FARMERS & MERCHANTS BANCORP
Form 10-Q
May 09, 2013

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2013

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from ________ to ________

Commission File Number: 000-26099

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

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

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

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

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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 definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer o	Accelerated filer x	Non-accelerated filer o	Smaller Reporting Company o

(Do not check if a smaller reporting company)

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

Number of shares of common stock of the registrant: Par value $0.01, authorized 7,500,000 shares; issued and outstanding 777,882 as of April 30, 2013.

FARMERS & MERCHANTS BANCORP

FORM 10-Q
TABLE OF CONTENTS

PART I. - FINANCIAL INFORMATION		Page
Item 1 -	Financial Statements	
	Consolidated Balance Sheets (Unaudited) as of March 31, 2013, December 31, 2012 and March 31, 2012.	3
	Consolidated Statements of Income (Unaudited) for the Three Months Ended March 31, 2013 and 2012.	4
	Consolidated Statements of Comprehensive Income (Unaudited) for the Three Months Ended March 31, 2013 and 2012.	5
	Consolidated Statements of Changes in Shareholders' Equity (Unaudited) for the Three Months Ended March 31, 2013 and 2012.	6
	Consolidated Statements of Cash Flows (Unaudited) for the Three Months Ended March 31, 2013 and 2012.	7
	Notes to the Consolidated Financial Statements (Unaudited)	8
Item 2 -	Management's Discussion and Analysis of Financial Condition and Results of Operations	33
Item 3 -	Quantitative and Qualitative Disclosures About Market Risk	52
Item 4 -	Controls and Procedures	55
PART II. - OTHER INFORMATION		
Item 1 -	Legal Proceedings	55
Item 1A –	Risk Factors	56
Item 2 -	Unregistered Sales of Equity Securities and Use of Proceeds	56
Item 3 -	Defaults Upon Senior Securities	56
Item 4 –	Mine Safety Disclosures	56
Item 5 -	Other Information	56

Item 6 -	Exhibits	56
Signatures		57
Index to Exhibits		57

31(a) Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31(b) Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARMERS & MERCHANTS BANCORP
Consolidated Balance Sheets

(in thousands)

Assets	March 31, 2013 (Unaudited)	December 31, 2012	March 31, 2012 (Unaudited)
Cash and Cash Equivalents:			
Cash and Due from Banks	$30,753	$47,366	$33,489
Interest Bearing Deposits with Banks	12,780	82,060	52,216
Total Cash and Cash Equivalents	43,533	129,426	85,705
Investment Securities:			
Available-for-Sale	515,573	417,991	531,817
Held-to-Maturity	67,708	68,392	66,416
Total Investment Securities	583,281	486,383	598,233
Loans	1,226,695	1,246,902	1,158,283
Less: Allowance for Credit Losses	34,255	34,217	32,942
Loans, Net	1,192,440	1,212,685	1,125,341
Premises and Equipment, Net	22,551	22,901	23,751
Bank Owned Life Insurance	50,711	50,253	47,874
Interest Receivable and Other Assets	79,045	73,038	64,813
Total Assets	$1,971,561	$1,974,686	$1,945,717
Liabilities			
Deposits:			
Demand	$417,341	$462,251	$371,760
Interest Bearing Transaction	257,171	259,141	230,323
Savings and Money Market	590,323	541,526	528,527
Time	450,331	459,108	513,432
Total Deposits	1,715,166	1,722,026	1,644,042
Securities Sold Under Agreements to Repurchase	-	-	60,000
Federal Home Loan Bank Advances	-	-	514
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	36,280	37,317	34,693
Total Liabilities	1,761,756	1,769,653	1,749,559
Shareholders' Equity			
Preferred Stock	-	-	-
Common Stock	8	8	8
Additional Paid-In Capital	75,014	75,014	75,410

Retained Earnings	129,263	123,012	115,271
Accumulated Other Comprehensive Income	5,520	6,999	5,469
Total Shareholders' Equity	209,805	205,033	196,158
Total Liabilities and Shareholders' Equity	$1,971,561	$1,974,686	$1,945,717

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

Table of Contents

FARMERS & MERCHANTS BANCORP
Consolidated Statements of Income (Unaudited)

(in thousands except per share data)	Three Months Ended March 31, 2013	2012
Interest Income		
Interest and Fees on Loans	$15,445	$16,475
Interest on Deposits with Banks	44	53
Interest on Investment Securities:		
Taxable	2,106	2,808
Exempt from Federal Tax	660	630
Total Interest Income	18,255	19,966
Interest Expense		
Deposits	683	1,057
Borrowed Funds	-	543
Subordinated Debentures	81	88
Total Interest Expense	764	1,688
Net Interest Income	17,491	18,278
Provision for Credit Losses	-	220
Net Interest Income After Provision for Credit Losses	17,491	18,058
Non-Interest Income		
Service Charges on Deposit Accounts	1,104	1,213
Net Gain on Sale of Investment Securities	735	-
Increase in Cash Surrender Value of Life Insurance	457	456
Debit Card and ATM Fees	727	723
Net Gain on Deferred Compensation Investments	1,690	931
Other	784	600
Total Non-Interest Income	5,497	3,923
Non-Interest Expense		
Salaries and Employee Benefits	8,045	7,921
Net Gain on Deferred Compensation Investments	1,690	931
Occupancy	621	641
Equipment	695	718
Legal Fees	197	395
FDIC Insurance	240	242
Other	1,471	1,274
Total Non-Interest Expense	12,959	12,122
Income Before Income Taxes	10,029	9,859
Provision for Income Taxes	3,778	3,669
Net Income	$6,251	$6,190
Basic Earnings Per Common Share	$8.04	$7.94

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

4

Table of Contents

FARMERS & MERCHANTS BANCORP
Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)	Three Months Ended March 31, 2013	2012
Net Income	$6,251	$6,190
Other Comprehensive Income		
(Decrease) Increase in Net Unrealized Gains on Available-for-Sale Securities	(1,817)	1,383
Reclassification Adjustment for Realized Gains on Available-for-Sale Securities Included in Net Income	(735)	-
Deferred Tax Benefit (Expense)	1,073	(581)
Change in Net Unrealized Gains on Available-for-Sale Securities, Net of Tax	(1,479)	802
Total Other Comprehensive Income	(1,479)	802
Comprehensive Income	$4,772	$6,992

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

Table of Contents

FARMERS & MERCHANTS BANCORP
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands except share data)	Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, net	Total Shareholders' Equity
Balance, January 1, 2012	779,424	$8	$75,590	$109,081	$ 4,667	$ 189,346
Net Income		-	-	6,190	-	6,190
Repurchase of Common Stock	(485)	-	(180)	-	-	(180)
Change in Net Unrealized Gains on Securities Available-for-Sale		-	-	-	802	802
Balance, March 31, 2012	778,939	$8	$75,410	$115,271	$ 5,469	$ 196,158
Balance, January 1, 2013	777,882	$8	$75,014	$123,012	$ 6,999	$ 205,033
Net Income		-	-	6,251	-	6,251
Repurchase of Common Stock	-	-	-	-	-	-
Change in Net Unrealized Gains on Securities Available-for-Sale		-	-	-	(1,479)	(1,479)
Balance, March 31, 2013	777,882	$8	$75,014	$129,263	$ 5,520	$ 209,805

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

Table of Contents

FARMERS & MERCHANTS BANCORP
Consolidated Statements of Cash Flows (Unaudited)

(in thousands)	Three Months Ended March 31, 2013	March 31, 2012
Operating Activities:		
Net Income	$6,251	$6,190
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Credit Losses	-	220
Depreciation and Amortization	395	441
Net Amortization of Investment Security Premiums & Discounts	957	825
Net Gain on Sale of Investment Securities	(735)	-
Net Change in Operating Assets & Liabilities:		
Net (Increase) Decrease in Interest Receivable and Other Assets	(5,322)	7,733
Net (Decrease) Increase in Interest Payable and Other Liabilities	(1,037)	1,392
Net Cash Provided by Operating Activities	509	16,801
Investing Activities:		
Purchase of Investment Securities Available-for-Sale	(219,545)	(98,147)
Proceeds from Sold, Matured or Called Securities Available-for-Sale	119,128	46,706
Purchase of Investment Securities Held-to-Maturity	(115)	(4,144)
Proceeds from Matured or Called Securities Held-to-Maturity	790	814
Net Loans Paid, Originated or Acquired	20,172	4,464
Principal Collected on Loans Previously Charged Off	73	36
Additions to Premises and Equipment	(45)	(134)
Net Cash Used by Investing Activities	(79,542)	(50,405)
Financing Activities:		
Net (Decrease) Increase in Deposits	(6,860)	17,845
Net Changes in Other Borrowings	-	(16)
Common Stock Repurchases	-	(180)
Net Cash (Used) Provided by Financing Activities	(6,860)	17,649
Decrease in Cash and Cash Equivalents	(85,893)	(15,955)
Cash and Cash Equivalents at Beginning of Period	129,426	101,660
Cash and Cash Equivalents at End of Period	$43,533	$85,705

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

Table of Contents

FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

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

The Company's other subsidiaries include F & M Bancorp, Inc. and FMCB Statutory Trust I. F & M Bancorp, Inc. was created in March 2002 to protect the name F & M Bank. During 2002 the Company completed a fictitious name filing in California to begin using the streamlined name "F & M Bank" as part of a larger effort to enhance the Company's image and build brand name recognition. In December 2003 the Company formed a wholly owned subsidiary, FMCB Statutory Trust I. FMCB Statutory Trust I is a non-consolidated subsidiary per Generally Accepted Accounting Principles in the United States of America ("U.S. GAAP") and was formed for the sole purpose of issuing Trust Preferred Securities.

