

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
October 30, 2013  
Table of Contents

**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, 2013**

**or**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 0-14492**

**FARMERS & MERCHANTS BANCORP, INC.**

**(Exact name of registrant as specified in its charter)**

**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**

**4,660,938**  
**Outstanding as of October 30, 2013**



**Table of Contents**

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

INDEX

Form 10-Q Items	Page
PART I. FINANCIAL INFORMATION	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Condensed Consolidated Balance Sheets-September 30, 2013 and December 31, 2012</u>	3
<u>Condensed Consolidated Statement of Income &amp; Comprehensive Income Three Months and Nine Months Ended September 30, 2013 and September 30, 2012</u>	4
<u>Condensed Consolidated Statements of Cash Flows-Nine Months Ended September 30, 2013 and September 30, 2012</u>	5
<u>Notes to Condensed Financial Statements</u>	6-26
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27-45
Item 3. <u>Qualitative and Quantitative Disclosures About Market Risk</u>	45-46
Item 4. <u>Controls and Procedures</u>	47
PART II. <u>OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	47
Item 1A. <u>Risk Factors</u>	47
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	47
Item 3. <u>Defaults Upon Senior Securities</u>	47
Item 4. <u>Mine Safety Disclosures</u>	47
Item 5. <u>Other Information</u>	47
Item 6. <u>Exhibits</u>	48
<u>Signatures</u>	49
Exhibit 31. Certifications Under Section 302	
Exhibit 32. Certifications Under Section 906	
101.INS XBRL Instance Document (1)	
101.SCH XBRL Taxonomy Extension Schema Document (1)	
101.CAL XBRL Taxonomy Extension Calculation Linkbase Document (1)	

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

- (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.

**Table of Contents**ITEM 1 FINANCIAL STATEMENTS  
FARMERS & MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

**Farmers & Merchants Bancorp, Inc. and Subsidiary**Condensed Consolidated Balance Sheets  
(in thousands of dollars)  
September 30, 2013 December 31, 2012

<b>Assets</b>			
Cash and due from banks	\$	15,928	\$ 25,620
Interest bearing deposits with banks		5,101	11,941
Federal Funds Sold		506	6,531
<b>Total cash and cash equivalents</b>		<b>21,535</b>	<b>44,092</b>
Securities - available for sale (Note 2)		337,298	355,905
Other Securities, at cost		4,216	4,365
Loans, net (Note 4)		518,296	496,178
Bank premises and equipment		18,452	17,599
Goodwill		4,074	4,074
Mortgage Servicing Rights		2,084	2,063
Other Real Estate Owned		2,361	2,310
Accrued interest and other assets		19,842	20,074
<b>Total Assets</b>	\$	<b>928,158</b>	\$ 946,660
<b>Liabilities and Stockholders Equity</b>			
<b>Liabilities</b>			
<b>Deposits</b>			
Noninterest-bearing	\$	103,535	\$ 103,966
<b>Interest-bearing</b>			
NOW accounts		199,090	196,971
Savings		201,568	192,808
Time		241,375	269,507
<b>Total deposits</b>		<b>745,568</b>	<b>763,252</b>
Federal funds purchased and securities sold under agreement to repurchase		61,322	51,312
FHLB Advances		7,100	11,600
Dividend payable		928	931
Accrued expenses and other liabilities		5,459	9,326
<b>Total liabilities</b>		<b>820,377</b>	<b>836,421</b>

**Stockholders Equity**

Common stock - No par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares	12,677	12,677
Treasury Stock - 539,062 shares 2013, 510,742 shares 2012	(11,108)	(10,588)
Unearned Stock Awards - 32,040 shares 2013, 30,670 shares 2012	(645)	(584)
Retained earnings	106,589	102,641
Accumulated other comprehensive income	268	6,093
<b>Total stockholders equity</b>	<b>107,781</b>	<b>110,239</b>
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 928,158</b>	<b>\$ 946,660</b>

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2012 Balance Sheet has been derived from the audited financial statements of that date.

**Table of Contents**

FARMERS &amp; MERCHANTS BANCORP, INC.

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

(Unaudited)

**Farmers & Merchants Bancorp, Inc. and  
Subsidiary**

Condensed Consolidated Statement of Income & Comprehensive Income  
(in thousands of dollars, except per share data)  
Three Months Ended                      Nine Months Ended  
September 30, 2012   September 30, 2011   September 30, 2011   September 30, 2012

<b>Interest Income</b>				
Loans, including fees	\$ 6,244	\$ 6,564	\$ 18,411	\$ 20,165
Debt securities:				
U.S. Treasury securities	64	93	189	266
Securities of U.S. Government Agencies	971	1,012	2,979	3,092
Municipalities	513	555	1,562	1,583
Dividends	47	46	141	141
Federal funds sold		2	11	13
Other	5	6	18	19
<b>Total interest income</b>	<b>7,844</b>	<b>8,278</b>	<b>23,311</b>	<b>25,279</b>
<b>Interest Expense</b>				
Deposits	1,023	1,345	3,229	4,254
Federal funds purchased and securities sold under agreements to repurchase	62	63	184	184
Borrowed funds	44	124	133	371
<b>Total interest expense</b>	<b>1,129</b>	<b>1,532</b>	<b>3,546</b>	<b>4,809</b>
<b>Net Interest Income</b> - Before provision for loan losses	<b>6,715</b>	<b>6,746</b>	<b>19,765</b>	<b>20,470</b>
<b>Provision for Loan Losses</b> (Note 4)	<b>303</b>	<b>236</b>	<b>582</b>	<b>442</b>
<b>Net Interest Income After Provision For Loan Losses</b>	<b>6,412</b>	<b>6,510</b>	<b>19,183</b>	<b>20,028</b>
<b>Noninterest Income</b>				
Customer service fees	1,252	1,239	3,869	3,808
Other service charges and fees	995	943	2,824	2,561
Net gain (loss) on sale of other assets owned	(21)	(209)	(147)	(486)
Net gain on sale of loans	176	602	978	1,385
Net gain on sale of securities	134	30	732	199
<b>Total noninterest income</b>	<b>2,536</b>	<b>2,605</b>	<b>8,256</b>	<b>7,467</b>
<b>Noninterest Expenses</b>				



Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Salaries and Wages	2,460	2,303	7,156	6,782
Pension and other employee benefits	819	713	2,273	2,285
Occupancy expense (net)	291	268	909	1,059
Furniture and equipment	350	371	1,057	1,072
Data processing	301	292	911	843
Franchise taxes	255	237	765	710
FDIC Assessment	146	126	406	345
Mortgage servicing rights amortization	88	177	345	549
Other general and administrative	1,382	1,240	4,165	3,690
<b>Total Noninterest Expense</b>	<b>6,092</b>	<b>5,727</b>	<b>17,987</b>	<b>17,335</b>
<b>Income Before Federal Income Taxes</b>	<b>2,856</b>	<b>3,388</b>	<b>9,452</b>	<b>10,160</b>
<b>Federal Income Taxes</b>	<b>791</b>	<b>947</b>	<b>2,732</b>	<b>2,897</b>
<b>Net Income</b>	<b>\$ 2,065</b>	<b>\$ 2,441</b>	<b>\$ 6,720</b>	<b>\$ 7,263</b>
<b>Other Comprehensive Income (Net of Tax):</b>				
Unrealized gains (loss) on securities	\$ (159)	\$ 589	\$ (5,825)	\$ 7,353
<b>Comprehensive Income</b>	<b>\$ 1,906</b>	<b>\$ 3,030</b>	<b>\$ 895</b>	<b>\$ 14,616</b>
<b>Net Income Per Share</b>	<b>\$ 0.45</b>	<b>\$ 0.52</b>	<b>\$ 1.44</b>	<b>\$ 1.55</b>
<b>Weighted Average Shares Outstanding</b>	<b>4,682,655</b>	<b>4,685,879</b>	<b>4,682,092</b>	<b>4,698,364</b>
<b>Dividends Declared</b>	<b>\$ 0.20</b>	<b>\$ 0.20</b>	<b>\$ 0.60</b>	<b>\$ 0.58</b>

See Notes to Condensed Consolidated Unaudited Financial Statements

**Table of Contents**

FARMERS &amp; MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Condensed Consolidated Statements of Cash Flows (in thousands of dollars) Nine Months Ended	
	September 30, 2013	September 30, 2012
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 6,720	\$ 7,263
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	916	899
Accretion and amortization of securities	1,714	2,346
Amortization of servicing rights	345	549
Amortization of core deposit intangible	234	234
Stock Based Compensation	(202)	(123)
Provision for loan loss	582	442
Gain on sale of loans held for sale	(978)	(1,385)
Originations of loans held for sale	(54,874)	(100,759)
Proceeds from sale of loans held for sale	57,957	104,147
Loss on sale of other assets	147	486
Gain on sales of investment securities	(732)	(199)
Change in operating assets and other liabilities, net	(117)	(682)
Net cash provided by operating activities	11,712	13,218
<b>Cash Flows from Investing Activities</b>		
Activity in securities:		
Maturities, prepayments and calls	28,722	30,404
Securities	63,570	29,084
Purchases	(83,310)	(86,101)
Proceeds from sales of assets	35	2
Additions to premises and equipment	(1,804)	(597)
Loan originations and principal collections, net	(25,783)	11,124
Net cash used in investing activities	(18,570)	(16,084)
<b>Cash Flows from Financing Activities</b>		
Net decrease in deposits	(17,684)	(4,551)
Net change in short-term debt	10,010	2,407
Repayments of long-term debt	(4,500)	(5,051)
Purchase of Treasury Stock	(734)	(789)
Cash dividends paid on common stock	(2,791)	(2,664)
Net cash used in financing activities	(15,699)	(10,648)

Decrease in Cash and Cash Equivalents	(22,557)	(13,514)
Cash and Cash Equivalents - Beginning of Year	44,092	43,143

Cash and Cash Equivalents - End of Period	\$ 21,535	\$ 29,629
---	-----------	-----------

**RECONCILIATION OF CASH AND CASH EQUIVALENTS:**

Cash and cash due from banks	\$ 15,928	\$ 13,994
Interest bearing deposits with banks	5,101	10,561
Federal funds sold	506	5,074

Cash at end of period	\$ 21,535	\$ 29,629
-----------------------	-----------	-----------

**Supplemental Information**

Cash paid during the year for:

Interest	\$ 3,689	\$ 4,833
----------	----------	----------

Income taxes	\$ 2,690	\$ 3,386
--------------	----------	----------

**Noncash investing activities:**

Transfer of loans to other real estate owned	\$ 945	\$ 334
--	--------	--------

See Notes to Condensed Consolidated Unaudited Financial Statements

**Table of Contents**

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2013 are not necessarily indicative of the results that are expected for the year ended December 31, 2013. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2012.

