b>	<b>20,565</b>	<b>19,458</b>
<b>Income Before Income Taxes</b>	<b>4,176</b>	<b>3,581</b>	<b>11,819</b>	<b>10,338</b>
<b>Income Taxes</b>	<b>1,161</b>	<b>961</b>	<b>3,349</b>	<b>2,770</b>
<b>Net Income</b>	<b>3,015</b>	<b>2,620</b>	<b>8,470</b>	<b>7,568</b>
<b>Other Comprehensive Income (Net of Tax):</b>				
Net unrealized gain on available for sale securities	58	1,210	2,652	1,116
Reclassification adjustment for gain on sale of available for sale securities	(47)	(172)	(503)	(418)
Net unrealized gain on available for sale securities	11	1,038	2,149	698
Tax expense	4	353	731	237
Other comprehensive income	7	685	1,418	461
<b>Comprehensive Income</b>	<b>\$ 3,022</b>	<b>\$ 3,305</b>	<b>\$ 9,888</b>	<b>\$ 8,029</b>
<b>Earnings Per Share - Basic and Diluted</b>	<b>\$ 0.65</b>	<b>\$ 0.57</b>	<b>\$ 1.84</b>	<b>\$ 1.64</b>
<b>Dividends Declared</b>	<b>\$ 0.23</b>	<b>\$ 0.22</b>	<b>\$ 0.68</b>	<b>\$ 0.65</b>

See Notes to Condensed Consolidated Unaudited Financial Statements

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## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	(in thousands of dollars)	
	Nine Months Ended	
	September 30, 2016	September 30, 2015
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 8,470	\$ 7,568
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,112	1,176
Accretion and amortization of available for sale securities, net	833	924
Amortization of servicing rights	311	276
Amortization of core deposit intangible	242	242
Compensation expense related to stock awards	297	224
Provision for loan loss	924	540
Gain on sale of loans held for sale	(619)	(531)
Originations of loans held for sale	(44,296)	(39,840)
Proceeds from sale of loans held for sale	44,119	39,812
Loss on sale of other assets	39	43
Gain on sales of securities available for sale	(503)	(418)
Change in other assets and other liabilities, net	(1,300)	(385)
Net cash provided by operating activities	9,629	9,631
<b>Cash Flows from Investing Activities</b>		
Activity in securities:		
Maturities, prepayments and calls	22,910	8,023
Sales	45,418	44,624
Purchases	(55,863)	(48,404)
Net change in interest-bearing time deposits	(1,915)	
Proceeds from sales of assets	20	54
Additions to premises and equipment	(1,901)	(1,037)
Loan originations and principal collections, net	(52,996)	(13,565)
Net cash used in investing activities	(44,327)	(10,305)
<b>Cash Flows from Financing Activities</b>		
Net change in deposits	66,762	5,482
Net change in federal funds purchased and securities sold under agreements to repurchase	(19,328)	5,542
Purchase of Treasury Stock	(194)	(493)
Cash dividends paid on common stock	(3,062)	(2,934)

Net cash provided by financing activities	44,178	7,597
<b>Net Increase in Cash and Cash Equivalents</b>	<b>9,480</b>	<b>6,923</b>
<b>Cash and cash equivalents - Beginning of year</b>	<b>22,018</b>	<b>24,295</b>
<b>Cash and cash equivalents - End of period</b>	<b>\$ 31,498</b>	<b>\$ 31,218</b>
<b>Supplemental Information</b>		
Cash paid during the year for:		
Interest	\$ 3,098	\$ 2,654
Income taxes	\$ 4,718	\$ 1,705
Noncash investing activities:		
Transfer of loans to other real estate owned	\$ 376	\$ 113

See Notes to Condensed Consolidated Unaudited Financial Statements.

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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, 2016 are not necessarily indicative of the results that are expected for the year ended December 31, 2016. The condensed consolidated balance sheet of the Company as of December 31, 2015, has been derived from the audited consolidated balance sheet of the Company as of that date. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2015.

## NOTE 2 ASSET PURCHASES

The Company 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, 2015 was \$323 thousand. Of the \$322 thousand to be expensed in 2016, \$242 thousand has been expensed for the nine months ended September 30, 2016. \$242 thousand was also expensed for the nine months ended September 30, 2015.

	Hicksville	Custar	Total
2016	\$ 155	\$ 167	\$ 322
2017	78	167	245
2018		167	167
2019		167	167
2020		161	161
	\$ 233	\$ 829	\$ 1,062

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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, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 30,962	\$ 97	\$	\$ 31,059
U.S. Government agencies	99,161	502	(9)	99,654
Mortgage-backed securities	29,986	408	(4)	30,390
State and local governments	61,893	1,488	(11)	63,370
<b>Total available-for-sale securities</b>	<b>\$ 222,002</b>	<b>\$ 2,495</b>	<b>\$ (24)</b>	<b>\$ 224,473</b>

	(In Thousands)			
	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 38,778	\$ 36	\$ (309)	\$ 38,505
U.S. Government agencies	99,000	55	(835)	98,220
Mortgage-backed securities	26,157	283	(116)	26,324
State and local governments	70,858	1,290	(82)	72,066
<b>Total available-for-sale securities</b>	<b>\$ 234,793</b>	<b>\$ 1,664</b>	<b>\$ (1,342)</b>	<b>\$ 235,115</b>

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, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

	(In Thousands)			
	September 30, 2016			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Government agencies	\$ (9)	\$ 2,981	\$	\$
Mortgage-backed securities	(4)	4,492		
State and local governments	(8)	1,040	(3)	827
Total available-for-sale securities	\$ (21)	\$ 8,513	\$ (3)	\$ 827

	(In Thousands)			
	December 31, 2015			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	\$ (142)	\$ 23,241	\$ (167)	\$ 10,195
U.S. Government agencies	(635)	68,957	(200)	9,793
Mortgage-backed securities	(60)	6,331	(56)	3,580
State and local governments	(54)	7,920	(28)	1,725
Total available-for-sale securities	\$ (891)	\$ 106,449	\$ (451)	\$ 25,293

Unrealized losses on securities have not been recognized into income because the issuers' bonds are of high credit quality, values have only been impacted by rate changes, 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)

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	2016	2015
Gross realized gains	\$ 513	\$ 418
Gross realized losses	(10)	
Net realized gains	\$ 503	\$ 418
Tax expense related to net realized gains	\$ 171	\$ 142

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 available-for-sale securities 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, 2016, 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	\$ 16,638	\$ 16,660
After one year through five years	119,625	120,549
After five years through ten years	52,489	53,310
After ten years	3,264	3,564
<b>Total</b>	<b>\$ 192,016</b>	<b>\$ 194,083</b>
Mortgage-backed securities	29,986	30,390
<b>Total</b>	<b>\$ 222,002</b>	<b>\$ 224,473</b>

Investments with a carrying value of \$193.3 million and \$189.3 million at September 30, 2016 and December 31, 2015, respectively, 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, 2016 and December 31, 2015.

## NOTE 4 LOANS

The Company had \$1.6 million in loans held for sale at September 30, 2016 as compared to \$1.2 million in loans held for sale at December 31, 2015. Due to materiality, these loans are included in the Consumer Real Estate and Agricultural Real Estate loan numbers.

Loan balances as of September 30, 2016 and December 31, 2015:

Loans:	(In Thousands)	
	September 30, 2016	December 31, 2015
Consumer Real Estate	\$ 87,222	\$ 88,189
Agricultural Real Estate	60,206	58,525
Agricultural	79,191	82,654

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Commercial Real Estate	370,315	322,762
Commercial and Industrial	105,961	100,125
Consumer	30,585	27,770
Industrial Development Bonds	5,892	6,491
	739,372	686,516
Less: Net deferred loan fees and costs	(690)	(638)
	738,682	685,878
Less: Allowance for loan losses	(6,612)	(6,057)
Loans - Net	\$ 732,070	\$ 679,821

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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, 2016:

	(In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	\$ 944	\$ 12,183	\$ 74,095
Agricultural Real Estate	745	3,189	56,272
Agricultural	50,164	23,273	5,754
Commercial Real Estate	13,808	91,293	265,214
Commercial and Industrial	47,474	32,484	26,003
Consumer	5,230	19,157	6,198
Industrial Development Bonds	1,000	185	4,707

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of September 30, 2016. 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	\$ 55,459	\$ 31,763
Agricultural Real Estate	43,065	17,141
Agricultural	49,358	29,833
Commercial Real Estate	233,377	136,938
Commercial and Industrial	61,617	44,344
Consumer	26,283	4,302
Industrial Development Bonds	5,892	

As of September 30, 2016 and December 31, 2015 one to four family residential mortgage loans amounting to \$21.3 and \$20.0 million, respectively, have been pledged as security for future 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 thousands) in past due loans by portfolio classification of loans as of September 30, 2016 and December 31, 2015, net of deferred loan fees and costs:

	30-59 Days			60-89 Days		Greater Than 90 Days		Total	Current	Total	Recorded Investment > 90 Days and Accruing
September 30, 2016	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due	Financing Receivables	Financing Receivables	Accruing
Consumer Real Estate	\$ 160	\$ 0	\$ 211	\$ 371	\$ 86,527	\$ 86,898	\$ 0				
Agricultural Real Estate			132	132	60,030	60,162					
Agricultural					79,332	79,332					
Commercial Real Estate		395		395	369,326	369,721					
Commercial and Industrial			46	46	111,907	111,953					
Consumer	10	4		14	30,602	30,616					
<b>Total</b>	<b>\$ 170</b>	<b>\$ 399</b>	<b>\$ 389</b>	<b>\$ 958</b>	<b>\$ 737,724</b>	<b>\$ 738,682</b>	<b>\$ 0</b>				

	30-59 Days			60-89 Days		Greater Than 90 Days		Total	Current	Total	Recorded Investment > 90 Days and Accruing
December 31, 2015	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due	Financing Receivables	Financing Receivables	Accruing
Consumer Real Estate	\$ 303	\$ 47	\$ 357	\$ 707	\$ 87,240	\$ 87,947	\$ 0				
Agricultural Real Estate			162	162	58,301	58,463					
Agricultural		145		145	82,617	82,762					
Commercial Real Estate	236		841	1,077	321,153	322,230					
Commercial and Industrial	51		20	71	106,618	106,689					
Consumer	19	9		28	27,759	27,787					
<b>Total</b>	<b>\$ 609</b>	<b>\$ 201</b>	<b>\$ 1,380</b>	<b>\$ 2,190</b>	<b>\$ 683,688</b>	<b>\$ 685,878</b>	<b>\$ 0</b>				

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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, 2016 and December 31, 2015:

	(In Thousands)	
	September 30, 2016	December 31, 2015
Consumer Real Estate	\$ 837	\$ 1,155
Agricultural Real Estate	132	162
Agricultural		
Commercial Real Estate		484
Commercial & Industrial	163	202
Consumer		38
<b>Total</b>	<b>\$ 1,132</b>	<b>\$ 2,041</b>

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 discussed during the approval process include 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. 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 projections, financial leverage, economic trends, management ability and estimated capital expenditures during the fiscal year. 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.