The accounting and reporting policies of the Company conform to U.S. GAAP and prevailing practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

Basis of Presentation

The accompanying consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America for financial information.

These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with U.S. GAAP have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. The results of operations for the three-month period ended March 31, 2013 may not necessarily be indicative of future operating results.

The accompanying consolidated financial statements include the accounts of the Company and the Company's wholly owned subsidiaries, F & M Bancorp, Inc. and the Bank, along with the Bank's wholly owned subsidiaries, Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Significant inter-company transactions have been eliminated in consolidation.

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

Certain amounts in the prior years' financial statements and related footnote disclosures have been reclassified to conform to the current-year presentation. These reclassifications had no effect on previously reported net income or total shareholders' equity. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which are necessary for a fair presentation of financial results for the periods presented.

Cash and Cash Equivalents

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

Investment Securities

Investment securities are classified at the time of purchase as held-to-maturity if it is management's intent and the Company has the ability to hold the securities until maturity. These securities are carried at cost, adjusted for amortization of premium and accretion of discount using a level yield of interest over the estimated remaining period until maturity. Losses, reflecting a decline in value judged by the Company to be other than temporary, are recognized in the period in which they occur.

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

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

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: (1) OTTI related to credit loss, which must be recognized in the income statement; and (2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

In order to determine OTTI for purchased beneficial interests that, on the purchase date, were not highly rated, the Company compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

Loans

Loans are reported at the principal amount outstanding net of unearned discounts and deferred loan fees and costs. Interest income on loans is accrued daily on the outstanding balances using the simple interest method. Loan origination fees are deferred and recognized over the contractual life of the loan as an adjustment to the yield. Loans are placed on non-accrual status when the collection of principal or interest is in doubt or when they become past due for 90 days or more unless they are both well-secured and in the process of collection. For this purpose a loan is considered well-secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or is guaranteed by a financially capable party. When a loan is placed on non-accrual status, the accrued and unpaid interest receivable is reversed and charged against current income; thereafter, interest income is recognized only as it is collected in cash. Additionally, cash would be applied to principal if all principal was not expected to be collected. Loans placed on non-accrual status are returned to accrual status when the loans are paid current as to principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan.

Table of Contents

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Impaired loans are either: (1) non-accrual loans; or (2) restructured loans that are still accruing interest. Loans determined to be impaired are individually evaluated for impairment. When a loan is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

A restructuring of a loan constitutes a troubled debt restructuring (TDR) if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

Generally, the Company will not restructure loans for customers unless: (i) the existing loan is brought current as to principal and interest payments; and (ii) the restructured loan can be underwritten to reasonable underwriting standards. If these standards are not met other actions will be pursued (e.g., foreclosure) to collect outstanding loan amounts. After restructure a determination is made whether the loan will be kept on accrual status based upon the underwriting and historical performance of the restructured credit.

Allowance for Credit Losses
The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan portfolio as of the balance-sheet date. The allowance is established through a provision for credit losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves for inherent losses related to loans that are not impaired.

The determination of the general reserve for loans that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, qualitative factors to include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1st mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; and (8) consumer and other. The allowance for credit losses attributable to each portfolio segment, which includes both individually evaluated impaired loans and loans that are collectively evaluated for impairment, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. A credit grade is established at inception for smaller balance loans, such as consumer and residential real estate, and then updated only when the loan becomes contractually delinquent or when the borrower requests a modification. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Table of Contents

Special Mention – A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Company's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently known facts, conditions and values, highly questionable or improbable.

Loss – Loans classified as loss are considered uncollectible. Once a loan becomes delinquent and repayment becomes questionable, the Company will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Company will estimate its probable loss and immediately charge-off some or all of the balance.

The general reserve component of the allowance for credit losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk; (2) historical losses; and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Real Estate Construction – Real Estate Construction loans including land loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial Real Estate – Commercial real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Commercial – Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agricultural Real Estate and Agricultural – Loans secured by crop production, livestock and related real estate are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Residential 1st Mortgages and Home Equity Lines and Loans – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments, although this is not always true as evidenced by the weakness in residential real estate values over the past five years. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Table of Contents

Consumer & Other – A consumer installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's and Bank's regulators, including the FRB, DFI and FDIC, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Allowance for Credit Losses on Off-Balance-Sheet Credit Exposures

The Company also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in Interest Payable and Other Liabilities on the Company’s Consolidated Balance Sheet.

Premises and Equipment

Premises, equipment, and leasehold improvements are stated at cost, less accumulated depreciation and amortization. Depreciation is computed principally by the straight line method over the estimated useful lives of the assets. Estimated useful lives of buildings range from 30 to 40 years, and for furniture and equipment from 3 to 7 years. Leasehold improvements are amortized over the lesser of the terms of the respective leases, or their useful lives, which are generally 5 to 10 years. Remodeling and capital improvements are capitalized while maintenance and repairs are charged directly to occupancy expense.

Other Real Estate

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

Income Taxes

The Company uses the liability method of accounting for income taxes. This method results in the recognition of deferred tax assets and liabilities that are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The deferred provision for income taxes is the result of the net change in the deferred tax asset and deferred tax liability balances during the year. This amount, combined with the current taxes payable or refundable, results in the income tax expense for the current year.

The Company follows the standards set forth in the “Income Taxes” topic of the FASB Accounting Standard Codification (“ASC”), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements. This standard prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of an income tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Table of Contents

Interest expense and penalties associated with unrecognized tax benefits, if any, are included in the provision for income taxes in the Consolidated Statements of Income.

Dividends and Basic Earnings Per Common Share

The Company's common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. There are no common stock equivalent shares. Therefore, there is no presentation of diluted basic earnings per common share. See Note 6.

Segment Reporting

The "Segment Reporting" topic of the FASB ASC requires that public companies report certain information about operating segments. It also requires that public companies report certain information about their products and services, the geographic areas in which they operate, and their major customers. The Company is a holding company for a community bank, which offers a wide array of products and services to its customers. Pursuant to its banking strategy, emphasis is placed on building relationships with its customers, as opposed to building specific lines of business. As a result, the Company is not organized around discernable lines of business and prefers to work as an integrated unit to customize solutions for its customers, with business line emphasis and product offerings changing over time as needs and demands change. Therefore, the Company only reports one segment.

Derivative Instruments and Hedging Activities

The "Derivatives and Hedging" topic of the FASB ASC establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. Changes in the fair value of those derivatives are accounted for depending on the intended use of the derivative and the resulting designation under specified criteria. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, designed to minimize interest rate risk, the effective portions of the change in the fair value of the derivative are recorded in other comprehensive income (loss), net of related income taxes. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

From time to time, the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps, and collars. These instruments are purchased and/or sold to reduce the Company's exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments as of or for the period ended March 31, 2013, December 31, 2012 or March 31, 2012.