NOTE 2 FAIR VALUE OF INSTRUMENTS  
FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

Cash and Cash Equivalents

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

Securities

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

Other Securities

The carrying value of Federal Home Loan Bank stock, listed as other securities, approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

Loans

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

#### Deposits Interest Bearing, Non-interest Bearing and Time

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

**Table of Contents****ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)**  
**FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)****Short-Term Borrowings**

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

**FHLB Advances**

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

**Accrued Interest Receivable and Payable**

The carrying amounts of accrued interest approximate their fair values.

**Dividends Payable**

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

**Off Balance Sheet Financial Instruments**

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

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of September 30, 2013 and December 31, 2012 are reflected below.

		(In Thousands)			
		September 2013			
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 21,535	\$ 21,535	\$ 21,535	\$	\$
Securities - available for sale	337,298	337,298	25,392	299,864	12,042
Other Securities	4,216	4,216			4,216
Loans, net	518,296	527,219			527,219
Interest receivable	4,289	4,289			4,289
<b>Total Assets</b>	<b>\$ 885,634</b>	<b>\$ 894,557</b>	<b>\$ 46,927</b>	<b>\$ 299,864</b>	<b>\$ 547,766</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 400,658	\$ 403,031	\$	\$	\$ 403,031

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Non-interest bearing Deposits	103,535	103,896		103,896
Time Deposits	241,375	241,155		241,155
Total Deposits	\$ 745,568	\$ 748,082	\$	\$ 103,896 \$ 644,186
Short-term debt	61,322	61,322		61,322
Federal Home Loan Bank advances	7,100	8,487		8,487
Interest payable	238	238		238
Dividends payable	928	928		928
Total Liabilities	\$ 815,156	\$ 819,057	\$	\$ 104,824 \$ 714,233

**Table of Contents****ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)**  
**FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

	(In Thousands)				
	December 2012				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 44,092	\$ 44,092	\$ 44,092	\$	\$
Securities - available for sale	355,905	355,905	10,568	328,929	16,408
Other Securities	4,365	4,365			4,365
Loans, net	496,178	502,125			502,125
Interest receivable	3,603	3,603			3,603
<b>Total Assets</b>	<b>\$ 904,143</b>	<b>\$ 910,090</b>	<b>\$ 54,660</b>	<b>\$ 328,929</b>	<b>\$ 526,501</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 389,779	\$ 390,066	\$	\$	\$ 390,066
Non-interest bearing Deposits	103,966	104,529		104,529	
Time Deposits	269,507	272,591			272,591
<b>Total Deposits</b>	<b>\$ 763,252</b>	<b>\$ 767,186</b>	<b>\$</b>	<b>\$ 104,529</b>	<b>\$ 662,657</b>
Short-term debt	51,312	51,312			51,312
Federal Home Loan Bank advances	11,600	11,012			11,012
Interest payable	288	288			288
Dividends payable	931	931		931	
<b>Total Liabilities</b>	<b>\$ 827,383</b>	<b>\$ 830,729</b>	<b>\$</b>	<b>\$ 105,460</b>	<b>\$ 725,269</b>
<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. The quoted prices are not adjusted.

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

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



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

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

**Table of Contents****ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)**  
**FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

## Fair Value Measurements (Continued)

The following summarizes financial assets measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012, 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			
	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
September 30, 2013 (In Thousands)			
<b>Assets-(Securities Available for Sale)</b>			
U.S. Treasury	\$ 25,392	\$	\$
U.S. Government agency		197,533	
Mortgage-backed securities		42,103	
State and local governments		60,228	12,042
<b>Total Securities Available for Sale</b>	<b>\$ 25,392</b>	<b>\$ 299,864</b>	<b>\$ 12,042</b>
December 31, 2012 (In Thousands)			
<b>Assets-(Securities Available for Sale)</b>			
U.S. Treasury	\$ 10,568	\$	\$
U.S. Government agency		220,200	
Mortgage-backed securities		53,006	
State and local governments		55,723	16,408
<b>Total Securities Available for Sale</b>	<b>\$ 10,568</b>	<b>\$ 328,929</b>	<b>\$ 16,408</b>

Most of the Company's available for sale securities, including any bonds issued by local municipalities, have CUSIP numbers or have similar characteristics of those in the municipal markets, making them marketable and comparable as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At September 30, 2013 and December 31, 2012, such assets consist primarily of impaired loans.

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

At September 30, 2013 and December 31, 2012, impaired loans categorized as Level 3 were \$1.6 and \$4.6 million, respectively. The specific allocation for impaired loans was \$423 and \$865 thousand as of September 30, 2013 and December 31, 2012, respectively, which are accounted for in the allowance for loan losses (see Note 4).

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

**Table of Contents****ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)**  
**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, 2013 and December 31, 2012:

(In Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2013				
	Balance at September 30, 2013	Quoted Prices in Active Markets for Significant Inputs			Change in fair value for nine-month period ended September 30, 2013
		Identical (Level 1)	Observable (Level 2)	Significant Unobservable (Level 3)	
Impaired loans	\$ 1,562	\$	\$	\$ 1,562	\$
Other real estate owned residential mortgages	\$ 886	\$	\$	\$ 886	\$ (16)
Other real estate owned commercial	\$ 1,475	\$	\$	\$ 1,475	\$ (64)
					\$ (80)

(In Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2012				
	Balance at December 31, 2012	Quoted Prices in Active Markets for Significant Inputs			Change in fair value for twelve-month period ended Dec. 31, 2012
		Identical (Level 1)	Observable (Level 2)	Significant Unobservable (Level 3)	
Impaired loans	\$ 4,591	\$	\$	\$ 4,591	\$ (76)
Other real estate owned residential mortgages	\$ 783	\$	\$	\$ 783	\$ (62)
Other real estate owned commercial	\$ 1,526	\$	\$	\$ 1,526	\$ (214)
					\$ (352)

The Company also has other assets, which under certain conditions, are subject to measurement at fair value. These assets include loans held for sale, bank owned life insurance, and mortgage servicing rights. The Company estimated the fair values of these assets utilizing Level 3 inputs, including, the discounted present value of expected future cash flows. At September 30, 2013 and December 31, 2012, the Company estimates that there is no impairment of these assets, with the exception of mortgage servicing rights. Mortgage servicing rights recognized impairment in one

stratum with a charge of \$16 thousand in 2012 to expense. The impairment however was eliminated, as of June 30, 2013. Therefore, no impairment charge to other expense was required to adjust these assets to their estimated fair values.

#### NOTE 3 ASSET PURCHASES

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

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

The amortization expense for the year ended December 31, 2012 was \$312 thousand. Of the \$312 thousand to be expensed in 2013, \$234 thousand has been expensed as of September 30, 2013.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 3 ASSET PURCHASES (Continued)

	(In Thousands)		
	Knisley	Hicksville	Total
2013	\$ 157	\$ 155	\$ 312
2014	157	155	312
2015		155	155
2016		155	155
2017		79	79

## NOTE 4 LOANS

The Company had \$689 thousand in loans held for sale as of September 30, 2013 as compared to \$2.5 million in loans held for sale on December 31, 2012. Due to lack of materiality, these loans are included in the Consumer Real Estate loans below.

Loan balances as of September 30, 2013 and December 31, 2012:

	(In Thousands)	
Loans:	September 30, 2013	December 31, 2012
Commercial real estate	\$ 232,104	\$ 199,999
Agricultural real estate	37,758	40,143
Consumer real estate	79,268	80,287
Commercial and industrial	92,340	101,624
Agricultural	56,752	57,770
Consumer	21,002	20,413
Industrial Development Bonds	4,303	1,299
	523,527	501,535
Less: Net deferred loan fees and costs	(201)	(133)
	523,326	501,402
Less: Allowance for loan losses	(5,030)	(5,224)
Loans - Net	\$ 518,296	\$ 496,178

**Table of Contents**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, 2013:

	Maturities (In Thousands)		
	Within One Year	Year Within Five Years	After Five Years
Commercial Real Estate	\$ 36,687	\$ 100,596	\$ 94,821
Agricultural Real Estate	1,987	10,068	25,703
Consumer Real Estate	10,208	12,796	56,264
Commercial/Industrial	58,743	26,504	7,093
Agricultural	31,918	21,995	2,839
Consumer	4,956	12,966	2,879
Industrial Development Bonds	1,900	490	1,913

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of September 30, 2013. 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
Commercial Real Estate	\$ 141,991	\$ 90,113
Agricultural Real Estate	\$ 28,277	\$ 9,481
Consumer Real Estate	\$ 66,464	\$ 12,804
Commercial/Industrial	\$ 72,385	\$ 19,955
Agricultural	\$ 51,662	\$ 5,090
Consumer	\$ 16,686	\$ 4,115
Industrial Development Bonds	\$ 4,303	\$

As of September 30, 2013 and December 31, 2012 one to four family residential mortgage loans amounting to \$25.3 and \$26.8 million, respectively, have been pledged as security for loans the Bank has received from the Federal Home Loan Bank.

The percentage of delinquent loans has trended downward since the beginning of January 2010 from a high of 2.85% of total loans to a low of .62% as of September 30, 2013. These percentages do not include nonaccrual loans which are not past due (nonaccruals are not considered past due if current). This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, and the writing down of uncollectable credits in a timely manner.

