

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
April 27, 2016  
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**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period March 31, 2016**

**or**

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

**Commission File Number 0-14492**

**FARMERS & MERCHANTS BANCORP, INC.**

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

**OHIO**  
**(State or other jurisdiction of  
incorporation or organization)**

**34-1469491**  
**(IRS Employer  
Identification No.)**

**307 North Defiance Street, Archbold, Ohio**  
**(Address of principal executive offices)**

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

**(419) 446-2501**

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

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

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

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

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

Large accelerated filer  Accelerated filer

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

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

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

Common Stock, No Par Value  
Class

4,605,534  
Outstanding as of April 22, 2016

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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

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## ITEM 1 FINANCIAL STATEMENTS

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

## CONDENSED CONSOLIDATED BALANCE SHEETS

	(in thousands of dollars)	
	March 31, 2016	December 31, 2015
	(Unaudited)	
<b>Assets</b>		
Cash and due from banks	\$ 25,205	\$ 21,333
Federal funds sold	703	685
Total cash and cash equivalents	25,908	22,018
Interest-bearing time deposits	1,960	
Securities - available-for-sale	226,512	235,115
Other securities, at cost	3,717	3,717
Loans, net	701,375	679,821
Premises and equipment	20,872	20,587
Goodwill	4,074	4,074
Mortgage servicing rights	2,108	2,056
Other real estate owned	1,061	1,175
Other assets	21,481	20,505
<b>Total Assets</b>	<b>\$ 1,009,068</b>	<b>\$ 989,068</b>
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest-bearing	\$ 163,769	\$ 171,112
Interest-bearing		
NOW accounts	208,928	190,890
Savings	240,713	225,052
Time	184,722	184,285
Total deposits	798,132	771,339
Federal Funds purchased and securities sold under agreements to repurchase	69,390	78,815
Federal Home Loan Bank (FHLB) advances	10,000	10,000
Dividend payable	1,005	1,007
Accrued expenses and other liabilities	7,858	7,810
Total liabilities	886,385	868,971
<b>Commitments and Contingencies</b>		
<b>Stockholders Equity</b>		

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Common stock - No par value - 6,500,000 shares authorized 5,200,000 shares issued and outstanding	12,181	12,086
Treasury Stock - 594,466 shares 2016, 587,466 shares 2015	(12,583)	(12,389)
Retained earnings	121,664	120,188
Accumulated other comprehensive income	1,421	212
<b>Total stockholders equity</b>	<b>122,683</b>	<b>120,097</b>
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 1,009,068</b>	<b>\$ 989,068</b>

See Notes to Condensed Consolidated Unaudited Financial Statements.

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

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

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

(Unaudited)

## Condensed Consolidated Statements of Income &amp; Comprehensive Income

(in thousands of dollars, except per share data)

	Three Months Ended	
	March 31, 2016	March 31, 2015
<b>Interest Income</b>		
Loans, including fees	\$ 8,006	\$ 7,094
Debt securities:		
U.S. Treasury and government agencies	580	596
Municipalities	369	447
Dividends	38	37
Federal funds sold		2
Other	11	8
<b>Total interest income</b>	<b>9,004</b>	<b>8,184</b>
<b>Interest Expense</b>		
Deposits	854	797
Federal funds purchased and securities sold under agreements to repurchase	105	61
Borrowed funds	37	
<b>Total interest expense</b>	<b>996</b>	<b>858</b>
<b>Net Interest Income - Before Provision for Loan Losses</b>	<b>8,008</b>	<b>7,326</b>
<b>Provision for Loan Losses</b>	<b>277</b>	<b>114</b>
<b>Net Interest Income After Provision For Loan Losses</b>	<b>7,731</b>	<b>7,212</b>
<b>Noninterest Income</b>		
Customer service fees	1,478	1,359
Other service charges and fees	910	914
Net gain on sale of loans	169	175
Net gain on sale of available for sale securities	113	109
<b>Total noninterest income</b>	<b>2,670</b>	<b>2,557</b>
<b>Noninterest Expense</b>		
Salaries and Wages	2,840	2,655
Employee benefits	862	1,064
Net occupancy expense	378	355
Furniture and equipment	412	422

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Data processing	411	329
Franchise taxes	214	187
Net loss on sale of other assets owned	45	6
FDIC Assessment	121	119
Mortgage servicing rights amortization	89	80
Other general and administrative	1,614	1,348
Total other operating expenses	6,986	6,565
<b>Income Before Income Taxes</b>	<b>3,415</b>	<b>3,204</b>
<b>Income Taxes</b>	<b>934</b>	<b>853</b>
<b>Net Income</b>	<b>2,481</b>	<b>2,351</b>
<b>Other Comprehensive Income (Net of Tax):</b>		
Net unrealized gain on available for sale securities	1,945	1,730
Reclassification adjustment for gain on sale of available for sale securities	(113)	(109)
Net unrealized gain on available for sale securities	1,832	1,621
Tax expense	623	551
Other comprehensive income	1,209	1,070
<b>Comprehensive Income</b>	<b>\$ 3,690</b>	<b>\$ 3,421</b>
<b>Earnings Per Share - Basic and Diluted</b>	<b>\$ 0.54</b>	<b>\$ 0.51</b>
<b>Dividends Declared</b>	<b>\$ 0.22</b>	<b>\$ 0.21</b>

See Notes to Condensed Consolidated Unaudited Financial Statements



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

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Condensed Consolidated Statements of Cash Flows (in thousands of dollars) Three Months Ended	
	March 31, 2016	March 31, 2015
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 2,481	\$ 2,351
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	367	390
Accretion and amortization of available for sale securities, net	274	294
Amortization of servicing rights	89	80
Amortization of core deposit intangible	81	81
Compensation expense related to stock awards	104	78
Provision for loan loss	277	114
Gain on sale of loans held for sale	(169)	(175)
Originations of loans held for sale	(12,010)	(9,199)
Proceeds from sale of loans held for sale	12,426	9,658
Loss on sale of other assets	45	6
Gain on sales of securities available for sale	(113)	(109)
Change in other assets and other liabilities, net	(1,545)	(1,701)
Net cash provided by operating activities	2,307	1,868
<b>Cash Flows from Investing Activities</b>		
Activity in securities:		
Maturities, prepayments and calls	4,230	1,790
Sales	17,453	16,301
Purchases	(11,408)	(14,233)
Net change in interest-bearing time deposits	(1,960)	
Proceeds from sales of assets	1	1
Additions to premises and equipment	(653)	(88)
Loan originations and principal collections, net	(22,247)	6,716
Net cash provided by (used in) investing activities	(14,584)	10,487
<b>Cash Flows from Financing Activities</b>		
Net change in deposits	26,793	14,127
Net change in federal funds purchased and securities sold under agreements to repurchase	(9,425)	(4,221)
Purchase of Treasury Stock	(194)	(490)

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Cash dividends paid on common stock	(1,007)	(965)
Net cash provided by financing activities	16,167	8,451
<b>Net Increase in Cash and Cash Equivalents</b>	<b>3,890</b>	<b>20,806</b>
<b>Cash and cash equivalents - Beginning of year</b>	<b>22,018</b>	<b>24,295</b>
<b>Cash and cash equivalents - End of period</b>	<b>\$ 25,908</b>	<b>\$ 45,101</b>
<b>Supplemental Information</b>		
Cash paid during the year for:		
Interest	\$ 958	\$ 852
Income taxes	\$ 746	\$ 520
Noncash investing activities:		
Transfer of loans to other real estate owned	\$	\$ 46

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 three months ended March 31, 2016 are not necessarily indicative of the results that are expected for the year ended December 31, 2016. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2015.