Comprehensive Income

The "Comprehensive Income" topic of the FASB ASC establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Other comprehensive income (loss) refers to revenues, expenses, gains, and losses that generally accepted accounting principles recognize as changes in value to an enterprise but are excluded from net income. For the Company, comprehensive income includes net income and changes in fair value of its available-for-sale investment securities.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

13

Table of Contents

2. Investment Securities

The amortized cost, fair values, and unrealized gains and losses of the securities available-for-sale are as follows (in thousands):

	Amortized	Gross Unrealized		Fair/Book
March 31, 2013	Cost	Gains	Losses	Value
Government Agency & Government-Sponsored Entities	$26,436	$256	$-	$26,692
Obligations of States and Political Subdivisions	5,643	-	-	5,643
Mortgage Backed Securities (1)	423,298	10,273	1,286	432,285
Corporate Securities	49,846	321	39	50,128
Other	825	-	-	825
Total	$506,048	$10,850	$1,325	$515,573

	Amortized	Gross Unrealized		Fair/Book
December 31, 2012	Cost	Gains	Losses	Value
Government Agency & Government-Sponsored Entities	$26,546	$277	$-	$26,823
Obligations of States and Political Subdivisions	5,665	-	-	5,665
Mortgage Backed Securities (1)	341,212	11,570	10	352,772
Corporate Securities	22,318	252	12	22,558
Other	10,173	-	-	10,173
Total	$405,914	$12,099	$22	$417,991

	Amortized	Gross Unrealized		Fair/Book
March 31, 2012	Cost	Gains	Losses	Value
Government Agency & Government-Sponsored Entities	$66,995	$347	$-	$67,342
Obligations of States and Political Subdivisions	5,753	-	-	5,753
Mortgage Backed Securities (1)	439,222	9,347	258	448,311
Corporate Securities	344	-	-	344
Other	10,067	-	-	10,067
Total	$522,381	$9,694	$258	$531,817

The book values, estimated fair values and unrealized gains and losses of investments classified as held-to-maturity are as follows (in thousands):

	Book	Gross Unrealized		Fair
March 31, 2013	Value	Gains	Losses	Value
Obligations of States and Political Subdivisions	$65,165	$1,896	$22	$67,039
Mortgage Backed Securities (1)	341	8	-	349
Other	2,202	-	-	2,202
Total	$67,708	$1,904	$22	$69,590

	Book	Gross Unrealized		Fair
December 31, 2012	Value	Gains	Losses	Value
Obligations of States and Political Subdivisions	$65,694	$2,296	$3	$67,987
Mortgage Backed Securities (1)	484	12	-	496

Other	2,214	-	-	2,214
Total	$68,392	$2,308	$3	$70,697

March 31, 2012	Book Value	Gross Unrealized Gains	Losses	Fair Value
Obligations of States and Political Subdivisions	$63,174	$2,565	$-	$65,739
Mortgage Backed Securities (1)	1,003	37	-	1,040
Other	2,239	-	-	2,239
Total	$66,416	$2,602	$-	$69,018

(1) All Mortgage Backed Securities consist of securities collateralized by residential real estate and were issued by an agency or government sponsored entity of the U.S. government.

Fair values are based on quoted market prices or dealer quotes. If a quoted market price or dealer quote is not available, fair value is estimated using quoted market prices for similar securities.

Table of Contents

The amortized cost and estimated fair values of investment securities at March 31, 2013 by contractual maturity are shown in the following table (in thousands):

	Available-for-Sale		Held-to-Maturity	
March 31, 2013	Amortized Cost	Fair/Book Value	Book Value	Fair Value
Within one year	$11,424	$11,475	$1,775	$1,788
After one year through five years	64,583	64,968	12,144	12,527
After five years through ten years	1,315	1,417	38,182	39,602
After ten years	5,428	5,428	15,266	15,324
	82,750	83,288	67,367	69,241
Investment securities not due at a single maturity date:				
Mortgage-backed securities	423,298	432,285	341	349
Total	$506,048	$515,573	$67,708	$69,590

Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The following tables show those investments with gross unrealized losses and their market value aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at the dates indicated (in thousands):

	Less Than 12 Months		12 Months or More		Total	
March 31, 2013	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities Available-for-Sale						
Mortgage Backed Securities	$115,238	$1,286	$-	$-	$115,238	$1,286
Corporate Securities	18,691	39	-	-	18,691	39
Total	$133,929	$1,325	$-	$-	$133,929	$1,325
Securities Held-to-Maturity						
Obligations of States and Political Subdivisions	$2,841	$22	$-	$-	$2,841	$22
Total	$2,841	$22	$-	$-	$2,841	$22

	Less Than 12 Months		12 Months or More		Total	
December 31, 2012	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities Available-for-Sale						
Mortgage Backed Securities	$4,542	$10	$-	$-	$4,542	$10
Corporate Securities	3,442	12	-	-	3,442	12
Total	$7,984	$22	$-	$-	$7,984	$22
Securities Held-to-Maturity						

Obligations of States and Political Subdivisions	$528	$3	$-	$-	$528	$3
Total	$528	$3	$-	$-	$528	$3

Table of Contents

March 31, 2012	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Loss	12 Months or More Fair Value	12 Months or More Unrealized Loss	Total Fair Value	Total Unrealized Loss
Securities Available-for-Sale						
Mortgage Backed Securities	$56,721	$258	$-	$-	$56,721	$258
Total	$56,721	$258	$-	$-	$56,721	$258

As of March 31, 2013, the Company held 355 investment securities of which 27 were in a loss position for less than twelve months. No securities were in a loss position for twelve months or more. Management periodically evaluates each investment security for other-than-temporary impairment relying primarily on industry analyst reports and observations of market conditions and interest rate fluctuations. Management believes it will be able to collect all amounts due according to the contractual terms of the underlying investment securities.

Securities of Government Agency and Government Sponsored Entities – There were no unrealized losses on the Company's investments in securities of government agency and government sponsored entities at March 31, 2013, December 31, 2012 and March 31, 2012.

Mortgage Backed Securities - The unrealized losses on the Company's investment in mortgage backed securities were $1.3 million, $10,000, and $258,000 at March 31, 2013, December 31, 2012, and March 31, 2012, respectively. The unrealized losses on the Company’s investment in mortgage backed securities were caused by interest rate fluctuations. The contractual cash flows of these investments are guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2013, December 31, 2012 and March 31, 2012, respectively.

Obligations of States and Political Subdivisions - The financial problems experienced by certain municipalities over the past five years, along with the financial stresses exhibited by some of the large monoline bond insurers have increased the overall risk associated with bank-qualified municipal bonds. As of March 31, 2013, over ninety-three percent of the Company’s bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are “investment grade.” The Company monitors the status of the seven percent of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

The unrealized losses on the Company’s investment in obligation of states and political subdivision were $22,000, $3,000, and $0 at March 31, 2013, December 31, 2012 and March 31, 2012, respectively. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were primarily caused by interest rate fluctuations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2013 and December 31, 2012.

Corporate Securities - The unrealized losses on the Company’s investment in corporate securities were $39,000. $12,000, and $0 at March 31, 2013, December 31, 2012, and March 31, 2012. Changes in the prices of corporate securities are primarily influenced by: (1) changes in market interest rates; (2) changes in perceived credit risk in the general economy or in particular industries; (3) changes in the perceived credit risk of a particular company; and (4) day to day trading supply, demand and liquidity. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2013 and December 31, 2012.

Table of Contents

Proceeds from sales and calls of securities available-for-sale were as follows:

(in thousands)		Proceeds		Gains		Losses
Three Months Ended March 31, 2013	$	45,259	$	749	$	14
Three Months Ended March 31, 2012		25,000		-		-

Pledged Securities
As of March 31, 2013, securities carried at $300.2 million were pledged to secure public deposits, FHLB borrowings, and other government agency deposits as required by law. This amount at December 31, 2012, was $296.9 million.

Table of Contents

3. Allowance for Credit Losses

The following tables show the allocation of the allowance for credit losses by portfolio segment and by impairment methodology at the dates indicated (in thousands):

March 31, 2013	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Unallocated	Total
Year-To-Date Allowance for Credit Losses:										
Beginning Balance- January 1, 2013	$6,464	$2,877	$986	$1,219	$3,235	$10,437	$7,963	$182	$854	$34,217
Charge-Offs	-	-	-	(16)	(1)	-	-	(18)	-	(35)
Recoveries	-	-	-	-	2	13	47	11	-	73
Provision	207	918	(17)	57	(27)	(1,038)	(44)	(12)	(44)	-
Ending Balance- March 31, 2013	$6,671	$3,795	$969	$1,260	$3,209	$9,412	$7,966	$163	$810	$34,255
Ending Balance Individually Evaluated for Impairment	-	263	-	-	153	1,022	210	58	-	1,706
Ending Balance Collectively Evaluated for Impairment	6,671	3,532	969	1,260	3,056	8,390	7,756	105	810	32,549
Loans:										
Ending Balance	$360,893	$318,823	$32,681	$145,419	$40,141	$181,725	$142,115	$4,898	$-	$1,226,695
Ending Balance Individually Evaluated for Impairment	107	5,335	-	735	398	3,740	533	58	-	10,906
Ending Balance Collectively Evaluated for Impairment	360,786	313,488	32,681	144,684	39,743	177,985	141,582	4,840	-	1,215,789