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





**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment in past due loans by portfolio segment of loans as of September 30, 2013 and December 31, 2012, net of deferred fees:

(In Thousands)

September 30, 2013	30-59 Days			Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
	Past Due	60-89 Days Past Due	Greater Than 90 Days				
Residential	\$ 847	\$ 106	\$ 339	\$ 1,292	\$ 77,976	\$ 79,268	\$
Ag Real Estate	\$	\$ 88	\$	88	37,670	\$ 37,758	\$
Ag	\$	\$	\$		56,752	\$ 56,752	\$
Commercial Real Estate	\$	\$ 975	\$ 571	1,546	230,558	\$ 232,104	\$
Commercial and Industrial	\$ 228	\$	\$ 50	278	96,365	\$ 96,643	\$
Consumer	\$ 14	\$ 18	\$	32	20,769	\$ 20,801	\$
<b>Total</b>	<b>\$ 1,089</b>	<b>\$ 1,187</b>	<b>\$ 960</b>	<b>\$ 3,236</b>	<b>\$ 520,090</b>	<b>\$ 523,326</b>	<b>\$</b>

December 31, 2012	30-59 Day		60-89 Days Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
	Past Due	Past Due					
Residential	\$ 575	\$	\$ 648	\$ 1,223	\$ 79,064	\$ 80,287	\$
Ag Real Estate					40,143	40,143	
Ag	11			11	57,759	57,770	
Commercial Real Estate			877	877	199,122	199,999	
Commercial and Industrial	78		2,567	2,645	100,278	102,923	
Consumer	65	7		72	20,208	20,280	1
<b>Total</b>	<b>\$ 729</b>	<b>\$ 7</b>	<b>\$ 4,092</b>	<b>\$ 4,828</b>	<b>\$ 496,574</b>	<b>\$ 501,402</b>	<b>\$ 1</b>

**Table of Contents**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, 2013 and December 31, 2012:

	(In Thousands)	
	September 30 2013	December 31 2012
Consumer Real Estate	\$ 635	\$ 964
Agricultural Real Estate	88	
Agriculture		
Commercial Real Estate	1,751	877
Commercial and Industrial	434	2,987
Consumer		
<b>Total</b>	<b>\$ 2,908</b>	<b>\$ 4,828</b>

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

**Table of Contents**

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.

6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential , versus defined , impairments to the primary source of loan repayment and collateral.
  
7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
  - a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
  
  - b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.
  
  - c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
  
  - d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
  
  - e. Unusual courses of action are needed to maintain a high probability of repayment.
  
  - f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.
  
  - g.

The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.

- h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.
  - i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.
  - j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.
8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:
- a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.
  - b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.
  - c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.
9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by class based on the most recent analysis performed as of September 30, 2013 and December 31, 2012:

	(In Thousands)				
	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>September 30, 2013</b>					
1-2	\$ 3,620	\$ 5,792	\$ 2,506	\$ 2,234	\$
3	13,749	23,382	56,952	22,392	3,959
4	19,523	27,578	161,927	64,002	344
5	743		5,065	2,142	
6	35		5,184	1,143	
7	88		470	427	
8					
<b>Total</b>	<b>\$ 37,758</b>	<b>\$ 56,752</b>	<b>\$ 232,104</b>	<b>\$ 92,340</b>	<b>\$ 4,303</b>

	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>December 31, 2012</b>					
1-2	\$ 2,719	\$ 5,022	\$ 4,046	\$ 750	\$ 97
3	15,111	23,525	42,467	21,750	859
4	21,481	29,188	137,537	71,228	343
5	794	35	8,984	3,385	
6	38		6,295	2,202	
7			670	2,309	
8					
<b>Total</b>	<b>\$ 40,143</b>	<b>\$ 57,770</b>	<b>\$ 199,999</b>	<b>\$ 101,624</b>	<b>\$ 1,299</b>

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of September 30, 2013 and December 31, 2012.

Grade	(In Thousands)	
	Consumer Real Estate September 30 2013	Consumer Real Estate December 31 2012
Pass	\$ 78,767	\$ 79,766
Special Mention (5)		
Substandard (6)	216	110
Doubtful (7)	285	411
Total	\$ 79,268	\$ 80,287

	(In Thousands)			
	Consumer - Credit		Consumer - Other	
	September 30 2013	December 31 2012	September 30 2013	December 31 2012
Performing	\$ 3,412	\$ 3,470	\$ 17,364	\$ 16,775
Nonperforming		3	25	32
Total	\$ 3,412	\$ 3,473	\$ 17,389	\$ 16,807

Information about impaired loans as of September 30, 2013, December 31, 2012 and September 30, 2012 are as follows:

	(In Thousands)		
	September 30, 2013	December 31, 2012	September 30, 2012
Impaired loans without a valuation allowance	\$ 253	\$ 730	\$ 1,145
Impaired loans with a valuation allowance	1,308	3,861	3,371

Total impaired loans	\$ 1,561	\$ 4,591	\$ 4,516
Valuation allowance related to impaired loans	\$ 423	\$ 865	\$ 453
Total non-accrual loans	\$ 2,908	\$ 4,828	\$ 5,260
Total loans past-due ninety days or more and still accruing	\$	\$ 1	\$
Quarter ended average investment in impaired loans	\$ 1,879	\$ 4,468	\$ 4,548
Year to date average investment in impaired loans	\$ 3,521	\$ 3,436	\$ 3,091

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

The Bank had approximately \$378 thousand of its impaired loans classified as troubled debt restructured as of September 30, 2013, \$627.3 thousand as of December 31, 2012 and as of September 30, 2012.



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

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

Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 3 Months	Recorded Investment	Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 9 Months	Recorded Investment
Commercial Real Estate		\$	Commercial Real Estate		\$
Ag Real Estate		\$	Ag Real Estate		\$
Commercial and Industrial		\$	Commercial and Industrial		\$

The following table represents three months and nine months ended September 30, 2012.

Three Months September 30, 2012	(In Thousands)		September 30, 2012	(In Thousands)			
	Number of Contracts Modified in the Last 3 Months	Pre- Modification Outstanding Recorded Investment		Post- Modification Outstanding Recorded Investment	Nine Months September 30, 2012	Number of Contracts Modified in the Last 9 Months	Pre- Modification Outstanding Recorded Investment
Troubled Debt Restructurings Commercial Real Estate		\$	\$	Troubled Debt Restructurings Commercial Real Estate	1	\$ 1,937	\$ 1,937

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Ag Real Estate		\$	\$	Ag Real Estate		\$	\$
Commercial and Industrial	2	\$ 420	\$ 420	Commercial and Industrial	2	\$ 420	\$ 420

Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 3 Months		Recorded Investment	Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 9 Months		Recorded Investment
	Last 3 Months	Recorded Investment			Last 9 Months	Recorded Investment	
Commercial Real Estate		\$		Commercial Real Estate		\$	
Ag Real Estate		\$		Ag Real Estate		\$	
Commercial and Industrial		\$		Commercial and Industrial		\$	

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

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

The following table presents loans individually evaluated for impairment by class of loans for three months ended September 30, 2013.

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

Agriculture real estate	\$ 88	\$ 88	\$ 9	\$ 88	\$
Agriculture	\$	\$	\$	\$	\$
Commercial real estate	\$ 571	\$ 818	\$ 219	\$ 878	\$
Commercial and industrial	\$ 378	\$ 378	\$ 81	\$ 416	\$
Consumer	\$	\$	\$	\$	\$

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

Three Months Ended September 30, 2012	In Thousands				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	\$ 573	\$ 645	\$	\$ 485	\$ 2
Agriculture real estate					
Agriculture					
Commercial real estate	207	384		207	
Commercial and industrial	365	365		365	
Consumer		4			
With a specific allowance recorded:					
Consumer real estate	391	391	69	489	1
Agriculture real estate					
Agriculture					
Commercial real estate	600	847		620	
Commercial and industrial	2,380	2,380	383	2,380	7
Consumer					
Totals:					
Consumer real estate	\$ 964	\$ 1,036	\$ 69	\$ 974	\$ 3
Agriculture real estate					
Agriculture					
Commercial real estate	\$ 807	\$ 1,231	\$	\$ 827	\$
Commercial and industrial	\$ 2,745	\$ 2,745	\$ 383	\$ 2,745	\$ 7
Consumer	\$	\$ 4	\$	\$	\$

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans for nine months ended September 30, 2013.

Nine Months Ended September 30, 2013	In Thousands				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer Real Estate	\$ 152	\$ 224	\$	\$ 162	\$ 7
Agriculture Real Estate					
Agriculture					
Commercial Real Estate	101	101		536	
Commercial and Industrial				198	
Consumer					
With a specific allowance recorded:					
Consumer Real Estate	372	372	114	172	4
Agriculture Real Estate	88	88	9	66	
Agriculture					
Commercial Real Estate	470	717	219	393	
Commercial and Industrial	378	378	81	1,940	1
Consumer					
Totals:					
Consumer Real Estate	\$ 524	\$ 596	\$ 114	\$ 334	\$ 11
Agriculture Real Estate	\$ 88	\$ 88	\$ 9	\$ 66	\$
Agriculture	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 571	\$ 818	\$ 219	\$ 929	\$
Commercial and Industrial	\$ 378	\$ 378	\$ 81	\$ 2,138	\$ 1
Consumer	\$	\$	\$	\$	\$

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

Nine Months Ended September 30, 2012	In Thousands				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer Real Estate	\$ 573	\$ 645	\$	\$ 285	\$ 7
Agriculture Real Estate					
Agriculture					
Commercial Real Estate	207	384		207	
Commercial and Industrial	365	365		162	
Consumer		4			
With a specific allowance recorded:					
Consumer Real Estate	391	391	69	427	1
Agriculture Real Estate					
Agriculture					
Commercial Real Estate	600	847		662	
Commercial and Industrial	2,380	2,380	383	1,345	10
Consumer				3	
Totals:					
Consumer Real Estate	\$ 964	\$ 1,036	\$ 69	\$ 712	\$ 8
Agriculture Real Estate					
Agriculture	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 807	\$ 1,231	\$	\$ 869	\$
Commercial and Industrial	\$ 2,745	\$ 2,745	\$ 383	\$ 1,507	\$ 10
Consumer	\$	\$ 4	\$	\$ 3	\$

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

Allowance for Loan Losses	(In Thousands)	
	Nine Months Ended September 30, 2013	Twelve Months Ended December 31, 2012
Balance at beginning of year	\$ 5,224	\$ 5,091

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Provision for loan loss	582	738
Loans charged off	(1,008)	(891)
Recoveries	232	286
Allowance for Loan & Leases Losses	\$ 5,030	\$ 5,224
Allowance for Unfunded Loan Commitments & Letters of Credit	\$ 169	\$ 162
Total Allowance for Credit Losses	\$ 5,199	\$ 5,386