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

NOTE 4 LOANS (Continued)

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 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.

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

NOTE 4 LOANS (Continued)

- 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 portfolio class, net of deferred fees and costs, based on the most recent analysis performed as of September 30, 2016 and December 31, 2015:

	(In Thousands)				
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>September 30, 2016</b>					
1-2	\$ 4,120	\$ 8,062	\$ 1,806	\$ 1,623	\$
3	17,861	23,442	25,792	22,225	2,745
4	36,512	46,157	334,827	81,177	3,147
5	1,346	1,671	1,282	431	
6	323		5,570	487	
7			444	118	
8					
<b>Total</b>	<b>\$ 60,162</b>	<b>\$ 79,332</b>	<b>\$ 369,721</b>	<b>\$ 106,061</b>	<b>\$ 5,892</b>

	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>December 31, 2015</b>					
1-2	\$ 5,841	\$ 12,025	\$ 597	\$ 261	\$
3	16,593	21,247	24,264	22,300	3,100
4	35,475	49,220	293,381	76,855	3,391
5	192	250	1,738	57	
6	362		1,828	543	
7		20	422	182	
8					
<b>Total</b>	<b>\$ 58,463</b>	<b>\$ 82,762</b>	<b>\$ 322,230</b>	<b>\$ 100,198</b>	<b>\$ 6,491</b>

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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, as 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, 2016 and December 31, 2015.

Grade	(In Thousands)	
	Consumer Real Estate September 30, 2016	Consumer Real Estate December 31, 2015
Pass	\$ 86,423	\$ 87,292
Special Mention (5)	10	48
Substandard (6)	136	332
Doubtful (7)	329	275
Total	\$ 86,898	\$ 87,947

	(In Thousands)			
	Consumer - Credit		Consumer - Other	
	September 30, 2016	December 31, 2015	September 30, 2016	December 31, 2015
Performing	\$ 3,726	\$ 3,901	\$ 26,870	\$ 23,863
Nonperforming			20	23
Total	\$ 3,726	\$ 3,901	\$ 26,890	\$ 23,886

Information about impaired loans as of September 30, 2016, December 31, 2015 and September 30, 2015 are as follows:

Impaired loans without a valuation allowance	(In Thousands)		
	September 30, 2016	December 31, 2015	September 30, 2015
	\$ 515	\$ 1,257	\$ 1,483
	891	879	1,058

## Impaired loans with a valuation allowance

Total impaired loans	\$ 1,406	\$ 2,136	\$ 2,541
Valuation allowance related to impaired loans	\$ 125	\$ 330	\$ 465
Total non-accrual loans	\$ 1,132	\$ 2,041	\$ 2,294
Total loans past-due ninety days or more and still accruing	\$	\$	\$
Quarter ended average investment in impaired loans	\$ 1,499	\$ 2,207	\$ 2,924
Year to date average investment in impaired loans	\$ 1,843	\$ 2,509	\$ 2,609

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

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

## NOTE 4 LOANS (Continued)

The Bank had approximately \$562 thousand of its impaired loans classified as troubled debt restructured (TDR) as of September 30, 2016, \$1.1 million as of December 31, 2015 and \$1.2 million as of September 30, 2015. During the year-to-date 2016, one new loan was considered TDR. This loan is making interest-only payments.

The following table represents three and nine months ended September 30, 2016.

Three Months September 30, 2016 (in thousands)	Pre- Post-		Nine Months September 30, 2016 (in thousands)	Pre- Post-	
	Number of Contract Modified in Last	Modification Outstanding Recorded		Number of Contract Modified in Last	Modification Outstanding Recorded
	3			6	
Troubled Debt Restructurings Consumer Real Estate	Months Investment	Investment	Months Investment	1	\$ 138
			Consumer Real Estate		\$ 138

The following table represents three and nine months ended September 30, 2015.

Three Months September 30, 2015 (in thousands)	Pre- Post-		Nine Months September 30, 2015 (in thousands)	Pre- Post-	
	Number of Contract Modified in the Last	Modification Outstanding Recorded		Number of Contract Modified in the Last	Modification Outstanding Recorded
	3			9	
Troubled Debt Restructurings Commercial Real Estate	Months Investment	Investment	Months Investment	1	\$ 528
			Commercial Real Estate		\$ 430
Commercial and Industrial			Commercial and Industrial	1	25
					21

For the three and nine month period ended September 30, 2016 and 2015, there were no TDRs that subsequently defaulted after modification.

For the majority of the Bank's impaired loans, the Bank will apply the fair value of collateral or use a measurement incorporating the present value of expected future cash flows discounted at the loan's effective rate of interest. To determine fair value of collateral, 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. 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.

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

## NOTE 4 LOANS (Continued)

The following tables present loans individually evaluated for impairment by class of loans for three months ended September 30, 2016 and September 30, 2015.

	(In Thousands)					
	Unpaid Recorded	Principal Balance	Related Allowance	QTD Average Recorded	QTD Interest Income Recognized	QTD Interest Income Recognized Cash Basis
Three Months Ended September 30, 2016	Investment	Balance	Allowance	Investment	Recognized	Basis
With no related allowance recorded:						
Consumer Real Estate	\$ 383	\$ 383	\$	\$ 51	\$	\$
Agricultural Real Estate	132	132		132		
Agricultural						
Commercial Real Estate				345	4	4
Commercial and Industrial				446	6	
Consumer						
With a specific allowance recorded:						
Consumer Real Estate	329	329	35	377	4	1
Agricultural Real Estate						
Agricultural						
Commercial Real Estate	444	444	68	30		
Commercial and Industrial	118	118	22	118		
Consumer						
Totals:						
Consumer Real Estate	\$ 712	\$ 712	\$ 35	\$ 428	\$ 4	\$ 1
Agricultural Real Estate	\$ 132	\$ 132	\$	\$ 132	\$	\$
Agricultural	\$	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 444	\$ 444	\$ 68	\$ 375	\$ 4	\$ 4
Commercial and Industrial	\$ 118	\$ 118	\$ 22	\$ 564	\$ 6	\$
Consumer	\$	\$	\$	\$	\$	\$



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

## NOTE 4 LOANS (Continued)

	(In Thousands)					
	Recorded	Unpaid Principal	Related Allowance	QTD Average Recorded	QTD Interest Income Recognized	QTD Interest Income Recognized Cash Basis
Three Months Ended September 30, 2015	Investment	Balance	Investment	Investment	Recognized	Recognized
With no related allowance recorded:						
Consumer Real Estate	\$ 201	\$ 201	\$	\$ 159	\$ 2	\$ 2
Agricultural Real Estate	222	222		222		
Agricultural						
Commercial Real Estate	482	482		567	10	10
Commercial and Industrial	578	578		462	7	
Consumer						
With a specific allowance recorded:						
Consumer Real Estate	305	305	76	182	1	
Agricultural Real Estate						
Agricultural						
Commercial Real Estate	560	560	201	1,013		
Commercial and Industrial	193	193	188	319		
Consumer						
Totals:						
Consumer Real Estate	\$ 506	\$ 506	\$ 76	\$ 341	\$ 3	\$ 2
Agricultural Real Estate	\$ 222	\$ 222	\$	\$ 222	\$	\$
Agricultural	\$	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 1,042	\$ 1,042	\$ 201	\$ 1,580	\$ 10	\$ 10
Commercial and Industrial	\$ 771	\$ 771	\$ 188	\$ 781	\$ 7	\$
Consumer	\$	\$	\$	\$	\$	\$

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

## NOTE 4 LOANS (Continued)

The following tables present loans individually evaluated for impairment by class of loans for nine months ended September 30, 2016 and September 30, 2015.

