FARMERS & MERCHANTS BANCORP INC
Form 10-K
March 02, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

þ **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2010

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 0-14492

FARMERS & MERCHANTS BANCORP, INC.

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)

Registrant s telephone number, including area code (419) 446-2501

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
None	None

Securities registered pursuant to Section 12(g) of the Act:

Common shares without par value

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No þ

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 þ 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 (§ 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 o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes o No þ

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. (Check one):

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

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

As of June 30, 2010, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $86,373,431.65

As of February 25, 2011, the Registrant had 5,200,000 shares of common stock issued of which 4,693,969 shares are outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of Form 10-K Portions of the definitive Proxy Statement for the 2010 Annual Meeting of Shareholders of Farmers & Merchants Bancorp, Inc.

FARMERS & MERCHANTS BANCORP, INC.
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Statements contained in this portion of the Company s annual report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of such words as intend, believe, expect, anticipate, should, planned, estimated, and potential. S forward-looking statements are based on current expectations, but may differ materially from

those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the Company and its subsidiaries which include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank s market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results could differ from those projected in the forward-looking statements.

PART 1.

ITEM 1. BUSINESS

General

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

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

For a discussion of the general development of the Company s business throughout 2010, please see the portion of Management s Discussion and Analysis of Financial Condition and Results of Operations captioned 2010 in Review .

Nature Of Activities

The Bank s primary service area, Ohio, continued to experience high but declining unemployment. After reaching a high of 11% unemployment in March, 2010, the unemployment rate decreased in each of the ensuing months and closed the year at 9.6%. The agricultural industry continued its strong performance in 2010. Steel and trucking showed renewed strength early in the year and provided a portent of an improving economy. 1-4 family residential and construction remain weak. The Consumer Confidence increased from an average of 45% in 2009 to 53% in 2010 and January, 2011 topped 60%.

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

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

The Bank s underwriting policies, exercised through established procedures, facilitate operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank s practice has been not to promote innovative, unproven credit products which may not be in the best

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interest of the Bank or its customers. The Bank does offer a hybrid loan. Hybrid loans are loans that start as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank s adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer Mac and Small Business Lending programs. The Bank also retains the servicing on these partially or 100% sold loans. In order for the customer to participate in these programs they must meet the requirements established by these agencies.

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

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

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

Agricultural Real Estate: Purchase of farm real estate or for permanent improvements to the farm real estate. Cash flow from the farm operation is the primary 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 other factors.

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

Agricultural: Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re-finance of capital assets such as machinery and equipment, and livestock. The production of crops and livestock is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmer s ability to hedge their position by using 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.

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

Consumer Loans**:**

Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect. Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage periods of lost wages or death.

Boats, campers, motorcycles, RV s and Motor Coaches range from 80%-90% based on age of vehicle. 1st or 2nd mortgages on 1-4 family homes range from 75%-90% with in-house first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV.

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

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Commercial/Agriculture:
Real Estate:
Maximum LTVs range from 70%-80% depending on type.
Accounts Receivable:
Up 80% LTV
Inventory:
Agriculture:
Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%
Commercial:
Maximum LTV of 50% on raw and finished goods
Used vehicles, new recreational vehicles and manufactured homes not to exceed (NTE) 80% LTV
Equipment:

New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value
Restaurant equipment up to 35% of market value
Heavy trucks, titled trailers and NTE 75% LTV and aircraft up to 75% of appraised value

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

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

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

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

At December 31, 2010, we had 248 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be excellent.

Supervision and Regulation

General

The Company is a corporation organized under the laws of the State of Ohio. The business in which the Company and its subsidiary are engaged is subject to extensive supervision, regulation and examination by various bank regulatory authorities. The supervision, regulation and examination to which the Company and its subsidiary are subject are intended primarily for the protection of depositors and the deposit insurance funds that insure the deposits of banks, rather than for the protection of shareholders.

Several of the more significant regulatory provisions applicable to banks and bank holding companies to which the Company and its subsidiary are subject are discussed below, along with certain regulatory matters concerning the Company and its subsidiary. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statutory provisions. Any change in applicable law or regulation may have a material effect on the business and prospects of the Company and its subsidiary.

Regulatory Agencies

The Company is a registered bank holding company and is subject to inspection, examination and supervision by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) pursuant to the Bank Holding Company Act of 1956, as amended.

The Bank is an Ohio chartered commercial bank. It is subject to regulation and examination by both the Ohio Division of Financial Institutions (ODFI) and the Federal Deposit Insurance Corporation (FDIC).

Holding Company Activities

As a bank holding company incorporated and doing business within the State of Ohio, the Company is subject to regulation and supervision under the Bank Holding Act of 1956, as amended (the Act). The Company is required to file with the Federal Reserve Board on quarterly basis information pursuant to the Act. The Federal Reserve Board may conduct examinations or inspections of the Company and its subsidiary.

The Company is required to obtain prior approval from the Federal Reserve Board for the acquisition of more than five percent of the voting shares or substantially all of the assets of any bank or bank holding company. In addition, the Company is generally prohibited by the Act from acquiring direct or indirect ownership or control of more than five percent of the voting shares of any company which is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks or furnishing services to its subsidiaries. The Company may, however, subject to the prior approval of the Federal Reserve Board, engage in, or acquire shares of companies engaged in activities which are deemed by the Federal Reserve Board by order or by regulation to be so closely related to banking or managing and controlling a bank as to be a proper activity.

On November 12, 1999, the Gramm-Leach-Bliley Act (the GLB Act) was enacted into law. The GLB Act made sweeping changes with respect to the permissible financial services which various types of financial institutions may now provide. The Glass-Steagall Act, which had generally prevented banks from affiliation with securities and insurance firms, was repealed. Pursuant to the GLB Act, bank holding companies may elect to become a financial holding company, provided that all of the depository institution subsidiaries of the bank holding company are well capitalized and well managed under applicable regulatory standards.