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

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



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

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

	(In Thousands)									
	Consumer Real Estate		Agriculture	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit		Unallocated	Total
<b>Three Months Ended September 30, 2013</b>										
<b>ALLOWANCE FOR CREDIT LOSSES:</b>										
Beginning balance	\$ 361	\$ 115	\$ 277	\$ 1,460	\$ 2,138	\$ 266	\$ 187	\$ 680	\$ 5,484	
Charge Offs	(12)				(513)	(122)			\$ (647)	
Recoveries	6		1		17	53			\$ 77	
Provision	52	(1)	4	523	(313)	76		(38)	\$ 303	
Other Non-interest expense related to unfunded								(18)	\$ (18)	
Ending Balance	\$ 407	\$ 114	\$ 282	\$ 1,983	\$ 1,329	\$ 273	\$ 169	\$ 642	\$ 5,199	
Ending balance: individually evaluated for impairment	\$ 114	\$ 9	\$	\$ 219	\$ 80	\$	\$	\$	\$ 422	
Ending balance: collectively evaluated for impairment	\$ 293	\$ 105	\$ 282	\$ 1,764	\$ 1,249	\$ 273	\$ 169	\$ 642	\$ 4,777	
Ending balance: loans acquired with deteriorated credit quality	\$ 2	\$	\$	\$	\$	\$	\$	\$	\$ 2	

**FINANCING  
RECEIVABLES:**

Ending balance	\$ 79,268	\$ 37,758	\$ 56,752	\$ 232,104	\$ 96,643	\$ 20,801	\$	\$	\$ 523,326
----------------	-----------	-----------	-----------	------------	-----------	-----------	----	----	------------

Ending balance:

individually  
evaluated for  
impairment

\$ 525	\$ 88	\$	\$ 571	\$ 378	\$	\$	\$	\$ 1,562
--------	-------	----	--------	--------	----	----	----	----------

Ending balance:

collectively  
evaluated for  
impairment

\$ 78,743	\$ 37,670	\$ 56,752	\$ 231,533	\$ 96,265	\$ 20,801	\$	\$	\$ 521,764
-----------	-----------	-----------	------------	-----------	-----------	----	----	------------

Ending balance:

loans acquired with  
deteriorated credit  
quality

\$ 539	\$	\$	\$	\$	\$	\$	\$	\$ 539
--------	----	----	----	----	----	----	----	--------

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

	(In Thousands)										
	Consumer Real Estate			Agriculture Real Estate		Commercial Real Estate		Commercial and Industrial Consumer		Unfunded Loan Commitment & Letters of Credit	Total
<b>Three Months Ended September 30, 2012</b>											
<b>ALLOWANCE FOR CREDIT LOSSES:</b>											
Beginning balance	\$ 460	\$ 92	\$ 275	\$ 1,722	\$ 1,856	\$ 283	\$ 141	\$ 348	\$ 5,177		
Charge Offs	(92)		(6)			(142)			(240)		
Recoveries	23		1	3	5	71			103		
Provision	(38)	(1)	14	64	14	59		123	235		
Other Non-interest expense related to unfunded								8	8		
Ending Balance	\$ 353	\$ 91	\$ 284	\$ 1,789	\$ 1,875	\$ 271	\$ 149	\$ 471	\$ 5,283		
Ending balance: individually evaluated for impairment	\$ 69	\$	\$	\$	\$ 383	\$	\$	\$	\$ 452		
Ending balance: collectively evaluated for impairment	\$ 284	\$ 91	\$ 284	\$ 1,789	\$ 1,492	\$ 271	\$ 149	\$ 471	\$ 4,831		
Ending balance: loans acquired with deteriorated credit quality	\$ 1	\$	\$	\$	\$	\$	\$	\$	\$ 1		
<b>FINANCING RECEIVABLES:</b>											
Ending balance	\$ 81,041	\$ 32,221	\$ 56,581	\$ 198,856	\$ 101,553	\$ 21,052	\$	\$	\$ 491,304		
Ending balance: individually	\$ 964	\$	\$	\$ 807	\$ 2,745	\$	\$	\$	\$ 4,516		

evaluated for  
impairment

Ending balance:

collectively

evaluated for

impairment

\$ 80,077	\$ 32,221	\$ 56,581	\$ 198,049	\$ 98,808	\$ 21,052	\$	\$	\$ 486,788
-----------	-----------	-----------	------------	-----------	-----------	----	----	------------

Ending balance:

loans acquired with

deteriorated credit

quality

\$ 547	\$	\$	\$	\$	\$	\$	\$	\$ 547
--------	----	----	----	----	----	----	----	--------

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

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

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

Ending balance: individually evaluated for impairment	\$ 525	\$ 88	\$ 571	\$ 378	\$	\$	\$	\$ 1,562
Ending balance: collectively evaluated for impairment	\$ 78,743	\$ 37,670	\$ 56,752	\$ 231,533	\$ 96,265	\$ 20,801	\$	\$ 521,764
Ending balance: loans acquired with deteriorated credit quality	\$ 539	\$	\$	\$	\$	\$	\$	\$ 539

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

	(In Thousands)									
	Consumer Real Estate		Agriculture Real Estate		Commercial Real Estate		Commercial and Industrial Consumer		Unfunded Loan Commitment & Letters of Credit Unallocated Total	
<b>Nine Months Ended September 30, 2012</b>										
<b>ALLOWANCE FOR CREDIT LOSSES:</b>										
Beginning balance	\$ 261	\$ 140	\$ 266	\$ 2,088	\$ 1,947	\$ 315	\$ 130	\$ 74	\$ 5,221	
Charge Offs	(185)		(6)	(97)		(351)			(639)	
Recoveries	52		11	5	24	148			240	
Provision	225	(49)	13	(207)	(96)	159		397	442	
Other Non-interest expense related to unfunded								19	19	
Ending Balance	\$ 353	\$ 91	\$ 284	\$ 1,789	\$ 1,875	\$ 271	\$ 149	\$ 471	\$ 5,283	
Ending balance: individually evaluated for impairment	\$ 69	\$	\$	\$	\$ 383	\$	\$	\$	\$ 452	
Ending balance: collectively evaluated for impairment	\$ 284	\$ 91	\$ 284	\$ 1,789	\$ 1,492	\$ 271	\$ 149	\$ 471	\$ 4,831	
Ending balance: loans acquired with deteriorated credit quality	\$ 1	\$	\$	\$	\$	\$	\$	\$	\$ 1	
<b>FINANCING RECEIVABLES:</b>										
Ending balance	\$ 81,041	\$ 32,221	\$ 56,581	\$ 198,856	\$ 101,553	\$ 21,052	\$	\$	\$ 491,304	
	\$ 964	\$	\$	\$ 807	\$ 2,745	\$	\$	\$	\$ 4,516	

Ending balance:  
individually  
evaluated for  
impairment

Ending balance:  
collectively  
evaluated for

impairment	\$ 80,077	\$ 32,221	\$ 56,581	\$ 198,049	\$ 98,808	\$ 21,052	\$	\$	\$ 486,788
------------	-----------	-----------	-----------	------------	-----------	-----------	----	----	------------

Ending balance:  
loans acquired with  
deteriorated credit  
quality

	\$ 547	\$	\$	\$	\$	\$	\$	\$	\$ 547
--	--------	----	----	----	----	----	----	----	--------



**Table of Contents**

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

INTRODUCTION

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

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

For a discussion of the general development of the Company's business throughout 2013, please see the portion of Management's Discussion and Analysis of Financial Condition and Results of Operations captioned "2013 in Review".

NATURE OF ACTIVITIES

The Bank's primary service area, Northwest Ohio and Northeast Indiana, continue to experience a higher level of unemployment as compared to the national average. All averages both local and national however, show a slight downward trend. The agricultural industry continued its strong performance in 2013 as evidenced by strengthened financial statements. Automotive showed improvement with car dealers in our marketing area ending with more profitable numbers than in recent years. Overall, business profits are improving. Loan growth occurred during the third quarter and the Bank finally surpassed the loan balances of year end 2012. New 1-4 family residential and construction remain weak and refinancing activity is also below the level of same period 2012.

The Bank opened its 20<sup>th</sup> office during the second quarter of 2013. The office is located in Waterville, Ohio and was a natural extension of the Bank's market area. The office provides the full range of services discussed below. The Bank prepares to add its 21<sup>st</sup> office in the fourth quarter of 2013 through acquisition. The office is located in Custar, Ohio and will also provide a full range of services and fits well with the Bank's footprint.

The Farmers & Merchants State Bank engages in general commercial banking and savings business. Their activities include commercial, agricultural and residential mortgage, consumer and credit card lending activities. Because the Bank's offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such things 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 such items as autos, trucks, recreational vehicles, motorcycles, etc.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition ATM's (Automated Teller Machines) are provided at most branch locations along with other independent locations such as major employers and hospitals in the market area. The Bank has custodial services for IRA's (Individual Retirement Accounts) and HSA's (Health Savings Accounts). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and ACH 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.

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

**Table of Contents**

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

**INTRODUCTION (Continued)**

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

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

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

**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/Industrial** Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of profit projections, financial leverage, economic trends, management ability, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

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

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

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

All loan requests are reviewed as to credit worthiness and are subject to the Bank's underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on

collateral types as set forth in the Bank's Loan Policy. In addition, credit scores of principal borrowers are reviewed and an approved exception from an additional officer is required should a credit score not meet the Bank's Loan Policy guidelines.

Consumer Loans:

Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect.

Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage in the event of wage loss resulting from disability 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.

Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

**Table of Contents**

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

INTRODUCTION (Continued)

Commercial/Agriculture/Real Estate:

Maximum LTVs range from 70%-80% depending on type.

Accounts Receivable:

Up to 80% LTV.

Inventory:

Agriculture:

Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%.

Commercial:

Maximum LTV of 50% on raw and finished goods.

Used vehicles, new recreational vehicles and manufactured homes not to exceed (NTE) 80% LTV.

Equipment:

New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value.

Restaurant equipment up to 35% of market value.

Heavy trucks, titled trailers, NTE 75% LTV and aircraft up to 75% of appraised value.

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

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

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

The Bank's primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Williams and Wood and in the Indiana counties of DeKalb and Steuben. The commercial banking business in this market is highly competitive with approximately 17 other depository institutions currently doing business in the Bank's primary market. In our banking activities, we compete directly with other commercial banks, credit unions and farm credit services and savings and loan institutions in each of their operating localities. In a number of locations, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of service provided. On December 31, 2007, the Bank acquired the Knisely Bank of Indiana, expanding its market with the addition of offices in Butler and Auburn, Indiana, both located in DeKalb County. An additional office was opened in the summer of 2008 in Angola, Indiana, located in Steuben County. On July 9, 2010 the Bank purchased a branch office in Hicksville, Ohio shortening the distance between our Ohio and Indiana offices. During 2012, the Bank purchased land in Waterville, Lucas County, Ohio, and began construction of an office. The office was opened in second quarter 2013 providing growth opportunity and extension of the market area.

