FARMERS & MERCHANTS BANCORP INC
Form 10-Q
October 29, 2014
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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 September 30, 2014

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	**4,627,848**
Class	**Outstanding as of October 29, 2014**

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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.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

Farmers & Merchants Bancorp, Inc. and Subsidiary

	Condensed Consolidated Balance Sheets (in thousands of dollars)	
	September 30, 2014	December 31, 2013
Assets		
Cash and due from banks	$ 12,058	$ 15,376
Interest bearing deposits with banks	4,899	2,889
Federal Funds Sold	322	998
Total cash and cash equivalents	17,279	19,263
Securities - available-for-sale	253,119	324,509
Other Securities, at cost	3,717	4,216
Loans, net	602,688	570,919
Bank premises and equipment	20,293	18,709
Goodwill	4,074	4,074
Mortgage Servicing Rights	2,019	2,066
Other Real Estate Owned	1,264	2,091
Accrued interest and other assets	20,788	20,091
Total Assets	$ 925,241	$ 965,938
Liabilities and Stockholders Equity		
Liabilities		
Deposits		
Noninterest-bearing	$ 120,103	$ 110,452
Interest-bearing		
NOW accounts	204,919	215,185
Savings	214,607	214,467
Time	205,277	236,360
Total deposits	744,906	776,464
Federal funds purchased and securities sold under agreement to repurchase	62,219	69,756
FHLB Advances		4,500
Dividend payable	965	967
Accrued expenses and other liabilities	5,129	5,911

Total liabilities	813,219	857,598
Commitments and Contingencies		
Stockholders Equity		
Common stock - No par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares	12,677	12,677
Treasury Stock - 572,152 shares 2014, 561,562 shares 2013	(11,916)	(11,611)
Unearned Stock Awards - 33,900 shares 2014, 31,530 shares 2013	(772)	(642)
Retained earnings	112,059	107,910
Accumulated other comprehensive income (loss)	(26)	6
Total stockholders equity	112,022	108,340
Total Liabilities and Stockholders Equity	$ 925,241	$ 965,938

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2013 Balance Sheet has been derived from the audited financial statements of that date.

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FARMERS & MERCHANTS BANCORP, INC.

CONDENSED CONSOLIDATED STATEMENT OF INCOME & COMPREHENSIVE INCOME

(Unaudited)

Farmers & Merchants Bancorp, Inc. and Subsidiary

	Condensed Consolidated Statement of Income & Comprehensive Income (in thousands of dollars, except per share data)			
	Three Months Ended		Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Interest Income				
Loans, including fees	$ 7,108	$ 6,244	$ 20,762	$ 18,411
Debt securities:				
U.S. Treasury securities	64	64	190	189
Securities of U.S. Government Agencies	747	971	2,292	2,979
Municipalities	512	513	1,559	1,562
Dividends	36	47	119	141
Federal funds sold	3		4	11
Other	1	5	8	18
Total interest income	8,471	7,844	24,934	23,311
Interest Expense				
Deposits	832	1,023	2,615	3,229
Federal funds purchased and securities sold under agreements to repurchase	63	62	190	184
Borrowed funds		44	4	133
Total interest expense	895	1,129	2,809	3,546
Net Interest Income - Before provision for loan losses	7,576	6,715	22,125	19,765
Provision for Loan Losses	282	303	1,154	582
Net Interest Income After Provision For Loan Losses	7,294	6,412	20,971	19,183
Noninterest Income				
Customer service fees	1,317	1,252	3,841	3,869
Other service charges and fees	1,047	995	2,767	2,824
Net gain on sale of loans	205	176	497	978
Net gain on sale of securities - available-for-sale	192	134	494	732
Total noninterest income	2,761	2,557	7,599	8,403
Noninterest Expenses				
Salaries and Wages	2,638	2,460	7,529	7,156

Pension and other employee benefits		927		819		2,492		2,273
Occupancy expense (net)		267		291		842		909
Furniture and equipment		439		350		1,232		1,057
Data processing		305		301		943		911
Franchise taxes		195		255		586		765
Net loss on sale of other assets owned		95		21		153		147
FDIC Assessment		126		146		388		406
Mortgage servicing rights amortization		92		88		258		345
Other general and administrative		1,495		1,382		4,405		4,165
Total Noninterest Expense		6,579		6,113		18,828		18,134
Income Before Federal Income Taxes		3,476		2,856		9,742		9,452
Federal Income Taxes		1,002		791		2,757		2,732
Net Income		2,474		2,065		6,985		6,720
Other Comprehensive Loss (Net of Tax):								
Unrealized loss on securities, net of tax benefit of $105, $82, $16, and $3,001 respectively		(204)		(159)		(32)		(5,825)
Comprehensive Income	$	2,270	$	1,906	$	6,953	$	895
Basic Earnings Per Share	$	0.54	$	0.45	$	1.51	$	1.44
Weighted Average Shares Outstanding		4,621,298		4,682,655		4,628,429		4,682,092
Dividends Declared	$	0.21	$	0.20	$	0.63	$	0.60