Under the GLB Act, a bank holding company that has elected to become a financial holding company may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. Activities that are financial in nature include securities underwriting, dealing and market-making, sponsoring mutual funds and investment companies, insurance underwriting and agency, merchant banking, and activities that the Federal Reserve Board has determined to be closely related to banking. No Federal Reserve Board approval is required for the Company to acquire a company, other than a bank holding company, bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve

Board. Prior Federal Reserve Board approval is required before the Company may acquire the beneficial ownership or control of more than 5% of the voting shares, or substantially all of the assets, of a bank holding company, bank or savings association. If any subsidiary bank of the Company ceases to be well capitalized or well managed under applicable regulatory standards, the Federal Reserve Board may, among other actions, order the Company to divest the subsidiary bank. Alternatively, the Company may elect to conform its activities to those permissible for a bank holding company that is not also a financial holding company. If any subsidiary bank of the Company receives a rating under the Community Reinvestment Act of 1977 of less than satisfactory, the Company will be prohibited from engaging in new activities or acquiring companies other than bank holding companies, banks or savings associations. The Company has not elected to become a financial holding company and has no current intention of making such an election.

Affiliate Transactions

Various governmental requirements, including Sections 23A and 23B of the Federal Reserve Act, limit borrowings by holding companies and non-bank subsidiaries from affiliated insured depository institutions, and also limit various other transactions between holding companies and their non-bank subsidiaries, on the one hand, and their affiliated insured depository institutions on the other. Section 23A of the Federal Reserve Act also generally requires that an insured depository institution s loan to its non-bank affiliates be secured, and Section 23B of the Federal Reserve Act generally requires that an insured depository institution s transactions with its non-bank affiliates be on arms-length terms.

Interstate Banking and Branching

Under the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal), subject to certain concentration limits and other requirements, adequately capitalized bank holding companies such as the Company are permitted to acquire banks and bank holding companies located in any state. Any bank that is a subsidiary of a bank holding company is permitted to receive deposits, renew time deposits, close loans, service loans and receive loan payments as an agent for any other bank subsidiary of that bank holding company. Banks are permitted to acquire branch offices outside their home states by merging with out-of-state banks, purchasing branches in other states and establishing de novo branch offices in other states. The ability of banks to acquire branch offices is contingent, however, on the host state having adopted legislation opting in to those provisions of Riegle-Neal. In addition, the ability of a bank to merge with a bank located in another state is contingent on the host state not having adopted legislation opting out of that provision of Riegle-Neal. The Company could from time to time use Riegle-Neal to acquire banks in additional states.

Control Acquisitions

The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company, unless the Federal Reserve Board has been notified and has not objected to the transaction. Under the rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, such as the Company, would, under the circumstances set forth in the presumption, constitute acquisition of control of the bank holding company. In addition, a company is required to obtain the approval of the Federal Reserve Board under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of any class of outstanding voting stock of a bank holding company, or otherwise obtaining control or a controlling influence over that bank holding company.

Liability for Banking Subsidiaries

Under the current Federal Reserve Board policy, a bank holding company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to maintain resources adequate to support each subsidiary bank. This support may be required at times when the bank holding company may not have the resources to provide it. In the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a U.S. federal bank regulatory agency to maintain the capital of a subsidiary bank would be assumed by the bankruptcy trustee and entitled to priority of payment. Any depository institution insured by the FDIC can be held liable for any

loss incurred, or reasonably expected to be incurred, by the FDIC in connection with (1) the default of a commonly controlled FDIC-insured depository institution; or (2) any assistance provided by the FDIC to both a commonly controlled FDIC-insured depository institution in danger of default. The Company s subsidiary bank is an FDIC-insured depository institution. If a default occurred with respect to the Bank, any capital loans to the Bank from its parent holding company would be subordinate in right of payment to payment of the Bank s depositors and certain of its other obligations.

Regulatory Capital Requirements

The Company is required by the various regulatory authorities to maintain certain capital levels. Bank holding companies are required to maintain minimum levels of capital in accordance with Federal Reserve Board capital adequacy guidelines. If capital falls below minimum guideline levels, a bank holding company, among other things, may be denied approval to acquire or establish additional banks or non-bank businesses. The required capital levels and the Company s capital position at December 31, 2010 are summarized in the table included in Note 14 to the consolidated financial statements.

FDICIA

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the regulations promulgated under FDICIA, among other things, established five capital categories for insured depository institutions-well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized-and requires U.S. federal bank regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements based on these categories. Unless a bank is well capitalized, it is subject to restrictions on its ability to offer brokered deposits and on certain other aspects of its operations. An undercapitalized bank must develop a capital restoration plan and its parent bank holding company must guarantee the bank s compliance with the plan up to the lesser of 5% of the banks or thrift s assets at the time it became undercapitalized and the amount needed to comply with the plan. As of December 31, 2010, the Company s banking subsidiary was well capitalized pursuant to these prompt corrective action guidelines.

Dividend Restrictions

The ability of the Company to obtain funds for the payment of dividends and for other cash requirements will be largely dependent on the amount of dividends which may be declared by its banking subsidiary. Various U.S. federal statutory provisions limit the amount of dividends the Company s banking subsidiary can pay to the Company without regulatory approval. Dividend payments by the Bank are limited to its retained earnings during the current year and its prior two years. See Note 15 to the consolidated financial statements for the actual amount.

Deposit Insurance Assessments

The deposits of the Company s banking subsidiary are insured up to regulatory limits set by the FDIC, and, accordingly in 2010, were subject to deposit insurance assessments based on the Federal Deposit Insurance Reform Act of 2005, as adopted and effective on April 21, 2006. The FDIC maintains the Deposit Insurance Fund (DIF) by assessing depository institutions an insurance premium (assessment). The amount assessed to each institution is based on statutory factors that include the balance of insured deposits as well as the degree of risk the institution poses to the DIF. The FDIC assesses higher rates to those institutions that pose greater risks to the insurance fund.

