FARMERS & MERCHANTS BANCORP
Form 10-Q
November 08, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006
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: 000-26099

FARMERS & MERCHANTS BANCORP
(Exact name of registrant as specified in its charter)

DELAWARE	94-3327828
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
111 W. Pine Street, Lodi, California	95240
(Address of principal Executive offices)	(Zip Code)

Registrant's telephone number, including area code (209) 367-2300

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

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act: (Check one):

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ]

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

Number of shares of common stock of the registrant: Par value $0.01, authorized 2,000,000 shares; issued and outstanding 811,933 as of November 1, 2006.

FARMERS & MERCHANTS BANCORP

FORM 10-Q

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PART I. - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

FARMERS & MERCHANTS BANCORP
CONSOLIDATED BALANCE SHEETS

(in thousands) ASSETS	Sept. 30, 2006 (Unaudited)	December 31, 2005	Sept. 30, 2005 (Unaudited)
Cash and Cash Equivalents:			
Cash and Due From Banks	$ 41,609	$ 50,669	$ 36,871
Federal Funds Sold	-	-	-
Total Cash and Cash Equivalents	41,609	50,669	36,871
Investment Securities:			
Available-for-Sale	150,994	158,029	143,884
Held-to-Maturity	113,045	109,911	110,540
Total Investment Securities	264,039	267,940	254,424
Loans:	1,035,200	973,257	944,579
Less: Allowance for Loan Losses	18,300	17,860	17,905
Loans, Net	1,016,900	955,397	926,674
Land, Buildings & Equipment	19,731	17,522	16,311
Bank Owned Life Insurance	38,026	36,799	36,404
Interest Receivable and Other Assets	35,508	24,662	22,670
TOTAL ASSETS	$ 1,415,813	$ 1,352,989	$ 1,293,354
LIABILITIES & SHAREHOLDERS' EQUITY			
Deposits:			
Demand	$ 269,519	$ 325,745	$ 267,765
Interest Bearing Transaction	125,488	138,321	119,918
Savings	272,127	283,226	289,662
Time Deposits	447,258	356,048	369,271
Total Deposits	1,114,392	1,103,340	1,046,616
Fed Funds Purchased	-	650	19,700
FHLB Borrowings	138,844	98,847	75,857
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	21,946	16,194	17,827
Total Liabilities	1,285,492	1,229,341	1,170,310
SHAREHOLDERS' EQUITY			
Common Stock	8	8	8
Additional Paid-In Capital	90,334	95,862	96,808
Retained Earnings	41,759	29,463	28,509
Accumulated Other Comprehensive Loss	(1,780)	(1,685)	(2,281)
TOTAL SHAREHOLDERS' EQUITY	130,321	123,648	123,044

TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	$ 1,415,813	$ 1,352,989	$ 1,293,354

The accompanying notes are an integral part of these unaudited consolidated financial statements

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FARMERS & MERCHANTS BANCORP
CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(in thousands except per share data)	Three Months Ended Sept. 30, 2006	Three Months Ended Sept. 30, 2005	Nine Mo Ended, Se 2006
INTEREST INCOME			
Interest & Fees on Loans	$ 20,015	$ 16,061	$ 56,595
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	11	41	48
Interest on Investment Securities:			
Taxable	2,099	1,769	6,232
Tax-Exempt	825	834	2,447
Total Interest Income	22,950	18,705	65,322
INTEREST EXPENSE			
Deposits	5,048	2,689	12,515
Borrowed Funds	1,590	992	4,255
Subordinated Debentures	218	166	613
Total Interest Expense	6,856	3,847	17,383
NET INTEREST INCOME	16,094	14,858	47,939
Provision for Loan Losses	-	-	275
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	16,094	14,858	47,664
NON-INTEREST INCOME			
Service Charges on Deposit Accounts	1,754	1,128	4,326
Net Loss on Sale of Investment Securities	(664)	(307)	(1,083)
Credit Card Merchant Fees	552	546	1,626
Increase in Cash Surrender Value of Life Insurance	425	403	1,228
ATM Fees	307	277	892
Other	740	937	2,228
Total Non-Interest Income	3,114	2,984	9,217
NON-INTEREST EXPENSE			
Salaries & Employee Benefits	6,919	7,027	21,527
Occupancy	564	495	1,801
Equipment	817	772	2,463
Credit Card Merchant Expense	416	395	1,203
Marketing	311	232	688
Other	1,750	1,531	5,005