December 31, 2012	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Unallocated	Total
Year-To-Date Allowance for Credit Losses:										
	$5,823	$2,583	$1,933	$1,251	$3,746	$8,127	$8,733	$207	$614	$33,017

Beginning Balance-January 1, 2012										
Charge-Offs	-	-	-	(152)	(259)	(294)	(198)	(145)	-	(1,048
Recoveries	-	90	-	53	14	61	117	63	-	398
Provision	641	204	(947)	67	(266)	2,543	(689)	57	240	1,850
Ending Balance-December 31, 2012	$6,464	$2,877	$986	$1,219	$3,235	$10,437	$7,963	$182	$854	$34,217
Ending Balance Individually Evaluated for Impairment	-	-	-	-	173	996	144	61	-	1,374
Ending Balance Collectively Evaluated for Impairment	6,464	2,877	986	1,219	3,062	9,441	7,819	121	854	32,843
Loans:										
Ending Balance	$350,548	$311,992	$32,680	$140,257	$42,042	$221,032	$143,293	$5,058	$-	$1,246,90
Ending Balance Individually Evaluated for Impairment	289	5,423	-	657	980	3,937	250	61	-	11,597
Ending Balance Collectively Evaluated for Impairment	350,259	306,569	32,680	139,600	41,062	217,095	143,043	4,997	-	1,235,30

Table of Contents

March 31, 2012	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Unallocated	Total
Year-To-Date Allowance for Credit Losses:										
Beginning Balance - January 1, 2012	$5,823	$2,583	$1,933	$1,251	$3,746	$8,127	$8,733	$207	$614	$33,017
Charge-Offs	-	-	-	-	(69)	-	(198)	(64)	-	(331)
Recoveries	-	-	-	-	8	2	8	18	-	36
Provision	(1,380)	192	268	44	(133)	628	94	1	506	220
Ending Balance - March 31, 2012	$4,443	$2,775	$2,201	$1,295	$3,552	$8,757	$8,637	$162	$1,120	$32,942
Ending Balance Individually Evaluated for Impairment	-	-	-	48	114	846	51	22	-	1,081
Ending Balance Collectively Evaluated for Impairment	4,443	2,775	2,201	1,247	3,438	7,911	8,586	140	1,120	31,861
Loans:										
Ending Balance	$321,161	$277,631	$32,036	$111,660	$49,094	$200,034	$160,066	$6,601	$-	$1,158,283
Ending Balance Individually Evaluated for Impairment	1,137	933	-	406	1,007	1,155	339	22	-	4,999
Ending Balance Collectively Evaluated for Impairment	320,024	276,698	32,036	111,254	48,087	198,879	159,727	6,579	-	1,153,284

Table of Contents

The following tables show the loan portfolio allocated by management's internal risk ratings at the dates indicated (in thousands):

March 31, 2013	Pass	Special Mention	Substandard	Total Loans
Loans:				
Commercial Real Estate	$ 336,525	$ 15,273	$ 9,095	$ 360,893
Agricultural Real Estate	308,475	3,799	6,549	318,823
Real Estate Construction	26,472	6,209	-	32,681
Residential 1st Mortgages	142,951	1,376	1,092	145,419
Home Equity Lines & Loans	38,870	-	1,271	40,141
Agricultural	177,245	980	3,500	181,725
Commercial	135,375	6,289	451	142,115
Consumer & Other	4,644	-	254	4,898
Total	$ 1,170,557	$ 33,926	$ 22,212	$ 1,226,695

December 31, 2012	Pass	Special Mention	Substandard	Total Loans
Loans:				
Commercial Real Estate	$ 326,037	$ 15,528	$ 8,983	$ 350,548
Agricultural Real Estate	299,642	6,605	5,745	311,992
Real Estate Construction	26,445	6,235	-	32,680
Residential 1st Mortgages	137,998	1,192	1,067	140,257
Home Equity Lines & Loans	40,866	-	1,176	42,042
Agricultural	216,164	1,168	3,700	221,032
Commercial	137,217	5,586	490	143,293
Consumer & Other	4,737	-	321	5,058
Total	$ 1,189,106	$ 36,314	$ 21,482	$ 1,246,902

March 31, 2012	Pass	Special Mention	Substandard	Total Loans
Loans:				
Commercial Real Estate	$ 283,721	$ 29,510	$ 7,930	$ 321,161
Agricultural Real Estate	250,827	22,541	4,263	277,631
Real Estate Construction	23,876	3,217	4,943	32,036
Residential 1st Mortgages	109,453	1,454	753	111,660
Home Equity Lines & Loans	47,468	-	1,626	49,094
Agricultural	193,600	3,295	3,139	200,034
Commercial	157,953	1,614	499	160,066
Consumer & Other	6,348	-	253	6,601
Total	$ 1,073,246	$ 61,631	$ 23,406	$ 1,158,283

See "Note 1. Significant Accounting Policies - Allowance for Credit Losses" for a description of the internal risk ratings used by the Company. There were no loans outstanding at March 31, 2013, December 31, 2012, and March 31, 2012, rated doubtful or loss.

20

Table of Contents

The following tables show an aging analysis of the loan portfolio by the time past due at the dates indicated (in thousands):

March 31, 2013	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Loans:						
Commercial Real Estate	$364	$-	$-	$364	$360,529	$360,893
Agricultural Real Estate	893	-	5,335	6,228	312,595	318,823
Real Estate Construction	-	-	-	-	32,681	32,681
Residential 1st Mortgages	-	-	405	405	145,014	145,419
Home Equity Lines & Loans	275	-	195	470	39,671	40,141
Agricultural	-	-	3,237	3,237	178,488	181,725
Commercial	-	-	287	287	141,828	142,115
Consumer & Other	178	-	19	197	4,701	4,898
Total	$1,710	$-	$9,478	$11,188	$1,215,507	$1,226,695

December 31, 2012	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Loans:						
Commercial Real Estate	$150	$-	$-	$150	$350,398	$350,548
Agricultural Real Estate	-	-	5,423	5,423	306,569	311,992
Real Estate Construction	-	-	-	-	32,680	32,680
Residential 1st Mortgages	23	-	445	468	139,789	140,257
Home Equity Lines & Loans	70	-	213	283	41,759	42,042
Agricultural	-	-	3,198	3,198	217,834	221,032
Commercial	293	-	-	293	143,000	143,293
Consumer & Other	11	-	19	30	5,028	5,058
Total	$547	$-	$9,298	$9,845	$1,237,057	$1,246,902

March 31, 2012	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Loans:						
Commercial Real Estate	$-	$-	$831	$831	$320,330	$321,161
Agricultural Real Estate	594	-	934	1,528	276,103	277,631
Real Estate Construction	-	-	-	-	32,036	32,036
Residential 1st Mortgages	-	-	391	391	111,269	111,660
Home Equity Lines & Loans	221	-	523	744	48,350	49,094
Agricultural	-	-	846	846	199,188	200,034
Commercial	-	-	213	213	159,853	160,066
Consumer & Other	57	-	22	79	6,522	6,601
Total	$872	$-	$3,760	$4,632	$1,153,651	$1,158,283

Table of Contents

The following tables show information related to impaired loans for the periods indicated (in thousands):

March 31, 2013	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial Real Estate	$107	$110	$-	$198	$2
Agricultural Real Estate	3,508	3,500	-	4,473	-
Residential 1st Mortgages	736	782	-	697	3
Home Equity Lines & Loans	249	268	-	521	1
Agricultural	1,753	1,783	-	1,843	-
Commercial	103	110	-	105	2
	$6,456	$6,553	$-	$7,837	$8
With an allowance recorded:					
Agricultural Real Estate	$1,841	$1,834	$263	$921	$-
Home Equity Lines & Loans	153	196	153	174	-
Agricultural	1,988	2,004	1,022	1,997	8
Commercial	143	144	210	144	2
Consumer & Other	345	354	58	203	1
	$4,470	$4,532	$1,706	$3,439	$11
Total	$10,926	$11,085	$1,706	$11,276	$19

December 31, 2012	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial Real Estate	$289	$289	$-	$506	$20
Agricultural Real Estate	5,437	5,454	-	2,611	-
Residential 1st Mortgages	658	761	-	458	3
Home Equity Lines & Loans	792	871	-	775	23
Agricultural	1,932	1,954	-	1,159	19
Commercial	106	106	-	144	6
	9,214	9,435	-	5,653	71
With an allowance recorded:					
Residential 1st Mortgages	$-	$-	$-	$54	$-
Home Equity Lines & Loans	194	237	173	182	4
Agricultural	2,006	2,019	996	997	1
Commercial	144	144	144	159	4
Consumer & Other	61	63	61	31	-
	$2,405	$2,463	$1,374	$1,423	$9
Total	$11,619	$11,898	$1,374	$7,076	$80

March 31, 2012	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial Real Estate	$1,142	$1,136	$-	$1,349	$3

Agricultural Real Estate	934	1,183	-	945	-
Residential 1st Mortgages	297	309	-	758	-
Home Equity Lines & Loans	822	850	-	646	4
Agricultural	309	309	-	286	4
Commercial	239	315	-	214	-
	$3,743	$4,102	$-	$4,196	$11
With an allowance recorded:					
Commercial Real Estate	$-	$-	$-	$1,509	$-
Residential 1st Mortgages	108	109	48	54	-
Home Equity Lines & Loans	187	190	114	150	1
Agricultural	847	1,577	846	962	-
Commercial	100	106	51	102	-
Consumer & Other	22	23	22	23	-
	$1,264	$2,005	$1,081	$2,799	$1
Total	$5,007	$6,107	$1,081	$6,995	$12

Total recorded investment shown in the prior table will not equal the total ending balance of loans individually evaluated for impairment on the allocation of allowance table. This is because the calculation of recorded investment for purposes of this table only takes into account charge-offs, net deferred loans fees & costs, unamortized premium or discount, and accrued interest.