See Notes to Condensed Consolidated Unaudited Financial Statements

FARMERS & MERCHANTS BANCORP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

Farmers & Merchants Bancorp, Inc. and Subsidiary

	Condensed Consolidated Statements of Cash Flows (in thousands of dollars) Nine Months Ended	
	September 30, 2014	September 30, 2013
Cash Flows from Operating Activities		
Net income	$ 6,985	$ 6,720
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,091	916
Amortization of securities, net	1,130	1,714
Amortization of servicing rights	258	345
Amortization of core deposit intangible	360	234
Compensation expense related to stock awards	205	202
Provision for loan loss	1,154	582
Gain on sale of loans	(497)	(978)
Originations of loans held for sale	(26,312)	(54,874)
Proceeds from sale of loans held for sale	30,391	57,957
Loss on sale of other assets	153	147
Gain on sales of securities available for sale	(494)	(732)
Change in other assets and other liabilities, net	(1,369)	(521)
Net cash provided by operating activities	13,055	11,712
Cash Flows from Investing Activities		
Activity in securities:		
Maturities, prepayments and calls	13,281	28,722
Sales	57,928	63,570
Purchases		(83,310)
Proceeds from sale of fixed assets	9	35
Additions to premises and equipment	(2,684)	(1,804)
Loan originations and principal collections, net	(36,505)	(25,783)
Net cash provided by (used in) investing activities	32,029	(18,570)
Cash Flows from Financing Activities		
Net increase in deposits	(31,558)	(17,684)
Net change in short-term debt	(7,537)	10,010
Repayments of FHLB advances	(4,500)	(4,500)

Purchase of Treasury Stock		(576)		(734)
Cash dividends paid on common stock		(2,897)		(2,791)
Net cash used in financing activities		(47,068)		(15,699)
Change in Cash and Cash Equivalents		(1,984)		(22,557)
Cash and cash equivalents - Beginning of year		19,263		44,092
Cash and cash equivalents - End of period	$	17,279	$	21,535
Supplemental Information				
Cash paid during the year for:				
Interest	$	2,918	$	3,689
Income taxes	$	2,137	$	2,690
Noncash investing activities:				
Transfer of loans to other real estate owned	$	139	$	945

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 nine months ended September 30, 2014 are not necessarily indicative of the results that are expected for the year ended December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2013.

NOTE 2 ASSET PURCHASES
In connection with a December 31, 2007 Knisely acquisition, the Company recognized a core deposit intangible asset of $1.1 million, which is being amortized on a straight line basis over 7 years, which represents the estimated remaining economic useful life of the deposits.

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

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, 2013 was $319 thousand. Of the $480 thousand to be expensed in 2014, $360 thousand has been expensed as of September 30, 2014.

	(In Thousands)			
	Knisley	Hicksville	Custar	Total
2014	$ 157	$ 156	$ 167	$ 480
2015		155	167	322
2016		155	167	322
2017		77	167	244
2018			167	167
Thereafter			330	330
	$ 157	$ 543	$ 1,165	$ 1,865

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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) September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
U.S. Treasury	$ 25,892	$	$ (610)	$ 25,282
U.S. Government agency	120,245	534	(1,823)	118,956
Mortgage-backed securities	30,773	536	(176)	31,133
State and local governments	76,248	1,864	(364)	77,748
	$ 253,158	$ 2,934	$ (2,973)	$ 253,119

	(In Thousands) December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
U.S. Treasury	$ 26,067	$	$ (795)	$ 25,272
U.S. Government agency	174,772	1,386	(3,186)	172,972
Mortgage-backed securities	44,638	728	(574)	44,792
State and local governments	79,023	2,909	(459)	81,473
	$ 324,500	$ 5,023	$ (5,014)	$ 324,509

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 September 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

	(In Thousands) September 30, 2014			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$	$	$ (610)	$ 25,282
U.S. Government agency	(7)	5,488	(1,816)	85,088
Mortgage-backed securities	(10)	4,654	(166)	8,227
State and local governments	(234)	7,866	(130)	9,342
Total available-for-sale securities	$ (251)	$ 18,008	$ (2,722)	$ 127,939

	(In Thousands) December 31, 2013			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ (795)	$ 25,272	$	$
U.S. Government agency	(2,783)	96,241	(403)	4,598
Mortgage-backed securities	(574)	23,171		
State and local governments	(459)	19,594		
Total available-for-sale securities	$ (4,611)	$ 164,278	$ (403)	$ 4,598

Unrealized losses on securities have not been recognized into income because the issuers bonds are of high credit quality 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 September 30 for each of the years presented.