Total Non-Interest Expense	10,777	10,452	32,687
INCOME BEFORE INCOME TAXES	8,431	7,390	24,194
Provision for Income Taxes	3,098	2,643	8,830
NET INCOME	$ 5,333	$ 4,747	$ 15,364
EARNINGS PER SHARE	$ 6.54	$ 5.74	$ 18.77

The accompanying notes are an integral part of these unaudited consolidated financial statements

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FARMERS & MERCHANTS BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(in thousands)	Three Mont Ended Sept. 2006	
NET INCOME	$ 5,333	$
OTHER COMPREHENSIVE (LOSS) INCOME -		
UNREALIZED (LOSSES) GAINS ON DERIVATIVE INSTRUMENTS:		
Unrealized holding (losses) gains arising during the period, net of income tax effects of $0 and $1 for the quarters ended September 30, 2006 and 2005, respectively, and $0 and $0 for the nine months ended September 30, 2006 and 2005, respectively.	-	
Less: Reclassification adjustment for realized losses included in net income, net of related income tax effects of $(3) and $(3) for the quarters ended September 30, 2006 and 2005, respectively, and $(2) and $(9) for the nine months ended September 30, 2006 and 2005, respectively.	(5)	
UNREALIZED GAINS (LOSSES) ON SECURITIES:		
Unrealized holding gains (losses) arising during the period, net of income tax provision (benefit) of $992 and $(435) for the quarters ended September 30, 2006 and 2005, respectively, and of $(521) and $(968) for the nine months ended September 30, 2006 and 2005, respectively.	1,365	
Less: Reclassification adjustment for realized losses included in net income, net of related income tax effects of $278 and $129 for the quarters ended September 30, 2006 and 2005, respectively, and of $455 and $69 for the nine months ended September 30, 2006 and 2005, respectively.	386	
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	1,746	
COMPREHENSIVE INCOME	$ 7,079	$

The accompanying notes are an integral part of these unaudited consolidated financial statements

FARMERS & MERCHANTS BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

(in thousands except share data)

	COMMON SHARES OUTSTANDING	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	C
BALANCE, DECEMBER 31, 2004	792,722	$ 8	$ 82,237	$ 35,332	$
Net Income		-	-	13,767	
Cash Dividends Declared on Common Stock		-	-	(2,659)	
5% Stock Dividend	38,995	-	17,641	(17,641)	
Cash Paid in Lieu of Fractional Shares Related to Stock Dividend		-	-	(290)	
Repurchase of Stock	(6,143)	-	(3,070)	-	
Change in Unrealized Loss on Derivative Instruments					
Change in Net Unrealized Loss on Securities Available for Sale		-	-	-	
BALANCE, SEPTEMBER 30, 2005	825,574	$ 8	$ 96,808	$ 28,509	$
BALANCE, DECEMBER 31, 2005	823,651	$ 8	$ 95,862	$ 29,463	$
Net Income		-	-	15,364	
Cash Dividends Declared on Common Stock		-	-	(3,068)	
Repurchase of Stock	(10,918)	-	(5,528)	-	
Change in Unrealized Loss on Derivative Instruments					
Change in Net Unrealized Loss on Securities Available for Sale		-	-	-	
BALANCE, SEPTEMBER 30, 2006	812,733	$ 8	$ 90,334	$ 41,759	$

The accompanying notes are an integral part of these unaudited consolidated financial statements

FARMERS & MERCHANTS BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)	Nine Months En Sept. 30, 2006	S
OPERATING ACTIVITIES:		
Net Income	$ 15,364	$