## NOTE 2 ASSET PURCHASES

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

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

The amortization expense for the year ended December 31, 2015 was \$323 thousand. Of the \$322 thousand to be expensed in 2016, \$81 thousand has been expensed for the three months ended March 31, 2016. \$81 thousand was also expensed for the three months ended March 31, 2015.

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

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

## NOTE 3 SECURITIES

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

	(In Thousands) March 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 33,696	\$ 56	\$ (31)	\$ 33,721
U.S. Government agencies	102,437	420	(43)	102,814
Mortgage-backed securities	24,787	372	(12)	25,147
State and local governments	63,439	1,420	(29)	64,830
<b>Total available-for-sale securities</b>	<b>\$ 224,359</b>	<b>\$ 2,268</b>	<b>\$ (115)</b>	<b>\$ 226,512</b>

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

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

1. The fair value of the security has significantly declined from book value.
2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB by Standard and Poors.)

3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.
4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.
5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

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

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

Information pertaining to securities with gross unrealized losses at March 31, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

	(In Thousands)			
	March 31, 2016		Twelve Months & Over	
	Less Than Twelve Months	Fair Value	Gross Unrealized	Fair Value
	Losses	Value	Losses	Value
U.S. Treasury	\$ (31)	\$ 19,510	\$	\$
U.S. Government agencies	(11)	7,984	(32)	4,969
Mortgage-backed securities	(12)	4,953		
State and local governments	(19)	1,034	(10)	1,220
<b>Total available-for-sale securities</b>	<b>\$ (73)</b>	<b>\$ 33,481</b>	<b>\$ (42)</b>	<b>\$ 6,189</b>

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

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

Below are the gross realized gains and losses as of March 31 for each of the years presented.

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	(In Thousands)	
	2016	2015
Gross realized gains	\$ 123	\$ 109
Gross realized losses	(10)	
Net realized gains	\$ 113	\$ 109
Tax expense related to net realized gain	\$ 38	\$ 37

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

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

The amortized cost and fair value of debt securities at March 31, 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(In Thousands)	
	Amortized Cost	Fair Value
One year or less	\$ 7,679	\$ 7,722
After one year through five years	152,418	153,383
After five years through ten years	32,591	33,145
After ten years	6,884	7,115
<b>Total</b>	<b>\$ 199,572</b>	<b>\$ 201,365</b>
Mortgage-backed securities	24,787	25,147
<b>Total</b>	<b>\$ 224,359</b>	<b>\$ 226,512</b>

Investments with a carrying value of \$197.1 million and \$189.3 million at March 31, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and securities sold under repurchase agreements.

Other securities include Federal Home Loan Bank of Cincinnati and Farmer Mac stock as of March 31, 2016 and December 31, 2015.

## NOTE 4 LOANS

The Company had \$1.1 million in loans held for sale at March 31, 2016 as compared to \$1.2 million in loans held for sale at December 31, 2015. Due to materiality, these loans are included in the Consumer Real Estate and Agricultural Real Estate loan numbers.

Loan balances as of March 31, 2016 and December 31, 2015:

Loans:	(In Thousands)	
	March 31, 2016	December 31, 2015
Consumer Real Estate	\$ 88,365	\$ 88,189
Agricultural Real Estate	59,533	58,525
Agricultural	77,909	82,654
Commercial Real Estate	345,223	322,762
Commercial and Industrial	102,892	100,125



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Consumer	27,995	27,770
Industrial Development Bonds	6,420	6,491
	708,337	686,516
Less: Net deferred loan fees and costs	(677)	(638)
	707,660	685,878
Less: Allowance for loan losses	(6,285)	(6,057)
Loans - Net	\$ 701,375	\$ 679,821

**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 March 31, 2016:

	Maturities (In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	\$ 1,033	\$ 12,132	\$ 75,200
Agricultural Real Estate	955	3,569	55,009
Agricultural	48,960	23,832	5,117
Commercial Real Estate	14,434	77,031	253,758
Commercial and Industrial	50,820	31,829	20,243
Consumer	5,186	17,525	5,284
Industrial Development Bonds	1,300	185	4,935

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of March 31, 2016. Variable rate loans whose current rates are equal to their floor or ceiling are classified as fixed in this table.

	(In Thousands)	
	Fixed Rate	Variable Rate
Consumer Real Estate	\$ 55,792	\$ 32,573
Agricultural Real Estate	43,422	16,111
Agricultural	45,761	32,148
Commercial Real Estate	224,647	120,576
Commercial and Industrial	60,300	42,592
Consumer	23,957	4,038
Industrial Development Bonds	6,290	130

As of March 31, 2016 and December 31, 2015 one to four family residential mortgage loans amounting to \$18.8 and \$20.0 million, respectively, have been pledged as security for future loans the Bank has received from the Federal Home Loan Bank.

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

**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 classification of loans as of March 31, 2016 and December 31, 2015, net of deferred loan fees and costs:

	30-59 Days		60-89 Days		Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
	Past Due	Past Due							
March 31, 2016									
Consumer Real Estate	\$ 621	\$ 156	\$ 443	\$ 1,220	\$ 86,877	\$ 88,097	\$ 0		
Agricultural Real Estate		57	162	219	59,260	59,479			
Agricultural		3		3	78,018	78,021			
Commercial Real Estate	148		422	570	344,091	344,661			
Commercial and Industrial			19	19	109,367	109,386			
Consumer	37	10	4	51	27,965	28,016			
<b>Total</b>	<b>\$ 806</b>	<b>\$ 226</b>	<b>\$ 1,050</b>	<b>\$ 2,082</b>	<b>\$ 705,578</b>	<b>\$ 707,660</b>	<b>\$ 0</b>		

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

**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 March 31, 2016 and December 31, 2015:

	(In Thousands)	
	March 31, 2016	December 31, 2015
Consumer Real Estate	\$ 1,196	\$ 1,155
Agricultural Real Estate	162	162
Agricultural		
Commercial Real Estate	422	484
Commercial	200	202
Consumer	23	38
<b>Total</b>	<b>\$ 2,003</b>	<b>\$ 2,041</b>

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

**Commercial Real Estate** Construction, purchase, and refinance of business purpose real estate. Risks discussed during the approval process include construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower's ability to repay in a timely fashion, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer's ability to repay in a changing rate environment.

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

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

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

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

by requiring federal crop insurance.

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

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

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

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

The risk ratings are described as follows.

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

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

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

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

- b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;
  - c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.
5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.
6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential , versus defined , impairments to the primary source of loan repayment and collateral.
7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
- a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
  - b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.

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

- c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
  - d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
  - e. Unusual courses of action are needed to maintain a high probability of repayment.
  - f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.
  - g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.
  - h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.
  - i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.
  - j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.
8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:
- a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.
  - b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.