In order to recapitalize and restore the DIF, the FDIC initially established a Restoration Plan in October 2008 to return the DIF to the statutorily mandated minimum reserve ratio of 1.15 percent within five years. Since 2008 and due to the extraordinary circumstances facing the banking industry, the FDIC imposed an emergency special assessment in 2009 and has continued to make further amendments to its Restoration Plan by extending the restoration period for the DIF, increasing the premium assessments, and changing how regular deposit insurance premiums are assessed. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) revised the statutory authorities governing the FDIC s management of the DIF. Key requirements from the Dodd-Frank Act have resulted in the FDIC s adoption of the following proposed amendments: (1) redefined the assessment base used to calculate deposit insurance assessments to average consolidated total assets minus average

tangible equity ; (2) raised the DIF s minimum reserve ratio to 1.35 percent and removed the upper limit on the reserve ratio; (3) revised adjustments to the assessment rates by eliminating one adjustment and adding another; and (4) revised the deposit insurance assessment rate schedules due to changes to the assessment base. Revised rate schedules and other revisions to the deposit insurance assessment rules would become effective April 1, 2011 and would be used to calculate the June 30, 2011 assessments which are due September 30, 2011. Though deposit insurance assessments maintain a risk-based approach, the FDIC s proposed changes effective April 1, 2011, impose a more extensive risk-based assessment system on large insured depository institutions with at least $10 billion in total assets since they are more complex in nature and could pose greater risk. Due to the changes to the assessment base and assessment rates, as well as the DIF restoration time frame, the impact on the Company s future deposit insurance assessments will likely result in increased premiums in future years.

The Emergency Economic Stabilization Act of 2008 provided a temporary increase in deposit insurance coverage from $100,000 to $250,000 per depositor. This legislation was effective immediately upon the President s signature on October 3, 2008. The basic deposit insurance limit was set to return to $100,000 on January 1, 2010; however, on May 20, 2009 the temporary increase was extended through December 31, 2013.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) permanently raised the standard maximum deposit insurance coverage amount to $250,000 and made the increase retroactive to January 1, 2008. This was effective immediately upon the President s signature on July 21, 2010. The FDIC deposit insurance coverage limit applies per depositor, per insurance depository institution for each account ownership category.

The FDIC Board of Directors issued a final rule on November 9, 2010 implementing a provision of the Dodd-Frank Act which temporarily provided for separate deposit insurance coverage for noninterest-bearing transaction accounts. Funds held in noninterest-bearing transaction accounts are fully insured, without limit, and the temporary unlimited coverage is separate from, and in addition to, the deposit insurance coverage provided to depositors with respect to other accounts held at an insured depository institution. This temporary deposit insurance coverage became effective on December 31, 2010 and will terminate on December 31, 2012. A noninterest-bearing transaction account is a deposit account in which (1) interest is neither accrued nor paid, (2) depositors are permitted to make an unlimited number of transfers and withdrawals, and (3) the insured depository institution does not reserve the right to require advance notice of an intended withdrawal. As of January 1, 2013, noninterest-bearing transaction accounts will then be insured under the FDIC s general deposit insurance coverage rules. The Dodd-Frank Act provision did not include low-interest NOW (Negotiable Order of Withdrawal) Accounts or Interest on Lawyer Trust Accounts (IOLTAs) within the definition of noninterest-bearing transaction accounts. On December 29, 2010, the FDIC Board of Directors issued a final rule amending the Federal Deposit Insurance Act (FDI Act) to include IOLTAs within the definition of a noninterest-bearing transaction account thereby providing such accounts with temporary, unlimited deposit insurance coverage.

Depositor Preference Statute

In the liquidation or other resolution of an institution by any receiver, U.S. federal legislation provides that deposits and certain claims for administrative expenses and employee compensation against the insured depository institution would be afforded a priority over general unsecured claims against that institution, including federal funds and letters of credit.

Government Monetary Policy

The earnings of the Company are affected primarily by general economic conditions and to a lesser extent by the fiscal and monetary policies of the federal government and its agencies, particularly the Federal Reserve. Its policies influence, to some degree, the volume of bank loans and deposits, and interest rates charged and paid thereon, and thus have an effect on the earnings of the Company s subsidiary Bank.

Capital Purchase Program

In response to the financial crisis affecting the banking system and financial markets, the Emergency Economic Stabilization Act of 2008 (the EESA) was signed into law on October 3, 2008 creating the Troubled Assets Relief Program (TARP). As part of TARP, the U.S. Treasury established the Capital Purchase Program to provide up to

$700 billion of funding to eligible financial institutions through the purchase of capital stock and other financial institutions for the purpose of stabilizing and providing liquidity to the United States financial markets. The Company did not participate in the TARP Capital Purchase Program. In connection with the EESA, there have been numerous actions by the Federal Reserve Board, the United States Congress, the U.S. Treasury, the FDIC, the SEC and others to further the economic and banking industry stabilization efforts under the EESA. It remains unclear at this time what further legislative and regulatory measures will be implemented under the EESA that affect the Company.

