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

WASHINGTON, D.C. 20549

FORM 10-Q

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

or

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

Commission File Number 0-14492

FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

OHIO	**34-1469491**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
307 North Defiance Street, Archbold, Ohio	**43502**
(Address of principal executive offices)	**(Zip Code)**

(419) 446-2501

Registrant s telephone number, including area code

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

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

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

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

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

Indicate the number of shares of each of the issuers classes of common stock, as of the latest practicable date:

Common Stock, No Par Value	4,605,534
Class	Outstanding as of April 22, 2016

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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

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

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ITEM 1 FINANCIAL STATEMENTS

FARMERS & MERCHANTS BANCORP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

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

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

See Notes to Condensed Consolidated Unaudited Financial Statements.

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

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FARMERS & MERCHANTS BANCORP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME & COMPREHENSIVE INCOME

(Unaudited)

Condensed Consolidated Statements of Income & Comprehensive Income

(in thousands of dollars, except per share data)

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

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

See Notes to Condensed Consolidated Unaudited Financial Statements

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FARMERS & MERCHANTS BANCORP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

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

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

See Notes to Condensed Consolidated Unaudited Financial Statements.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS
NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2016 are not necessarily indicative of the results that are expected for the year ended December 31, 2016. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2015.

NOTE 2 ASSET PURCHASES

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

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

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

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

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

NOTE 3 SECURITIES

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

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

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

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

1. The fair value of the security has significantly declined from book value.

2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB by Standard and Poors.)

3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.

4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.

5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

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

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)
NOTE 3 SECURITIES (Continued)

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

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

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

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

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

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

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

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)
NOTE 3 SECURITIES (Continued)

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

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

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

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

NOTE 4 LOANS

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

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

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

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

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

The following is a maturity schedule by major category of loans as of March 31, 2016:

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

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

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

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

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

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

The following table represents the contractual aging of the recorded investment in past due loans by portfolio classification of loans as of March 31, 2016 and December 31, 2015, net of deferred loan fees and costs:

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

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

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

The following table presents the recorded investment in nonaccrual loans by class of loans as of March 31, 2016 and December 31, 2015:

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

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

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

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

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

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

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

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

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

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

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

The risk ratings are described as follows.

1. Zero (0) Unclassified. Any loan which has not been assigned a classification.

2. One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of Risk Management Association ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank s loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.

3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50, and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.

4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans that are meeting the terms of repayment.

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

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

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

b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;

c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.

5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.

6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential , versus defined , impairments to the primary source of loan repayment and collateral.

7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:

a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.

b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.

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

c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.

d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.

e. Unusual courses of action are needed to maintain a high probability of repayment.

f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.

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

h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.

i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.

j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:

a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.

b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.

c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.

9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution s financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

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

The following table represents the risk category of loans by portfolio class, net of deferred fees and costs, based on the most recent analysis performed as of March 31, 2016 and December 31, 2015:

			(In Thousands)		
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
March 31, 2016					
1-2	$ 5,912	$ 9,251	$ 536	$ 509	$
3	17,289	23,093	27,635	21,747	3,073
4	35,750	45,467	312,972	79,918	3,347
5	110	192	1,284	52	
6	361		1,812	559	
7	57	18	422	181	
8					
Total	$ 59,479	$ 78,021	$ 344,661	$ 102,966	$ 6,420

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

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

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of March 31, 2016 and December 31, 2015.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(In Thousands)

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

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

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

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

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

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

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

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

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

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

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

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

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commetment & Letters of Credit	Unallocated	Tota
ee Months Ended March 31, 2016									
LOWANCE FOR CREDIT LOSSES:									
nning balance	$ 338	$ 211	$ 582	$ 2,516	$ 1,229	$ 337	$ 208	$ 844	$ 6,2
rge Offs				(3)	(20)	(61)			(
overies	2		4	1	3	25			
ision (Credit)	117	61	(38)	164	39	34		(100)	2
r Non-interest expense related to nded							12		
ng Balance	$ 457	$ 272	$ 548	$ 2,678	$ 1,251	$ 335	$ 220	$ 744	$ 6,5
ng balance: individually evaluated for airment	$ 104	$ 57	$	$ 152	$ 113	$	$	$	$ 4
ng balance: collectively evaluated for airment	$ 353	$ 215	$ 548	$ 2,526	$ 1,138	$ 335	$ 220	$ 744	$ 6,0
ng balance: loans acquired with rioriated credit quality	$ 1								$
ANCING RECEIVABLES:									
ng balance	$ 88,097	$ 59,479	$ 78,021	$ 344,661	$ 109,386	$ 28,016	$	$	$ 707,6
ng balance: individually evaluated for airment	$ 874	$ 219	$	$ 937	$ 181	$	$	$	$ 2,2
	$ 87,223	$ 59,260	$ 78,021	$ 343,724	$ 109,205	$ 28,016	$	$	$ 705,4

ing balance: collectively evaluated for irment									
ing balance: loans acquired with riorated credit quality	$ 502	$	$	$	$	$	$	$	$ 5

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

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
Three Months Ended March 31, 2015									
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	$ 537	$ 184	$ 547	$ 2,367	$ 1,421	$ 323	$ 207	$ 526	$ 6,112
Charge Offs						(92)			(92)
Recoveries	2		1	1	5	41			50
Provision (Credit)	(42)	3	(24)	(156)	(7)	12		328	114
Other Non-interest expense related to unfunded							(5)		(5)
Ending Balance	$ 497	$ 187	$ 524	$ 2,212	$ 1,419	$ 284	$ 202	$ 854	$ 6,179
Ending balance: individually evaluated for impairment	$ 35	$	$ 24	$ 131	$ 238	$	$	$	$ 428