- c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.
9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

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

	(In Thousands)				
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
March 31, 2016					
1-2	\$ 5,912	\$ 9,251	\$ 536	\$ 509	\$
3	17,289	23,093	27,635	21,747	3,073
4	35,750	45,467	312,972	79,918	3,347
5	110	192	1,284	52	
6	361		1,812	559	
7	57	18	422	181	
8					
Total	\$ 59,479	\$ 78,021	\$ 344,661	\$ 102,966	\$ 6,420
December 31, 2015					
1-2	\$ 5,841	\$ 12,025	\$ 597	\$ 261	\$
3	16,593	21,247	24,264	22,300	3,100
4	35,475	49,220	293,381	76,855	3,391
5	192	250	1,738	57	
6	362		1,828	543	
7		20	422	182	
8					
Total	\$ 58,463	\$ 82,762	\$ 322,230	\$ 100,198	\$ 6,491

**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 March 31, 2016 and December 31, 2015.

Grade	(In Thousands)	
	Consumer Real Estate March 31, 2016	Consumer Real Estate December 31, 2015
Pass	\$ 87,257	\$ 87,292
Special Mention (5)		48
Substandard (6)	330	332
Doubtful (7)	510	275
Total	\$ 88,097	\$ 87,947

	(In Thousands)			
	Consumer Credit		Consumer	Other
	March 31, 2016	December 31, 2015	March 31, 2016	December 31, 2015
Performing	\$ 3,587	\$ 3,901	\$ 24,408	\$ 23,863
Nonperforming			21	23
Total	\$ 3,587	\$ 3,901	\$ 24,429	\$ 23,886

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

	March 31, 2016	December 31, 2015	March 31, 2015
Impaired loans without a valuation allowance	\$ 1,042	\$ 1,257	\$ 624
Impaired loans with a valuation allowance	1,169	879	1,619
Total impaired loans	\$ 2,211	\$ 2,136	\$ 2,243
	\$ 426	\$ 330	\$ 428

Valuation allowance related to  
impaired loans

Total non-accrual loans	\$ 2,003	\$ 2,041	\$ 2,424
Total loans past-due ninety days or more and still accruing	\$	\$	\$
Quarter ended average investment in impaired loans	\$ 2,130	\$ 2,207	\$ 1,958
Year to date average investment in impaired loans	\$ 2,130	\$ 2,509	\$ 1,958

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

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

The Bank had approximately \$1.1 million of its impaired loans classified as troubled debt restructured (TDR) as of March 31, 2016, \$1.1 million as of December 31, 2015 and \$1.3 million as of March 31, 2015. During the first quarter 2016, one new loan was considered TDR. This loan is making interest-only payments.

The following table represents three months ended March 31, 2016.

Three Months	Number of Contracts Modified in the Last 3 Months	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
March 31, 2016			
Troubled Debt Restructurings			
Commercial Real Estate		\$	\$
Commercial and Industrial			
Consumer Real Estate	1	138	138

The following table represents three months ended March 31, 2015.

Three Months	Number of Contracts Modified in the Last 3 Months	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
March 31, 2015			
Troubled Debt Restructurings			
Commercial Real Estate	1	\$ 528	\$ 430
Commercial and Industrial	1	28	24
Consumer Real Estate			

For the three month period ended March 31, 2016 and 2015, there were no TDRs that subsequently defaulted after modification.

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

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

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

The following tables present loans individually evaluated for impairment by class of loans for three months ended March 31, 2016 and March 31, 2015.

	(In Thousands)					
Three Months Ended March 31, 2016	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
<b>With no related allowance recorded:</b>						
Consumer Real Estate	\$ 365	\$ 365	\$	\$ 156	\$ 3	\$ 3
Agricultural Real Estate	162	162		162		
Agricultural						
Commercial Real Estate	515	515		409	8	7
Commercial and Industrial				454	6	
Consumer						
<b>With a specific allowance recorded:</b>						
Consumer Real Estate	509	628	104	307	1	
Agricultural Real Estate	57	57	57	38	1	
Agricultural						
Commercial Real Estate	422	422	152	422		
Commercial and Industrial	181	239	113	182		
Consumer						
<b>Totals:</b>						
Consumer Real Estate	\$ 874	\$ 993	\$ 104	\$ 463	\$ 4	\$ 3
Agricultural Real Estate	\$ 219	\$ 219	\$ 57	\$ 200	\$ 1	\$
Agricultural	\$	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 937	\$ 937	\$ 152	\$ 831	\$ 8	\$ 7
Commercial and Industrial	\$ 181	\$ 239	\$ 113	\$ 636	\$ 6	\$
Consumer	\$	\$	\$	\$	\$	\$

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

Three Months Ended March 31, 2015	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
<b>With no related allowance recorded:</b>						
Consumer Real Estate	\$ 157	\$ 157	\$	\$ 173	\$	\$
Agricultural Real Estate						
Agricultural						
Commercial Real Estate						
Commercial and Industrial	467	467		469	7	
Consumer						
<b>With a specific allowance recorded:</b>						
Consumer Real Estate	96	96	35	96	3	3
Agricultural Real Estate						
Agricultural	24	24	24	24		
Commercial Real Estate	1,139	1,139	131	852		
Commercial and Industrial	360	360	238	337		
Consumer				7		
<b>Totals:</b>						
Consumer Real Estate	\$ 253	\$ 253	\$ 35	\$ 269	\$ 3	\$ 3
Agricultural Real Estate	\$	\$	\$	\$	\$	\$
Agricultural	\$ 24	\$ 24	\$ 24	\$ 24	\$	\$
Commercial Real Estate	\$ 1,139	\$ 1,139	\$ 131	\$ 852	\$	\$
Commercial and Industrial	\$ 827	\$ 827	\$ 238	\$ 806	\$ 7	\$
Consumer	\$	\$	\$	\$ 7	\$	\$

As of March 31, 2016, the Company had \$456 thousand of foreclosed residential real estate property obtained by physical possession and \$568 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions.

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



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	(In Thousands)	
	Three Months Ended March 31, 2016	Twelve Months Ended December 31, 2015
<b>Allowance for Loan &amp; Lease Losses</b>		
Balance at beginning of year	\$ 6,057	\$ 5,905
Provision for loan loss	277	625
Loans charged off	(84)	(1,030)
Recoveries	35	557
Allowance for Loan & Lease Losses	\$ 6,285	\$ 6,057
<b>Allowance for Unfunded Loan Commitments &amp; Letters of Credit</b>		
	\$ 220	\$ 208
Total Allowance for Credit Losses	\$ 6,505	\$ 6,265

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

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

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

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**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 classification and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs.

Additional analysis related to the allowance for credit losses for three months ended March 31, 2016 and March 31, 2015 is as follows:

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Three Months Ended March 31, 2016</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 338	\$ 211	\$ 582	\$ 2,516	\$ 1,229	\$ 337	\$ 208	\$ 844	\$ 6,200
Charge Offs				(3)	(20)	(61)			(90)
Recoveries	2		4	1	3	25			35
Provision (Credit)	117	61	(38)	164	39	34		(100)	207
For Non-interest expense related to ended							12		
Ending Balance	\$ 457	\$ 272	\$ 548	\$ 2,678	\$ 1,251	\$ 335	\$ 220	\$ 744	\$ 6,500
Ending balance: individually evaluated for impairment	\$ 104	\$ 57	\$	\$ 152	\$ 113	\$	\$	\$	\$ 423
Ending balance: collectively evaluated for impairment	\$ 353	\$ 215	\$ 548	\$ 2,526	\$ 1,138	\$ 335	\$ 220	\$ 744	\$ 6,077
Ending balance: loans acquired with deteriorated credit quality	\$ 1								\$
<b>FINANCING RECEIVABLES:</b>									
Ending balance	\$ 88,097	\$ 59,479	\$ 78,021	\$ 344,661	\$ 109,386	\$ 28,016	\$	\$	\$ 707,660
Ending balance: individually evaluated for impairment	\$ 874	\$ 219	\$	\$ 937	\$ 181	\$	\$	\$	\$ 2,211
	\$ 87,223	\$ 59,260	\$ 78,021	\$ 343,724	\$ 109,205	\$ 28,016	\$	\$	\$ 705,449