Additional Regulation

The Bank is also subject to federal regulation as to such matters as required reserves, limitation as to the nature and amount of its loans and investments, regulatory approval of any merger or consolidation, issuance or retirement of their own securities, limitations upon the payment of dividends and other aspects of banking operations. In addition, the activities and operations of the Bank are subject to a number of additional detailed, complex and sometimes overlapping laws and regulations. These include state usury and consumer credit laws, state laws relating to fiduciaries, the federal Truth-in-Lending Act and Regulation Z, the federal Equal Credit Opportunity Act and Regulation B, the Fair Credit Reporting Act, the federal Home Mortgage Disclosure Act and Regulation C, the federal Electronic Funds Transfer Act and Regulation E, the federal Truth in Lending Act and Regulation Z, the federal Truth in Savings Act and Regulation DD, the Bank Secrecy Act, the federal Community Reinvestment Act, HUD s Real Estate Settlement Act (RESPA) regulations, anti-discrimination laws and legislation, and antitrust laws.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) signed by the President on July 21, 2010 posed a significant impact on financial regulations. Certain provisions such as the permanent increase in deposit insurance coverage had an immediate effective date. Provisions regarding rules for interchanges fees on electronic debit transactions must be effective by July 21, 2011. Other provisions which, though intended to provide regulatory relief to community banks, may require time and further analysis to evaluate the actual consequences. Implementation of the Dodd-Frank Act provisions, which are conservatively estimated at more than 5,000 pages of new or expanded regulations for banks, will result in new rulemaking by the federal regulatory agencies over the next several years. Fully implementing the new and expanded regulation will involve ensuring compliance with extensive new disclosure and reporting requirements. The Dodd-Frank Act created an independent regulatory body, the Bureau of Consumer Financial Protection (Bureau), with authority and responsibility to set rules and regulations for most consumer protection laws applicable to all banks large and small adds another regulator to scrutinize and police financial activities. Transfer to the Bureau of all consumer financial protection functions for designated laws by the other federal agencies must be completed no later than July 21, 2011. The Bureau has responsibility for mortgage reform and enforcement, as well as broad new powers over consumer financial activities which could impact what consumer financial services would be available and how they are provided. The following consumer protection laws are the designated laws that will fall under the Bureau s rulemaking authority: the Alternative Mortgage Transactions Parity Act of 1928, the Consumer Leasing Act of 1976, the Electronic Fund Transfer Act, the Equal Credit Opportunity Act, the Fair Credit Billing Act, the Fair Credit Reporting Act subject to certain exclusions, the Fair Debt Collection Practices Act, the Home Owners Protection Act, certain privacy provisions of the Gramm-Leach-Bliley Act, the Home Mortgage Disclosure Act (HMDA), the Home Ownership and Equity Protection Act of 1994, the Real Estate Settlement Procedures Act (RESPA), the S.A.F.E. Mortgage Licensing Act of 2008 (SAFE Act), and the Truth in Lending Act. Review and revision of current financial regulations in conjunction with added new financial service regulations will heighten the regulatory compliance burden and increase litigation risk for the banking industry.

Future Legislation

Changes to the laws and regulations, both at the federal and state levels, can affect the operating environment of the Company and its subsidiary in substantial and unpredictable ways. The Company cannot accurately predict whether those changes in laws and regulations will occur, and, if those changes occur, the ultimate effect they would have upon the financial condition or results of operations of the Company or its subsidiary.

****Available Information:

The Company maintains an Internet web site at the following internet address: www.fm-bank.com. The Company files reports with the Securities and Exchange Commission (SEC). Copies of all filings made with the SEC may be

read and

copied at the SEC s Public Reference Room, 450 Fifth Street, Washington, DC, 20549. You may obtain information about the SEC s Public Reference Room by calling (800/SEC-0330). Because the Company makes its filing with the SEC electronically, you may access such reports at the SEC s website, www.sec.gov. The Company makes available, free of charge through its internet address, copies of its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to these reports as soon as reasonable practicable after such materials have been filed with or furnished to the SEC. Copies of these documents may also be obtained, either in electronic or paper form, by contacting Barbara J. Britenriker, Chief Financial Officer of the Company at (419) 446-2501.

Please see the Consolidated Financial Statements provided under Part II, Item 8 of this Form 10-K for information regarding the Company s revenues from external customers, profits, and total assets for and as of, respectively, the fiscal year ended December 31, 2010.

ITEM 1a. RISK FACTORS

Significant Competition from an Array of Financial Service Providers

Our ability to achieve strong financial performance and a satisfactory return on investment to shareholders will depend in part on our ability to expand our available financial services. In addition to the challenge of attracting and retaining customers for traditional banking services, our competitors now include securities dealers, brokers, mortgage bankers, investment advisors and finance and insurance companies who seek to offer one-stop financial services to their customers that may include services that banks have not been able or allowed to offer to their customers in the past. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems and the accelerating pace of consolidation among financial services providers. If we fail to adequately address each of the competitive pressures in the banking industry, our financial condition and results of operations could be adversely affected.

Credit Risk

The risk of nonpayment of loans is inherent in commercial banking. Such nonpayment could have an adverse effect on the Company s earnings and our overall financial condition as well as the value of our common stock. Management attempts to reduce the Bank s credit exposure by carefully monitoring the concentration of its loans within specific industries and through the loan approval process. However, there can be no assurance that such monitoring and procedures will totally mitigate the risks. Credit losses can cause insolvency and failure of a financial institution and, in such event, its shareholders could lose their entire investment. For more information on the exposure of the Company and the Bank to credit risk, see the section under Part II, Item 7 of this Form 10-K captioned Loan Portfolio.

Susceptibility to Changes in Regulation

Any changes to state and federal banking laws and regulations may negatively impact our ability to expand services and to increase the value of our business. We are subject to extensive state and federal regulation, supervision, and legislation that govern almost all aspects of our operations. These laws may change from time to time and are primarily intended for the protection of consumers, depositors and the deposit insurance funds. In addition, the Company s earnings are affected by the monetary policies of the Board of Governors of the Federal Reserve. These policies, which include regulating the national supply of bank reserves and bank credit, can have a major effect upon the source and cost of funds and the rates of return earned on loans and investments. The Federal Reserve influences the size and distribution of bank reserves through its open market operations and changes in cash reserve requirements against member bank deposits. The Gramm-Leach-Bliley Act regarding financial modernization that became effective in November, 1999 removed many of the barriers to the integration of the banking, securities and insurance industries and is likely to increase the competitive pressures upon the Bank. We cannot predict what effect such Act and any presently contemplated or future changes in the laws or regulations or their interpretations would have on us, but such changes could be materially adverse to our financial performance. For more information on this subject, see the section under Part I, Item 1 of this Form 10-K captioned Supervision and Regulation.