	(In Thousands)					
	Investment Recorded	Unpaid Principal Balance	Related Allowance	YTD Average Recorded Investment	YTD Interest Income Recognized	YTD Interest Income Recognized Cash Basis
Nine Months Ended September 30, 2016						
With no related allowance recorded:						
Consumer Real Estate	\$ 383	\$ 383	\$	\$ 78	\$ 1	\$ 1
Agricultural Real Estate	132	132		152	1	
Agricultural						
Commercial Real Estate				367	17	16
Commercial and Industrial				450	18	
Consumer						
With a specific allowance recorded:						
Consumer Real Estate	329	329	35	387	11	7
Agricultural Real Estate				13		
Agricultural						
Commercial Real Estate	444	444	68	254		
Commercial and Industrial	118	118	22	142		
Consumer						
Totals:						
Consumer Real Estate	\$ 712	\$ 712	\$ 35	\$ 465	\$ 12	\$ 8
Agricultural Real Estate	\$ 132	\$ 132	\$	\$ 165	\$ 1	\$
Agricultural	\$	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 444	\$ 444	\$ 68	\$ 621	\$ 17	\$ 16
Commercial and Industrial	\$ 118	\$ 118	\$ 22	\$ 592	\$ 18	\$
Consumer	\$	\$	\$	\$	\$	\$



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

## NOTE 4 LOANS (Continued)

	(In Thousands)					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	YTD Average Recorded Investment	YTD Interest Income Recognized	YTD Interest Income Recognized Cash Basis
Nine Months Ended September 30, 2015						
With no related allowance recorded:						
Consumer Real Estate	\$ 201	\$ 201	\$	\$ 159	\$ 2	\$ 2
Agricultural Real Estate	222	222		99		
Agricultural						
Commercial Real Estate	482	482		400	10	10
Commercial and Industrial	578	578		420	20	
Consumer					13	
With a specific allowance recorded:						
Consumer Real Estate	305	305	76	133	8	7
Agricultural Real Estate						
Agricultural						
Commercial Real Estate	560	560	201	1,069		
Commercial and Industrial	193	193	188	327		
Consumer				2		
Totals:						
Consumer Real Estate	\$ 506	\$ 506	\$ 76	\$ 292	\$ 10	\$ 9
Agricultural Real Estate	\$ 222	\$ 222	\$	\$ 99	\$	\$
Agricultural	\$	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 1,042	\$ 1,042	\$ 201	\$ 1,469	\$ 10	\$ 10
Commercial and Industrial	\$ 771	\$ 771	\$ 188	\$ 747	\$ 20	\$
Consumer	\$	\$	\$	\$ 2	\$ 13	\$

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

## NOTE 4 LOANS (Continued)

As of September 30, 2016, the Company had \$808 thousand of foreclosed residential real estate property obtained by physical possession and \$211 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions. As of September 30, 2015, the Company had \$452 thousand of foreclosed residential real estate property obtained by physical possession and \$411 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions.

The Allowance for Loan and Lease Losses (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, 2016	Twelve Months Ended December 31, 2015
<b>Allowance for Loan &amp; Lease Losses</b>		
Balance at beginning of year	\$ 6,057	\$ 5,905
Provision for loan loss	924	625
Loans charged off	(476)	(1,030)
Recoveries	107	557
Allowance for Loan & Lease Losses	\$ 6,612	\$ 6,057
<b>Allowance for Unfunded Loan Commitments &amp; Letters of Credit</b>		
	\$ 227	\$ 208
Total Allowance for Credit Losses	\$ 6,839	\$ 6,265

The Company segregates its 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 classification 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, presented in thousands, related to the allowance for credit losses for three months ended September 30, 2016 and September 30, 2015 is as follows:

	Consumer Real Estate	Agricultural Real Estate	Agricultural Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer Credit	Unfunded Loan Commitment & Letters of Credit Unallocated	Total	
<b>Three Months Ended September 30, 2016</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 413	\$ 229	\$ 591	\$ 2,717	\$ 1,215	\$ 365	\$ 219	\$ 963	\$ 6,712
Charge Offs	(42)		(3)	(90)		(83)			(218)
Recoveries	1		4	2	3	19			29
Provision (Credit)	(86)	5	(12)	376	(23)	59		(11)	308
Other Non-interest expense related to unfunded							8		8
Ending Balance	\$ 286	\$ 234	\$ 580	\$ 3,005	\$ 1,195	\$ 360	\$ 227	\$ 952	\$ 6,839
Ending balance: individually evaluated for impairment	\$ 35	\$	\$	\$ 68	\$ 22	\$	\$	\$	\$ 125
Ending balance: collectively evaluated for impairment	\$ 251	\$ 234	\$ 580	\$ 2,937	\$ 1,173	\$ 360	\$ 227	\$ 952	\$ 6,714

Ending balance: loans acquired with deteriorated credit quality	\$	1								\$	1
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**FINANCING  
RECEIVABLES:**

Ending balance	\$ 86,898	\$ 60,162	\$ 79,332	\$ 369,721	\$ 111,953	\$ 30,616	\$	\$	\$ 738,682
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Ending balance: individually evaluated for impairment	\$	712	\$	132	\$		\$	444	\$	118	\$		\$		\$	1,406
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Ending balance: collectively evaluated for impairment	\$ 86,186	\$ 60,030	\$ 79,332	\$ 369,277	\$ 111,835	\$ 30,616	\$	\$	\$ 737,276
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Ending balance: loans acquired with deteriorated credit quality	\$	265	\$		\$		\$		\$		\$		\$		\$	265
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Three Months Ended September 30, 2015</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 309	\$ 189	\$ 519	\$ 2,286	\$ 1,288	\$ 309	\$ 201	\$ 1,027	\$ 6,128
Charge Offs				(25)	(79)	(73)			(177)
Recoveries	12		61	1	66	32			172
Provision (Credit)	32	7	(60)	144	(125)	56		189	243
Other Non-interest expense related to unfunded							(5)		(5)
Ending Balance	\$ 353	\$ 196	\$ 520	\$ 2,406	\$ 1,150	\$ 324	\$ 196	\$ 1,216	\$ 6,361
Ending balance: individually evaluated for impairment	\$ 76	\$	\$	\$ 201	\$ 188	\$	\$	\$	\$ 465
Ending balance: collectively evaluated for impairment	\$ 277	\$ 196	\$ 520	\$ 2,205	\$ 962	\$ 324	\$ 196	\$ 1,216	\$ 5,896
Ending balance: loans acquired with deteriorated credit quality	\$ 1								\$ 1
<b>FINANCING RECEIVABLES:</b>									
Ending balance	\$ 88,020	\$ 54,995	\$ 73,310	\$ 301,342	\$ 91,114	\$ 26,458	\$	\$	\$ 635,239

Ending balance: individually evaluated for impairment	\$ 506	\$ 222	\$	\$ 1,042	\$ 771	\$	\$	\$ 2,541
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Ending balance: collectively evaluated for impairment	\$ 87,514	\$ 54,773	\$ 73,310	\$ 300,300	\$ 90,343	\$ 26,458	\$	\$ 632,698
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Ending balance: loans acquired with deteriorated credit quality	\$ 512	\$	\$	\$	\$	\$	\$	\$ 512
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

Additional analysis, presented in thousands, related to the allowance for credit losses for nine months ended September 30, 2016 and September 30, 2015 is as follows:

	Consumer Real Estate	Agricultural Real Estate	Agricultural Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Nine Months Ended September 30, 2016</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 338	\$ 211	\$ 582	\$ 2,516	\$ 1,229	\$ 337	\$ 208	\$ 844	\$ 6,265
Charge Offs	(106)		(21)	(93)	(20)	(236)			(476)
Recoveries	23		9	7	8	60			107
Provision (Credit)	31	23	10	575	(22)	199		108	924
Other Non-interest expense related to unfunded							19		19
Ending Balance	\$ 286	\$ 234	\$ 580	\$ 3,005	\$ 1,195	\$ 360	\$ 227	\$ 952	\$ 6,839
Ending balance: individually evaluated for impairment	\$ 35	\$	\$	\$ 68	\$ 22	\$	\$	\$	\$ 125
Ending balance: collectively evaluated for impairment	\$ 251	\$ 234	\$ 580	\$ 2,937	\$ 1,173	\$ 360	\$ 227	\$ 952	\$ 6,714
Ending balance: loans acquired with deteriorated credit	\$ 1								\$ 1

quality

**FINANCING  
RECEIVABLES:**

Ending balance	\$ 86,898	\$ 60,162	\$ 79,332	\$ 369,721	\$ 111,953	\$ 30,616	\$	\$	\$ 738,682
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Ending balance: individually evaluated for impairment	\$ 712	\$ 132	\$	\$ 444	\$ 118	\$	\$	\$	\$ 1,406
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Ending balance: collectively evaluated for impairment	\$ 86,186	\$ 60,030	\$ 79,332	\$ 369,277	\$ 111,835	\$ 30,616	\$	\$	\$ 737,276
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Ending balance: loans acquired with deteriorated credit quality	\$ 265	\$	\$	\$	\$	\$	\$	\$	\$ 265
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Nine Months Ended September 30, 2015</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 537	\$ 184	\$ 547	\$ 2,367	\$ 1,421	\$ 323	\$ 207	\$ 526	\$ 6,112
Charge Offs				(111)	(468)	(219)			(798)
Recoveries	39		64	203	88	124			518
Provision (Credit)	(223)	12	(91)	(53)	109	96		690	540
Other Non-interest expense related to unfunded							(11)		(11)
Ending Balance	\$ 353	\$ 196	\$ 520	\$ 2,406	\$ 1,150	\$ 324	\$ 196	\$ 1,216	\$ 6,361
Ending balance: individually evaluated for impairment	\$ 76	\$	\$	\$ 201	\$ 188	\$	\$	\$	\$ 465
Ending balance: collectively evaluated for impairment	\$ 277	\$ 196	\$ 520	\$ 2,205	\$ 962	\$ 324	\$ 196	\$ 1,216	\$ 5,896
Ending balance: loans acquired with deteriorated credit quality	\$ 1								\$ 1
<b>FINANCING RECEIVABLES:</b>									
Ending balance	\$ 88,020	\$ 54,995	\$ 73,310	\$ 301,342	\$ 91,114	\$ 26,458	\$	\$	\$ 635,239

Ending balance: individually evaluated for impairment	\$ 506	\$ 222	\$	\$ 1,042	\$ 771	\$	\$	\$ 2,541
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Ending balance: collectively evaluated for impairment	\$ 87,514	\$ 54,773	\$ 73,310	\$ 300,300	\$ 90,343	\$ 26,458	\$	\$ 632,698
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Ending balance: loans acquired with deteriorated credit quality	\$ 512	\$	\$	\$	\$	\$	\$	\$ 512
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 EARNINGS PER SHARE

Basic earnings per share are calculated using the two-class method. The two-class method is an earnings allocation formula under which earnings per share is calculated from common stock and participating securities according to dividends declared and participation rights in undistributed earnings. Under this method, all earnings distributed and undistributed, are allocated to participating securities and common shares based on their respective rights to receive dividends. Unvested share-based payment awards that contain non-forfeitable rights to dividends are considered participating securities (i.e. unvested restricted stock), not subject to performance based measures. Basic earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding. Application of the two-class method for participating securities results a more dilutive basic earnings per share as the participating securities are allocated the same amount of income as if they are outstanding for purposes of basic earnings per share. There is no additional potential dilution in calculating diluted earnings per share, therefore basic and diluted earnings per share are the same amounts. Other than the restricted stock plan, the Company has no other stock based compensation plans.