(In Thousands)

	2014	2013
Gross realized gains	$ 638	$ 735
Gross realized losses	(144)	(3)
Net realized gains	$ 494	$ 732
Tax expense related to net realized gains	$ 168	$ 249

The net realized gain on sales and related tax expense is a reclassification out of accumulated other comprehensive income. 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 September 30, 2014, 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	$ 20,590	$ 20,827
After one year through five years	146,785	146,351
After five years through ten years	46,793	46,842
After ten years	8,217	7,966
Total	$ 222,385	$ 221,986
Mortgage-backed securities	30,773	31,133
Total	$ 253,158	$ 253,119

Investments with a carrying value and fair value of $176.9 million at September 30, 2014 and $205.2 million at December 31, 2013 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 September 30, 2014. Federal Home Loan Bank of Indianapolis stock which was acquired in the Knisely acquisition, completely redeemed in early 2013. The stock acquired had a five-year redemption period. The stock is carried at cost, which approximates fair value.

NOTE 4 LOANS

The Company had $678 thousand in consumer real estate loans held for sale as of September 30, 2014 as compared to $556 thousand in loans held for sale on December 31, 2013. Due to lack of materiality, these loans are included in the Consumer Real Estate loans below.

Loan balances as of September 30, 2014 and December 31, 2013:

	(In Thousands)	
Loans:	September 30, 2014	December 31, 2013
Consumer real estate	$ 97,651	$ 92,438
Agricultural real estate	48,812	44,301

Agricultural	67,221	65,449
Commercial real estate	274,074	248,893
Commercial and industrial	92,926	99,498
Consumer	23,455	21,406
Industrial Development Bonds	4,854	4,358
	608,993	576,343
Less: Net deferred loan fees and costs	(389)	(230)
	608,604	576,113
Less: Allowance for loan losses	(5,916)	(5,194)
Loans - Net	$ 602,688	$ 570,919

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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 September 30, 2014:

	Maturities (In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	$ 10,820	$ 19,204	$ 67,627
Agricultural Real Estate	3,558	14,253	31,001
Agricultural	39,834	23,228	4,159
Commercial Real Estate	43,036	92,764	138,274
Commercial/Industrial	55,248	31,686	5,992
Consumer	5,307	14,137	4,011
Industrial Development Bonds	2,363	340	2,151

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of September 30, 2014. 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	$ 77,757	$ 19,894
Agricultural Real Estate	34,129	14,683
Agricultural	62,153	5,068
Commercial Real Estate	175,742	98,332
Commercial/Industrial	69,495	23,431
Consumer	19,191	4,264
Industrial Development Bonds	4,685	169

As of September 30, 2014 and December 31, 2013 one to four family residential mortgage loans amounting to $22.0 and $24.2 million, respectively, have been pledged as security for 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 segment of loans as of September 30, 2014 and December 31, 2013, net of deferred fees:

(In Thousands)

September 30, 2014	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	$ 576	$ 150	$ 489	$ 1,215	$ 96,436	$ 97,651	$
Agricultural Real Estate	25			25	48,787	48,812	
Agricultural					67,221	67,221	
Commercial Real Estate	56	709		765	273,309	274,074	
Commercial and Industrial					97,780	97,780	
Consumer	60	18	5	83	22,983	23,066	
Total	$ 717	$ 877	$ 494	$ 2,088	$ 606,516	$ 608,604	$

December 31, 2013	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	$ 778	$	$ 234	$ 1,012	$ 91,426	$ 92,438	$
Agricultural Real Estate					44,301	44,301	
Agricultural					65,449	65,449	
Commercial Real Estate			373	373	248,520	248,893	
Commercial and Industrial			26	26	103,830	103,856	
Consumer	28	2		30	21,146	21,176	
Total	$ 806	$ 2	$ 633	$ 1,441	$ 574,672	$ 576,113	$

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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 September 30, 2014 and December 31, 2013:

	(In Thousands)	
	September 30 2014	December 31 2013
Consumer Real Estate	$ 568	$ 483
Agricultural Real Estate		
Agricultural	2	
Commercial Real Estate	709	2,436
Commercial and Industrial	350	410
Consumer	5	
Total	$ 1,634	$ 3,329