Table of Contents

At March 31, 2013, the Company allocated $444,000 of specific reserves to $2.1 million of troubled debt restructured loans, of which $1.4 million were performing. The Company had no commitments at March 31, 2013 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the three-month period ending March 31, 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods of 5 years. Modifications involving an extension of the maturity date were for periods ranging from 16 months to 10 years.

The following table presents loans by class modified as troubled debt restructured loans during the three-month period ended March 31, 2013 (in thousands):

		March 31, 2013	
Troubled Debt Restructurings	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Residential 1st Mortgages	4	$ 306	$ 290
Home Equity Lines & Loans	1	16	15
Commercial	2	292	292
Total	7	$ 614	$ 597

The TDRs described above increased the allowance for credit losses by $61,000 and resulted in charge-offs of $17,000 for the three-month period ending March 31, 2013.

During the three-months ended March 31, 2013, there were no payment defaults on loans modified as troubled debt restructurings within twelve months following the modification The Company considers a loan to be in payment default once it is greater than 90 days contractually past due under the modified terms.

At December 31, 2012, the Company allocated $401,000 of specific reserves to $2.6 million of troubled debt restructured loans, of which $2.3 million were performing. The Company had no commitments at December 31, 2012, to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the twelve-month period ending December 31, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 2 years to 5 years. Modifications involving an extension of the maturity date were for periods ranging from 6 months to 10 years.

Table of Contents

The following table presents loans by class modified as troubled debt restructured loans during the twelve-month period ended December 31, 2012 (in thousands):

		December 31, 2012	
Troubled Debt Restructurings	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial Real Estate	1	$ 116	$ 116
Residential 1st Mortgages	2	216	201
Home Equity Lines & Loans	7	529	480
Agricultural	4	858	858
Commercial	3	273	273
Consumer & Other	1	41	41
Total	18	$ 2,033	$ 1,969

The TDRs described above increased the allowance for credit losses by $53,000 and resulted in charge-offs of $64,000 during the year ended December 31, 2012.

During the twelve-month period ended December 31, 2012, there were no payment defaults on loans modified as troubled debt restructurings within twelve months following the modification.

At March 31, 2012, the Company allocated $44,000 of specific reserves to $1.3 million of troubled debt restructured loans, of which $1.2 million were performing. The Company had no commitments at March 31, 2012, to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the three-month period ending March 31, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods of 5 years. Modifications involving an extension of the maturity date were for periods ranging from 6 months to15 years.

The following table presents loans by class modified as troubled debt restructured loans during the three-month period ended March 31, 2012 (in thousands):

		March 31, 2012	
Troubled Debt Restructurings	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial Real Estate	1	$ 116	$ 116
Residential 1st Mortgages	3	116	110
Home Equity Lines & Loans	1	74	68
Agricultural	1	180	180
Commercial	2	126	126
Total	8	$ 612	$ 600

The TDRs described above resulted in charge-offs of $12,000 but did not increase the allowance for credit losses for the three-month period ending March 31, 2012.

During the twelve months ended March 31, 2012, there were no loans modified as troubled debt restructurings for which there was a payment default within twelve months following the modification.

Table of Contents

4. Fair Value Measurements

The Company follows the "Fair Value Measurement and Disclosures" topic of the FASB ASC, which establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. This standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, this standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Securities classified as available-for-sale are reported at fair value on a recurring basis utilizing Level 1, 2 and 3 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

The Company does not record all loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for credit losses is established. Once a loan is identified as individually impaired, management measures impairment in accordance with the "Receivable" topic of the FASB ASC. The fair value of impaired loans is estimated using one of several methods, including collateral value when the loan is collateral dependent, market value of similar debt, enterprise value, and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses observable data, the Company records the impaired loan as nonrecurring Level 2. Otherwise, the Company records the impaired loan as nonrecurring Level 3.

Other Real Estate ("ORE") is reported at fair value on a non-recurring basis. When the fair value of the ORE is based on an observable market price or a current appraised value which uses observable data, the Company records the ORE as nonrecurring Level 2. Otherwise, the Company records the ORE as nonrecurring Level 3. Other real estate is reported in Interest Receivable and Other Assets on the Company's Consolidated Balance Sheets.

Table of Contents

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the periods indicated.

(in thousands)	Fair Value Total	Fair Value Measurements At March 31, 2013, Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	$26,692	$21,612	$5,080	$ -
Obligations of States and Political Subdivisions	5,643	-	-	5,643
Mortgage Backed Securities	432,285	-	432,285	-
Corporate Securities	50,128	9,373	40,755	-
Other	825	515	310	-
Total Assets Measured at Fair Value On a Recurring Basis	$515,573	$31,500	$478,430	$ 5,643

(in thousands)	Fair Value Total	Fair Value Measurements At December 31, 2012, Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	$26,823	$21,731	$5,092	$ -
Obligations of States and Political Subdivisions	5,665	-	-	5,665
Mortgage Backed Securities	352,772	-	352,772	-
Corporate Securities	22,558	4,020	18,538	-
Other	10,173	9,863	310	-
Total Assets Measured at Fair Value On a Recurring Basis	$417,991	$35,614	$376,712	$ 5,665

	Fair Value	Fair Value Measurements At March 31, 2012, Using Quoted Prices in Active Markets	Other Observable Inputs	Significant Unobservable Inputs

(in thousands)	Total	for Identical Assets (Level 1)	(Level 2)	(Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	$67,342	$20,970	$46,372	$ -
Obligations of States and Political Subdivisions	5,753	-	-	5,753
Mortgage Backed Securities	448,311	-	448,311	-
Corporate Securities	344	-	344	-
Other	10,067	9,657	410	-
Total Assets Measured at Fair Value On a Recurring Basis	$531,817	$30,627	$495,437	$ 5,753

Table of Contents

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the quarters ended March 31, 2013 and 2012, there were no transfers in or out of level 1, 2, or 3. The following table presents changes in level 3 assets measured at fair value on a recurring basis.

	Three Months Ended March 31,	
(in thousands)	2013	2012
Balance at Beginning of Period	$5,665	$5,782
Total Realized and Unrealized Gains/(Losses) Included in Income	-	-
Total Unrealized Gains/(Losses) Included in Other Comprehensive Income	-	-
Purchase of Securities	-	-
Sales, Maturities, and Calls of Securities	(22)	(29)
Net Transfers In/(Out) of Level 3	-	-
Balance at End of Period	$5,643	$5,753

Available for sale investments securities categorized as Level 3 assets primarily consist of obligations of states and political subdivisions. These bonds were issued by local housing authorities and have no active market. These bonds are carried at historical cost, which approximates fair value, unless economic conditions for the municipality changes to a degree requiring a valuation adjustment.

The following tables present information about the Company's other real estate and impaired loans, classes of assets or liabilities that the Company carries at fair value on a non-recurring basis, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the periods indicated. Not all impaired loans are carried at fair value. Impaired loans are only included in the following tables when their fair value is based upon a current appraisal of the collateral, and if that appraisal results in a partial charge-off or the establishment of a specific reserve.