ing balance: collectively evaluated for  
airment

ing balance: loans acquired with  
riorated credit quality

\$ 502 \$ \$ \$ \$ \$ \$ \$ \$ \$ 5

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

	Consumer Real Estate	Agricultural Real Estate	Agricultural Agricultural	Commercial Real Estate	Commercial and Industrial	Commercial Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Three Months Ended March 31, 2015</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 537	\$ 184	\$ 547	\$ 2,367	\$ 1,421	\$ 323	\$ 207	\$ 526	\$ 6,111
Charge Offs						(92)			(92)
Recoveries	2		1	1	5	41			50
Provision (Credit)	(42)	3	(24)	(156)	(7)	12		328	111
Other Non-interest expense related to unfunded							(5)		(5)
Ending Balance	\$ 497	\$ 187	\$ 524	\$ 2,212	\$ 1,419	\$ 284	\$ 202	\$ 854	\$ 6,177
Ending balance: individually evaluated for impairment	\$ 35		\$ 24	\$ 131	\$ 238				\$ 428
Ending balance: collectively evaluated for impairment	\$ 462	\$ 187	\$ 500	\$ 2,081	\$ 1,181	\$ 284	\$ 202	\$ 854	\$ 5,749
Ending balance: loans acquired with deteriorated credit quality	\$ 1								\$ 1
<b>FINANCING RECEIVABLES:</b>									
Ending balance	\$ 97,019	\$ 51,396	\$ 71,571	\$ 271,201	\$ 99,895	\$ 23,627	\$	\$	\$ 614,709
Ending balance: individually evaluated for impairment	\$ 253		\$ 24	\$ 1,139	\$ 827				\$ 2,243
Ending balance: collectively evaluated for impairment	\$ 96,766	\$ 51,396	\$ 71,547	\$ 270,062	\$ 99,068	\$ 23,627			\$ 612,466
Ending balance: loans acquired with deteriorated credit quality	\$ 520								\$ 520

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

## NOTE 5 EARNINGS PER SHARE

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

	Three Months Ended	
	March 31 2016	March 31 2015
<b>Earnings per share</b>		
Net income	\$ 2,481	\$ 2,351
Less: distributed earnings allocated to participating securities	(8)	(7)
Less: undistributed earnings allocated to participating securities	(13)	(10)
<b>Net earnings available to common shareholders</b>	<b>\$ 2,460</b>	<b>\$ 2,334</b>
Weighted average common shares outstanding including participating securities	4,609,226	4,623,322
Less: average unvested restricted shares	(38,670)	(32,923)
Weighted average common shares outstanding	4,570,556	4,590,399
<b>Basic earnings and diluted per share</b>	<b>\$ 0.54</b>	<b>\$ 0.51</b>

## NOTE 6 FAIR VALUE OF INSTRUMENTS

## FAIR VALUE OF FINANCIAL INSTRUMENTS

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

realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered in any of the estimates.

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

#### Cash and Cash Equivalents

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

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Interest Bearing Time Deposits

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Securities Available-for-sale

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

Other Securities

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

Loans, net

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

Deposits

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

Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

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

Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

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.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	(In Thousands) March 31, 2016				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 25,908	\$ 25,908	\$ 25,908	\$	\$
Interest-bearing time deposits	1,960	1,960		1,960	
Securities - available-for-sale	226,512	226,512	33,721	185,676	7,115
Other Securities	3,717	3,717			3,717
Loans, net	701,375	704,996			704,996
Interest receivable	4,112	4,112			4,112
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 449,641	\$ 449,641	\$	\$	\$ 449,641
Non-interest bearing Deposits	163,769	163,769		163,769	
Time Deposits	184,722	184,843			184,843
<b>Total Deposits</b>	<b>\$ 798,132</b>	<b>\$ 798,253</b>	<b>\$</b>	<b>\$ 163,769</b>	<b>\$ 634,484</b>
<b>Fed Funds purchased and Securities sold under agreement to repurchase</b>					
	\$ 69,390	\$ 69,390	\$	\$	\$ 69,390
Federal Home Loan Bank advances	10,000	9,822			9,822
Interest payable	222	222			222

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

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

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

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

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

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

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

The following summarizes financial assets measured at fair value on a recurring basis as of March 31, 2016 and December 31, 2015, segregated by level or the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured at Fair Value on a Recurring Basis (In Thousands)			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
<u>March 31, 2016</u>			
Assets (Securities Available-for-Sale)			
U.S. Treasury	\$ 33,721	\$	\$
U.S. Government agencies		102,814	
Mortgage-backed securities		25,147	
State and local governments		57,715	7,115
Total Securities Available-for-Sale	\$ 33,721	\$ 185,676	\$ 7,115
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
<u>December 31, 2015</u>			
Assets (Securities Available-for-Sale)			
U.S. Treasury	\$ 38,505	\$	\$
U.S. Government agencies		98,220	
Mortgage-backed securities		26,324	
State and local governments		64,714	7,352
Total Securities Available-for-Sale	\$ 38,505	\$ 189,258	\$ 7,352



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table represents the changes in the Level 3 fair-value category of which unobservable inputs are relied upon as of March 31, 2016 and March 31, 2015.

	(In Thousands)		
	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	State and Local Governments Tax-Exempt	State and Local Governments Taxable	State and Local Governments Total
Balance at January 1, 2016	\$ 5,904	\$ 1,448	\$ 7,352
Change in Market Value		33	33
Payments & Maturities	(270)		(270)
Balance at March 31, 2016	\$ 5,634	\$ 1,481	\$ 7,115

	(In Thousands)		
	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	State and Local Governments Tax-Exempt	State and Local Governments Taxable	State and Local Governments Total
Balance at January 1, 2015	\$ 6,638	\$ 1,293	\$ 7,931
Change in Market Value	(3)	109	106
Payments & Maturities	(200)		(200)
Balance at March 31, 2015	\$ 6,435	\$ 1,402	\$ 7,837

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 March 31, 2016 and December 31, 2015, such assets consist primarily of collateral dependent impaired loans. Collateral dependent impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future

payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

At March 31, 2016 and December 31, 2015, fair value of collateral dependent impaired loans categorized as Level 3 were \$0.7 and \$0.5 million, respectively. The specific allocation for impaired loans was \$426 and \$330 thousand as of March 31, 2016 and December 31, 2015, respectively, which are accounted for in the allowance for loan losses (see Note 4).

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

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

	Fair Value at March 31, 2016	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and local government	\$ 7,115	Discounted cash flow	Credit strength of underlying project or entity / Discount rate	0-5%
Collateral dependent Impaired loans	\$ 743	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%
Other real estate owned commercial	\$	Appraisals	Discount to reflect current market	0-20%
	Fair Value at December 31, 2015	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and local government	\$ 7,352	Discounted cash flow	Credit strength of underlying project or entity / Discount rate	0-5%
Collateral dependent Impaired loans	\$ 549	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%
Other real estate owned commercial	\$ 216	Appraisals	Discount to reflect current market	0-20%



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents impaired loans and other real estate owned as recorded at fair value on March 31, 2016 and December 31, 2015:

(In Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2016			
	Balance at March 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent impaired loans	\$ 743	\$	\$	\$ 743
Total change in fair value				\$ 743

(In Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2015			
	Balance at December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent impaired loans	\$ 549	\$	\$	\$ 549
Other real estate owned commercial	\$ 216	\$	\$	\$ 216
Total change in fair value				\$ 765

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

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

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

The Company had \$9 million and \$22 million in Federal Funds Purchased as of March 31, 2016, and December 31, 2015, respectively. During the same time periods the company also had \$60 million and \$57 million in securities sold under agreement to repurchase.