	In Thousands			
	Three Months Ended		Year to Date Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
<b>Earnings per share</b>				
Net income	\$ 3,015	\$ 2,620	\$ 8,470	\$ 7,568
Less: distributed earnings allocated to participating securities	(10)	(9)	(27)	(23)
Less: undistributed earnings allocated to participating securities	(16)	(11)	(45)	(32)
<b>Net earnings available to common shareholders</b>	<b>\$ 2,989</b>	<b>\$ 2,600</b>	<b>\$ 8,398</b>	<b>\$ 7,513</b>
Weighted average common shares outstanding including participating securities	4,612,766	4,615,379	4,609,188	4,615,689
Less: average unvested restricted shares	(40,211)	(35,092)	(38,933)	(33,654)
Weighted average common shares outstanding	4,572,555	4,580,287	4,570,255	4,582,035
<b>Basic earnings and diluted per share</b>	<b>\$ 0.65</b>	<b>\$ 0.57</b>	<b>\$ 1.84</b>	<b>\$ 1.64</b>

## NOTE 6 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.

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

NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Interest Bearing Time Deposits

Fair values 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.

Securities Available-for-sale

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

Other Securities

The carrying value of Federal Home Loan Bank and Farmer Mac 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

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.

Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

The carrying value of federal funds purchased and securities sold under agreements to repurchase approximates fair values.

Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

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.

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 of borrowing arrangements.

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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of September 30, 2016 and December 31, 2015 are reflected below.

	(In Thousands)				
	September 30, 2016				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 31,498	\$ 31,498	\$ 31,498	\$	\$
Interest-bearing time deposits	1,915	1,915		1,915	
Securities available-for-sale	224,473	224,473	31,059	191,873	1,541
Other Securities	3,717	3,717			3,717
Loans, net	732,070	735,456			735,456
Interest receivable	4,430	4,430			4,430
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 449,879	\$ 449,879	\$	\$	\$ 449,879
Non-interest bearing Deposits	176,180	176,180		176,180	
Time Deposits	212,042	212,254			212,254
<b>Total Deposits</b>	<b>\$ 838,101</b>	<b>\$ 838,313</b>	<b>\$</b>	<b>\$ 176,180</b>	<b>\$ 662,133</b>
Fed Funds purchased and Securities sold under agreements to repurchase	\$ 59,487	\$ 59,487	\$	\$	\$ 59,487
Federal Home Loan Bank advances	10,000	10,041			10,041
Interest payable	228	228			228

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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands)				
	December 31, 2015				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 22,018	\$ 22,018	\$ 22,018	\$	\$
Securities available-for-sale	235,115	235,115	38,505	189,258	7,352
Other Securities	3,717	3,717			3,717
Loans, net	679,821	683,332			683,332
Interest receivable	3,589	3,589			3,589
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 415,942	\$ 415,942	\$	\$	\$ 415,942
Non-interest bearing Deposits	171,112	171,112		171,112	
Time Deposits	184,285	184,308			184,308
<b>Total Deposits</b>	<b>\$ 771,339</b>	<b>\$ 771,362</b>	<b>\$</b>	<b>\$ 171,112</b>	<b>\$ 600,250</b>
Federal Funds Purchased and Securities Sold Under Agreement to Repurchase	\$ 78,815	\$ 78,815	\$	\$	\$ 78,815
Federal Home Loan Bank advances	10,000	9,986			9,986
Interest payable	185	185			185
<b>Fair Value Measurements</b>					

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

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

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 marketplace.

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. The fair value is determined by valuing similar credit payment streams at similar rates.

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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

The following summarizes financial assets measured at fair value on a recurring basis as of September 30, 2016 and December 31, 2015, 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 Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
September 30, 2016			
Assets - (Securities Available-for-Sale)			
U.S. Treasury	\$ 31,059	\$	\$
U.S. Government agencies		99,654	
Mortgage-backed securities		30,390	
State and local governments		61,829	1,541
Total Securities Available-for-Sale	\$ 31,059	\$ 191,873	\$ 1,541
December 31, 2015			
Assets - (Securities Available-for-Sale)			
U.S. Treasury	\$ 38,505	\$	\$
U.S. Government agencies		98,220	
Mortgage-backed securities		26,324	
State and local governments		64,714	7,352
Total Securities Available-for-Sale	\$ 38,505	\$ 189,258	\$ 7,352



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

## NOTE 6 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, 2016 and September 30, 2015.

	(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, 2016	\$ 5,904	\$ 1,448	\$ 7,352
Change in Market Value		93	93
Payments & Maturities	(5,904)		(5,904)
Balance at September 30, 2016	\$	\$ 1,541	\$ 1,541

	(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, 2015	\$ 6,638	\$ 1,293	\$ 7,931
Change in Market Value	(256)	130	(126)
Payments & Maturities	(200)		(200)
Balance at September 30, 2015	\$ 6,182	\$ 1,423	\$ 7,605

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, 2016 and December 31, 2015, such assets consist primarily of collateral dependent impaired loans. Collateral dependent 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 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

At September 30, 2016 and December 31, 2015, fair value of collateral dependent impaired loans categorized as Level 3 were \$766 and \$549 thousand, respectively. The specific allocation for impaired loans was \$125 and \$330 thousand as of September 30, 2016 and December 31, 2015, 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.

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

	Fair Value at September 30, 2016	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and local government	\$ 1,541	Discounted Cash Flow	Credit strength of underlying project or entity / Discount rate	0-5%
Collateral dependent Impaired loans	766	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%
Other real estate owned - residential	165	Appraisals	Discount to reflect current market	0-20%
Other real estate owned - commercial		Appraisals	Discount to reflect current market	0-20%
				Range
	Fair Value at December 31, 2015	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and local government	\$ 7,352	Discounted Cash Flow	Credit strength of underlying project or entity / Discount rate	0-5%
	549			0-50%

Collateral dependent Impaired loans		Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	
Other real estate owned - residential		Appraisals	Discount to reflect current market	0-20%
Other real estate owned - commercial	216	Appraisals	Discount to reflect current market	0-20%

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

## NOTE 6 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, 2016 and December 31, 2015:

Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2016				
(In Thousands)	Balance at September 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent impaired loans	\$ 766	\$	\$	\$ 766
Other real estate owned residential mortgages	\$ 165	\$	\$	\$ 165

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2015				
(In Thousands)	Balance at December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent impaired loans	\$ 549	\$	\$	\$ 549
Other real estate owned commercial	\$ 216	\$	\$	\$ 216

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, 2016 and December 31, 2015, the Company estimates that there is no impairment of these assets.

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

## NOTE 7 FEDERAL FUNDS PURCHASED AND SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

The Company had \$0 and \$22 million in Federal Funds Purchased as of September 30, 2016, and December 31, 2015, respectively. During the same time periods the company also had \$59 million and \$57 million in securities sold under agreement to repurchase.

	September 30, 2016					Total
	Remaining Overnight & Continuous	Contratual Up to 30 days	Maturity 30-90 days	of the Agreements Greater Than 90 days	(In Thousands)	
Federal funds purchased	\$	\$	\$	\$	\$	\$
Repurchase Agreements; US Treasury & agency securities	\$ 39,077	\$	\$	\$ 20,410	\$ 59,487	\$ 59,487
	\$ 39,077	\$	\$	\$ 20,410	\$ 59,487	\$ 59,487

	December 31, 2015					Total
	Remaining Overnight & Continuous	Contratual Up to 30 days	Maturity 30-90 days	of the Agreements Greater Than 90 days	(In Thousands)	
Federal funds purchased	\$ 22,000	\$	\$	\$	\$ 22,000	\$ 22,000
Repurchase Agreements; US Treasury & agency securities	\$ 39,691	\$	\$	\$ 17,124	\$ 56,815	\$ 56,815
	\$ 61,691	\$	\$	\$ 17,124	\$ 78,815	\$ 78,815

## NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments-Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments*. The provisions of ASU 2016-13 was issued to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments that are not accounted for at fair value through net income, including loans held for investment, held-to-maturity debt securities, trade and other receivables, net investment in leases and other commitments to extend credit held by a reporting entity at each reporting date. ASU 2016-13 requires that financial assets measured at amortized cost be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The amendments in ASU 2016-13 eliminate the probable initial recognition in current GAAP and reflect an entity's current estimate of all expected credit losses. The measurement of expected credit losses is based upon historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the financial assets. ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019.

Early adoption is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact of ASU 2016-13 on its accounting and disclosures.

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

## NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS (Continued)

In January 2016, the FASB issued ASU No. 2016-01 *Financial Instruments Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company is assessing the impact of ASU 2016-01 on its accounting and disclosures.

In February 2016, the FASB issued ASU No. 2016-02 *Leases (Topic 842)*. ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its accounting and disclosures.

In March 2016, the FASB issued ASU No. 2016-09 *Compensation - Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee's shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election for forfeitures as they occur. The guidance is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted. The Company is assessing the impact of ASU 2016-09 on its accounting and disclosures.