Adjustments to Reconcile Net Income to Net		
Cash Provided by Operating Activities:		
Provision for Loan Losses		275
Depreciation and Amortization		1,387
Net (Accretion) Amortization of Investment Security Discounts & Premium		(73)
Net Loss on Sale of Investment Securities		1,083
Net Gain on Sale of Property & Equipment		(3)
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets		(12,010)
Net Increase in Interest Payable and Other Liabilities		5,752
Net Cash Provided by Operating Activities		11,775
INVESTING ACTIVITIES:		
Securities Available-for-Sale:		
Purchased		(41,826)
Sold, Matured or Called		47,733
Securities Held-to-Maturity:		
Purchased		(7,348)
Matured or Called		4,174
Net Loans Originated or Acquired		(62,519)
Principal Collected on Loans Previously Charged Off		741
Net Additions to Premises and Equipment		(3,598)
Proceeds from Sale of Property & Equipment		5
Net Cash Used by Investing Activities		(62,638)
FINANCING ACTIVITIES:		
Net Decrease in Demand, Interest-Bearing Transaction, and Savings Accounts		(80,158)
Increase in Time Deposits		91,210
Net (Decrease) Increase in Federal Funds Purchased		(650)
Net Increase (Decrease) in Federal Home Loan Bank Advances		39,997
Cash Dividends		(3,068)
Stock Repurchases		(5,528)
Net Cash Provided by Financing Activities		41,803
(Decrease) Increase in Cash and Cash Equivalents		(9,060)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR		50,669
CASH AND CASH EQUIVALENTS AS OF SEPT. 30, 2006 AND SEPT. 30, 2005	$	41,609 $

The accompanying notes are an integral part of these unaudited consolidated financial statements

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FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Farmers & Merchants Bancorp (the Company) was organized March 10, 1999. Primary operations are related to traditional banking activities through its subsidiary Farmers & Merchants Bank of Central California (the Bank) which was established in 1916. The Bank's wholly owned subsidiaries include Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Farmers & Merchants Investment Corporation has been dormant since 1991. Farmers/Merchants Corp. acts as trustee on deeds of trust originated by the Bank.

The Company's other subsidiaries include F & M Bancorp, Inc. and FMCB Statutory Trust I. F & M Bancorp, Inc. was created in March 2002 to protect the name F & M Bank. During 2002, the Company completed a fictitious name filing in California to begin using the streamlined name, "F & M Bank" as part of a larger effort to enhance the Company's image and build brand name recognition. In December 2003, the Company formed a wholly owned subsidiary, FMCB Statutory Trust I. FMCB Statutory Trust I is a non-consolidated subsidiary per generally accepted accounting principles (GAAP), and was formed for the sole purpose of issuing Trust Preferred Securities. The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America and prevailing practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

BASIS OF PRESENTATION
The accompanying consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America for financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (which consist solely of normal recurring accruals) considered necessary for a fair presentation of the results for the interim periods presented have been included. These interim consolidated financial statements should be read in conjunction with the financial statements and related notes contained in the Company's 2005 Annual Report to Shareholders on Form 10-K.

The accompanying consolidated financial statements include the accounts of the Company and the Company's wholly owned subsidiaries, F & M Bancorp, Inc. and the Bank, along with the Bank's wholly owned subsidiaries, Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Significant inter-company transactions have been eliminated in consolidation. The results of operations for the nine-month period ended September 30, 2006 may not necessarily be indicative of the operating results for the full year 2006.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Certain amounts in the prior years' financial statements and related footnote disclosures have been reclassified to conform to the current-year presentation. These reclassifications have no effect on previously reported income.

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CASH AND CASH EQUIVALENTS
For purposes of the Consolidated Statements of Cash Flows, the Company has defined cash and cash equivalents as those amounts included in the balance sheet captions Cash and Due from Banks, Federal Funds Sold and Securities Purchased Under Agreements to Resell. Generally, these transactions are for one-day periods. For these instruments, the carrying amount is a reasonable estimate of fair value.

INVESTMENT SECURITIES
Investment securities are classified at the time of purchase as held-to-maturity if it is management's intent and the Company has the ability to hold the securities until maturity. These securities are carried at cost, adjusted for amortization of premium and accretion of discount using a level yield of interest over the estimated remaining period until maturity. Losses, reflecting

a decline in value judged by the Company to be other than temporary, are recognized in the period in which they occur.

Securities are classified as available-for-sale if it is management's intent, at the time of purchase, to hold the securities for an indefinite period of time and/or to use the securities as part of the Company's asset/liability management strategy. These securities are reported at fair value with aggregate unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes. Fair values are based on quoted market prices or broker/dealer price quotations on a specific identification basis. Gains or losses on the sale of these securities are computed using the specific identification method.

Trading securities, if any, are acquired for short-term appreciation and are recorded in a trading portfolio and are carried at fair value, with unrealized gains and losses recorded in non-interest income.