		Fair Value Measurements At March 31, 2013, Using		
(in thousands)	Fair Value Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans				
Agricultural Real Estate	$1,572	$-	$-	$ 1,572
Residential 1st Mortgage	289	-	-	289
Home Equity Lines and Loans	15	-	-	15
Agricultural	965	-	-	965
Commercial	220	-	-	220
Total Impaired Loans	3,061	-	-	3,061
Other Real Estate				
Real Estate Construction	2,553	-	-	2,553
Agricultural Real Estate	1,910	-	-	1,910
Agricultural	280	-	-	280
Total Other Real Estate	4,743	-	-	4,743

Total Assets Measured at Fair Value On a Non-Recurring Basis	$7,804	$-	$-	$ 7,804

The fair value of impaired loans with a specific reserve or a partial charge-off was $3.0 million, net of an allowance for credit losses of $1.7 million.

Table of Contents

ORE was $4.7 million, net of a $4.1 million valuation allowance. ORE has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, foreclosed assets are recorded at the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for credit losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in non-interest expense on the Consolidated Statements of Income.

		Fair Value Measurements At December 31, 2012, Using		
(in thousands)	Fair Value Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans				
Residential 1st Mortgage	$235	$-	$-	$ 235
Home Equity Lines and Loans	462	-	-	462
Agricultural	1,010	-	-	1,010
Total Impaired Loans	1,707	-	-	1,707
Other Real Estate				
Real Estate Construction	2,553	-	-	2,553
Total Other Real Estate	2,553	-	-	2,553
Total Assets Measured at Fair Value On a Non-Recurring Basis	$4,260	$-	$-	$ 4,260

The fair value of impaired loans with a specific reserve or a partial charge-off or was $1.7 million, net of an allowance for credit losses of $1.4 million. The fair value of ORE was $2.6 million, net of a $4.1 million valuation allowance.

		Fair Value Measurements At March 31, 2012, Using		
(in thousands)	Fair Value Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans				
Commercial Real Estate	$61	$-	$-	$ 61
Home Equity Lines and Loans	225	-	-	225
Commercial	49	-	-	49
Total Impaired Loans	335	-	-	335
Other Real Estate				
Real Estate Construction	2,553	-	-	2,553
Residential 1st Mortgage	371	-	-	371

Total Other Real Estate	2,924	-	-	2,924
Total Assets Measured at Fair Value On a Non-Recurring Basis	$3,259	$-	$-	$ 3,259

The fair value of impaired loans with a specific reserve or a partial charge-off or was $335,000, net of an allowance for credit losses of $1.1 million. The fair value of ORE was $2.9 million, net of a $4.1 million valuation allowance.

Table of Contents

5. Fair Value of Financial Instruments

U.S. GAAP requires disclosure of fair value information about financial instruments, whether or not recognized on the balance sheet, for which it is practical to estimate that value. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization.

The following tables summarize the book value and estimated fair value of financial instruments for the periods indicated:

		Fair Value of Financial Instruments Using			
March 31, 2013 (in thousands)	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Estimated Fair Value
Assets:					
Cash and Cash Equivalents	$43,533	$43,533	$-	$ -	$43,533
Investment Securities Available-for-Sale:					
Government Agency & Government-Sponsored Entities	26,692	21,612	5,080	-	26,692
Obligations of States and Political Subdivisions	5,643	-	-	5,643	5,643
Mortgage Backed Securities	432,285		432,285	-	432,285
Corporate Securities	50,128	9,373	40,755	-	50,128
Other	825	515	310	-	825
Total Investment Securities Available-for-Sale	515,573	31,500	478,430	5,643	515,573
Investment Securities Held-to-Maturity:					
Obligations of States and Political Subdivisions	65,165	-	59,757	7,282	67,039
Mortgage Backed Securities	341	-	349	-	349
Other	2,202	-	2,202	-	2,202
Total Investment Securities Held-to-Maturity	67,708	-	62,308	7,282	69,590
FHLB Stock	7,368	N/A	N/A	N/A	N/A
Loans, Net of Deferred Loan Fees & Allowance:					
Commercial Real Estate	354,222	-	-	358,684	358,684
Agricultural Real Estate	315,028	-	-	321,212	321,212

Real Estate Construction	31,712	-	-	32,070	32,070
Residential 1st Mortgages	144,159	-	-	149,062	149,062
Home Equity Lines and Loans	36,932	-	-	39,477	39,477
Agricultural	172,313	-	-	171,562	171,562
Commercial	134,149	-	-	133,299	133,299
Consumer & Other	4,735	-	-	4,769	4,769
Unallocated Allowance	(810)	-	-	(810)	(810)
Total Loans, Net of Deferred Loan Fees & Allowance	1,192,440	-	-	1,209,325	1,209,325
Accrued Interest Receivable	6,661	-	6,661	-	6,661
Liabilities:					
Deposits:					
Demand	417,341	417,341	-	-	417,341
Interest Bearing Transaction	257,171	257,171	-	-	257,171
Savings and Money Market	590,323	590,323	-	-	590,323
Time	450,331	-	451,084	-	451,084
Total Deposits	1,715,166	1,264,835	451,084	-	1,715,919
FHLB Advances & Securities Sold Under Agreement to Repurchase	-	-	-	-	-
Subordinated Debentures	10,310	-	5,758	-	5,758
Accrued Interest Payable	427	-	427	-	427

Table of Contents

		Fair Value of Financial Instruments Using			
December 31, 2012 (in thousands)	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Estimated Fair Value
Assets:					
Cash and Cash Equivalents	$129,426	$129,426	$-	$ -	$129,426
Investment Securities Available-for-Sale:					
Government Agency & Government-Sponsored Entities	26,823	21,731	5,092	-	26,823
Obligations of States and Political Subdivisions	5,665	-	-	5,665	5,665
Mortgage Backed Securities	352,772	-	352,772	-	352,772
Corporate Securities	22,558	4,020	18,538	-	22,558
Other	10,173	9,863	310	-	10,173
Total Investment Securities Available-for-Sale	417,991	35,614	376,712	5,665	417,991
Investment Securities Held-to-Maturity:					
Obligations of States and Political Subdivisions	65,694	-	60,177	7,810	67,987
Mortgage Backed Securities	484	-	496	-	496
Other	2,214	-	2,214	-	2,214
Total Investment Securities Held-to-Maturity	68,392	-	62,887	7,810	70,697
FHLB Stock	7,368	N/A	N/A	N/A	N/A
Loans, Net of Deferred Loan Fees & Allowance:					
Commercial Real Estate	344,084	-	-	349,524	349,524
Agricultural Real Estate	309,115	-	-	316,302	316,302
Real Estate Construction	31,694	-	-	32,024	32,024
Residential 1st Mortgages	139,038	-	-	144,203	144,203
Home Equity Lines and Loans	38,807	-	-	41,419	41,419
Agricultural	210,595	-	-	209,578	209,578
Commercial	135,330	-	-	134,647	134,647
Consumer & Other	4,876	-	-	4,847	4,847
Unallocated Allowance	(854)	-	-	(854)	(854)
Total Loans, Net of Deferred Loan Fees & Allowance	1,212,685	-	-	1,231,690	1,231,690
Accrued Interest Receivable	6,389	-	-	6,389	6,389
Liabilities:					
Deposits:					

Demand	462,251	462,251	-	-	462,251
Interest Bearing Transaction	259,141	259,141	-	-	259,141
Savings and Money Market	541,526	541,526	-	-	541,526
Time	459,108	-	459,993	-	459,993
Total Deposits	1,722,026	1,262,918	459,993	-	1,722,911
Subordinated Debentures	10,310	-	5,750	-	5,750
Accrued Interest Payable	498	-	498	-	498

Table of Contents

		Fair Value of Financial Instruments Using			
March 31, 2012 (in thousands)	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Estimated Fair Value
Assets:					
Cash and Cash Equivalents	$85,705	$85,705	$-	$ -	$85,705
Investment Securities Available-for-Sale:					
Government Agency & Government-Sponsored Entities	67,342	20,970	46,372	-	67,342
Obligations of States and Political Subdivisions	5,753	-	-	5,753	5,753
Mortgage Backed Securities	448,311	-	448,311	-	448,311
Corporate Securities	344	-	344	-	344
Other	10,067	9,657	410	-	10,067
Total Investment Securities Available-for-Sale	531,817	30,627	495,437	5,753	531,817
Investment Securities Held-to-Maturity:					
Obligations of States and Political Subdivisions	63,174	-	57,327	8,412	65,739
Mortgage Backed Securities	1,003	-	1,040	-	1,040
Other	2,239	-	2,239	-	2,239
Total Investment Securities Held-to-Maturity	66,416	-	60,606	8,412	69,018
FHLB Stock	7,035	N/A	N/A	N/A	N/A
Loans, Net of Deferred Loan Fees & Allowance:					
Commercial Real Estate	316,718	-	-	326,891	326,891
Agricultural Real Estate	274,856	-	-	283,685	283,685
Real Estate Construction	29,835	-	-	30,029	30,029
Residential 1st Mortgages	110,365	-	-	114,402	114,402
Home Equity Lines and Loans	45,542	-	-	48,863	48,863
Agricultural	191,277	-	-	192,031	192,031
Commercial	151,429	-	-	151,175	151,175
Consumer & Other	6,439	-	-	6,560	6,560
Unallocated Allowance	(1,120)	-	-	(1,120)	(1,120)
Total Loans, Net of Deferred Loan Fees & Allowance	1,125,341	-	-	1,152,516	1,152,516
Accrued Interest Receivable	6,463	-	6,463	-	6,463
Liabilities:					
Deposits:					