At September 30, 2013, we had 249 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be excellent.

#### 2013 IN REVIEW

Net interest income improved during the third quarter of 2013 as compared to the second quarter of 2013 and was only \$31 thousand behind third quarter 2012. This was accomplished due to increased loan balances and lower borrowing levels for the quarter. Most of the loan growth occurred closer to the end of the quarter so the full benefit to interest income won't occur until the fourth quarter.

**Table of Contents**

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

**INTRODUCTION (Continued)**

During the 1<sup>st</sup> quarter, the largest improvement in the non-interest income arena was the net gain on sale of loans; sales of 1-4 family and agricultural real estate loans were an extension of 2012's heightened activity level. Due to the continued low rate environment, the Company's customers were able to refinance their loans and lower their payments and/or reduce the term of the loan. During the second and third quarter, gain on sale of securities bolstered the noninterest income and was the largest improvement in the quarters.

Total allowance provision for loan losses was \$140 thousand higher than 2012. Loan growth and charge-offs warranted additional provision expense be taken in the third quarter. Impaired loans decreased \$3 million from December 31, 2012 levels. The same comparison applied for nonaccrual loans, showing an improvement in lower balances by \$1.9 million than December 31, 2012. Past dues decreased by almost \$1.6 million in comparing September 30, 2013 to December 31, 2012 balances. Overall, the Company continues to work on the collection of these loans and looks forward to continuing to decrease the exposure during 2013.

All rates remain low and are expected to remain low throughout 2013. This has enabled the Company to continue to sell investment securities and recognize a gain without compromising the yield. The transactions have modestly extended the duration of the investment portfolio. For all of 2012, the recognized gain was \$852 thousand, of which \$30 thousand was recognized in the third quarter. For third quarter 2013, the Company has recognized gains of \$134 thousand bringing the total for 2013 to \$732 thousand. Most of the securities sold were agencies maturing in a shorter time period than the securities that were purchased to replace them. The Bank was able to continue to capitalize on the steepness of the yield curve and the unrealized market gain position the last three years. Additional sales in fourth quarter 2013 will be executed to fund loan growth which management expects to continue through the fourth quarter and into the first quarter of 2014. The market value of the security portfolio has declined as evidenced by the high negative comprehensive income reported on the income statement. Additional opportunity to sell investment securities for a gain is limited for the remainder of 2013.

The majority of the Bank's commercial borrowers have experienced slight improvement, although a few still lag. As the economic recovery remains fragile and consumer confidence still remains at lower levels, consumer sensitive industries and the retail sector may continue to experience pressures as well. Drought conditions existed in the majority of the market area we service during 2012. 2013 brought increased moisture and storms. Crop insurance and two previous years of strong yields lessened any negative impact on our agricultural portfolio. Though crop yields in 2012 were down, prices were higher than a year earlier which helped lessen the financial impact. Though water levels have not yet returned to pre-drought levels, the outlook remains optimistic for 2013 agricultural activity.

Overall, profitability in the third quarter of 2013 was down as compared to the same quarter last year. In year-to-date comparisons, net income is down 7% or \$543 thousand. Noninterest income was up 10.6% over the same period 2012. The Company has done an exceptional job of recognizing opportunities to provide services and products that the low rate environment made possible. These opportunities are further discussed in the Material Changes in Results of Operations. The Company remains strong, stable, and well capitalized and has the capacity to continue to cover the increased costs of doing business in a tough economy while seeking good loans to improve profitability. The Company continues to look for new opportunities to generate and protect revenue and provide additional channels

through which to serve our customers and maintain our high level of customer satisfaction.

The Bank has been attentive to the significant final mortgage rules and additional guidance issued by the Consumer Financial Protection Bureau to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions. Effective in January 2014, these rules are a game-changer which impacts the entire mortgage lending industry, as well as the Bank's perspective on its mortgage lending business. The Bank continues to work toward fulfillment of applicable requirements for these new mortgage rules, as it gains further understanding of the complexities and inter-related nature of these rules, makes strategic decisions, and addresses key considerations necessary for implementation of each rule.



**Table of Contents**

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

**CRITICAL ACCOUNTING POLICY AND ESTIMATES**

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

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

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

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

Foreclosed real estate for sale is carried at the lower of fair value minus estimated costs to sell, or cost. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and a write-down is recorded by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell. Foreclosed real estate is classified as other real estate owned. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At September 30, 2013, holdings were \$2.4 million and were \$2.3 million as of December 31, 2012 and \$3.1 million as of September 30, 2012.

The ALLL represents management's estimate of credit losses inherent in the Bank's loan portfolio at the report date. The estimate is a composite of a variety of factors including past experience, collateral value and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion. The collection and ultimate recovery of the book value of the collateral, in most cases, is beyond our control.

The Company is required to estimate the value of its Mortgage Servicing Rights. The Company recognizes as separate assets rights to service fixed rate single-family mortgage loans that it has sold without recourse but services for others for a fee. Mortgage servicing assets are initially recorded at cost, based upon pricing multiples as determined by the

purchaser, when the loans are sold. Mortgage servicing assets are carried at the lower of the initial carrying value, adjusted for amortization, or estimated fair value. Amortization is determined in proportion to and over the period of estimated net servicing income using the level yield method. For purposes of determining impairment, the mortgage servicing assets are stratified into like groups based on loan type, term, new versus seasoned and interest rate. The valuation is completed by an independent third party.

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

The Company's mortgage servicing rights relating to loans serviced for others represent an asset of the company. This asset is initially capitalized and included in other assets on the Company's consolidated balance sheet. The

---

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****CRITICAL ACCOUNTING POLICY AND ESTIMATES (Continued)**

mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Company, including the estimated prepayment speed of the loan and the discount rate used to present value the servicing right. For example, if the mortgage loan is prepaid, the Company will receive fewer servicing fees, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Company's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Company of the mortgage servicing rights, the Company receives a valuation of its mortgage servicing rights from an independent third party. The independent third party's valuation of the mortgage servicing rights is based on relevant characteristics of the Company's loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as current national market interest rate levels, market forecasts and other economic conditions. Management, with the advice from its third party valuation firm reviewed the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter's analysis related to the mortgage servicing asset. In addition, based upon the independent third party's valuation of the Company's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Company. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Company's net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on market conditions. The accuracy of these estimates and assumptions by management and its third party valuation specialist can be directly tied back to the fact that management has only been required to record minor valuation allowances through its income statement over time based upon the valuation of each stratum of servicing rights. For more information regarding the estimates and calculations used to establish the ALLL and the value of Mortgage Servicing Rights, please see Note 1 to the consolidated financial statements provided herewith.

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

In comparing the balance sheet of September 30, 2013 to that of December 31, 2012, the cash equivalent liquidity of the Bank has decreased by approximately \$22.6 million and still remains strong. The size of the Bank is smaller by a similar amount of \$18.5. The decrease in liquidity also corresponds to a lower balance in the lowest interest yielding category. During the nine months of 2013, net loans have increased \$22.1 million even with a \$10 million decrease stemming from the repayment on a line of credit by a single borrowing relationship which was expected and which happens each year at this time. The fact that loan levels increased in light of the anticipated yearly reduction is a positive factor towards future improvement to profitability.

The Company's decrease in size was due to lower liability balances within deposits and FHLB borrowings. The Company has an unsecured borrowing capacity of \$95.3 million through correspondent banks and over \$128.0 million of unpledged securities which may be sold or used as collateral. The strength of the security portfolio is shown in the tables to follow. With the exception of stock, all of the Bank's security portfolio is categorized as available for sale and as such is recorded at market value. The charts that follow do not include stock.

Investment securities will at times depreciate to an unrealized loss position. The Bank utilizes the following criteria to assess whether or not an impaired security is other than temporary. No one item by itself will necessarily signal that a security's impairment should be recognized as other than temporary impairment.

1. The fair value of the security has significantly declined from book value.
2. A down grade has occurred that lowers 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.

**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)**

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 amount of the write down shall be included in earnings as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value. The recovery in fair value shall be recognized in earnings when the security is sold. The first table is presented by category of security and length of time in a continuous loss position. Municipalities may be more likely to be in a loss position greater than 12 months due to their length to maturity and are not indicative of an issue with safety and soundness of the municipality. The Bank currently does not hold any securities with other than temporary impairment.

As the chart below shows, there were only minor amounts of securities in a loss position as of September 30, 2013.

September 30, 2013	(In Thousands)			
	Less Than Twelve Months Gross Unrealized Losses	Fair Value	Twelve Months & Over Gross Unrealized Losses	(In Thousands) Fair Value
U.S. Treasury	\$ (733)	\$ 25,392	\$	\$
U.S. Government agency	(3,301)	109,333		
Mortgage-backed securities	(371)	16,355		
State and local governments	(406)	12,450		

A large fluctuation in the market value of the securities occurred during the third quarter causing the unrealized gain position to decrease significantly. Management recognized the change in the market early and was quick to capture the gain before it fluctuated to an unrealized loss position. Management feels confident that liquidity needs can easily be funded from an orderly runoff of the investment portfolio.

The following chart shows the breakdown of the unrealized gain or loss associated within each category of the investment portfolio as of September 30, 2013.