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

**OVERVIEW**

Loan growth continued to drive improvement in the net interest income of the Company. It also translated into an improved bottom line even with the increased provision for loan losses expense. As harvest in the Company's market area continues, the majority of agricultural producers have reported high crop yields. Prices, however, remain weak so it is expected that inventories may increase. Profits may not be as high as prior recent years but should be adequate and above breakeven. Farmers may increase line usage for 2017 inputs until prices improve. Asset quality remains strong. Consumer loans also maintained strong growth through the third quarter of 2016. Automobile loans lead the improvement as area dealers also reported increased levels of sales. One-to four family residential mortgage loan activity increased as long term interest rates remain at low levels. Regulatory requirements have lengthened the time for a loan to close from when the application is taken. Tighter profit margins are impacting used equipment valuations, purchases and sales. Land prices have decreased slightly with the greater fluctuations in the lower quality land.

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

**OVERVIEW (Continued)**

Unemployment rates continue to improve throughout the Company's market area. Manufacturing activity remains similar to last year. Low gas prices continue to help the local economies. Commercial lending remains firm with the growth in the portfolio dominated by market share increases. Modest improvement in the economy has not spurred much in expansion. The Company's growth has been largely attributable to expanding relationships with newer customers and acquiring customers from our competitors.

Loan growth drove the improvement in net interest income as compared to last year and was the driving factor for the increased loan loss provision. Noninterest income also strengthened and net income after taxes ended the third quarter 2016 was 15.1% above third quarter 2015. The 12.6% increase in net interest income after provision for loan losses, and a 3.1% increase in noninterest income, partially offset by a 6.3% increase in noninterest expense, resulted in a 14.0% increase in earnings per share for the 2016 third quarter as compared to 2015's third quarter.

**NATURE OF ACTIVITIES**

Farmers & Merchants Bancorp, Inc. (the Company) is a financial holding company incorporated under the laws of Ohio in 1985. Our subsidiaries are, The Farmers & Merchants State Bank (the Bank), a community bank operating in Northwest Ohio since 1897 and Farmers & Merchants Risk Management, Inc., a captive insurance company formed in December 2014 and is located in Nevada. We report our financial condition and net income on a consolidated basis and we have only one segment.

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

The Bank opened an additional office during April of 2016 in Fort Wayne, Indiana. The office is located within the corporation limits of Hometown, with a Fort Wayne address. The Bank has continued its expansion strategy and the new office is expected to provide new growth opportunities. The doors officially opened on April 7<sup>th</sup>.

The Bank will be opening its twenty-fourth location in Bowling Green, Ohio in the fourth quarter. It is the second leased office and was renovated to meet the Bank's needs before opening.

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. The largest segment of the lending business relates to commercial, both real estate and non-real estate. The type of commercial business ranges from small business to multi-million dollar companies. The loans are a reflection of business located within the Bank's market area. 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, Automated Teller Machines (ATMs) 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 Individual Retirement Accounts (IRAs) and Health Savings Accounts (HSAs). 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 Automated Clearing House (ACH) file transmittal. In addition, the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Mobile banking was added in 2012 and has been widely accepted and used by consumers. Over the past couple of years, the Bank has updated its consumer offerings with Secure and Pure checking in 2014 and with KASASA Cash Bank in 2015. Upgrades to our digital products and services continue to occur in both retail and business lines.

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

**NATURE OF ACTIVITIES (Continued)**

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 to not promote innovative, unproven credit products which may 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 those 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.

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.

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 for 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

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.

Floor plan.

New/used vehicles to 100% of wholesale.

New/Used recreational vehicles and manufactured homes to 80% of wholesale.

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.

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

**NATURE OF ACTIVITIES (Continued)**

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.

In December of 2014, the Company became a financial holding company within the meaning of the Bank Holding Company Act of 1956 as amended (the Act), in order to provide the flexibility to take advantage of the expanded powers available to a financial holding company under the Act. 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 Company also formed a captive insurance company (the captive) in December 2014 which is located in Nevada and regulated by the State of Nevada Division of Insurance.

The Bank's primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Lucas, Williams, Wood and in the Indiana counties of DeKalb and Steuben. In the second quarter of 2016 the Bank added the Indiana county of Allen to its service area with the opening of its newly constructed office in Fort Wayne. 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, farm credit services, and savings and loan institutions in each of our operating localities. In a number of our 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 the services provided.

At September 30, 2016, we had 268 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 good.

**REGULATORY DEVELOPMENTS**

The Bank has been attentive to the significant final mortgage rules, revisions to the rules, and additional guidance issued by the Consumer Financial Protection Bureau (CFPB) to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions. Effective January 2014, these rules altered the landscape for the entire mortgage lending industry. The Bank continues to test, train, validate results, and review the applicable requirements of these new mortgage rules. The TILA-RESPA Integrated Disclosure (TRID) rules became effective on October 3, 2015. The Bank's residential mortgage lending staff worked closely with the Bank's mortgage loan origination software vendor and diligently strived to achieve TRID compliance as of the October 2015 effective date. The vendor has been attentive to the key regulatory requirements and receptive to its individual clients' needs. Further changes and enhancements to the loan origination software have served to better accommodate documentation needs and compliance strategies. Bank staff has continued outreach efforts with real estate agents, attorneys, and closing agents to further cultivate collaboration and attain TRID compliance, and thus minimize the impact of these regulatory changes on home loan borrowers. Due to the complexities of the new TRID rules, the lack of clarity or guidance involving various provisions, and the lingering uncertainties regarding liability, remaining attentive to industry

questions and concerns to ensure full compliance remains an ongoing priority. The Bank has committed to make good faith efforts in compliance with the technical requirements of the TRID rules. The industry awaited a Proposed Rule announced in April 2016 by the CFPB which was released in August 2016 and subject to comment until October 18, 2016. The Proposed Rule is intended to resolve places in areas of the regulation text and commentary where the CFPB believes adjustments would be useful for greater certainty and clarity. Though various matters proposed do appear to provide more certainty, when issued, the final rules will have to be carefully evaluated to discern what matters have achieved more clarity and what remains unclear.

Implementation of the new Military Lending Act (MLA) requirements was completed to meet the mandatory compliance date of October 3, 2016. New requirements have resulted in expanded coverage of more types of loans. The MLA is intended to protect active duty military service members and their dependents from potentially abusive lending practices. Employees received training on new MLA requirements. The Department of Defense's August 26, 2016 publication of an interpretive rule which provided 19 questions and answers was intended to provide guidance and further clarifications on certain questions and matters. The types of consumer purpose covered loans offered by the Bank that could be made to active duty military service members, as well as their dependents were identified. Safe harbor methods to identify covered borrowers who are military service members or their dependents were implemented,

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

**REGULATORY DEVELOPMENTS (Continued)**

along with disclosures required to be provided. Prohibited loan provisions were addressed in loan contracts to ensure they conform to MLA restrictions. Loan Application and Loan Origination software vendors' readiness was critical to properly addressing MLA requirements. Credit card accounts are not covered by MLA requirements until October 3, 2017.

The Company has implemented Basel III capital rules which began to be phased 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.

**CRITICAL ACCOUNTING POLICIES 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 ALLL, the valuation of its Mortgage Servicing Rights and the valuation of real estate acquired through or in lieu of, loan foreclosures (OREO Property) 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.

OREO Property held for sale and is 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 cost or fair value minus estimated costs to sell.

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. The net income from operations of foreclosed real estate held for sale is reported in non-interest income or

non-interest expense determined by whether in a gain or loss position overall. At September 30, 2016, OREO Property holdings were \$1.3 million and were \$1.3 million as of December 31, 2015 and \$1.1 million as of September 30, 2015.

The ALLL and ACL 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, and abilities of lending staff, valuation trends of fixed assets, and trends in credit delinquency, classified credits, and credit losses.

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

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES (Continued)**

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 Bank is required to estimate the value of its Mortgage Servicing Rights. The Bank 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 Bank's mortgage servicing rights relating to loans serviced for others represent an asset. 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. The amortization thereof is recorded in non-interest expense. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Bank, 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 Bank 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 Bank's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Bank of the mortgage servicing rights, the Bank 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 Bank'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 Bank's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Bank. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Bank'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.

Servicing Rights, please see Note 1 to the consolidated financial statements provided herewith.

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

The Company ended March 31, 2016 with its total asset balance over a billion dollars. It represented a new record high in the Company's 119 year history. The Bank did not reach a billion dollars in total assets until the quarter ending, June 30, 2016. The Company plans to continue in its growth mode with the addition of the Bank's 23<sup>rd</sup> office which opened April 7, 2016 in Indiana, making it the fourth office in the state. The Bank will also be adding its 24th office during the fourth quarter with a leased office in Bowling Green, Ohio.

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Liquidity in terms of cash and cash equivalents ended almost \$9.5 million higher as of September 30, 2016 than it was at yearend December 31, 2015. Decreased securities along with increased deposits funded the \$52.2 million increase in net loans since yearend 2015. The largest loan growth occurred in commercial real estate and commercial and industrial. Agricultural real estate and the consumer portfolios also experienced increases. The largest decline was in agricultural which seasonally increases at the end of the year.

In comparing to the same period, prior year, the September 30, 2016 (net of deferred fees) loan balances of \$738.7 million accounted for a 16.3% increase when compared to \$635.2 million. The year over year improvement was made up of a 25.6% increase in commercial and industrial, a 22.7% increase in commercial real estate, a 15.7% increase in consumer and lastly a combined 17.6% increase in agricultural related, 9.4% in agricultural real estate and 8.2% in non-real estate agricultural. Consumer real estate decreased by 1.3% while Industrial Development Bonds ( IDB s ) decreased 11.4%. While the last percentage seems high, the decrease in dollars was only \$757 thousand. The Company credits the growth to a strong team of lenders focused on providing customers valuable localized services and thereby increasing our market share.