LOANS

Loans are reported at the principal amount outstanding net of unearned discounts and deferred loan fees. Interest income on loans is accrued daily on the outstanding balances using the simple interest method. Loan origination fees are deferred and recognized over the contractual life of the loan as an adjustment to the yield. Loans are placed on non-accrual status when the collection of principal or interest is in doubt or when they become past due for 90 days or more unless they are both well-secured and in the process of collection. For this purpose a loan is considered well-secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or is guaranteed by a financially capable party. When a loan is placed on non-accrual status, the accrued and unpaid interest receivable is reversed and charged against current income; thereafter, interest income is recognized only as it is collected in cash. Loans placed on a non-accrual status are returned to accrual status when the loans are paid current as to principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan.

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is impaired, the recorded amount of the loan in the Consolidated Balance Sheets is based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the observable or estimated market price of the loan or on the fair value of the collateral if the loan is collateral dependent. Impaired loans are placed on non-accrual status with income reported accordingly. Cash payments are first applied as a reduction of the principal balance until collection of the remaining principal and interest can be reasonably assured. Thereafter, interest income is recognized as it is collected in cash.

ALLOWANCE FOR LOAN LOSSES

As a financial institution which assumes lending and credit risks as a principal element in its business, the Company anticipates that credit losses will be experienced in the normal course of business. Accordingly, the allowance for loan losses is maintained at a level considered adequate by management to provide for losses that are inherent in the portfolio. The allowance is reduced by charge-offs and increased by provisions charged to operating expense and by recoveries on loans previously charged-off. Management employs a systematic methodology for determining the allowance for loan losses. On a quarterly basis, management reviews the credit quality of the loan portfolio and considers many factors in determining the adequacy of the allowance at the balance sheet date.

The factors evaluated in connection with the allowance may include existing general economic and business conditions affecting the key lending areas of the Company, current levels of problem loans and delinquencies, credit quality trends, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, specific industry conditions, recent loss experience, duration of the current business cycle, bank regulatory examination results and findings of the Company's internal credit examiners.

The allowance also incorporates the results of measuring impaired loans as provided in Statement of Financial Accounting Standards (SFAS) No. 114, "Accounting by Creditors for Impairment of a Loan" and SFAS No. 118, "Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures." These accounting standards prescribe the measurement methods, income recognition and disclosures related to impaired loans, which are discussed more fully in Note 4 to the Consolidated Financial Statements in the Company's 2005 Annual Report to Shareholders.

While the Company utilizes a systematic methodology in determining its allowance, the allowance is based on estimates, and ultimate losses may vary from current estimates. The estimates are reviewed periodically and, as adjustments become necessary, are reported in earnings in the periods in which they become probable.

PREMISES AND EQUIPMENT

Premises, equipment and leasehold improvements are stated at cost, less accumulated depreciation and amortization. Depreciation is computed principally by the straight line method over the estimated useful lives of the assets. Estimated useful lives of buildings range from 30 to 40 years, and for furniture and equipment from 3 to 8 years. Leasehold improvements are amortized over the lesser of the terms of the respective leases, or their useful lives, which are generally 5 to 10 years. Remodeling and capital improvements are capitalized while maintenance and repairs are charged directly to occupancy expense.

OTHER REAL ESTATE

Other real estate, which is included in other assets, is comprised of properties no longer utilized for business operations and property acquired through foreclosure in satisfaction of indebtedness. These properties are recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Initial losses on properties acquired through full or partial satisfaction of debt are treated as credit losses and charged to the Allowance for Loan Losses at the time of acquisition. Subsequent declines in value from the recorded amounts, routine holding costs, and gains or losses upon disposition, if any, are included in non-interest income or expense as incurred.

INCOME TAXES

The Company uses the liability method of accounting for income taxes. This method results in the recognition of deferred tax assets and liabilities that are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or

settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The deferred provision for income taxes is the result of the net change in the deferred tax asset and deferred tax liability balances during the year. This amount combined with the current taxes payable or refundable results in the income tax expense for the current year.

DIVIDENDS AND EARNINGS PER SHARE

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. No cash dividends were declared during the third quarter of 2006.

Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The weighted average number of shares outstanding for the three and nine month periods ended September 30, 2006 were 814,887 and 818,719. The weighted average number of shares outstanding for the three and nine month periods ended September 30, 2005 were 827,012 and 829,976. Prior periods have been restated for stock dividends paid in 2005. No stock dividends have been paid in 2006.