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

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

NOTE 4 LOANS (Continued)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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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 class based on the most recent analysis performed as of September 30, 2014 and December 31, 2013:

	(In Thousands)				
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
September 30, 2014					
1-2	$ 3,961	$ 7,964	$ 1,250	$ 212	$
3	14,844	23,115	51,943	22,552	4,392
4	29,512	36,142	216,262	67,672	462
5	276		1,828	2,085	
6	219		2,791	174	
7				231	
8					
Total	$ 48,812	$ 67,221	$ 274,074	$ 92,926	$ 4,854

	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
December 31, 2013					
1-2	$ 3,764	$ 9,263	$ 1,104	$ 2,525	$
3	14,588	27,212	55,060	21,610	3,869
4	25,186	28,974	182,277	72,059	489
5	729		4,987	2,119	
6	34		5,092	758	
7			373	427	
8					
Total	$ 44,301	$ 65,449	$ 248,893	$ 99,498	$ 4,358

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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 September 30, 2014 and December 31, 2013.

	(In Thousands) Consumer Real Estate September 30 2014	Consumer Real Estate December 31 2013
Grade		
Pass	$ 96,961	$ 92,226
Special Mention (5)		
Substandard (6)	552	18
Doubtful (7)	138	194
Total	$ 97,651	$ 92,438

	(In Thousands)			
	Consumer - Credit		Consumer - Other	
	September 30 2014	December 31 2013	September 30 2014	December 31 2013
Performing	$ 3,618	$ 3,721	$ 19,421	$ 17,425
Nonperforming			27	30
Total	$ 3,618	$ 3,721	$ 19,448	$ 17,455

Information about impaired loans as of September 30, 2014, December 31, 2013 and September 30, 2013 are as follows:

	September 30, 2014	December 31, 2013	September 30, 2013
Impaired loans without a valuation allowance	$ 1,209	$ 924	$ 253
Impaired loans with a valuation allowance	477	1,516	1,308

Total impaired loans	$	1,686	$	2,440	$	1,561
Valuation allowance related to impaired loans	$	252	$	516	$	423
Total non-accrual loans	$	1,634	$	3,329	$	2,908
Total loans past-due ninety days or more and still accruing	$		$		$	
Quarter ended average investment in impaired loans	$	1,788	$	2,532	$	1,879
Year to date average investment in impaired loans	$	1,989	$	3,274	$	3,521

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

The Bank had approximately $824.4 thousand of its impaired loans classified as troubled debt restructured as of September 30, 2014, $861.2 thousand as of December 31, 2013 and $378.0 thousand as of September 30, 2013.

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

NOTE 4 LOANS (Continued)

The following table represents three months and nine months ended September 30, 2014.

Three Months September 30, 2014 Troubled Debt Restructurings	Number of Contracts Modified in the Last 3 Months	(In Thousands) Pre-Modification Outstanding Recorded Investment	(In Thousands) Post-Modification Outstanding Recorded Investment
Ag Real Estate		$	$

Nine Months September 30, 2014 Troubled Debt Restructurings	Number of Contracts Modified in the Last 9 Months	(In Thousands) Pre-Modification Outstanding Recorded Investment	(In Thousands) Post-Modification Outstanding Recorded Investment
Ag Real Estate	2	$ 153	$ 141

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

Three Months September 30, 2013 Troubled Debt Restructurings	Number of Contracts Modified in the Last 3 Months	(In Thousands) Pre-Modification Outstanding Recorded Investment	(In Thousands) Post-Modification Outstanding Recorded Investment
Commercial and Industrial		$	$

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

For the three and nine month periods ended September 30, 2014 and 2013, there were no TDRs that subsequently defaulted after modification.

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

NOTE 4 LOANS (Continued)

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

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

The following table presents loans individually evaluated for impairment by class of loans for three months ended September 30, 2014 and September 30, 2013.

	(In Thousands)				
Three Months Ended September 30, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	$ 26	$ 26	$	$ 26	$
Agricultural real estate				94	7
Agricultural					
Commercial real estate	709	709		739	
Commercial and industrial	474	474		476	7
Consumer					
With a specific allowance recorded:					
Consumer real estate	139	139	49	112	1
Agricultural real estate					
Agricultural					
Commercial real estate					
Commercial and industrial	338	338	203	341	
Consumer					
Totals:					

Consumer real estate	$	165	$	165	$	49	$	138	$	1
Agricultural real estate	$		$		$		$	94	$	7
Agricultural	$		$		$		$		$	