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

	(In Thousands)		
	September-16 Amount	September-15 Amount	September-14 Amount
Consumer Real Estate	\$ 86,898	\$ 88,020	\$ 97,651
Agricultural Real Estate	60,162	54,995	48,812
Agricultural	79,332	73,310	67,221
Commercial Real Estate	369,721	301,342	274,074
Commercial and Industrial	106,061	84,465	92,926
Consumer	30,616	26,458	23,066
Industrial Development Bonds	5,892	6,649	4,854
<b>Total Loans, net</b>	<b>\$ 738,682</b>	<b>\$ 635,239</b>	<b>\$ 608,604</b>

While the security portfolio has been utilized to fund loan growth for the last three years, additional sources have been cultivated during 2016. The security portfolio decreased \$10.6 million in the first three quarters 2016 from yearend 2015 and is lower by \$20.3 million from September 30, 2015. The current portfolio is in a net unrealized gain position of \$1.6 million. With the exception of stock, which is shown as other securities, all of the Company's security portfolio is categorized as available for sale and as such is recorded at fair value.

Management feels confident that liquidity needs for future growth can be met through additional run-off and/or sales from the security portfolio, increased deposits and additional borrowings. For short term needs, the Bank has \$106.5 million of unsecured borrowing capacity through its correspondent banks.

Overall assets grew 5.6% since yearend 2015 and 9.1% since September 30, 2015. The largest growth was in the loan portfolios.

Deposits accounted for the largest growth within liabilities, up 8.7% or \$66.8 million since yearend and 9.1% or \$70.1 million over September 30, 2015 balances. Core deposits continue to drive the increase which provide the greatest benefit for both lower cost of funds and the opportunity to generate additional noninterest income. When comparing to a year ago, other borrowed money increased \$10 million as the borrowings took place during the fourth quarter of 2015.

Time deposits increased during the third quarter due to the use of short term deposits from the Promontory Network. The Promontory Network has been used by the Bank for many years to provide additional FDIC insurance coverage to the Bank's depositors having deposits with the Bank in excess of the FDIC's insurance limits by using Promontory's CDARS product. When the Bank, as a member of the network, places a customer's deposit using the CDARS service, the deposit is divided into amounts under the standard FDIC insurance maximum and placed with other Network

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

member banks in exchange for certificates of deposit. This makes the full amount placed by the Bank eligible for FDIC coverage. The Bank used the CDARS product in a reciprocal manner previously and expanded into a one-way usage whereby the Bank can place or receive time deposits.

As of September 30, 2016, the Bank had balances of \$25.3 million in the one-way receipt of funds from the network. This was the main factor in the increased time deposits. Original maturities are six months or less. The Bank will continue to explore additional sources of funds to supplement deposit growth and provide a base for future loan growth.

Federal Funds purchased and securities sold under agreements to repurchase decreased \$2.0 million when comparing September 30, 2016 balances to September 30, 2015. This category decreased by \$19.3 million when comparing September 30, 2016 to December 31, 2015. Borrowings from FHLB in fourth quarter 2015 aided in the year over year decrease as these replaced \$10 million of Fed Funds purchased.

Shareholder's equity increased by \$6.8 million as of the third quarter of 2016 compared to yearend 2015, as earnings exceeded dividend declarations. Accumulated other comprehensive income increased in gain position \$1.4 million which encompassed the shift of \$503 thousand from unrealized gain to realized gain with the sale of securities since yearend 2015. Dividends paid year-to-date differed by \$128.0 thousand from the same period last year.

The beginning of the Basel III capital rule applies in 2016. The Bank and Company include a capital conservation buffer as a part of the transition provision. For calendar year 2016, the applicable required capital conservation buffer percentage of 0.625% is the base above which institutions avoid limitations on distributions and certain discretionary bonus payments. The total buffer requirement will increase to 2.5% for calendar year 2019. As of September 30, 2016, the Company and the Bank are both positioned well above the 2019 requirement.

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

Tier I Leverage Ratio	11.74%
Risk Based Capital Tier I	14.04%
Total Risk Based Capital	14.83%
Stockholders' Equity/Total Assets	12.15%
Capital Conservation Buffer	6.83%

**MATERIAL CHANGES IN RESULTS OF OPERATIONS****Comparison of Results of Operation for three month periods ended September 30, 2016, 2015 and June 30, 2016.**

The third quarter 2016 had an increase of 2.3% or \$16.5 million in net average loan growth over the average balances of second quarter 2016. This result emphasizes that the trend of solid loan growth continues, with new loans providing more than just replacement of pay downs. The benefits of these higher loan balances can be seen in interest income from loans, as it was \$267 thousand higher for the quarter ended September 30, 2016, over the second quarter 2016.

The higher levels of loan interest income helped to offset the available-for-sale securities portfolio, which decreased in average balances, whether comparing to last quarter or the previous year. The decreased balances were expected as available for sale securities represented a source of funds for loan growth. The income associated with the security portfolio decreased by \$72 thousand in comparison to second quarter 2016 and \$156 thousand in comparison to the same third quarter 2015. The benefit of the increase in interest income from loans was well above the loss of interest income from the smaller security portfolio.

When comparing third quarter 2016 to third quarter 2015, average loan balances grew \$109.2 million. This represented a strong 17.4% increase in a one year time period. Interest income also experienced an impressive increase of \$3.4 million as compared to the quarter ended September 30, 2015. Overall, interest income for the quarter comparisons was higher for third quarter 2016 by 2.2% or \$203 thousand as to last quarter 2016 and by 13.6% or \$1.1 million as to same quarter 2015.

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

In terms of annualized yield, for the quarter ended September 30, 2016, it was 4.03% which compares to last quarter's 3.99% and a year ago third quarter ended September 30, 2015 of 3.96%. The following chart demonstrates the value of increased loan balances in the balance sheet mix, even if offset by lower balances in other interest bearing assets.

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

	(In Thousands)		Yield/Rate	
	Quarter to Date Ended September 30, 2016		September 30, 2016	September 30, 2015
Interest Earning Assets:	Average Balance	Interest/ Dividends		
Loans	\$ 736,924	\$ 8,629	4.69%	4.77%
Taxable Investment Securities	164,222	646	1.57%	1.57%
Tax-exempt Investment Securities	53,395	293	3.33%	3.52%
Fed Funds Sold & Interest Bearing Deposits	13,832	22	0.64%	0.25%
<b>Total Interest Earning Assets</b>	<b>\$ 968,373</b>	<b>\$ 9,590</b>	<b>4.03%</b>	<b>3.96%</b>

**Change in Quarter to Date September 30, 2016 Interest Income Compared to September 30, 2015 (In Thousands)**

	Change	Due to Volume	Due to Rate
Interest Earning Assets:			
Loans	\$ 1,288	\$ 1,416	\$ (128)
Taxable Investment Securities	(52)	(55)	3
Tax-exempt Investment Securities	(105)	(126)	21
Fed Funds Sold & Interest Bearing Deposits	15	4	11
<b>Total Interest Earning Assets</b>	<b>\$ 1,146</b>	<b>\$ 1,239</b>	<b>\$ (93)</b>

Offsetting some of the increase in interest income for the quarter was the increase in cost of funds in 2016. Third quarter 2016 was higher by \$164 thousand than third quarter 2015. Since 2015, average interest-bearing deposit balances have increased \$57 million and resulted in \$106 thousand more in interest expense for the most recent quarter. Additionally, interest expense on Fed Funds Purchased, Securities Sold Under Agreement to Repurchase and

FHLB borrowings was up \$21 thousand in the third quarter 2016 over the same time frame in 2015.

In comparing third quarter 2016 to second quarter 2016, interest expense increased \$52 thousand. Interest expense on deposits increased \$62 thousand, as average balances were \$27 million higher for the third quarter.

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	(In Thousands)			
	Quarter to Date Ended		Yield/Rate	
	September 30, 2016		September 30, 2016	September 30, 2015
Interest Bearing Liabilities:	Average Balance	Interest/Dividends		
Savings Deposits	\$ 456,013	\$ 433	0.38%	0.38%
Other Time Deposits	203,368	514	1.01%	0.95%
Other Borrowed Money	10,000	37	1.48%	0.00%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	61,874	115	0.74%	0.65%
<b>Total Interest Bearing Liabilities</b>	<b>\$ 731,255</b>	<b>\$ 1,099</b>	<b>0.60%</b>	<b>0.57%</b>

**Change in Quarter to Date September 30, 2016 Interest Expense Compared to September 30, 2015 (In Thousands)**

Interest Bearing Liabilities:	Change	Due to Volume	Due to Rate
Savings Deposits	\$ 42	\$ 42	\$
Other Time Deposits	64	34	30
Other Borrowed Money	37	37	
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	21	7	14
<b>Total Interest Bearing Liabilities</b>	<b>\$ 164</b>	<b>\$ 120</b>	<b>\$ 44</b>

Overall, net interest spread and net interest margin figures for the third quarter 2016 are higher than last year and down just a tick from last quarter. As the chart below illustrates, higher yields on interest and dividend income offset the higher interest expense in the most recent quarter when comparing to the same period a year ago. Interest expense for the quarter as compared to last quarter increased more than the improvement to the asset yield, some of which can be attributed to a higher number of days in the current quarter compared to last quarter.

	9/30/2016	9/30/2015	6/30/2016
Interest/Dividend income/yield	4.03%	3.96%	3.99%
Interest Expense / yield	0.60%	0.57%	0.52%

Net Interest Spread	3.43%	3.39%	3.47%
Net Interest Margin	3.57%	3.53%	3.58%

Net interest income was up \$982 thousand for the third quarter 2016 over the same time frame in 2015 due to the increase in loan interest income and partially offset by higher interest expense, as previously mentioned. There has also been a \$151 thousand increase in net interest income over second quarter 2016. As the new loans added in 2016 generate more income, management expects the benefits of the Company's strategy of repositioning the balance sheet to continue to widen this margin.