Demand	371,760	371,760	-	-	371,760
Interest Bearing Transaction	230,323	230,323	-	-	230,323
Savings and Money Market	528,527	528,527	-	-	528,527
Time	513,432	-	514,503	-	514,503
Total Deposits	1,644,042	1,130,610	514,503	-	1,645,113
FHLB Advances & Securities Sold Under Agreement to Repurchase	60,514	-	62,643	-	62,643
Subordinated Debentures	10,310	-	5,895	-	5,895
Accrued Interest Payable	842	-	842	-	842

Table of Contents

Fair value estimates presented herein are based on pertinent information available to management as of March 31, 2013, December 31, 2012, and March 31, 2012. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purpose of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above. The methods and assumptions used to estimate the fair value of each class of financial instrument listed in the table above are explained below.

Cash and Cash Equivalents - The carrying amounts reported in the balance sheet for cash and due from banks, interest bearing deposits with banks, federal funds sold, and securities purchased under agreements to resell are a reasonable estimate of fair value. All cash and cash equivalents are classified as Level 1.

Investment Securities - Fair values for investment securities consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Based on the available market information the classification level could be 1, 2, or 3.

Federal Home Loan Bank Stock - It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Loans, Net of Deferred Loan Fees & Allowance - Fair values of loans are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Deposit Liabilities - The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. Fair values for fixed-maturity certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

FHLB Advances & Securities Sold Under Agreement to Repurchase - The fair value of federal funds purchased and other short-term borrowings is approximated by the book value resulting in a Level 2 classification. The fair value for Federal Home Loan Bank advances is determined using discounted future cash flows resulting in a Level 2 classification.

Subordinated Debentures - The fair values of the Company's Subordinated Debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

Accrued Interest Receivable and Payable - The carrying amount of accrued interest receivable and payable approximates their fair value resulting in a Level 2 classification.

6. Dividends and Basic Earnings Per Common Share

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. No cash dividends were declared during the first quarter of 2013 or 2012.

Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the basic earnings per common share for the three months ended March 31, 2013 and 2012.

Table of Contents

(net income in thousands)	2013	2012
Net Income	$6,251	$6,190
Average Number of Common Shares Outstanding	777,882	779,296
Basic Earnings Per Common Share Amount	$8.04	$7.94

7. Recent Accounting Pronouncements

In February 2013, the FASB issued Accounting Standards Update (ASU) No. 2013-02, Comprehensive Income (Topic 220)—Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of this Update is to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this Update seek to attain that objective by requiring an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles (GAAP) to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. The new guidance is effective for reporting periods beginning after December 15, 2012. The adoption of this ASU did not have a material impact on the Company's financial position, results of operation, cash flows, or disclosure.

Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three months ended March 31, 2013. This analysis should be read in conjunction with our 2012 Annual Report to Shareholders on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

Forward–Looking Statements

This Form 10-Q contains various forward-looking statements, usually containing the words "estimate," "project," "expect," "objective," "goal," or similar expressions and includes assumptions concerning Farmers & Merchants Bancorp's (together with its subsidiaries, the "Company" or "we") operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risks and uncertainties. In connection with the "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (1) the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto; (2) the effect of changing regional and national economic conditions including the housing market in the Central Valley of California; (3) significant changes in interest rates and prepayment speeds; (4) credit risks of lending and investment activities; (5) changes in federal and state banking laws or regulations; (6) competitive pressure in the banking industry; (7) changes in governmental fiscal or monetary policies; (8) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (9) other factors discussed in Item 1A. Risk Factors located in the Company's 2012 Annual Report on Form 10-K.

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

Introduction

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California state-chartered bank formed in 1916. The Bank serves the northern Central Valley of California through twenty-two banking offices and two stand-alone ATM's. The service area includes Sacramento, San Joaquin, Stanislaus and Merced Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock, Hilmar, and Merced. Substantially all of the Company's business activities are conducted within its market area.

Table of Contents

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

Overview

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

For the three months ended March 31, 2013, Farmers & Merchants Bancorp reported net income of $6,251,000, earnings per share of $8.04 and return on average assets of 1.28%. Return on average shareholders' equity was 12.04% for the three months ended March 31, 2013.

For the three months ended March 31, 2012, Farmers & Merchants Bancorp reported net income of $6,190,000, earnings per share of $7.94 and return on average assets of 1.29%. Return on average shareholders' equity was 12.80% for the three months ended March 31, 2012.

The primary reasons for the Company's improved earnings performance in the first quarter of 2013 as compared to the same period last year were: (1) a $220,000 decrease in the loan loss provision; (2) a $198,000 decrease in legal fee expenses; and (3) a $735,000 increase in net gain on investment securities. These positive impacts were partially offset by: (1) a $109,000 decrease in service charges on deposit accounts; (2) a $124,000 increase in salaries and employee benefits; and (3) a $787,000 decrease in net interest income.

The following is a summary of the financial results for the three-month period ended March 31, 2013 compared to March 31, 2012.

- Net income increased 1.0% to $6,251,000 from $6,190,000.
- Earnings per share increased 1.3% to $8.04 from $7.94.
- Total assets increased 1.3% to $1.97 billion.
- Total loans increased 5.9% to $1.23 billion.
- Total deposits increased 4.3% to $1.72 billion.

Results of Operations

Net Interest Income / Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the three month periods ended March 31, 2013 and 2012.

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

Table of Contents

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

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

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

Table of Contents

Farmers & Merchants Bancorp
Year-to-Date Average Balances and Interest Rates
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Three Months Ended March 31, 2013			Three Months Ended March 31, 2012		
Assets	Balance	Interest	Annualized Yield/Rate	Balance	Interest	Annualized Yield/Rate
Interest Bearing Deposits With Banks	$70,206	$44	0.25 %	$83,877	$53	0.25 %
Investment Securities						
U.S. Agencies	29,835	71	0.95 %	75,489	202	1.07 %
Municipals - Non-Taxable	71,114	1,011	5.69 %	65,379	962	5.89 %
Mortgage Backed Securities	366,810	1,891	2.06 %	406,869	2,598	2.55 %
Other	48,637	144	1.18 %	3,094	8	1.03 %
Total Investment Securities	516,396	3,117	2.41 %	550,831	3,770	2.74 %
Loans						
Real Estate	840,253	11,154	5.38 %	729,282	10,992	6.06 %
Home Equity Line and Loans	40,556	455	4.55 %	49,947	707	5.69 %
Agricultural	187,871	1,969	4.25 %	201,036	2,614	5.23 %
Commercial	144,532	1,777	4.99 %	157,631	2,041	5.21 %
Consumer	4,733	87	7.45 %	6,647	118	7.14 %
Other	232	3	5.24 %	239	3	5.05 %
Total Loans	1,218,177	15,445	5.14 %	1,144,782	16,475	5.79 %
Total Earning Assets	1,804,779	$18,606	4.18 %	1,779,490	$20,298	4.59 %
Unrealized Gain (Loss) on Securities Available-for-Sale	10,623			9,095		
Allowance for Loan Losses	(34,253)			(32,859)		
Cash and Due From Banks	33,086			32,733		
All Other Assets	146,547			138,124		
Total Assets	$1,960,782			$1,926,583		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits						
Interest Bearing DDA	$253,157	$29	0.05 %	$225,974	$46	0.08 %
Savings and Money Market	577,270	244	0.17 %	524,375	351	0.27 %
Time Deposits	455,171	410	0.37 %	511,980	660	0.52 %
Total Interest Bearing Deposits	1,285,598	683	0.22 %	1,262,329	1,057	0.34 %
Securities Sold Under Agreement to Repurchase	-	-	0.00 %	60,000	536	3.59 %
Other Borrowed Funds	87	-	0.00 %	524	7	5.37 %
Subordinated Debentures	10,310	81	3.19 %	10,310	88	3.43 %
Total Interest Bearing Liabilities	1,295,995	$764	0.24 %	1,333,163	$1,688	0.51 %
Interest Rate Spread			3.94 %			4.08 %

Demand Deposits (Non-Interest Bearing)	421,845			368,286		
All Other Liabilities	35,220			31,712		
Total Liabilities	1,753,060			1,733,161		
Shareholders' Equity	207,722			193,422		
Total Liabilities & Shareholders' Equity	$1,960,782			$1,926,583		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.07 %			0.13 %
Net Interest Income and Margin on Total Earning Assets		17,842	4.01 %		18,610	4.21 %
Tax Equivalent Adjustment		(351)			(332)	
Net Interest Income		$17,491	3.93 %		$18,278	4.13 %

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $774,000 and $684,000 for the quarters ended March 31, 2013 and 2012, respectively. Yields on securities available-for-sale are based on historical cost.