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Interest Rate Risk

Changes in interest rates affect our operating performance and financial condition in diverse ways. Our profitability depends in substantial part on our net interest spread, which is the difference between the rates we receive on loans and investments and the rates we pay for deposits and other sources of funds. Our net interest spread will depend on many factors that are partly or entirely outside our control, including competition, federal economic, monetary and fiscal policies, and economic conditions generally. Historically, net interest spreads for other financial institutions have widened and narrowed in response to these and other factors, which are often collectively referred to as interest rate risk. Over the last few years, the Bank, along with most other financial institutions, has experienced a margin squeeze as drastic interest rate fluctuations have made it difficult to maintain a more favorable net interest spread. During 2010, the Bank s margin and spread tightened slightly as the rate environment remained low and flat. Maturities of higher rate deposits aided the decrease in cost of funds.

The Bank manages interest rate risk within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. For more information regarding the Company s exposure to interest rate risk, see Part II, Item 7A of this Form 10-K.

Attraction and Retention of Key Personnel

Our success depends upon the continued service of our senior management team and upon our ability to attract and retain qualified financial services personnel. Competition for qualified employees is intense. In our experience, it can take a significant period of time to identify and hire personnel with the combination of skills and attributes required in carrying out our strategy. If we lose the services of our key personnel, or are unable to attract additional qualified personnel, our business, financial condition, results of operations and cash flows could be materially adversely affected.

A key component of employee retention is providing a fair compensation base combined with the opportunity for additional compensation for above average performance. In this regard, the Company and the Bank use two incentive programs. The Company uses a stock award program to recognize and incent officers of the Bank. Under the long-term incentive compensation plan, restricted stock awards may be granted to officers. The amount of shares to be granted each year is determined by the Board Compensation Committee and may vary each year in its amount of shares and the number of recipients. The Compensation Committee determines the number of shares to be awarded overall and to the Chief Executive Officer (CEO). The CEO then makes recommendations to the committee as to the recipients of the remaining shares. The full Board of Directors approves the action of the Committee. Since the plan s inception in 2005, all granted stock awards have utilized a three year cliff vesting feature. This is viewed as a retention aid as the awards may be forfeited should an officer leave employment during the vesting period.

A second incentive program of the Bank is based on cash compensation of which almost all employees participate (excluding commission based employees and other employees paid for specific higher paid positions, such as peak time.) A discussion of executive officer pay is incorporated within the proxy and as such, this discussion will pertain to all other employees. Non-officer employees are paid a cash incentive based on the projected overall performance of the Bank in terms of Return of Average Assets (ROA). The Compensation Committee determines the target performance levels on which the percentage of pay will be based. The Committee takes into account the five and ten year trend of ROA along with budget forecasted for the next year and the Bank s past year performance. The Committee also considers the predicted banking environment under which the Bank will be operating. Non-officers receive incentive pay in December of the same year based on the year-to-date base compensation through the last pay received in November.

Officers, other than executive, receive incentive pay based on additional criterion. The officers are rewarded based on overall ROA of the Bank along with individual pre-established goals. Officers, therefore, have incentive pay at risk for individual performance. The individualized goals are recommended by each officer s supervisor and are approved by an incentive committee of the Bank. The goals are designed to improve the performance of the Bank while also

limiting the risk of a short-term performance focus. For example, a lending officer may be given two goals of which one is to grow loans within specific targets and another is tied to a specific level of past dues and charge-offs. The second goal limits the ability to be rewarded for growth at all costs along with the specific target levels within the growth goal itself. Officers in a support department may be given goals which create efficiencies, ensure compliance with procedures, or generate new fee or product opportunities. An average of four goals were given to each officer in 2010. Officers are paid cash incentives based on the year end ROA of the Bank and receive it within the first quarter of the following year. Should the ROA be forecasted to be positive but below the base target set by the Board, the officers are paid an incentive under the same basis and timing as non-officers disclosed above.

The percentages of base pay on which the incentive is calculated graduates higher as does the responsibility level of the employee and their ability to impact the financial performance of the Bank. These percentages are recommended by management to the Compensation Committee and Board for approval. The cash incentive plan along with its targets and goals are subject to modification at the Compensation Committee and Board s discretion throughout each year.

Dividend Payout Restrictions

We currently pay a quarterly dividend on our common shares. However, there is no assurance that we will be able to pay dividends in the future. Dividends are subject to determination and declaration by our board of directors, which takes into account many factors. The declaration of dividends by us on our common stock is subject to the discretion of our board and to applicable state and federal regulatory limitations. The Company s ability to pay dividends on its common stock depends on its receipt of dividends from the Bank. The Bank is subject to restrictions and limitations in the amount and timing of the dividends it may pay to the Company.

Anti-Takeover Provisions

Provisions of our Articles of Incorporation and Ohio law could have the effect of discouraging takeover attempts which certain stockholders might deem to be in their interest. These anti-takeover provisions may make us a less attractive target for a takeover bid or merger, potentially depriving shareholders of an opportunity to sell their shares of common stock at a premium over prevailing market prices as a result of a takeover bid or merger.

Operational Risks

We are subject to certain operational risks, including, but not limited to, data processing system failures and errors, customer or employee fraud and catastrophic failures resulting from terrorist acts or natural disasters. We maintain a system of internal controls to mitigate against such occurrences and maintain insurance coverage for such risks that are insurable, but should such an event occur that is not prevented or detected by our internal controls, uninsured or in excess of applicable insurance limits, it could have a significant adverse impact on our business, financial condition or results of operations.

Limited Trading Market

Our common stock is not listed on any exchange or The NASDAQ Stock Market. Our stock is currently quoted in the over-the-counter markets.

ITEM 1b. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal office is located in Archbold, Ohio.

The Bank operates from the facilities at 307 North Defiance Street. In addition, the Bank owns the property from 200 to 208 Ditto Street, Archbold, Ohio, which it uses for Bank parking and a community mini-park area. The Bank owns

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real estate at two locations, 207 Ditto Street and 209 Ditto Street in Archbold, Ohio upon which the bank built a commercial building to be used for storage, and a parking lot for company vehicles and employee parking. The Bank also owns real estate across from the main facilities to provide for parking.

The Bank occupies an Operations Center at 622 Clydes Way in Archbold, Ohio to accommodate our growth over the years. The bank owns a parking lot in downtown Montpelier which had been provided for customer use. The bank owns a property at 204 Washington Street, St Joe, Indiana at which an ATM is located.