	(In Thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 26,125	\$	\$ (733)	\$ 25,392
U.S. Government agency	199,284	1,550	(3,301)	197,533

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Mortgage-backed securities	41,682	792	(371)	42,103
State and local governments	69,801	2,875	(406)	72,270
	\$ 336,892	\$ 5,217	\$ (4,811)	\$ 337,298

**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)**

The following table shows the maturity schedule of the security portfolio as of September 30, 2013

	(In Thousands)	
	September 30, 2013	
	Amortized	
	Cost	Fair Value
One year or less	\$ 5,803	\$ 5,818
After one year through five years	168,097	169,486
After five years through ten years	110,821	108,284
After ten years	10,489	11,607
<b>Subtotal</b>	<b>\$ 295,210</b>	<b>\$ 295,195</b>
Mortgage Backed Securities	41,682	42,103
<b>Total</b>	<b>\$ 336,892</b>	<b>\$ 337,298</b>

As previously stated, net loans show an increase for the nine months ended September 30, 2013, which reverses the trend in declining loan balances which the Bank experienced all throughout fiscal year 2012 and up through the second quarter 2013. The Bank achieved the increase in spite of charged-offs aggregating \$1.0 million during the nine month period. Growth came within commercial and consumer real estate portfolios with the remaining portfolios showing decreases. The balance of the decrease in the other loan portfolios was due to the pay down, payoff or refinancing of loans. Loan sales into the secondary market have also impacted the consumer and agricultural real estate portfolios. Year to date, the Bank has sold approximately \$58.0 million of loans into the secondary market, while originating only \$54.9 million of the loans during the same nine month period as demonstrated in the cash flow statement for the period. Agricultural real estate accounted for just under one fourth of the activity with 1-4 family representing the majority. Both portfolios include a large portion of refinancing. The trend of decreasing loan balances is not unique to this year as the chart to follow shows the decreasing 2012 trend and shows an uptick for September 2013 as compared to September 2012. The Bank is also closer to reversing the trend after our third quarter activity when comparing to yearend. The Bank's pipeline of loans has increased, driven by opportunities for new relationships as business activity begins to reflect a more optimistic opinion of the economy and larger financial institutions downsize certain portfolios.

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

(In Thousands)

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

	September 2013 Amount	September 2012 Amount	September 2011 Amount
Commercial Real Estate	\$ 232,104	\$ 198,856	\$ 201,167
Agricultural Real Estate	37,758	32,221	31,806
Consumer Real Estate	79,268	81,041	80,607
Commercial and Industrial	92,340	100,126	112,542
Agricultural	56,752	56,581	54,134
Consumer, Overdrafts and other loans	20,801	21,052	23,861
Industrial Development Bonds	4,303	1,427	1,347
 Total Loans	 \$ 523,326	 \$ 491,304	 \$ 505,464

The Commercial and Industrial portfolio shows the largest decrease of \$7.8 million in balance as of September 30, 2013 compared to September 30, 2012. Agricultural real estate shows an increase of \$5.5 million. Commercial real estate showed the largest improvement in balances of \$33.2 million which was higher than the two previous quarters comparison increases of \$12.3 million and of \$8.7 million. Overall, loans increased \$32.0 million as compared to the same period last year and increased \$17.9 million as compared to September 30, 2011.

Overall, total assets of the Company decreased \$18.5 million from December 31, 2012 to September 30, 2013.



**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)**

Deposits decreased \$17.7 million with the largest decrease of \$28.1 million in the time deposits. The largest increase in the deposit portfolio of \$8.8 million was in the savings portfolio due to the continuing popularity of the KASASA program. The mix of the portfolio continued to transition to a higher level of core deposits as a result primarily of the Bank's offering of a high interest bearing transaction account along with an increase in health savings accounts. In 2010, the Bank strengthened its line of deposit products by adding additional products which added additional options to its already highly successful Reward Checking, which was renamed KASASA Cash. The additional options include KASASA Saver, KASASA Giver and KASASA iTunes. KASASA Saver, whose product utilizes a higher yielding rate than the Bank's regular saving account, is the reason behind the retention and increase of dollars in savings. These continue to be the deposits of choice and attract not only new money from existing customers but new customers to the Bank.

The Certificate of Deposit (COD) portfolio has decreased \$28.1 million during the first nine months of 2013, which is part of the reason why the Bank continues to decrease the cost of funds. Through its pricing, the Bank has limited its attractiveness to short-term rate shoppers and foresees continuing this strategy through the remainder of 2013. This is demonstrated below in the section of this MD&A captioned MATERIAL CHANGES IN RESULTS OF OPERATION Interest Expense .

The Bank paid off \$5.1 million in FHLB advances which had matured during 2012 and made principal payments and payoffs totaling \$4.5 million so far in 2013 with an additional pay off of \$2.6 million early in the fourth quarter. This too should lower the cost of funds. Securities sold under agreement to repurchase increased \$10.0 million during the first nine months of 2013 as compared to year end.

Capital decreased a modest \$2.5 million from year-end during the nine months of 2013. Positive earnings offset by a significant decrease in accumulated other comprehensive income are the factors behind the decrease. Comprehensive income decreased \$5.8 million which encompassed the shift of \$732 thousand from unrealized gain to realized gain with the sale of securities. Dividends paid year-to-date were \$127 thousand higher the same period last year.

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

Primary Ratio	11.66%
Tier I Leverage Ratio	11.15%
Risk Based Capital Tier I	16.61%
Total Risk Based Capital	17.45%
Stockholders' Equity/Total Assets	11.61%

**MATERIAL CHANGES IN RESULTS OF OPERATIONS**

Comparison of Results of Operation for nine month periods ended September 30, 2013 and 2012.

Noninterest income for the third quarter 2013 was not high enough to offset the loss of interest income. As a result, net income was \$376 thousand lower than 2012's third quarter. The \$789 thousand higher balance in noninterest income was on a year-to-date comparison driven primarily by (i) an increase in the gain on sale of securities of \$533 thousand, (ii) a \$339 thousand lower loss on sale of assets and (iii) smaller improvements in the remainder of categories in the range of \$61 to \$263 thousand. The increase in the aggregate number of checking and savings accounts has been the principal factor behind the increase in customer service fees for the two periods.

Net interest income after the provision for loan expense for the quarter ended September 30, 2013 was down \$845 thousand from the nine-month period ended September 30, 2012. The decrease in total interest income for the comparison of the two periods was \$705 thousand less than the decrease in total interest expense, making it the principal driver behind the overall decrease. The provision for loan loss expense was approximately \$140 thousand higher than same period 2012.

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

Noninterest expense was higher by \$652 thousand in comparison largely due to the addition of the Waterville office. The number of full time equivalent employees was 245 as of September 30, 2012 compared to 249 as of September 30, 2013.

Overall, the performance for the year-to-date comparison had lower bottom line income of \$543 thousand caused by an office being added along with lower loan to asset ratios. 2013 continues to showcase the issue of lower interest income being offset by strong noninterest revenue. Improvement in the loan to asset ratio for the fourth quarter forecasts a stronger finish to the year.

**Interest Income**

Annualized interest income and yield on earning assets is down 31 basis points in 2013 as compared to September 30, 2012. While the average total earning assets were only higher by less than 1% for \$797 thousand than the prior year, the decrease in interest income resulted primarily from the decreased yields of the Company's earning assets. As the table that follows confirms, the decrease in the rate of the interest earning portfolios from loans to investments caused a lower September 2013 yield in loans and securities thereby causing lower interest income. The increased volume in the security portfolio did not offset the loss in interest income due to rate changes. The portfolio continues to have calls due to the low rate environment. Prepayment speeds remain high on mortgage-backed securities. These may slow as the Bank's refinancing activity has and long term rates inch higher.

Overall, interest income from loans was down \$1.8 million in comparing the nine months ended September 30, 2013 to same period 2012 which accounts for the majority of the overall drop in interest income. This emphasizes the importance of increasing higher yielding loan balances and the need to find good loans with which to rebuild the portfolio.

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

	(In Thousands)		Yield/Rate	
	Average Balance	Interest/Dividends	September 30, 2013	September 30, 2012
Interest Earning Assets:				
Loans	\$ 494,627	\$ 18,411	5.00%	5.44%
Taxable Investment Securities	295,580	3,510	1.58%	1.68%
Tax-exempt Investment Securities	63,208	1,362	4.35%	4.53%
Fed Funds Sold & Interest Bearing Deposits	19,490	28	0.19%	0.18%
<b>Total Interest Earning Assets</b>	<b>\$ 872,905</b>	<b>\$ 23,311</b>	<b>3.69%</b>	<b>3.98%</b>

**Change in September 30, 2013 Interest Income Compared to September 30, 2012**

Interest Earning Assets:	Change	Due to Volume	Due to Rate
Loans	\$ (1,754)	\$ (6)	\$ (1,748)
Taxable Investment Securities	(121)	53	(174)
Tax-exempt Investment Securities	(90)	(34)	(56)
Fed Funds Sold & Interest Bearing Deposits	(3)	(4)	1
<b>Total Interest Earning Assets</b>	<b>\$ (1,968)</b>	<b>\$ 9</b>	<b>\$ (1,977)</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 continued to be lower than the comparable nine months of 2012. Interest expense related to deposits was down \$1.0 million while the average interest-bearing deposit balance decreased by \$7.8 million in comparing the balances of each nine month period. Time deposits continue to reprice down and the Bank continues to try and lengthen the duration of the portfolio with specials offered in terms longer than thirty-six months. However, depositors continue to place more funds in shorter term deposits while they wait for rates to rise or move funds elsewhere. KASASA Cash and Saver along with HSA's helped to increase the savings average deposit balances by \$25.6 million.

Interest on borrowed funds was \$238 thousand lower for the nine month period ended September 30, 2013 than 2012. More borrowings from Federal Home Loan Bank were paid off during 2012 and 2013, making the average balance in other borrowed money considerably lower by \$11.3 million in 2013 in comparison. Thus the largest decrease in cost of funds for other borrowed money was due to the decreased volume which also impacted the rate of the remaining borrowings portfolio. Fed Funds Purchased and Securities Sold under Agreement to Repurchase had similar balances in 2013 and 2012 making the fluctuation cost a minimal \$1 thousand.

For the same comparison as last year, the decrease in interest expense did not outpace the decrease in interest income. It remains a focus for improvement in 2013. Asset yield decreased 31 basis points while cost of funds decreased 22 basis points. The main focus is to increase asset yield by using excess cash and the liquidation of lower yielding investments to fund loan growth.