Noninterest income was up \$88 thousand for the third quarter 2016 over the same time frame in 2015. The Company has seen an increase in its mortgage production volume, and as such the gain on the sale of these loans was \$33 thousand for the third quarter 2016 over the same period in 2015. The Company also took advantage of market fluctuations in its available-for-sale portfolio and sales on securities were conducted, though \$125 thousand lower in the most recent quarter than the same quarter prior year. The largest fluctuation was in the combined service fee lines, which was \$180 thousand over same quarter last year.

Noninterest income for the third quarter 2016 also shows improvement over the second quarter by \$31 thousand. An increase in customer service fees relates to the collection of prepayment fees on three loans and the foreign ATM fees generated from increased usage of the Bank's mobile ATM at market area festivities held during the third quarter, specifically county fairs. Second quarter 2016 experienced greater noninterest revenue from gain on sales, both in loans and available for sale securities. These offset the third quarter improvement in customer service fees.

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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)

Total provision for loan losses was \$65 thousand higher for the third quarter 2016 as compared to the same quarter 2015. Loan growth warranted a higher provision expense be taken in 2016 than in 2015. Management continues to monitor asset quality, making adjustments to the provision as necessary. Loan charge-offs were \$41 thousand higher in third quarter 2016 than the same quarter 2015, recoveries decreased \$143 thousand. Past due loans decreased \$1.3 million from September 30, 2015 to September 30, 2016, the bulk of which came from the commercial real estate portfolio.

Since the second quarter 2016, past due loans have decreased by \$449 thousand. Charge-offs were \$218 thousand, which was \$44 thousand higher than second quarter and recoveries of \$29 thousand for the quarter were \$14 thousand lower than second quarter. Overall net charge-offs were \$189 thousand for third quarter 2016 compared to second quarter 2016's \$131 thousand. Provision expense was \$308 thousand in the third quarter 2016, as loan volumes continued to increase during the third quarter.

The following table breaks down the activity within the ALLL for each loan portfolio class and shows the contribution provided by both recoveries and the provision, along with the reduction of the allowance caused by charge-offs. The time period covered is for three months ended September 30, 2016, 2015, and 2014.

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

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

	In Thousands		
	Three Months Ended	Three Months Ended	Three Months Ended
	September-16	September-15	September-14
Loans	\$ 738,682	\$ 635,239	\$ 608,604
Daily average of outstanding loans	\$ 736,924	\$ 627,677	\$ 599,995
Allowance for Loan Losses- Jul 1	\$ 6,493	\$ 5,927	\$ 5,663
Loans Charged off:			
Consumer Real Estate	42		
Agriculture Real Estate			
Agricultural	3		
Commercial Real Estate	90	25	
Commercial and Industrial		79	
Consumer	83	73	95
	218	177	95
Loan Recoveries:			
Consumer Real Estate	1	12	11
Agriculture Real Estate			
Agricultural	4	61	1
Commercial Real Estate	2	1	
Commercial and Industrial	3	66	5
Consumer	19	32	49
	29	172	66
Net Charge Offs	189	5	29
Provision for loan loss	308	243	282
Acquisition provision for loan loss			
Allowance for Loan & Lease Losses Sept 30	6,612	6,165	5,916
Allowance for Unfunded Loan			
Commitments & Letters of Credit Sept 30	227	196	196
Total Allowance for Credit Losses Sept 30	\$ 6,839	\$ 6,361	\$ 6,112

Ratio of net charge-offs to average Loans outstanding	0.03%	0.00%	0.00%
Ratio of the Allowance for Loan Loss to Nonperforming Loans*	584.18%	266.69%	362.07%

\* Nonperforming loans are defined as all loans on nonaccrual, plus any loans past 90 days not on nonaccrual. For the third quarter 2016, noninterest expenses were \$410 thousand higher than for the same quarter in 2015. Salaries, wages, and employee benefits increased \$312 thousand, with the addition of the Hometown office, normal merit increases and the hiring of staff for the new Bowling Green office. Data processing charges increased \$42 thousand for third quarter 2016 over the third quarter 2015, with the bulk of this being related to the cost of upgrading Bank customer debit cards to incorporate EMV chip card technology, which is more secure than cards having only magnetic strip capabilities. The Bank also signed a 7 year extension contract with our core processor during third quarter 2016. It is expected to better align with our future strategies while controlling costs.

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

In comparison to the second quarter 2016, noninterest expenses increased \$265 thousand during the third quarter. Employee salaries and benefits increased \$275 thousand for the third quarter, as well as a \$34 thousand decrease in other general and administrative. These increases stem from the ramp up for the new Bowling Green office to open in fourth quarter.

Overall, net income in the third quarter of 2016 was up \$395 thousand as compared to the same quarter last year and improved upon second quarter 2016 income by \$41 thousand. 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 to cover the increased costs of expansion and doing business in a tough economy.

**Comparison of Results of Operation for nine months ended September 30, 2016 and 2015.****Interest Income**

Higher loan balances created the improvement in the interest income for the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015. Interest income rose 12.3% or \$3.1 million while loans interest income accounted for a 15.7% or \$3.4 million increase. Offsetting the improvement from loans was a decrease in securities income of \$353 thousand. The change in the balance sheet mix along with the loan growth caused the asset yield to improve by 8 basis points to 4.0% for the year to date quarter 2016 compared to same year to date quarter 2015's 3.92%.

With each quarter of 2016, the loan growth contributes to the continued improvement in asset yield. The growth factor contribution is shown in the charts which follow. Improvement in loan interest income far outweighs the decrease in income from investment securities.

The average interest earning asset base was \$81.1 million higher in third quarter 2016 than for third quarter 2015, an increase of approximately 9.3%.

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

	(In Thousands)		Yield/Rate	
	Year to Date Ended 9/30/2016		September 30, 2016	September 30, 2015
Interest Earning Assets:	Average Balance	Interest/ Dividends		
Loans	\$ 716,731	\$ 24,997	4.66%	4.75%
Taxable Investment Securities	167,668	1,999	1.59%	1.57%

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Tax-exempt Investment Securities	55,453	939	3.42%	3.59%
Fed Funds Sold & Interest Bearing Deposits	10,083	46	0.61%	0.23%
<b>Total Interest Earning Assets</b>	<b>\$ 949,935</b>	<b>\$ 27,981</b>	<b>4.00%</b>	<b>3.92%</b>

**Change in Year to Date September 30, 2016 Interest Income Compared to September 30, 2015 (In Thousands)**

Interest Earning Assets:	Change	Due to Volume	Due to Rate
Loans	\$ 3,399	\$ 3,835	\$(436)
Taxable Investment Securities	(100)	(127)	27
Tax-exempt Investment Securities	(253)	(300)	47
Fed Funds Sold & Interest Bearing Deposits	18	(29)	47
<b>Total Interest Earning Assets</b>	<b>\$ 3,064</b>	<b>\$ 3,379</b>	<b>\$(315)</b>

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

Interest expense was also higher for the nine months ended September 30, 2016 compared to the same period from 2015. Interest expense increased \$478 thousand for the period when compared to same period from 2015, which represented an increase of 17.9%.

The average balance of interest-bearing liabilities was higher by \$51.3 million in 2016 than third quarter 2015. \$10 million of which is attributed to the FHLB borrowings. The higher balance coupled with the slight variation of the balance sheet mix, resulted in a 5 basis points increase in the cost of funds at 0.59% for third quarter 2016 as compared to 2015's 0.54%.

The Federal Funds and prime rate increase of 25 basis points in December 2015 had only a marginal effect on the Bank's pricing methodologies. Rates, both loan and deposit, remain at low levels.

	(In Thousands)		Yield/Rate	
	Year to Date Ended		September 30, September 30,	
	Average	Interest/	2016	2015
Interest Bearing Liabilities:	Balance	Dividends		
Savings Deposits	\$ 440,107	\$ 1,292	0.39%	0.38%
Other Time Deposits	192,577	1,394	0.97%	0.90%
Other Borrowed Money	10,000	110	1.47%	0.00%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	66,271	346	0.70%	0.53%
<b>Total Interest Bearing Liabilities</b>	<b>\$ 708,955</b>	<b>\$ 3,142</b>	<b>0.59%</b>	<b>0.54%</b>

**Change in Year to Date September 30, 2016 Interest Expense Compared to September 30, 2015 (In Thousands)**

	Change	Due to Volume	Due to Rate
Interest Bearing Liabilities:			
Savings Deposits	\$ 132	\$ 84	\$ 48
Other Time Deposits	108	11	97
Other Borrowed Money	110	110	
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	128	59	69

Total Interest Bearing Liabilities	\$ 478	\$ 264	\$ 214
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**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)****Net Interest Income**

Overall, net interest spread and net interest margin figures through the third quarter 2016 have improved over the last two years. As the chart below illustrates, both higher yields on interest and dividend income, even offset by higher interest expense resulted with total net interest margin up 4 basis points since the year-to-date third quarter of 2015 and over year-to-date third quarter 2014 by 1 basis point.

	9/30/2016	9/30/2015	9/30/2014
Interest/Dividend income/yield	4.00%	3.92%	3.97%
Interest Expense / yield	0.59%	0.54%	0.52%
<b>Net Interest Spread</b>	<b>3.41%</b>	<b>3.38%</b>	<b>3.45%</b>
Net Interest Margin	3.56%	3.52%	3.53%

Net interest income was up \$2.6 million in the third quarter 2016 over the same time frame in 2015 due to the increase in loan income even with higher interest expense, as previously mentioned. New loans added in 2015 and 2016 will continue to generate more income; thereby maintaining the benefits from the Company's strategy of repositioning the balance sheet. Future loan growth will continue to benefit the Company as loans are the highest yielding asset the Bank can invest in.

**Provision Expense**

Provision for loan losses was over 70% higher through September 30, 2016 as the Bank sought to provide coverage for the much higher total loan balances as compared to same period 2015. The provision of \$924 thousand was partially due to net-charge offs of \$369 thousand during the period. September 2015 had lower net charge-offs of \$280 thousand and \$540 thousand of provision expense. Strong asset quality for both periods is reflected in the low past dues (30 days+ past due/total loans) percentages of 0.13% for September 30, 2016 and 0.35% for September 30, 2015.