The Bank owns all of its office locations, with the exception of Angola, Indiana. The Angola office location is leased. Current locations of retail banking services are:

Office	**Location**
Archbold, Ohio	1313 S Defiance Street
Wauseon, Ohio	1130 N Shoop Avenue 119 N Fulton Street
Stryker, Ohio	300 S Defiance Street
West Unity, Ohio	200 W Jackson Street
Bryan, Ohio	929 E High Street 1000 S Main Street
Delta, Ohio	101 Main Street
Montpelier, Ohio	1150 E Main Street
Napoleon, Ohio	2255 Scott Street
Swanton, Ohio	7 Turtle Creek Circle
Defiance, Ohio	1175 Hotel Drive
Perrysburg, Ohio	7001 Lighthouse Way
Butler, Indiana	200 S Broadway
Auburn, Indiana	403 Erie Pass
Angola, Indiana	2310 N Wayne Street
Hicksville, Ohio	100 N. Main Street

All but one of the above locations have drive-up service facilities and an ATM.

ITEM 3. LEGAL PROCEEDINGS

There are no material pending legal proceedings, other than ordinary routine proceedings incidental to the business of the Bank or the Company, to which we are a party or of which any of our properties are the subject.

ITEM 4. No longer applicable.

PART II.

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is not listed on the NASDAQ stock market or any other stock exchange. While there is no established public trading market for our common stock, our shares are currently dually-quoted by various market

makers on the Pink Sheets and the Over the Counter Bulletin Board, which are both over-the-counter quotation services for participant broker-dealers.

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There are market makers that set a price for our stock; however, private sales continue to occur. The high and low sale prices were from sales of which we have been made aware by researching daily on Bloomberg.com. The high and low sale prices known to our management are as follows:

	Stock Prices 2010	
Quarter	**Low**	**High**
1st	$ 16.00	$ 19.00
2nd	17.00	20.00
3rd	17.95	19.45
4th	16.95	18.75

	Stock Prices 2009	
Quarter	**Low**	**High**
1st	$ 17.60	$ 20.00
2nd	17.55	20.50
3rd	19.25	20.99
4th	15.20	19.00

The Company utilizes Registrar and Transfer Company as its transfer agent.

As of February 7, 2011 there were 2,052 record holders of our common stock.

Below is a line-graph presentation comparing the cumulative total shareholder returns for the Corporation, an index for NASDAQ Stock Market (U.S. Companies) comprised of all domestic common shares traded on the NASDAQ National Market System and the NASDAQ Bank Index for the five-year period ended December 31, 2010. The chart compares the value of $100 invested in the Corporation and each of the indices and assumes investment on December 31, 2005 with all dividends reinvested.

The Board of Directors recognizes that the market price of stock is influenced by many factors, only one of which is performance. The stock price performance shown on the graph is not necessarily indicative of future performance.

I. Year 2005 as the Base

	2005	**2006**	**2007**	**2008**	**2009**	**2010**
FMSB	100.00	102.11	95.40	97.31	84.16	94.87
NASDAQ COMPOSITE	100.00	110.33	121.98	74.11	106.34	124.87
NASDAQ-BANK INDEX	100.00	113.65	91.88	73.53	62.73	70.25

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Dividends are declared and paid quarterly. Per share dividends declared for the years ended 2010 and 2009 are as follows:

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2010	0.18	0.18	0.18	0.19	0.73
2009	0.18	0.18	0.18	0.18	0.72

The ability of the Company to pay dividends is limited by the dividend that the Company receives from the Bank. The Bank may pay as dividends to the Company its retained earnings during the current year and its prior two years. Currently, such limitation on the payment of dividends from the Bank to the Company does not materially restrict the Company s ability to pay dividends to its shareholders.

Dividends declared during 2010 were $0.73 per share totaling $3.44 million, 1.39% higher than 2009 declared dividends of $0.72 per share. During 2010, the Company purchased 48,130 shares and awarded 10,150 shares to 53 employees and 1,575 shares were forfeited under its long term incentive plan. At year end, 2010, the Company held 477,106 shares in Treasury stock and 28,925 in unearned stock awards.

Dividends declared during 2009 were $0.72 per share totaling $3.41 million, 5.88% higher than 2008 declared dividends of $0.68 per share. During 2009, the Company purchased 28,907 shares and awarded 10,000 restricted shares to 49 employees under its long term incentive plan. 350 shares were forfeited during 2009. At year end 2009, the Company held 437,551 shares in Treasury stock and 27,775 in unearned stock awards.

The Company continues to have a strong capital base and to maintain regulatory capital ratios that are significantly above the defined regulatory capital ratios. On January 21, 2011, the Company announced the authorization by its Board of Directors for the Company s repurchase, either on the open market, or in privately negotiated transactions, of up to 200,000 shares of its outstanding common stock commencing January 1, 2011 and ending December 31, 2011.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Remaining Share Repurchase Authorization
10/1/2010 to 10/31/2010				172,275
11/1/2010 to 11/30/2010	5,000	$ 18.00	5,000	167,275
12/1/2010 to 12/31/2010	15,405	$ 17.61	15,405	151,870
Total (I)	20,405	$ 17.70	20,405	151,870

(1) The Company purchased shares in the market pursuant to stock repurchase program publicly announced on December 18, 2009. On that date, the Board of Directors authorized the repurchase of 200,000 common shares between January 1, 2010 and December 31, 2010. 20,405 shares were repurchased in the fourth quarter. In total for 2010, 48,130 shares were repurchased.

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Reclassification

Certain amounts in the 2009 and 2008 consolidated financial statements have been reclassified to conform with the 2010 presentation.