SEGMENT REPORTING

Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" requires that public companies report certain information about operating segments. It also requires that public companies report certain information about their products and services, the geographic areas in which they operate, and their major customers. The Company is a holding company for a community bank which offers a wide array of products and services to its customers. Pursuant to its banking strategy, emphasis is placed on building relationships with its customers, as opposed to building specific lines of business. As a result, the Company is not organized around discernable lines of business and prefers to work as an integrated unit to customize solutions for its customers, with business line emphasis and product offerings changing over time as needs and demands change. Therefore, only one segment is reported.

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

Statement of Financial Accounting Standards, No. 133, "Accounting for Derivative Instruments and Certain Hedging Activities" as amended by the Statement of Financial Accounting Standards, No. 138, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. Changes in the fair value of those derivatives are accounted for depending on the intended use of the derivative and the resulting designation under specified criteria. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, designed to minimize interest rate risk, the effective portions of the change in the fair value of the derivative are recorded in other comprehensive income (loss), net of related income taxes. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

From time to time the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps and collars. These instruments are purchased and/or sold to reduce the Company's exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments during the nine month period ended September 30, 2006.

COMPREHENSIVE INCOME

Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Other comprehensive income refers to revenues, expenses, gains and losses that generally accepted accounting principles recognize as changes in value to an enterprise but are excluded from net income. For the Company, comprehensive income (loss) includes net income and changes in fair value of its available-for-sale investment securities, minimum pension liability adjustments and cash flow hedges.

2. RECENT ACCOUNTING DEVELOPMENTS

In June 2006, the FASB issued Financial Accounting Standards Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006. Management is in the process of evaluating the impact the adoption of FIN 48 will have on the results of operations.

In September 2006, the FASB issued Statement No. 157 (SFAS 157), "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Management is in the process of evaluating the impact the adoption of SFAS 157 will have on the results of operations.

In September 2006, the FASB ratified the consensuses reached by the Emerging Issues Task Force (the Task Force) on Issue No. 06-5 (EITF 06-5) "Accounting for the Purchases of Life Insurance - Determining the Amount that Could be Realized in Accordance with FASB Technical Bulletin No.85-4" (FTB 85-4). FTB 85-4 indicates that the amount of the asset included in the balance sheet for life insurance contracts within its scope should be "the amount that could be realized under the insurance contract as of the date of the statement of financial position." Questions arose in applying the guidance in FTB 85-4 to whether "the amount that could be realized" should consider 1) any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value and 2) the contractual ability to surrender all of the individual-life policies (or certificates in a group policy) at the same time. EITF 06-5 determined that "the amount that could be realized" should 1) consider any additional amounts included in the contractual terms of the policy and 2) assume the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy. Any amount that is ultimately realized by the policy holder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the "amount that could be realized." An entity should apply the provisions of EITF 06-5 through either a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or a change in accounting principle through retrospective application to all prior periods. The provisions of EITF 06-5 are effective for fiscal years beginning after December 15, 2006. Management is in the process of evaluating the impact the adoption of EITF 06-5 will have on the results of operations.

In September 2006, the FASB ratified the consensuses reached by the Task Force on Issue No. 06-4 (EITF 06-4) "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." A question arose when an employer enters into an endorsement split-dollar life insurance arrangement related to whether the employer should recognize a liability for the future benefits or premiums to be provided to the employee. EITF 06-4 indicates that an employer should recognize a liability for future benefits and that a liability for the benefit obligation has not been settled through the purchase of an endorsement type policy. An entity should apply the provisions of EITF 06-4 either through a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or a change in accounting principle through retrospective application to all prior periods. The provisions of EITF 06-4 are effective for fiscal years beginning after December 15, 2007. Management is in the process of evaluating the impact the adoption of EITF 06-4 will have on the results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ("SAB 108"), "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements", providing guidance on quantifying financial statement misstatement and implementation (e.g., restatement or cumulative effect to assets, liabilities and retained earnings) when first applying this guidance. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company does not believe the guidance provided by SAB 108 will have a material effect on the Company's financial condition or results of operations.