Interest Bearing Liabilities:	(In Thousands)		Yield/Rate	
	Average Balance	Interest/Dividends	September 30, 2013	September 30, 2012
Savings Deposits	\$ 397,616	\$ 1,118	0.38%	0.55%
Other Time Deposits	255,976	2,111	1.10%	1.25%
Other Borrowed Money	7,326	133	2.42%	2.65%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	52,653	184	0.46%	0.47%
<b>Total Interest Bearing Liabilities</b>	<b>\$ 713,571</b>	<b>\$ 3,546</b>	<b>0.66%</b>	<b>0.88%</b>

**Change in September 30, 2013 Interest Expense Compared to September 30, 2012**

Interest Bearing Liabilities:	Change	Due to Rate
-------------------------------	--------	-------------

		Due to Volume	
Savings Deposits	\$ (425)	\$ 48	\$ (473)
Other Time Deposits	(600)	(184)	(416)
Other Borrowed Money	(238)	(137)	(101)
Fed Funds Purchased & Securities Sold under Agreement to Repurch.		2	(2)
<b>Total Interest Bearing Liabilities</b>	<b>\$ (1,263)</b>	<b>\$ (271)</b>	<b>\$ (992)</b>

#### Net Interest Income

Net interest income is lower in the nine month comparison, which is the same position as yearend 2012's comparison to yearend 2011. The issue of earning less per earning asset dollar still remains as evidenced by a 26 basis point lower net interest margin ratio when comparing year-to-date 2013 to 2012. The tables above demonstrate that the decline in net interest income is primarily a result of continued interest rate compression that results from falling rates impacting yields on assets more dramatically than rates paid on liabilities.

**Table of Contents**

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

**MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

Management expects the current interest rate environment to continue to further compress the Company's interest margins throughout the remainder of the fiscal year. As a result, interest income, in comparison to 2012, may remain behind throughout the year even if a higher level of loan growth does continue in the fourth quarter. The Bank continues to attempt to add spread on renewing loans while loan growth is needed to improve the overall numbers. Interest expense on time deposits should also continue to show a decrease until depositors begin to transition back into longer-term deposits. Should rates begin to rise, the challenge will be to delay the pricing up of deposits in order to allow the Bank to generate a greater spread from the increased yield on its earning assets.

**Provision Expense**

Provision for loan loss was \$140 thousand higher for the nine months ended September 30, 2013 as compared to the same 2012 period. A higher net charge-off position in 2013 than in 2012 along with third quarter loan growth warranted the increased provision to the loan loss reserve. The balance in nonaccrual loans decreased \$1.9 million along with a decrease of \$3.0 million in impaired loan balances as of September 30, 2013 as compared to the balances as of December 31, 2012. In comparing to September 30, 2012, nonaccrual balances decreased \$2.4 million and impaired loan balances decreased \$3.0 million. Provision expense related to those increased balances was recognized in the later time periods of 2012. The overall loan portfolio was also \$32.0 million higher as of September 30, 2013 compared to September 30, 2012. The Bank continues to focus on the commercial and commercial real estate portfolios for both asset quality and growth. As the charts below will show for 2013 and 2012, a large portion of the provision was also to replace the reserve balance depleted from the net charge-offs during the period and 2013 had a larger net charge-off position than 2012.

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

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

Looking at the balance in impaired loans, it shows the Bank has recognized a significant decrease in the overall balance of impaired loans when looking at September 2013 compared to September 2012. A positive factor can also be seen in the decrease in the current average balance during 2013 as compared to yearend December 2012. This is due mainly to the collection of principal from the sale of collateral from borrowers and continual collection of

payments on these borrowers classified as impaired.

An increase in the impaired loans with a valuation allowance occurred during the second quarter 2012 related to two relationships of \$2.4 million, one comprising \$2.3 million. That same relationship was dissolved during the third quarter 2013 and was the main factor behind the lower balances of impaired loans in 2013.

The Bank had \$378 thousand of its impaired loans classified as troubled debt restructured as of September 30, 2013. No new impaired relationships were added during the third quarter and five were removed. The change resulted in \$3.0 million less in impaired balances; however the specific allocation balance was decreased by \$634 thousand due to the removals.

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



**Table of Contents**

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

The ALLL has a direct impact on the provision expense. The increase in the ALLL is funded through recoveries and provision expense. The following tables both deal with the allowance for credit losses. The first table breaks down the activity within ALLL for each loan portfolio segment and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table discloses how much of the ALLL is attributed to each segment of the loan portfolio, as well as the percent that each particular segment of the loan portfolio represents to the entire loan portfolio in the aggregate. Commercial and industrial loans accounted for the largest component of charge-offs and consumer activity has accounted for the largest component of recoveries in third quarter 2013 as compared to 2012. As was mentioned in previous discussion, the commercial and commercial real estate portfolios are having a major impact on the ALLL, one through charge-off activity and the other due to growth of balances.

**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 activities for the allowance for loan losses by loan type for three months ended September 30, 2013, 2012, and 2011.

	(In Thousands)		
	Three Months Ended September-13	Three Months Ended September-12	Three Months Ended September-11
<b>Loans</b>	\$ 523,326	\$ 491,304	\$ 505,464
Daily average of outstanding loans	\$ 504,063	\$ 492,125	\$ 499,122
Allowance for Loan Losses - July 1	\$ 5,297	\$ 5,036	\$ 5,489
Loans Charged off:			
Commercial Real Estate			55
Ag Real Estate			
Consumer Real Estate	12	92	190
Commercial and Industrial	513		180
Agricultural		6	
Consumer & other loans	122	142	99
	647	240	524
Loan Recoveries			
Commercial Real Estate		3	1
Ag Real Estate	1		
Consumer Real Estate	5	23	25
Commercial and Industrial	17	5	5
Agricultural	1	1	
Consumer & other loans	53	71	49
	77	103	80
Net Charge Offs	570	137	444
Provision for loan loss	303	235	92
Acquisition provision for loan loss			
Allowance for Loan & Lease Losses - September 30	\$ 5,030	\$ 5,134	\$ 5,137

Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Allowance for Unfunded Loan Commitments & Letters of Credit - September 30	169	149	156
Total Allowance for Credit Losses - September 30	\$ 5,199	\$ 5,283	\$ 5,293
Ratio of net charge-offs to average Loans outstanding	0.11%	0.03%	0.09%
Ratio of Allowance for Loan Loss to Nonperforming Loans	173.00%	97.62%	76.86%

**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 activities for the allowance for loan losses by loan type for nine months ended September 30, 2013, 2012, and 2011.

	(In Thousands)		
	Nine Months Ended September-13	Nine Months Ended September-12	Nine Months Ended September-11
Loans	\$ 523,326	\$ 491,304	\$ 505,464
Daily average of outstanding loans	\$ 494,627	\$ 494,860	\$ 506,045
Allowance for Loan Losses - January 1	\$ 5,224	\$ 5,091	\$ 5,706
Loans Charged off:			
Commercial Real Estate	64		210
Ag Real Estate			
Consumer Real Estate	112	185	380
Commercial and Industrial	512	97	1,496
Agricultural		6	24
Consumer & other loans	320	351	268
	1,008	639	2,378
Loan Recoveries			
Commercial Real Estate	1	5	30
Ag Real Estate			
Consumer Real Estate	15	53	48
Commercial and Industrial	71	23	11
Agricultural	5	11	65
Consumer & other loans	140	148	134
	232	240	288
Net Charge Offs	776	399	2,090
Provision for loan loss	582	442	1,522
Acquisition provision for loan loss			
	\$ 5,030	\$ 5,134	\$ 5,138

Allowance for Loan & Lease Losses - September 30			
Allowance for Unfunded Loan Commitments & Letters of Credit - September 30	169	149	156
Total Allowance for Credit Losses - September 30	\$ 5,199	\$ 5,283	\$ 5,294
Ratio of net charge-offs to average Loans outstanding	0.16%	0.08%	0.41%
Ratio of Allowance for Loan Loss to Nonperforming Loans	173.00%	97.61%	76.87%

**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, 2013 and September 30, 2012.

Balance at End of Period Applicable To:	(In Thousands September-2013 Amount	% of Portfolio	(In Thousands) September-2012 Amount	% of Portfolio
Commercial Real Estate	\$ 1,983	44.36	\$ 1,789	40.47
Ag Real Estate	114	7.22	91	6.56
Consumer Real Estate	407	15.15	353	16.50
Commercial and Industrial	1,329	17.64	1,875	20.38
Agricultural	282	10.84	284	11.52
Consumer, Overdrafts and other loans	273	3.97	271	4.28
Unallocated	642	0.82	471	0.29
Allowance for Loan & Lease Losses	\$ 5,030		\$ 5,134	
Off Balance Sheet Commitments	169		149	
Total Allowance for Credit Losses	\$ 5,199		\$ 5,283	

The percentage of delinquent loans has trended downward since the beginning of 2010 from a high of 2.85% of total loans in January to .62% as of the end of September 2013. These percentages do not include nonaccrual loans which are not past due. This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, and the write down of uncollectable credits in a timely manner.

**Non-interest Income**

Non-interest income was higher for the nine months ended September 30, 2013 as compared to same period in September 30, 2012. Improvement in non-interest income was reached in all categories from customer service fees to net gain on sale of securities with the exclusion of net gain on sales of loans. The increase in the checking and savings portfolios in terms of number of accounts in 2013 as compared to 2012 has been one of the main factors behind the maintaining of and additional collection of fees. Increases came from debit card usage during the first nine months of 2013 providing approximately \$248 thousand more in revenue than for the first nine months of 2012. This revenue stream is very important to the Bank and its ability to offer free checking accounts to our customers.

Net gain on sale of securities represented the largest improvement in noninterest income, up \$533 thousand as of third quarter end 2013 compared to third quarter end 2012. As the market rates for long term assets began to rise, the Bank

began to see the unrealized gain on the market value of securities erode. At the end of May and beginning of June, the Bank decided to capture some of the gain before the opportunity evaporated. During the third quarter the Bank sold off investments to fund loan growth and \$134 thousand was recognized.

The Bank was able to continue to take advantage of the opportunity to recognize gains from the sales of securities without impacting the yield of the investment portfolio by marginally extending the maturity duration. The gain in 2013 was based on security sales of \$63.6 million.

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. A slight impairment in the valuation of the thirty year segment occurred in the fourth quarter of 2012 and was reversed in the second quarter of 2013, eliminating all impairment.

**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)	
	2013	2012
Beginning Balance, January 1	\$ 2,063	\$ 2,071
Capitalized Additions	366	384
Amortization	(345)	(372)
Ending Balance, September 30	2,084	2,083
Valuation Allowance		
Mortgage Servicing Rights, net September 30	\$ 2,084	\$ 2,083

Loss on sale of assets was lower by \$339 thousand as of third quarter end 2013 as compared to same period 2012. This represents an improvement in non-interest income for the period. This line item includes losses from sales of assets, losses from write-downs to the Bank's Other Real Estate Owned (ORE) and losses resulting from the loss or disposal of fixed assets, though the fixed asset sales are inconsequential. Holdings in ORE decreased to \$757 thousand as of September 30, 2013 compared to holdings of \$3.1 million as of September 30, 2012. Activity on sales of ORE has increased in 2013 and the Bank expects this to continue throughout the remainder of 2013 and decrease the holdings even further.