The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off of a loan, whether partial loan balance 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-offs may be realized as further unsecured positions are recognized.

Loans classified as nonaccrual were more than cut in half as of September 30, 2016 at \$1.1 million compared to \$2.3 million as of September 30, 2015. One new loan was categorized as TDR during the year to date.

In determining the allocation for impaired loans the Bank applies the appraised market value 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.

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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)

For the majority of the Bank's impaired loans, including all collateral dependent loans, the Bank will apply the appraised market value 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 appraised market value, 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 class and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table discloses how much of the ALLL is attributed to each class of the loan portfolio, as well as the percent that each particular class of the loan portfolio represents to the entire loan portfolio in the aggregate. The consumer and consumer real estate loan portfolio accounted for the largest component of charge-offs and recoveries through third quarter of 2016. As was mentioned in previous discussion, the commercial real estate portfolio is currently having a major impact on the ALLL due to the loan growth.

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

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

	(In Thousands)		
	Nine Months Ended September-16	Nine Months Ended September-15	Nine Months Ended September-14
Loans	\$ 738,682	\$ 635,239	\$ 608,604
Daily average of outstanding loans	\$ 716,731	\$ 618,552	\$ 587,049
Allowance for Loan & Lease Losses - January 1	\$ 6,057	\$ 5,905	\$ 5,194
Loans Charged off:			
Consumer Real Estate	106		130
Agricultural Real Estate			
Agricultural	21		
Commercial Real Estate	93	111	230
Commercial and Industrial	20	468	
Consumer	236	219	270
	476	798	630
Loan Recoveries			
Consumer Real Estate	23	39	28
Agricultural Real Estate			
Agricultural	9	64	4
Commercial Real Estate	7	203	3
Commercial and Industrial	8	88	15
Consumer	60	124	148
	107	518	198
Net Charge Offs	369	280	432
Provision for loan loss	924	540	1,154
Allowance for Loan & Lease Losses - September 30	\$ 6,612	\$ 6,165	\$ 5,916
Allowance for Unfunded Loan Commitments & Letters of Credit - September 30	227	196	196

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Total Allowance for Credit Losses - September 30	\$ 6,839	\$ 6,361	\$ 6,112
Ratio of net charge-offs to average Loans outstanding	0.05%	0.05%	0.07%
Ratio of Allowance for Loan Loss to Nonperforming Loans	584.18%	266.69%	362.07%

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**Table of Contents****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, 2016 and September 30, 2015.

	(In Thousands) September-2016 Amount	% of Loan Category	(In Thousands) September-2015 Amount	% of Loan Category
<b>Balance at End of Period Applicable To:</b>				
Consumer Real Estate	\$ 286	11.77	\$ 353	13.86
Agricultural Real Estate	234	8.15	196	8.66
Agricultural	580	10.74	520	11.54
Commercial Real Estate	3,006	50.03	2,406	48.47
Commercial and Industrial	1,195	15.16	1,150	13.30
Consumer	360	4.15	324	4.17
Unallocated	951		1,216	
<b>Allowance for Loan &amp; Lease Losses</b>	<b>6,612</b>		<b>6,165</b>	
<b>Off Balance Sheet Commitments</b>	<b>227</b>		<b>196</b>	
<b>Total Allowance for Credit Losses</b>	<b>\$ 6,839</b>		<b>\$ 6,361</b>	

**Noninterest Income**

Noninterest income was up \$386 thousand through the third quarter 2016 over the same time frame in 2015. Fees accounted for \$213 thousand of the increase while gains on sales of investment securities made up the other \$173 thousand. Fees increased due to collection of prepayment fees and the changes made to deposit offerings both in product and bundling of services. An increase in the number of core deposit accounts was also a contributing factor. The proceeds from the sales were on available for sale securities used to partially fund the loan growth of 2016. Realizing a gain on the sale of these securities was an added benefit. Gain on sales of loans also increased due to higher activity in mortgage loan generation both in consumer and agricultural year to date.

Fees increased due to collection of prepayment fees and the changes made to deposit offerings both in product and bundling of services. An increase in the number of core deposit accounts also contributed. \$45.4 million has been realized in sales of investment securities, which captured the benefit of movement in market interest rates. The sales resulted in a gain of \$503 thousand. The same time period 2015 had similar sales of \$44.6 million resulting in gains of \$418 thousand. The difference between 2016 and 2015 sales was the utilization of the funds. 2016 went to fund loan growth while only a portion did in 2015 with the balances held in cash and reinvested in securities beginning in the second quarter.

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 the third quarter of 2016, mortgage servicing rights caused a net \$87 thousand in income, in comparison to \$22 thousand for the third quarter of 2015. The higher capitalized additions for 2016 are attributed to a higher loan origination level of 1-4 families in 2016 as compared to 2015. The carrying value is well below the market value of \$2.6 million which indicates any large expense to fund the valuation allowance to be unlikely in 2016.

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

	(In Thousands)	
	2016	2015
Beginning Balance, January 1	\$ 2,056	\$ 2,023
Capitalized Additions	398	298
Amortization	(311)	(276)
Ending Balance, September 30	2,143	2,045
Valuation Allowance		
Mortgage Servicing Rights, net September 30	\$ 2,143	\$ 2,045

**Noninterest Expense**

Through the third quarter 2016, noninterest expenses were \$1.1 million higher than in 2015. The effect of an increase of \$578 thousand in salaries and wages was lessened by a decrease of \$129 thousand in employee benefits. The decrease in employee benefits was derived from lower costs related to medical claims for the period and lower pension costs due to an adjustment in first quarter 2015 for the accrual.

Data processing fees were \$165 thousand higher than last year due to the increased number of customers, accounts and updated services. A seven year contract extension signed in the third quarter of 2016 is expected to help lower the increases while adding new products and serviced to better align with our customers' expectations in the coming years.

The next largest increase for 2016 was in other general and administrative. This line item on the income statement was up by \$320 thousand over 2015. ATM fees were higher by \$198.1 thousand so far in 2016 than for 2015. This relates to the increased cost of accelerating the issuance of our debit cards to EMV (chip) cards. The Bank is working to have all chip cards in 2016 which would have otherwise occurred over a three year renewal period. The cost of the chip cards is also higher than the previous magnetic strip cards. Marketing expenses were up \$85.6 thousand as advertising for the new offices and KASASA Cash Back went full swing in the third quarter 2016.

**Net Income**

Overall, net income through the third quarter of 2016 was up \$902 thousand as compared to the same time period last year. The Company has done an exceptional job of growing loans while keeping past dues low. The growth in loans has spurred the large increase in net interest income that has flowed through to the bottom line. The opening of the new offices may create a slight drag in the short run; however, the Company remains focused on the long term.

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.



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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)**

**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 actual results 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 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 shocks presented below assume an immediate change of rate in the percentages and directions shown covering a twelve month period:

Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total (\$000)	% Change to Flat Rate
2.99%	-9.35%	Rising	3.00%	30,599	-5.50%
3.08%	-6.81%	Rising	2.00%	30,947	-3.97%
3.17%	-3.86%	Rising	1.00%	31,410	-2.54%
3.30%	0.00%	Flat	0.00%	32,227	0.00%
3.29%	-0.35%	Falling	-1.00%	31,778	-1.39%
3.10%	-6.17%	Falling	-2.00%	30,176	-6.37%
2.92%	-11.67%	Falling	-3.00%	28,657	-11.08%

The net interest margin represents the forecasted twelve month margin. The Company also reviews shocks with a 4.0% fluctuation with a delayed time frame of 10 months and over a 24 month time frame. 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

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**ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK (continued)**

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 majority of customers look for terms twelve months and under while the Bank would prefer 24 months and longer. Some movement into the longer term time deposits has occurred. Compared to five years ago, what the Bank has experienced over the years is a decrease in the time balances of our deposit portfolio, therefore a loss of term funding

The shock chart currently shows a slight tightening in net interest margin over the next twelve months in an increasing rate environment with an even lower tightening in a falling rate environment at the 200 basis point shock level. Due to the length and existence of such a low rate environment, the model does not predict expansion of net interest income in any falling category. Cost of funds are below 0.60% 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. Since the average duration of the majority of the assets is outside the 12 month shock period, the rising rate environment does not show improvement. The majority of the newer loans added to the commercial real estate portfolio begin with an initial fixed rate period of three to five years whose variable adjustment is outside of the current shock time frame. 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 must concentrate on increasing loan spreads on variable loans and extend the duration on cost of funds where possible. Changes in portfolio and/or balance sheet composition are needed for the margin to improve regardless of any rate shock.

**ITEM 4 CONTROLS AND PROCEDURES**

As of September 30, 2016, 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, 2016. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2016 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, 2015.

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## ITEM 4 CONTROLS AND PROCEDURES (continued)

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

Treasury stock repurchased the quarter ended September 30, 2016 <sup>(1)</sup>.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	(d) Maximum Number of Shares that may yet be purchased under the Plans or Programs
7/1/2016 to 7/31/2016				193,000
8/1/2016 to 8/31/2016				193,000
9/1/2016 to 9/30/2016				193,000
<b>Total</b>				<b>193,000</b>

- (1) From time to time, the Company purchases shares in the market pursuant to a stock repurchase program publicly announced on January 15, 2016. On that date, the Board of Directors authorized the repurchase of 200,000 common shares between January 15, 2016 and December 31, 2016.

## ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

## ITEM 4 MINE SAFETY DISCLOSURES

Not applicable

## ITEM 5 OTHER INFORMATION

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 July 27, 2016)
- 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 Schem 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**

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

Farmers & Merchants Bancorp, Inc.,

Date: October 26, 2016

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

Date: October 26, 2016

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