	March 31, 2016				
	Remaining Contratual Maturity of the Agreements				
	Overnight & Continuous	Up to 30 days	30-90 days	Greater Than 90 days	Total
Federal funds purchased	\$ 9,000	\$	\$	\$	\$ 9,000
Repurchase Agreements					
US Treasury & agency securities	\$ 40,181	\$	\$	\$ 20,209	\$ 60,390
	\$ 49,181	\$	\$	\$ 20,209	\$ 69,390

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

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

**OVERVIEW**

The momentum of 2015 loan growth continued through the first quarter of 2016. Higher loan balances drove the improvement in net interest income along with overall net income. Competition remains challenging, especially for the well performing larger balance customers.

The agricultural market is facing a tougher environment this season with lower commodity prices, higher input prices and currently wet fields. Many are working with decreasing working capital which is both beneficial and slightly worrisome for the Bank. Important to note, the observation is decreasing, not insufficient capital. At this time it is felt, tighter profit margins may impact equipment valuations, purchases and sales. Land prices have decreased slightly with

the greater fluctuations in the lower quality land.

Unemployment rates continue to improve throughout the Company's market area. Manufacturing activity remains similar to last year and car dealerships are reporting strong sales. Low gas prices continue to help the local economies.

Overall, the 1-4 family business has improved with increased activity in the first quarter. New regulatory rules which became effective in 2015 continue to constrain the offering of construction loans. While some community banks are leaving this market, F&M is working to design products that comply with the regulatory requirements and meet our customer's needs. The construction loan products should be ready for bank-wide implementation in the second quarter.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OVERVIEW (Continued)**

Loan growth drove the improvement in net interest income as compared to last year and was the driving factor for the increased loan loss provision. Noninterest income also strengthened and net income after taxes ended the first quarter 2016 5.5% above first quarter 2015. The 7.2% increase in net interest income after provision for loan losses, and a 4.4% increase in noninterest income, partially offset by a 6.4% increase in noninterest expense resulted in a 5.9% increase in earnings per share for the 2016 quarter as compared to 2015's first quarter.

**NATURE OF ACTIVITIES**

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

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

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

The Farmers & Merchants State Bank engages in general commercial banking and savings business including commercial, agricultural and residential mortgage, consumer and credit card lending activities. The largest segment of the lending business relates to commercial, both real estate and non-real estate. The type of commercial business ranges from small business to multi-million dollar companies. The loans are a reflection of business located within the Bank's market area. Because the Bank's offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such items as farm land, farm equipment, livestock and operating loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for the purchase of autos, trucks, recreational vehicles, motorcycles, and other consumer goods.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition, Automated Teller Machines (ATMs) are provided at most branch locations along with other independent locations such as major employers and hospitals in the market area. The Bank has custodial services for Individual Retirement Accounts (IRAs) and Health Savings Accounts (HSAs). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and Automated Clearing House (ACH) file transmittal. In addition, the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Mobile banking was added in 2012 and has been widely accepted and used by consumers. Over the past couple of years, the Bank has updated its consumer offerings with Secure and Pure checking in 2014 and with KASASA Cash Bank in 2015. Upgrades to our digital products and services continue to occur in both retail and business lines.

The Bank has established underwriting policies and procedures which facilitate operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank's practice has been to not promote innovative, unproven credit products which may not be in the best interest of the Bank or its customers. The Bank does offer a hybrid mortgage loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank's adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS NATURE OF ACTIVITIES (Continued)**

Mac and Small Business Lending programs. The Bank also normally retains the servicing rights on these partially or 100% sold loans. In order for the customer to participate in these programs they must meet the requirements established by those agencies. In addition, the Bank does sell some of its longer term fixed rate agricultural mortgages into the secondary market with the aid of a broker.

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

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

**Consumer Loans:**

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

Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage periods for wage or death.

Boats, campers, motorcycles, RV's and Motor Coaches range from 80%-90% based on age of vehicle.

1st or 2nd mortgages on 1-4 family homes range from 75%-90% with in-house first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV

The Bank will only make Qualified Mortgages as defined by the Truth in Lending Act and Regulation Z.

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

**Commercial/Agriculture/Real Estate:**

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



Accounts Receivable: Up to 80% LTV.

Inventory:

Agriculture:

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

Commercial:

Maximum LTV of 50% on raw and finished goods.

Floor plan.

New/used vehicles to 100% of wholesale.

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

Equipment:

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

Restaurant equipment up to 35% of market value.

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

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

In December of 2014, the Company became a financial holding company within the meaning of the Bank Holding Company Act of 1956 as amended (the Act), in order to provide the flexibility to take advantage of the expanded powers available to a financial holding company under the Act. Our subsidiary bank is in turn regulated and examined by the Ohio Division of Financial Institutions and the Federal Deposit Insurance Corporation. The activities of our bank subsidiary are also subject to other federal and state laws and regulations. The Company also formed a captive insurance company (the captive) in December 2014 which is located in Nevada and regulated by the State of Nevada Division of Insurance. To enable the formation of the captive, the Company's status was changed to a financial holding company from a bank holding company.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS NATURE OF ACTIVITIES (Continued)**

The Bank's primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Lucas, Williams, Wood and in the Indiana counties of DeKalb and Steuben. In the first half of 2016 the Bank will add the Indiana county of Allen to its service area with the opening of its newly constructed office in Fort Wayne. The commercial banking business in this market is highly competitive, with approximately 17 other depository institutions currently doing business in the Bank's primary market. In our banking activities, we compete directly with other commercial banks, credit unions, farm credit services, and savings and loan institutions in each of our operating localities. In a number of our locations, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of the services provided.

At March 31, 2016, we had 264 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be good.

**REGULATORY DEVELOPMENTS**

The Bank has been attentive to the significant final mortgage rules, revisions to the rules, and additional guidance issued by the Consumer Financial Protection Bureau to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions. Effective in January 2014, these rules have altered the landscape for the entire mortgage lending industry. The Bank continues to test, train, validate results, and review the applicable requirements of these new mortgage rules to enhance knowledge and understanding. The TILA-RESPA Integrated Disclosure (TRID) rules which were originally to be effective on August 1, 2015 were subsequently postponed until October 3, 2015. Bank staff worked closely with the Mortgage Loan Origination software vendor and diligently strived to achieve TRID compliance as of the October 2015 effective date. The vendor has been attentive to the key regulatory requirements and receptive to its individual clients' needs. Further changes and enhancements to the loan origination software have served to better accommodate documentation needs and compliance strategies. Bank staff has continued outreach efforts with real estate agents, attorneys, and closing agents to further cultivate collaboration and attain TRID compliance, and thus minimize the impact of these regulatory changes on home loan borrowers. Due to the complexities of the new TRID rules, the lack of clarity or guidance involving various provisions, and the lingering uncertainties regarding liability, remaining attentive to industry questions and concerns to ensure full compliance remains an ongoing priority. The Bank has committed to make good faith efforts in compliance with the technical requirements of the TRID rules.

The Company has implemented Basel III capital rules which began to be phased in for the Company on January 1, 2015. These rules may impact the ability of some financial institutions to pay dividends, though the Company believes itself to be able to maintain its strong capital position and not be limited in that regard.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

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

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

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

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

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

Foreclosed real estate for sale is carried at the lower of fair value minus estimated costs to sell, or cost. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and a write-down is recorded by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell. Foreclosed real estate is classified as OREO. The net income from operations of foreclosed real estate held for sale is reported in non-interest income or non-interest expense determined by whether in a gain or loss position overall. At March 31, 2016, holdings were \$1.1 million and were \$1.2 million as of December 31, 2015 and \$1.1 million as of March 31, 2015.