ITEM 6. SELECTED FINANCIAL DATA

SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA

Summary of Consolidated Statement of Income UNAUDITED

	(In Thousands, except share data)				
	2010	**2009**	**2008**	**2007**	**2006**
Summary of Income:					
Interest income	$ 39,893	$ 41,114	$ 43,824	$ 45,424	$ 42,269
Interest expense	10,863	13,220	18,101	21,722	18,535
Net Interest Income	29,030	27,894	25,723	23,702	23,734
Provision for loan loss	5,325	3,558	1,787	871	525
Net interest income after provision for loan loss	23,705	24,336	23,936	22,831	23,209
Other income (expense), net	(14,342)	(15,256)	(14,763)	(12,269)	(11,966)
Net income before income taxes	9,363	9,080	9,173	10,562	11,243
Income taxes	2,382	2,475	2,450	2,828	3,107
Net income	$ 6,981	$ 6,605	$ 6,723	$ 7,734	$ 8,136
Per Share of Common Stock:					
Earnings per common share outstanding *					
Net income	$ 1.48	$ 1.39	$ 1.39	$ 1.52	$ 1.57
Dividends	$ 0.730	$ 0.720	$ 0.680	$ 0.640	$ 0.575
Weighted average number of shares outstanding	4,721,235	4,741,392	4,846,310	5,097,636	5,186,329

* Based on weighted average number of shares outstanding

Summary of Consolidated Balance Sheet UNAUDITED

	(In Thousands)				
	2010	**2009**	**2008**	**2007**	**2006**
Total assets	$ 906,363	$ 853,860	$ 805,729	$ 803,974	$ 737,096
Loans, net	521,883	563,911	562,336	523,474	498,580
Total Deposits	724,513	676,444	615,732	634,593	585,409
Stockholders equity	94,403	93,584	90,547	89,375	87,732

Key Ratios

Return on average equity	7.38%	7.19%	7.51%	8.71%	9.64%
Return on average assets	0.80%	0.80%	0.84%	1.06%	1.14%
Loans to deposits	72.03%	83.36%	91.33%	82.49%	85.17%
Capital to assets	10.42%	10.96%	11.24%	11.12%	11.90%
Dividend payout	49.33%	51.66%	48.77%	42.00%	36.63%

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ITEM 7. MANAGEMENTS DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Critical Accounting Policy and Estimates

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the financial services industry in which it operates. At times the application of these principles requires Management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments.
Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.
All significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the notes to the consolidated financial statements and in the management discussion and analysis of financial condition and results of operations, provide information on how significant assets and liabilities are valued and how those values are determined for the financial statements. Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL) and the valuation of its Mortgage Servicing Rights and Other Real Estate Owned (OREO) as the accounting areas that requires the most subjective or complex judgments, and as such could be the most subject to revision as new information becomes available.
Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of fair value or the loan carrying amount at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by Management and the assets are carried at the lower of carrying amount or fair value less cost to sell.
The ALLL represents management s estimate of credit losses inherent in the Bank s loan portfolio at the report date. The estimate is a composite of a variety of factors including experience, collateral value, and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion. The collection and ultimate recovery of the book value of the collateral, in most cases, is beyond our control.
The Company is also required to estimate the value of its Mortgage Servicing Rights. The Company recognizes as separate assets rights to service fixed rate single-family mortgage loans that it has sold without recourse but services for others for a fee. Mortgage servicing assets are initially recorded at cost, based upon pricing multiples as determined by the purchaser, when the loans are sold. Mortgage servicing assets are carried at the lower of the initial carrying value, adjusted for amortization, or estimated fair value. Amortization is determined in proportion to and over the period of estimated net servicing income using the level yield method. For purposes of determining impairment, the mortgage servicing assets are stratified into like groups based on loan type, term, new versus seasoned and interest rate. The valuation is completed by an independent third party.
The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced.
The Company s mortgage servicing rights relating to loans serviced for others represent an asset of the Company. This asset is initially capitalized and included in other assets on the Company s consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying mortgage servicing rights. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Company, including the estimated prepayment speed of the loan and the discount rate used to present value the servicing right. For

example, if the mortgage loan is prepaid, the Company will receive fewer servicing fees, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Company s balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Company of the mortgage servicing rights, the Company receives a valuation of its mortgage servicing rights from an independent third party. The independent third party s valuation of the mortgage servicing rights is based on relevant characteristics of the Company s loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as current national market interest rate levels, market forecasts and other economic conditions. Management, with the advice from its third party valuation firm, review the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter s analysis related to the mortgage servicing asset. In addition, based upon the independent third party s valuation of the Company s mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Company. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Company s net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on market conditions. The accuracy of these estimates and assumptions by management and its third party can be directly tied back to the fact that management has not been required to record a valuation allowance through its income statement based upon the valuation of each stratum of serving rights.

For more information regarding the estimates and calculations used to establish the ALLL and the value of Mortgage Servicing Rights, please see Note 1 to the consolidated financial statements provided herewith.

2010 in Review

During 2010 the Company proved it was up to the challenges presented by another tough year. One of the first indications of decreased revenue caused by regulatory changes was felt in the overdraft fee arena. The impact of regulatory reform on fees in banking remains a concern for the Company in the coming years. Economic challenges were also faced by the Company, our shareholders, employees and customers. Unemployment remained high in the markets we serve, though slight improvements began towards the second half of the year. The economic outlook appears to favor the economic recovery, though recognition of its fragility exists.

Continued difficult economic stresses caused the Company to experience significant expenses to improve its loan quality and to seek additional sources of revenue to offset these costs. Loan costs included increased collection, loss provision, and legal expenses. The benefits of those costs were an $8.2 million decrease in nonaccrual loans, $7.8 million decrease in loans classified as impaired, and an overall $8.7 million decrease in the Bank s watch list loans, as of December 31, 2010 as compared to 2009, all of which; positions the Company for better earnings in the year to come.

The improvement in asset quality also correlates to a $42 million decrease in the net loan balances when comparing December 31, 2010 to the same date in 2009. This smaller loans balance in turn explains a somewhat hidden cost a decline in the interest income from loans for 2010 as compared to 2009. This is discussed in greater detail in the net interest income section.