Table of Contents

Farmers & Merchants Bancorp
Volume and Rate Analysis of Net Interest Revenue
(Interest and Rates on a Taxable Equivalent Basis)

(in thousands)	Three Months Ended Mar. 31, 2013 compared to Mar. 31, 2012		
Interest Earning Assets	Volume	Rate	Net Chg.
Interest Bearing Deposits With Banks	$(9)	$-	$(9)
Investment Securities			
U.S. Agencies	(111)	(20)	(131)
Municipals - Non-Taxable	82	(33)	49
Mortgage Backed Securities	(240)	(467)	(707)
Other	135	1	136
Total Investment Securities	(134)	(519)	(653)
Loans			
Real Estate	1,520	(1,358)	162
Home Equity	(122)	(130)	(252)
Agricultural	(167)	(478)	(645)
Commercial	(175)	(89)	(264)
Consumer	(35)	4	(31)
Total Loans	1,021	(2,051)	(1,030)
Total Earning Assets	878	(2,570)	(1,692)
Interest Bearing Liabilities			
Interest Bearing Deposits			
Transaction	5	(22)	(17)
Savings and Money Market	32	(139)	(107)
Time Deposits	(68)	(182)	(250)
Total Interest Bearing Deposits	(31)	(343)	(374)
Securities Sold Under Agreement to Repurchase	(268)	(268)	(536)
Other Borrowed Funds	(3)	(4)	(7)
Subordinated Debentures	-	(7)	(7)
Total Interest Bearing Liabilities	(302)	(622)	(924)
Total Change	$1,180	$(1,948)	$(768)

Notes: Rate/volume variance is allocated based on the percentage relationship of changes in volume and changes in rate to the total "net change." The above figures have been rounded to the nearest whole number.

Net interest income decreased $787,000 or 4.3% to $17.5 million during the first quarter of 2013 compared to $18.3 million for the first quarter of 2012. On a fully tax equivalent basis, net interest income decreased 4.1% and totaled $17.8 million at March 31, 2013, compared to $18.6 million at March 31, 2012. As more fully discussed below, the decrease in net interest income was primarily due to a 20 basis point decrease in net interest margin.

Net interest income on a taxable equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For the quarter ended March 31, 2013, the Company's net interest margin was 4.01% compared to 4.21% for the quarter ended March 31, 2012. This decrease in net interest margin was due primarily to a decline in loan and investment securities yields that exceeded a corresponding drop in funding costs.

Average loans totaled $1.2 billion for the quarter ended March 31, 2013; an increase of $73.4 million compared to the average balance for the quarter ended March 31, 2012. Loans increased from 64.3% of average earning assets at March 31, 2012 to 67.5% at March 31, 2013. As a result of the continuing impact of the sustained low rate environment since late 2008, the annualized yield on the Company's loan portfolio declined to 5.14% for the quarter ended March 31, 2013, compared to 5.79% for the quarter ended March 31, 2012. Overall, the positive impact on interest revenue from the increase in loan balances was offset by the negative impact of a decline in yields resulting in interest revenue from loans decreasing 6.3% to $15.4 million for quarter ended March 31, 2013. The Company has been experiencing aggressive competitor pricing for loans to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Since the risk factor for investments is typically lower than that of loans, the yield earned on investments is generally less than that of loans. Average investment securities totaled $516.4 million for the quarter ended March 31, 2013; a decrease of $34.4 million compared to the average balance for the quarter ended March 31, 2012. Tax equivalent interest income on securities decreased $653,000 to $3.1 million for the quarter ended March 31, 2013, compared to $3.8 million for the quarter ended March 31, 2012. The average investment portfolio yield, on a tax equivalent (TE) basis, was 2.4% for the quarter ended March 31, 2013, compared to 2.7% for the quarter ended March 31, 2012. This decrease in yield was caused by a significant decline in the yield on the Company's mortgage-backed securities portfolio due to: (1) a shift in mix from 30 year MBS to 10, 15 and 20 year MBS; (2) a decline in overall mortgage rates; and (3) increased prepayment speeds on MBS purchased at a premium requiring those premiums to be amortized over a shorter period. This decline was partially offset by a shift in mix from short-term government agencies securities into mortgage-back securities and corporate securities. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2013. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statement of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Average interest bearing deposits with banks consisted of: (1) $750,000 in Community Reinvestment Act ('CRA') qualified CD's with various banks; and (2) $69.5 million in FRB deposits. The average rate paid on CRA qualified CD's for the first quarter of 2013 was 0.38% and balances with the FRB earn interest at the Fed Funds rate, which has been 0.25% since December 2008. Average interest bearing deposits with banks for the quarter ended March 31, 2013, was $70.2 million, a decrease of $13.7 million compared to the average balance for the quarter ended March 31, 2012. Interest income on interest bearing deposits with banks for the quarter ended March 31, 2013, decreased $9,000 to $44,000 compared to the quarter ended March 31, 2012.

Average interest-bearing sources of funds decreased $37.2 million or 2.8% during the first quarter of 2013. Of that decrease: (1) interest-bearing transaction deposits increased $27.2 million; (2) savings and money market deposits increased $52.9 million; (3) time deposits decreased $56.8 million; (4) securities sold under agreement to repurchase decreased $60 million (see “Financial Condition - Securities Sold Under Agreement to Repurchase”); (5) Federal Home Loan Bank (“FHLB”) Advances decreased $437,000 (see “Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings”); and (6) subordinated debt remained unchanged (see “Financial Condition – Subordinated Debentures”).

Table of Contents

During the first quarter of 2013, the Company was able to grow average interest bearing deposits by $23.3 million. See "Financial Condition – Deposits" for a discussion of trends in the Company's deposit base. Total interest expense on deposits was $683,000 for the first quarter of 2013 as compared to $1.1 million for the first quarter of 2012. The average rate paid on interest-bearing deposits was 0.22% for the first quarter of 2013 compared to 0.34% for the first quarter of 2012. The Company anticipates that this decline in deposit rates, if any, will be much more modest through the remainder of 2013.

Provision and Allowance for Credit Losses

As a financial institution that assumes lending and credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The Company has established credit management policies and procedures that govern both the approval of new loans and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans to one borrower, and by restricting loans made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Credit Risk." Management reports regularly to the Board of Directors regarding trends and conditions in the loan portfolio and regularly conducts credit reviews of individual loans. Loans that are performing but have shown some signs of weakness are subject to more stringent reporting and oversight.

Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan portfolio as of the balance-sheet date. The allowance is established through a provision for credit losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves for inherent losses related to loans collectively evaluated for impairment.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Loans determined to be impaired are individually evaluated for impairment. When a loan is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

A restructuring of a loan constitutes a troubled debt restructuring (TDR) if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

Generally, the Company will not restructure loans for customers unless: (i) the existing loan is brought current as to principal and interest payments; and (ii) the restructured loan can be underwritten to reasonable underwriting standards. If these standards are not met other actions will be pursued (e.g., foreclosure) to collect outstanding loan amounts. After restructure a determination is made whether the loan will be kept on accrual status based upon the underwriting and historical performance of the restructured credit.

The determination of the general reserve for loans that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors to include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

Table of Contents

The Company maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1st mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; and (8) consumer & other. See “Financial Condition – Loans” for examples of loans made by the Company. The allowance for credit losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. A credit grade is established at inception for smaller balance loans, such as consumer and residential real estate, and then updated only when the loan becomes contractually delinquent or when the borrower requests a modification. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Company's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently known facts, conditions and values, highly questionable or improbable.

Loss – Loans classified as loss are considered uncollectible. Once a loan becomes delinquent and repayment becomes questionable, the Company will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Bank will estimate its probable loss and immediately charge-off some or all of the balance.

The general reserve component of the allowance for credit losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk; (2) historical losses; and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Commercial Real Estate – Commercial real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Table of Contents

Agricultural Real Estate and Agricultural – Loans secured by crop production, livestock and related real estate are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Real Estate Construction – Real Estate Construction loans, including land loans, generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial – Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.