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

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

Inherent in most estimates is imprecision. The Bank's ALLL provides a margin for imprecision with an unallocated portion. Bank regulatory agencies and external auditors periodically review the Bank's methodology and adequacy of the ALLL. Any required changes in the ALLL or loan charge-offs by these agencies or auditors may have a material effect on the ALLL.

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

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

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

servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights. The amortization thereof is recorded in non-interest expense. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the 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

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

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**

The Company ended March 31, 2016 with its total asset balance over a billion dollars. It represents a new record high in the Company's 119 year history. The Company plans to continue in its growth mode with the addition of the Bank's 23<sup>rd</sup> office which opened April 7, 2016 in Indiana, making it the fourth office in the state.

Liquidity in terms of cash and cash equivalents ended almost \$4.9 million higher as of March 31, 2016 than it was at yearend December 31, 2015. Decreased securities along with increased deposits funded the \$21.6 million increase in net loans for the quarter. Loan growth occurred in commercial real estate, commercial and industrial, agricultural real estate and agricultural and consumer portfolios. These were slightly offset by the decrease in consumer real estate.

In comparing to the same period, prior year, the March 31, 2016 record loan balances of \$707.6 million increased 15.1% compared to \$614.7 million. The year over year improvement was made up of a 27.1% increase in commercial real estate loans, a 15.7% increase in agricultural real estate loans, a 9.0% increase in non-real estate agricultural loans and an 8.2% increase in commercial and industrial loans. The only portfolio which experienced a reduction was consumer real estate by 9.0%. The Company credits the growth to a strong team of lenders focused on providing customers valuable localized services and thereby increasing our market share.

The chart below shows the breakdown of the loan portfolio by category as of March 31 for the last three years, net of deferred fees and costs.

	March-16 Amount	March-15 Amount	March-14 Amount
Consumer Real Estate	\$ 88,097	\$ 97,019	\$ 91,368
Agricultural Real Estate	59,479	51,396	49,629

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Agricultural	78,021	71,571	64,859
Commercial Real Estate	344,661	271,201	261,634
Commercial and Industrial	102,966	95,222	90,024
Consumer	28,016	23,627	21,024
Industrial Development Bonds	6,420	4,673	4,334
Total Loans, net	\$ 707,660	\$ 614,709	\$ 582,872

As mentioned previously, the security portfolio was utilized to fund loan growth in both 2015 and the first quarter 2016. The security portfolio decreased \$8.6 million in the first quarter 2016 from yearend 2015 and is lower by \$19.6 million from March 31, 2015. The current portfolio is in a net unrealized gain position of \$2.2 million. With the exception of stock, which is shown as other securities, all of the Company's security portfolio is categorized as available for sale and as such is recorded at fair value.

**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)**

Management feels confident that liquidity needs for future growth can be met through additional run-off and/or sales from the security portfolio, increased deposits and additional borrowings. For short term needs, the Bank has \$104.2 million of unsecured borrowing capacity through its correspondent banks.

Overall assets grew 2.0% since yearend 2015 and 6.1% since March 31, 2015. The largest growth was in the targeted loan portfolios.

Deposits accounted for the largest growth within liabilities, up 3.5% or \$26.8 million since yearend and 2.8% or \$21.4 million over March 31, 2015 balances. Core deposits continue to drive the increase which provide the greatest benefit for both lower cost of funds and the opportunity to generate additional noninterest income. When comparing to a year ago, other borrowed money increased \$10 million as the borrowings took place during the fourth quarter of 2015.

Federal Funds purchased and securities sold under agreement to repurchase increased \$17.6 million when comparing March 31, 2016 balances to March 31, 2015. This category decreased by \$9.4 million when comparing March 31, 2016 to December 31, 2015. Borrowings from FHLB aided in the quarter decrease as these replaced \$10 million of Fed Funds purchased.

Capital increased \$2.6 million during the first quarter of 2016, as earnings exceeded dividend declarations. Accumulated other comprehensive income increased in gain position \$1.2 million which encompassed the shift of \$113 thousand from unrealized gain to realized gain with the sale of securities since yearend 2015. Dividends paid year-to-date differed by \$42 thousand from the same period last year.

The beginning of the Basel III capital rule applies in 2016. The Bank and Company include a capital conservation buffer as a part of the transition provision. For calendar year 2016, the applicable required capital conservation buffer percentage of 0.625% is the base above which institutions avoid limitations on distributions and certain discretionary bonus payments. The total buffer requirement will increase to 2.5% for calendar year 2019. As of March 31, 2016, the Company and the Bank are both positioned well above the 2019 requirement.

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

Tier I Leverage Ratio	11.72%
Risk Based Capital Tier I	13.89%
Total Risk Based Capital	14.66%
Stockholders' Equity/Total Assets	12.48%
Capital Conservation Buffer	6.66%

**MATERIAL CHANGES IN RESULTS OF OPERATIONS****Comparison of Results of Operation for three month periods ended March 31, 2016 and 2015, and December 31, 2015.**



## Interest Income

Higher loan balances created the improvement in the interest income for the first quarter 2016 as compared to first quarter 2015. Interest income rose 10% or \$820 thousand while loans accounted for a \$912 thousand increase. Offsetting the improvement from loans was a decrease in securities income of \$92 thousand. The change in the balance sheet mix along with the loan growth caused the asset yield to improve by 12 basis points to 3.97% for the first quarter 2016 compared to first quarter 2015 s 3.85%.

In terms of dollars, \$271 thousand additional interest income was earned in first quarter 2016 than in fourth quarter 2015. As a percentage, the 3.1% increase for first quarter is also attributed to higher loan balances during the quarter. 2016 is off to a strong start in interest income generation.

**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 average interest earning asset base was \$47.5 million higher in first quarter 2016 than for first quarter 2015 or up 5.4%.

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

Interest Earning Assets:	(In Thousands)		Yield/Rate	
	Quarter to Date Ended March 31, 2016 Average Balance	Interest/Dividend March 31, 2016	March 31, 2016	March 31, 2015
Loans	\$ 692,638	\$ 8,006	4.63%	4.64%
Taxable Investment Securities	167,815	670	1.60%	1.58%
Tax-exempt Investment Securities	55,940	317	3.43%	3.73%
Fed Funds Sold & Interest Bearing Deposits	8,857	11	0.50%	0.21%
<b>Total Interest Earning Assets</b>	<b>\$ 925,250</b>	<b>\$ 9,004</b>	<b>3.97%</b>	<b>3.85%</b>

**Change in Quarter to Date March 31, 2016 Interest Income Compared to March 31, 2015 (In Thousands)**

Interest Earning Assets:	Change	Due to	
		Volume	Due to Rate
Loans	\$ 912	\$ 947	\$ (35)
Taxable Investment Securities	(16)	(22)	6
Tax-exempt Investment Securities	(76)	(67)	(9)
Fed Funds Sold & Interest Bearing Deposits		(19)	19
<b>Total Interest Earning Assets</b>	<b>\$ 820</b>	<b>\$ 839</b>	<b>\$ (19)</b>

**Interest Expense**

Interest expense for the quarter was also higher for first quarter 2016 compared to the fourth quarter 2015 and first quarter 2015. At \$996 thousand, first quarter 2016 was up \$73 thousand as compared to fourth quarter 2015 and \$138 thousand as compared to same time period 2015.

The average balance of interest-bearing liabilities was higher by \$34.3 million in 2016 than first quarter 2015. \$10 million of the increase is attributed to the FHLB borrowings. The higher balance coupled with the slight variation of the balance sheet mix, resulted in a 5 basis points increase in the cost of funds at 0.58% for first quarter 2016 as compared to 2015's 0.53%.