Overall non-interest income improved \$789 thousand for the nine months of operations in 2013 as compared to 2012. It is expected to continue through 2013, specifically in the area of loss on sale of other assets owned.

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

	(In Thousands)	
	Nine Months Ended	
	September 30, 2013	Nine Months Ended September 30, 2012
Net Unrealized gain (loss) on available-for-sale securities	\$ (8,094)	\$ 1,672
Reclassification adjustment for gain on sale of available-for-sale securities	\$ (732)	\$ (199)



Edgar Filing: FARMERS & MERCHANTS BANCORP INC - Form 10-Q

Net unrealized gains (losses)	\$ (8,826)	\$ 1,473
Tax Effect	\$ 3,001	\$ (501)
Other comprehensive income (loss)	\$ (5,825)	\$ 972

Non-Interest Expense

Non-interest expense for the nine months ended September 30, 2013 was only \$652 thousand higher than for the same period of 2012. The largest individual increase in expense is related to the salaries and wages. Salaries and wages were higher by \$374 thousand during the nine months as compared to the same time frame of 2012. Base pay was higher by 3.7% or \$84.4 thousand in 2013 than 2012 with the number of full time equivalent employees having increased from 247 as of September 30, 2012 to 249 as of September 30, 2013. This percentage is in line with the small increases that were authorized to be implemented throughout the organization for higher performing employees. Pension and other employee benefits decreased by \$12 thousand in the same time period. Medical costs increased by \$69.5 thousand for the nine months ended September 30, 2013 as compared to September 30, 2012. This was due to a higher level of claims accompanied by higher insurance premiums for plan year 2013. Occupancy expense decreased \$150 thousand as compared to 2012.

**Table of Contents**

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Non-Interest Expense (Continued)

A decrease occurred of \$204 thousand in the amortization expense of mortgage servicing rights. When a mortgage is refinanced, any unamortized servicing right is fully expensed and therefore, drives the amortization expense higher within that period. Of the sales and originations shown in the cash flow, \$40.4 million were originated and \$42.3 million sold from the 1-4 family portfolio which had mortgage servicing rights attached. These were down from \$68.2 million in originations and \$68.1 million in sales from the same portfolio as of third quarter 2012. Therefore, amortization expense from refinancing activity would be expected to be lower, which it is.

Other general and administrative expenses were higher during the nine months for 2013 by \$475 thousand; as compared to the same nine months 2012. Almost 40%, \$184.9 thousand, of the increase is attributed to loan collection fees, including legal. Overall non-interest expense was just \$652 thousand higher in 2013 than in 2012. The Company continues to monitor costs to safeguard profitability.

Net Income

Overall, net income was down \$543 thousand for the nine months ended September 30, 2013, compared to the same period of 2012. The improvement in asset quality that has occurred over the last two years along with lower loan balances enabled the Company to have low levels of provision expense until third quarter 2013. Provision was increased during the quarter due to increased charge-offs and loan growth and was \$140 thousand higher than 2012 on a comparable year-to-date. This coupled with the decrease on ORE write-down and losses summarized in gain/loss on sale of other assets owned of \$339 thousand less in 2013 than in 2012, increased gain on sale of investments of \$533 thousand in 2013 over 2012, are the largest factors behind the decrease not being larger. Obviously, the gain on sale of securities plays a role in the improvement and the Company is fortunate that the opportunity existed to capture income that has been used to improve profitability the last two years. The decrease in net interest income is proof of the importance of the effect of balance sheet mix as the low loan balances continue to impact overall asset yield.

The Company is positioned for improvement in the net interest margin while rates remain low, provided there is an increase in loan demand. It will be a challenge to maintain the margin once short term rates begin to rise. However, the Bank remains focused on improving the asset yield through improved asset quality and added spread to prime on variable and adjustable rate loans. As with the rest of the banking industry, the Company is also limited from achieving higher profitability by the cost of increased regulatory requirements such as Regulation E, Dodd-Frank Wall Street Reform and Consumer Protection Act and any other additional regulations that may be enacted during 2013 and their corresponding cost of compliance. The Company will continue to seek to enhance existing products and services to increase revenue, improve efficiency and increase customer satisfaction.

Comparison of Results of Operations for the quarters ended September 30, 2013 and September 30, 2012.

In a reverse of what had been reported for the prior quarter comparisons of 2013, noninterest income was not higher than same quarter 2012. Noninterest income was \$69 thousand lower in the quarter comparisons. The decline of the gain on sales of loans was the main difference. Refinancing activity of 1-4 family real estate slowed considerable as long term rates were higher than the year prior. Agricultural real estate sales also slowed as the government struggled to pass a farm bill of which FSA guarantees are a part of the guarantees relied upon to make the sales in the secondary market attractive. Gain on sales of loans was \$426 thousand lower in third quarter 2013 as compared to same quarter 2012.

In comparing changes in the balance sheet composition from second quarter to third quarter-end 2013, the two most important ones are the net loans from the asset side and accumulated comprehensive income from the capital section. This statement would also hold true when comparing the September 30<sup>th</sup> balances of 2012 to 2013.

Net loans show an increase in both circumstances, which is a step in the desired direction. The increase is wider this quarter than the prior quarters \$32.1 million in year to year comparison, and is an increase in comparing 2013 quarter-end balances of \$22.1 million. The operative word in both instances is increase. Interest income on loans was up \$155 thousand for the third quarter as compared to the second quarter 2013. The Bank is anticipating it may be the start of a new trend that will help to bolster long-term profitability.

**Table of Contents**

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

**MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

Accumulated comprehensive income has experienced the opposite and is significantly lower at September 30, 2013 by \$7.1 million compared to September 30, 2012 and by \$160 thousand compared to June 30, 2013. This basically signifies that only a small opportunity or not one at all, exists to recognize additional income from gain on sale of investments, especially, if future income is not to be jeopardized by the sale. As the income statement has shown, this has been a portion of non-interest income for many recent years. This fluctuation also stresses the importance of why community banks did not want it to be a part of the Basel III capital rules to be implemented in the coming years: it can be a very volatile portion of capital and play havoc with meeting regulatory guidelines without much warning.

In comparing September quarterly results for 2012 and 2013, net interest income is lower in 2013 by just \$31 thousand, which is an improvement over second quarter's comparison of \$291 thousand. The increased loan balances helped to lessen the gap. Interest expense was lower by \$403 thousand due to the lower rate on deposits and lower time deposit balances.

Noninterest expense was separated by \$365 thousand in comparing the two periods. Third quarter 2013 was higher than 2012. Fluctuation by category was limited with the largest being \$142 thousand in other general and administrative. Legal and consulting fees for the Waterville office along with the preparation for the acquisition to occur in the fourth quarter contributed to the increase.

For third quarter comparison, net income was down \$376 thousand in 2013 as compared to 2012. Earnings per share were different by seven cents. Dividends declared matched at twenty cents per share. As discussed previously, the largest fluctuation in the quarter comparison relates to other comprehensive income, a loss of \$748 thousand in the market value of securities for 3 months ended September 30, 2013 and September 30, 2012.

Overall, the Bank is working to offset the probable loss of noninterest income streaming from sales by increasing the loan balances. Possible improvement in the net interest margin appears attainable with the loan increases shown in the quarterly comparisons.

**FORWARD LOOKING STATEMENTS**

Statements contained in this portion of the Company's report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as intend, believe, expect, anticipate, should, planned, estimated, and potential. Such forward-looking statements are based on current expectations, but may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the Company and its subsidiaries which include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors

over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.

### ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of the 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.

**Table of Contents****ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)**

Interest rate risk is managed within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.

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

Net Interest Margin (Ratio)	Interest Rate Shock on Net Interest Margin			Interest Rate Shock on Net Interest Income	
	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total (\$000)	% Change to Flat Rate
2.87%	-2.56%	Rising	3.00%	25,808	-0.70%
2.90%	-1.71%	Rising	2.00%	25,766	-0.87%
2.88%	-2.45%	Rising	1.00%	25,425	-2.18%
2.95%	0.00%	Flat	0.00%	25,991	0.00%
2.70%	-8.57%	Falling	-1.00%	23,787	-8.48%
2.55%	-13.48%	Falling	-2.00%	22,519	-13.36%
2.37%	-19.68%	Falling	-3.00%	20,974	-19.30%

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

The shock chart currently shows a tightening in net interest margin over the next twelve months in both a rising and decreasing rate environment. Due to the length of and existence of such a low rate environment, the model does not predict expansion of net income margin at any level. Cost of funds are below 1% so at even the lowest shock of 100 basis points, the Bank cannot take full advantage and reprice funds to match the level of shock. The negative impact in a rising rate environment is partially caused by a timing issue on the ability to reprice assets as immediately as the liabilities. The average duration of the majority of the assets is outside the 12 month shock period. The Bank enhanced its use of the software model during 2012 by including decay rates and key rate ties on certain deposit accounts. Both enhancements were based on historical performance data of the Bank. Both directional changes are within risk exposure guidelines at the 200 basis point level. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

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

**Table of Contents****ITEM 4 CONTROLS AND PROCEDURES**

As of September 30, 2013, 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, 2013. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2013 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, 2012.

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

Treasury stock repurchase for quarter ended September 30, 2013

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 yet to be purchased under the Plans or Programs
7/1/2013 to 7/31/2013				196,500
8/1/2013 to 8/31/2013				196,500
9/1/2013 to 9/30/2013	30,000	21.90	30,000	166,500
Total	30,000	21.90	30,000	166,500

- (1) The Company purchased shares in the market pursuant to a stock repurchase program publicly announced on January 18, 2013. On that date, the Board of Directors authorized the repurchase of 200,000 common shares between January 18, 2013 and December 31, 2013.



ITEM 3    DEFAULTS UPON SENIOR SECURITIES  
None

ITEM 4    MINE SAFETY DISCLOSURES  
Not applicable

ITEM 5    OTHER INFORMATION

47

**Table of Contents**

ITEM 6 EXHIBITS

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

**Table of Contents**

SIGNATURES

**SIGNATURES**

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

Date: October 30, 2013

Farmers & Merchants Bancorp, Inc.,

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

Date: October 30, 2013

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