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

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three and nine months ended September 30, 2006. This analysis should be read in conjunction with our 2005 Annual Report, filed as exhibit 13 on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

FORWARD-LOOKING STATEMENTS

This quarterly report contains various forward-looking statements, usually containing the words "estimate," "project," "expect," "objective," "goal," or similar expressions and includes assumptions concerning the Company's operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risk and uncertainties. In connection with the "safe-harbor" provisions of the private Securities Litigation Reform Act, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (i) the effect of changing regional and national economic conditions; (ii) significant changes in interest rates and prepayment speeds; (iii) credit risks of commercial, agricultural, real estate, consumer, and other lending activities; (iv) changes in federal and state banking laws or regulations; (v) competitive pressure in the banking industry; (vi) changes in governmental fiscal or monetary policies; (vii) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (viii) other factors discussed in the Company's Form 10-K filing for the year-ended December 31, 2005 with the Securities and Exchange Commission.

Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.

INTRODUCTION

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California, state-chartered bank formed in 1916. The Bank serves the northern Central Valley of California with 20 banking offices. The service area includes Sacramento, San Joaquin, Stanislaus and Merced Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock and Hilmar.

Substantially all of the Company's business activities are conducted within its market area.

As a bank holding company, the Company is subject to regulation and examination by the Board of Governors of the Federal Reserve System ("FRB"). Since the Bank is a California, state-chartered, non-FED member bank, it is subject to the regulation and examination of the California Department of Financial Institutions and the Federal Deposit Insurance Corporation.

OVERVIEW

The Company's primary service area encompasses the northern Central Valley of California, a region that is impacted by the seasonal needs of the agricultural industry. Accordingly, discussion of the Company's Financial Condition and Results of Operations is influenced by the seasonal banking needs of its agricultural customers (e.g., during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and planting of crops. Correspondingly, deposit balances are replenished and loans repaid in fall and winter as crops are harvested and sold).

For the three and nine months ended September 30, 2006, Farmers & Merchants Bancorp reported net income of $5,333,000 and $15,364,000, earnings per share of $6.54 and $18.77 and return on average assets of 1.54% and 1.51%, respectively. Return on average shareholders' equity was 16.81% and 16.23% for the three and nine months ended September 30, 2006.

For the three and nine months ended September 30, 2005, Farmers & Merchants Bancorp reported net income of $4,747,000 and $13,767,000, earnings per share of $5.74 and $16.59 and return on average assets of 1.50% and 1.47%, respectively. Return on average shareholders' equity was 15.73% and 15.31% for the three and nine months ended September 30, 2005.

The Company's improved earnings performance in the first nine months of 2006 when compared to the same period last year was due to a combination of (1) growth in earning assets; and (2) improvement in the net interest margin due to rising interest rates.

The following is a summary of the financial results for the nine-month period ended September 30, 2006 compared to September 30, 2005.

- Net income increased 11.6% to $15.4 million from $13.8 million.

- Earnings per share increased 13.1% to $18.77 from $16.59.
- Net interest income increased 12.2% to $47.9 million from $42.7 million.
- Net interest margin on a tax-equivalent basis increased 16 basis points from 5.07% to 5.23%.
- Total assets increased 9.5% to $1.4 billion.
- Gross loans increased 9.6% to $1.0 billion.
- Total deposits increased 6.5% to $1.1 billion.

RESULTS OF OPERATIONS

NET INTEREST INCOME / NET INTEREST MARGIN

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the three and nine month periods ending September 30, 2006 and 2005.

The average yields on earning assets and average rates paid on interest-bearing liabilities have been computed on an annualized basis for purposes of comparability with full year data. Average balance amounts for assets and liabilities are the computed average of daily balances.

Net interest income is the amount by which the interest and fees on loans and other interest earning assets exceed the interest paid on interest bearing sources of funds. For the purpose of analysis, the interest earned on tax-exempt investments and municipal loans is adjusted to an amount comparable to interest subject to normal income taxes. This adjustment is referred to as "taxable equivalent" and is noted wherever applicable.

The Volume and Rate Analysis of Net Interest Income summarizes the changes in interest income and interest expense based on changes in average asset and liability balances (volume) and changes in average rates (rate). For each category of interest-earning assets and interest-bearing liabilities, information is provided with respect to changes attributable to: (1) changes in volume (change in volume multiplied by initial rate); (2) changes in rate (change in rate multiplied by initial volume); and (3) changes in rate/volume (allocated in proportion to the respective volume and rate components).

The Company's earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix. (See Item 3. "Quantitative and Qualitative Disclosures about Market Risk: Market Risk - Interest Rate Risk").