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



**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)		Yield/Rate	
	Quarter to Date Ended March 31, 2016		March 31, 2016	March 31, 2015
Interest Bearing Liabilities:	Average Balance	Interest/Dividend		
Savings Deposits	\$ 427,173	\$ 410	0.38%	0.37%
Other Time Deposits	183,864	444	0.97%	0.88%
Other Borrowed Money	10,000	37	1.48%	0.00%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	66,708	105	0.63%	0.45%
<b>Total Interest Bearing Liabilities</b>	<b>\$ 687,745</b>	<b>\$ 996</b>	<b>0.58%</b>	<b>0.53%</b>

**Change in Quarter to Date March 31, 2016 Interest Expense Compared to March 31, 2015 (In Thousands)**

Interest Bearing Liabilities:	Change	Due to Volume	Due to Rate
Savings Deposits	\$ 37	\$ 20	\$ 17
Other Time Deposits	20	(21)	41
Other Borrowed Money	37	37	
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	44	20	24
<b>Total Interest Bearing Liabilities</b>	<b>\$ 138</b>	<b>\$ 56</b>	<b>\$ 82</b>

## Net Interest Income

Overall, net interest spread and net interest margin figures for the first quarter 2016 have improved over the last two years. As the chart below illustrates, both higher yields on interest and dividend income, even offset by higher interest expense resulted with total net interest margin up 9 basis points since the first quarter of 2015 and over first quarter 2014 by 20 basis points.

	3/31/2016	3/31/2015	3/31/2014
Interest/Dividend income/yield	3.97%	3.85%	3.76%
Interest Expense / yield	0.58%	0.53%	0.52%
<b>Net Interest Spread</b>	<b>3.39%</b>	<b>3.32%</b>	<b>3.24%</b>
Net Interest Margin	3.54%	3.45%	3.34%

Net interest income was up \$682 thousand in the first quarter 2016 over the same time frame in 2015 due to the increase in loan income even with higher interest expense, as previously mentioned. There has been a \$198 thousand increase in net interest income over fourth quarter 2015. New loans added in 2015 and 2016 will continue to generate more income; the benefits of the Company's strategy of repositioning the balance sheet will continue to grow.

The discussion will now be separated into two distinct quarter discussions first quarter comparisons and the two most recent quarter comparisons.

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

**Comparison of Noninterest Results of Operation First Quarter 2016 to First Quarter 2015**

Provision Expense

Provision for loan losses was almost 2.5 times higher for first quarter 2016 as the Bank sought to provide coverage for the much higher total loan balances as compared to first quarter 2015. The provision of \$277 thousand was partially due to net-charge offs of \$49 thousand during the quarter. First quarter 2015 had net charge-offs of \$42 thousand and \$114 thousand of provision expense. Strong asset quality for both periods is reflected in the low past dues (30 days+ past due/total loans) percentages of 0.29% for March 31, 2016 and 0.43% for March 31, 2015.

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

Loans classified as nonaccrual were lower as of March 31, 2016 at \$2.0 million compared to \$2.4 million as of March 31, 2015. One new loan was categorized as TDR during the first quarter 2016.

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

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

The ALLL has a direct impact on the provision expense. The increase in the ALLL is funded through recoveries and provision expense. The following tables both deal with the allowance for credit losses. The first table breaks down the activity within ALLL for each loan portfolio class and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table discloses how much of the ALLL is attributed to each class of the loan portfolio, as well as the percent that each particular class of the loan portfolio represents to the entire loan portfolio in the aggregate. The consumer loan portfolio and industrial loans

accounted for the largest component of charge-offs and recoveries through first three months of 2016. As was mentioned in previous discussion, the commercial real estate portfolio is currently having a major impact on the ALLL due to the loan growth.

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

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

	(In Thousands)		
	Three Months Ended March-16	Three Months Ended March-15	Three Months Ended March-14
Loans	\$ 707,660	\$ 614,709	\$ 582,872
Daily average of outstanding loans	\$ 692,638	\$ 610,798	\$ 569,081
Allowance for Loan & Lease Losses January 1	\$ 6,057	\$ 5,905	\$ 5,194
Loans Charged off:			
Consumer Real Estate			64
Agricultural Real Estate			
Agricultural			
Commercial Real Estate	3		201
Commercial and Industrial	20		
Consumer	61	92	101
	84	92	366
Loan Recoveries			
Consumer Real Estate	2	2	10
Agricultural Real Estate			
Agricultural	4	1	1
Commercial Real Estate	1	1	2
Commercial and Industrial	3	5	5
Consumer	25	41	51
	35	50	69
Net Charge Offs	49	42	297
Provision for loan loss	277	114	428
Allowance for Loan & Lease Losses March 31	\$ 6,285	\$ 5,977	\$ 5,325
Allowance for Unfunded Loan Commitments & Letters of Credit March 31	220	202	180
Total Allowance for Credit Losses March 31	\$ 6,505	\$ 6,179	\$ 5,505
Ratio of net charge-offs to average Loans outstanding	0.01%	0.01%	0.05%



Ratio of Allowance for Loan Loss to Nonperforming Loans	310.50%	246.56%	203.68%
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**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

The following table presents the balances for allowance of loan losses by loan type for three months ended March 31, 2016 and March 31, 2015.

	(In Thousands) March-2016		(In Thousands) March-2015	
	Amount	% of Loan Category	Amount	% of Loan Category
<b>Balance at End of Period Applicable To:</b>				
Consumer Real Estate	\$ 457	12.45	\$ 497	15.80
Agricultural Real Estate	272	8.41	187	8.36
Agricultural	548	11.03	524	11.64
Commercial Real Estate	2,678	48.69	2,212	44.13
Commercial and Industrial	1,251	15.46	1,419	16.25
Consumer	335	3.96	284	3.84
Unallocated	744	0.00	854	0.00
<b>Allowance for Loan &amp; Lease Losses</b>	<b>6,285</b>		<b>5,977</b>	
<b>Off Balance Sheet Commitments</b>	<b>220</b>		<b>202</b>	
<b>Total Allowance for Credit Losses</b>	<b>\$ 6,505</b>		<b>\$ 6,179</b>	

**Noninterest Income**

Noninterest income was up \$113 thousand in the first quarter 2016 over the same time frame in 2015. The bulk of this increase came from an increase in customer service fees. Customer service fees were positively impacted by the structural changes made to the Bank's bill pay program and checking accounts. All other categories of noninterest income showed only slight variations when comparing the two quarters.

\$17.5 million in sales of investment securities were conducted so far in 2016 to capture the benefit of movement in market interest rates. The sales resulted in a gain of \$113 thousand. The same time period 2015 had similar sales of \$16.3 million resulting in gains of \$109 thousand. The difference between 2016 and 2015 sales was the utilization of the funds. 2016 went to fund loan growth while only a portion did in 2015 with the balances held in cash and reinvested in securities beginning in the second quarter.

The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights. The capitalization runs through non-interest income while the amortization thereof is included in non-interest expense. For first quarter 2016, mortgage servicing rights caused a net \$52 thousand more in income. This is a reversal of 2015's first quarter net expense cost of \$7 thousand. The higher capitalized additions for 2016 are attributed to a higher loan origination level of 1-4 families in 2016 as compared to

2015. The carrying value is well below the market value of \$3.0 million which indicates any large expense to fund the valuation allowance to be unlikely in 2016.