FARMERS & MERCHANTS BANCORP
QUARTERLY AVERAGE BALANCES AND INTEREST RATES

(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Three Months Ended Sept 30, 2006			Thr
ASSETS	Balance	Interest	Rate	Balance
Federal Funds Sold	$ 772	$ 11	5.65%	$ 4,817
Investment Securities Available-for-Sale				
U.S. Treasuries	0	0	0.00%	0
U.S. Agencies	30,834	315	4.09%	57,496
Municipals - Taxable	0	0	0.00%	0
Municipals - Non-Taxable	15,417	251	6.51%	15,699
Mortgage Backed Securities	104,379	1,258	4.82%	75,354
Other	7,516	103	5.48%	3,548
Total Investment Securities Available-for-Sale	158,146	1,927	4.87%	152,097
Investment Securities Held-to-Maturity				
U.S. Treasuries	0	0	0.00%	0
U.S. Agencies	30,580	317	4.15%	30,701
Municipals - Taxable	0	0	0.00%	0
Municipals - Non-Taxable	66,910	997	5.96%	67,403
Mortgage Backed Securities	9,474	90	3.80%	11,932
Other	2,119	16	3.02%	277
Total Investment Securities Held-to-Maturity	109,083	1,420	5.21%	110,313
Loans				
Real Estate	575,798	10,600	7.30%	506,791
Home Equity	67,695	1,392	8.16%	65,976
Agricultural	172,982	3,769	8.64%	152,599
Commercial	178,849	3,825	8.48%	169,625
Consumer	13,580	285	8.33%	12,905
Credit Card	5,553	133	9.50%	5,095
Municipal	1,460	11	2.99%	1,002
Total Loans	1,015,917	20,015	7.82%	913,993
Total Earning Assets	1,283,918	$ 23,373	7.22%	1,181,220
Unrealized Gain/(Loss) on Securities Available-for-Sale	(4,856)			(2,053
Allowance for Loan Losses	(18,421)			(17,933
Cash and Due From Banks	37,797			35,904
All Other Assets	83,887			72,959
TOTAL ASSETS	$1,382,325			$1,270,097
LIABILITIES & SHAREHOLDERS' EQUITY				
Interest Bearing Deposits				
Interest Bearing DDA	$ 126,585	$ 22	0.07%	$ 116,849
Savings	274,822	665	0.96%	291,876
Time Deposits	434,155	4,361	3.99%	358,160
Total Interest Bearing Deposits	835,562	5,048	2.40%	766,885

Other Borrowed Funds	120,045	1,590	5.25%	89,120
Subordinated Debentures	10,310	218	8.39%	10,310
Total Interest Bearing Liabilities	965,917	$ 6,856	2.82%	866,315
Interest Rate Spread			4.41%	
Demand Deposits (Non-Interest Bearing)	270,111			266,351
All Other Liabilities	19,395			16,722
TOTAL LIABILITIES	1,255,423			1,149,388
Shareholders' Equity	126,902			120,709
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	$1,382,325			$1,270,097
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.70%	
Net Interest Income and Margin on Total Earning Assets		16,517	5.10%	
Tax Equivalent Adjustment		(423)		
Net Interest Income		$ 16,094	4.97%	

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. includes fee income and unearned discount in the amount of $596,000 and $877,000 for the quarters and 2005, respectively. Yields on securities available-for-sale are based on historical cost.

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FARMERS & MERCHANTS BANCORP
YEAR-TO-DATE AVERAGE BALANCES AND INTEREST RATES
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Nine Months Ended Sept. 30, 2006			Nine Mon
ASSETS	Balance	Interest	Rate	Balance
Federal Funds Sold	$ 1,334	$ 48	4.81%	$ 4,474
Investment Securities Available-for-Sale				
U.S. Agencies	30,846	939	4.06%	62,360
Municipals - Taxable	-	-	0.00%	108
Municipals - Non-Taxable	15,652	745	6.34%	16,175
Mortgage Backed Securities	106,765	3,746	4.68%	79,820
Other	5,509	260	6.29%	4,517
Total Investment Securities Available-for-Sale	158,772	5,690	4.78%	162,980
Investment Securities Held-to-Maturity				
U.S. Agencies	30,607	952	4.15%	27,443
Municipals - Non-Taxable	66,389	2,953	5.93%	64,114
Mortgage Backed Securities	10,059	288	3.82%	12,556
Other	2,122	47	2.95%	286
Total Investment Securities				

Held-to-Maturity	109,177	4,240	5.18%	104,399
Loans				
Real Estate	558,734	29,953	7.17%	501,071
Home Equity	67,002	3,973	7.93%	64,426
Agricultural	163,362	10,161	8.32%	139,178
Commercial	179,773	11,199	8.33%	164,668
Consumer	13,476	877	8.70%	12,647
Credit Card	5,435	400	9.84%	4,992
Municipal	1,175	32	3.64%	988
Total Loans	988,957	56,595	7.65%	887,970
Total Earning Assets	1,258,240	$ 66,572	7.07%	1,159,823
Unrealized Gain/(Loss) on Securities Available-for-Sale	(4,034)			(1,496)
Allowance for Loan Losses	(18,300)			(17,881)
Cash and Due From Banks	37,518			34,268
All Other Assets	80,373			70,682
TOTAL ASSETS	$1,353,797			$1,245,396
LIABILITIES & SHAREHOLDERS' EQUITY				
Interest Bearing Deposits				
Interest Bearing DDA	$ 128,382	$ 67	0.07%	$ 114,493
Savings	278,262	1,512	0.73%	299,336
Time Deposits	405,998	10,936	3.60%	352,939
Total Interest Bearing Deposits	812,642	12,515	2.06%	766,768
Other Borrowed Funds	111,024	4,255	5.12%	73,003
Subordinated Debentures	10,310	613	7.95%	10,310
Total Interest Bearing Liabilities	933,976	$ 17,383	2.49%	850,081
Interest Rate Spread			4.59%	
Demand Deposits (Non-Interest Bearing)	277,025			260,482
All Other Liabilities	16,588			14,966
TOTAL LIABILITIES	1,227,589			1,125,529
Shareholders' Equity	126,208			119,867
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	$1,353,797			$1,245,396
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.64%	
Net Interest Income and Margin on Total Earning Assets		49,189	5.23%	
Tax Equivalent Adjustment		(1,250)		
Net Interest Income		$ 47,939	5.09%	

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. fee income and unearned discount in the amount of $2.1 million and $2.6 million for the nine mont and 2005, respectively. Yields on securities available-for-sale are based on historical cost.

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FARMERS & MERCHANTS BANCORP
VOLUME AND RATE ANALYSIS OF NET INTEREST REVENUE
(Rates on a Taxable Equivalent Basis)
(in thousands)

	Three Months Ended Sept. 30, 2006 Compared to Sept. 30, 2005			Sept. 3
INTEREST EARNING ASSETS	Volume	Rate	Net Chg.	Volu
Federal Funds Sold	$ (47)	$ 17	$ (30)	$
Investment Securities Available for Sale				
U.S. Treasuries	0	0	0	
U.S. Agencies	(270)	37	(233)	
Municipals - Taxable	0	0	0	
Municipals - Non-Taxable	(4)	32	28	
Mortgage Backed Securities	323	206	529	
Other	58	(19)	39	
Total Investment Securities Available for Sale	107	256	363	
Investment Securities Held to Maturity				
U.S. Treasuries	0	0	0	
U.S. Agencies	(1)	10	9	
Municipals - Taxable	0	0	0	
Municipals - Non-Taxable	(7)	59	52	
Mortgage Backed Securities	(23)	1	(22)	
Other	17	(8)	9	
Total Investment Securities Held to Maturity	(14)	62	48	
Loans:				
Real Estate	1,239	672	1,911	
Home Equity	29	263	292	
Agricultural	397	625	1,022	
Commercial	175	561	736	
Consumer	15	(31)	(16)	
Credit Card	11	(2)	9	
Other	4	(4)	0	
Total Loans	1,870	2,084	3,954	
Total Earning Assets	1,916	2,419	4,335	
INTEREST BEARING LIABILITIES				
Interest Bearing Deposits:				
Transaction	2	0	2	
Savings	(20)	361	341	
Time Deposits	574	1,442	2,016	
Total Interest Bearing Deposits	556	1,803	2,359	
Other Borrowed Funds	386	212	598	

Subordinated Debentures	0	52	52	
Total Interest Bearing Liabilities	942	2,067	3,009	
TOTAL CHANGE	$ 974	$ 352	$ 1,326	$