	(In Thousands)	
	2016	2015
Beginning Balance, January 1	\$ 2,056	\$ 2,023
Capitalized Additions	141	73
Amortization	(89)	(80)
Ending Balance, March 31	2,108	2,016
Valuation Allowance		
Mortgage Servicing Rights, net March 31	\$ 2,108	\$ 2,016

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

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

**Noninterest Expense**

For the first quarter 2016, noninterest expenses were \$421 thousand higher than in 2015. An increase of \$185 thousand in salaries and wages was overshadowed by a decrease of \$202 thousand in employee benefits. The decrease in employee benefits was derived from lower costs related to medical claims for the quarter and lower pension costs due to an adjustment in first quarter 2015 for the accrual.

Data processing fees were \$82 thousand higher than last year due to the increased number of customers, accounts and updated services.

The largest increase for the 2016 first quarter was in other general and administrative. This line item on the income statement was up by \$266 thousand over 2015. Audit and exam fees were higher by \$140 thousand so far in 2016 than for 2015. This related to an accrual adjustment in 2015 which lowered the expense for that time period. Marketing expenses were up \$52 thousand as advertising for the new office and KASASA Cash Back went full swing in the first quarter 2016.

**Net Income**

Overall, net income in the first quarter of 2016 was up \$130 thousand as compared to the same quarter last year. The Company has done an exceptional job of growing loans while keeping past dues low. The Company remains strong, stable, and well capitalized and has the capacity to continue to cover the increased costs of doing business in a tough economy while seeking good loans to improve profitability. The opening of the new office may create a slight drag in the short run; however, the Company remains focused on the long term.

The Company continues to look for new opportunities to generate and protect revenue and provide additional channels through which to serve our customers and maintain our high level of customer satisfaction.

**Comparison of Noninterest Results of Operations First Quarter 2016 to Fourth Quarter 2015**

**Provision Expense**

In comparing the provision expense of first quarter 2016 to fourth quarter 2015, an increase of \$191.1 thousand was realized. The increased provision was for the continued loan growth experienced throughout the first quarter. The ratio of loans past due 30 and more days to total loans stood at 0.32% as of December 31, 2015 and 0.29% as of March 31, 2016. The average percentage for all of 2015 was 0.44%. The Bank continues to keep a tight watch and works to maintain its strong asset quality position. Increases to the ACL were for loan growth as net charge-offs remain at low levels also. Nonaccruals decreased slightly from yearend 2015, lower by \$38 thousand at first quarter end 2016.

**Noninterest Income**

Noninterest income for the first quarter 2016 shows under the fourth quarter by \$35 thousand. A decrease in other customer service fees accounted for \$198 thousand. First quarter 2016, however, had increases of over \$80 thousand in both other service charges and net gain on sale of securities line items.

#### Noninterest Expense

Noninterest expense was higher by \$377 thousand in comparison in the first quarter 2016. Medical claims were higher in the fourth quarter 2015 which is typical of yearend when deductibles have been met for the year so more elective procedures are performed. A decrease in the number of full time equivalent employees from 265 as of December 31, 2015, to 264 as of March 31, 2016 is representative of turnover and the number may increase as positions are filled with the addition of another office. Loan production offset the increase in base salaries with the establishment of deferred costs as related to personnel expense. Behind the increased cost of first quarter is the other general and administrative mentioned in the earlier first quarter comparisons discussion, mainly accounting and data processing, up \$42.4 and \$78.1 thousand respectively. ATM expense was also higher in the first quarter by \$62.1 thousand as the cost of card replacement is higher coupled with the fact the reissue time frame has been accelerated due to chip acceptance.

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

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

**Net Income**

Overall in comparing fourth quarter 2015 to first quarter 2016, the fourth quarter generated \$292 thousand more in net income. The higher interest income of 2016 was outweighed by the higher loan provision and noninterest expense. The Company recognizes the additional cost of its expansion strategy and is pleased with the strong loan growth seen so far in 2016.

A revitalized service and product was introduced in the fourth quarter of 2015. Overdraft privilege was renamed Courtesy Pay and utilizes new dynamic limits based on customer behavior in their checking account, and KASASA Cash Back was added to the KASASA product offerings. Courtesy pay has generated an additional \$24.1 thousand in net revenue and KASASA Cash Back has added 463 accounts with 85% of those being new relationships as of the first quarter end. The Company is focused on continuing to strengthen our core earnings through loan growth and improvement to the net interest margin.

**FORWARD LOOKING STATEMENTS**

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

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

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

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

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

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

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

Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total (\$000)	% Change to Flat Rate
3.07%	-7.92%	Rising	3.00%	30,090	-4.81%
3.15%	-5.47%	Rising	2.00%	30,506	-2.86%
3.25%	-2.51%	Rising	1.00%	31,059	-1.10%
3.33%	0.00%	Flat	0.00%	31,403	0.00%
3.33%	-0.05%	Falling	-1.00%	31,424	0.07%
3.07%	-7.81%	Falling	-2.00%	29,649	-5.58%
2.82%	-15.40%	Falling	-3.00%	27,907	-11.13%

The net interest margin represents the forecasted twelve month margin. The Company also reviews shocks with a 4.0% fluctuation with a delayed time frame of 10 months and over a 24 month time frame. It also shows what effect rate changes will have on both the margin and net interest income. The goal of the Company is to lengthen some of the liabilities or sources of funds to decrease the exposure to a rising rate environment. The Bank has offered higher rates on certificates of deposits for longer periods since 2011. Of course, customer desires also drive the ability to capture longer term deposits. Currently, the majority of customers look for terms twelve months and under while the Bank would prefer 24 months and longer. Some movement into the longer term time deposits has occurred. What the Bank has experienced is a decrease in the time balances of our deposit portfolio, therefore a loss of term funding

The shock chart currently shows a slight tightening in net interest margin over the next twelve months in an increasing rate environment with an even lower tightening in a falling rate environment. Due to the length and existence of such a low rate environment, the model does not predict expansion of net interest income in any falling category except the first one. Cost of funds are below 0.50% so at even the lowest shock of 100 basis points, the Bank cannot take full advantage and reprice funds to match the level of shock. Since the average duration of the majority of the assets is outside the 12 month shock period, the rising rate environment does not show improvement. The majority of the newer loans added to the commercial real estate portfolio begin with an initial fixed rate period of three to five years whose variable adjustment is outside of the current shock time frame. The Bank enhanced its use of the software model during 2012 by including decay rates and key rate ties on certain deposit accounts and continues to review and modify those rates as updated data is compiled. Both enhancements were based on historical performance data of the Bank. Both directional changes are within risk exposure guidelines at the 200 basis point level. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

Overall, what the chart shows is that the Company must concentrate on increasing loan spreads on variable loans and extend the duration on cost of funds where possible. Changes in portfolio and/or balance sheet composition are needed for the margin to improve regardless of any rate shock.

**ITEM 4 CONTROLS AND PROCEDURES**



As of March 31, 2016, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2016. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2016 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

## PART II OTHER INFORMATION

### ITEM 1 LEGAL PROCEEDINGS

None

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## ITEM 4 CONTROLS AND PROCEDURES (continued)

## ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2015.

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

Treasury stock repurchased the quarter ended March 31, 2016 <sup>(1)</sup>.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	(d) Maximum Number of Shares that may yet be purchased under the Plans or Programs
1/1/2016 to 1/31/2016				200,000
2/1/2016 to 2/29/2016	7,000	27.75	7,000	193,000
3/1/2016 to 3/31/2016				193,000
<b>Total</b>	<b>7,000</b>	<b>27.75</b>	<b>7,000</b>	<b>193,000</b>

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

## ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

## ITEM 4 MINE SAFETY DISCLOSURES

Not applicable

## ITEM 5 OTHER INFORMATION

## ITEM 6 EXHIBITS



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

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**SIGNATURES**

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

Farmers & Merchants Bancorp, Inc.,

Date: April 27, 2016

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

Date: April 27, 2016

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