Offsetting the additional expenses in the loan portfolio was the $956 thousand gain on sale of investments and an increase in noninterest income during 2010. A decrease in long-term rates during the fourth quarter spurred activity in the consumer real estate market and the addition of the Hicksville office in July 2010 contributed to the increase in noninterest income.

The Company is proud of the strides that were achieved in improving asset quality while increasing 2010 s net income over 2009. Earnings per share were $0.09 higher than the previous two years. The Company is well positioned to face the challenges of 2011.

Material Changes in Results of Operations

The discussion now turns to more financial based results and trends as a result of 2010 operations. In comparing line items of the consolidated statement of income for years ended 2008 through 2010, it is easily seen where the Company has been spending its time and the impact of the recession. Decreasing interest income and expense are obvious large factors on the profitability of the Company for 2010; however, that discussion can be found in the net interest income section. This discussion will focus on the significant noninterest items that impacted the operations of the Company.

Looking at the positive items first; overall, non-interest income shows a trend of improvement. A nice improvement of $1.1 million in 2010 over 2009 was preceded by a more significant gain of over $1.3 million in 2009 as compared to 2008. Accounting for over $1 million of the gain in 2009 was the revenue generated from mortgage loan activity through establishing mortgage servicing rights and gain on the sale of loans into the secondary market. As mentioned earlier, the fourth quarter of 2010 was also a busy time handling refinance activity for mortgages; however the volume was below 2009. In terms of dollars, 2010 was $381 thousand lower than 2009 s noninterest income from mortgage activities. It did make up almost $1.4 million of noninterest income in 2010. It was a much needed, but unexpected source of increased revenue.

The largest difference in noninterest income for 2010 compared to the previous years was the gain on sale of securities. For 2010, it accounted for $956 thousand compared to $230 and $15 thousand for 2009 and 2008 respectively. The Bank was able to take advantage of the ability to book some gains on the sale of securities. This opportunity presented itself in the first and last quarter of 2009 and the first three quarters of 2010. The Bank did not sacrifice long term profitability for short term gains as the yields of the portfolio were not negatively impacted by the sales. The discussion on causes for changes to yields follows in the interest section. The Bank did recognize a loss of just over $50 thousand on an equity security of a Banker s Bank in 2009. The entity had been taken over by the FDIC with its assets and deposits being bought by another financial institution.

Another increase to non-interest income was derived from increased debit card usage. As the Bank receives interchange revenue from each swipe of the card, usage increased thereby increasing revenue over $232 thousand in 2010 as compared to 2009 and over $126.5 thousand in 2009 over 2008. Both increases are attributed to the growth and popularity of the Bank s Reward checking product which migrated to KASASA in 2010. One of the criteria for the payment of high interest on the account is utilizing the debit card at least twelve times per statement cycle. The Bank s Reward & KASASA Checking customers averaged 25 transactions per statement during 2009 and 2010, surpassing the 9 transactions average of our Free Checking customers. The additional revenue from debit card usage offsets the interest expense, creating a win-win situation for the customers and the Bank. In 2011, this revenue stream may be reduced by the Federal Reserve regulating the interchange fee. All of the KASASA products have a debit card usage qualification; however, interest income is not the customer benefit for all accounts. As an alternative to receiving interest on their deposits, customers may choose to receive credit towards iTunes downloads or donate earnings to charity.

One additional noninterest income item to mention is overdraft and return check fee income. This revenue source increased $37.7 thousand or 1.6% in 2010 over 2009 supported by a 9% increase in the number of accounts and a $20 million increase in year-end balances. Hicksville accounted for 44% of the increase in the number of accounts and only 19% in the balances. During 2009, this revenue stream decreased 6.5%, or $176 thousand, during 2009 even though the number of checking accounts increased 4.16% and the portfolio yearend balance was $23.6 million higher in 2009 than 2008. Over the last three years, the average revenue per account continued to decrease due to regulatory changes. This revenue source remains under intense regulatory review and additional changes are required in 2011 that may negatively impact revenue.

Service charge income remained virtually unchanged from 2008 even with the increase in accounts. Most of the new accounts added either don t have service fee charges and/or the balances are high enough to offset any charges. The largest increase was in the Health Savings Account portfolio where the volume of accounts has increased steadily the last two years. Both the OD and return check and service charge income from checking accounts are included in the customer service fees line item on the income statement.

Switching to the expense side, overall, non-interest expense increased less than 1% in 2010 over 2009 while an increase of 8.6% or $1.8 million occurred in 2009 over 2008. The largest factor behind the 2009 increase was FDIC assessment, which was broken out as its own line item on the statement of income due to its significance. Of the $1.8 million increase in 2009 noninterest expense, $1.2 million is attributed to the cost of FDIC insurance. FDIC insurance, while still costly at $1.1 million, decreased in 2010 as compared to 2009 by $253 thousand.
The largest increase in 2010 over 2009 in noninterest expense, aside from provision expense, was the summation line of Other general and administrative expenses on the income statement. Within this summation line, the larger increases correspond to the asset quality issues and included an increase in loan collection expenses, cost of appraisals, and insurance cost for other real estate owned totaling $403 thousand. This was the second year of increased cost due to collection as 2009 had an increase of $251 thousand as compared to 2008. These costs were necessary to improve the asset quality and position the Bank for higher profitability in the future.
Also mentioned previously was the mortgage refinancing activity of the last two years. A correlating expense to that activity is the amortization of mortgage servicing rights. The income was discussed previously; the amortization is the offset to the income recognized. These remain large line items on both sides of the income statement. Income is recorded when the mortgage loan is first sold with servicing retained and is therefore recognized within one year. The amortization, however, is calculated over the life of the loan and accelerated when paid off early. An increase in this expense can be driven by two activities: an increase in the number of sold loans and/or by the acceleration of the expense from payoff and refinance activity. The best picture of the bottom line impact is achieved by netting the income with the expense each year. 2008 had net income of $77 thousand, 2009 had net income of $225 thousand and 2010 had net income of only $1.1 thousand. Of course, the value (or income) of the mortgage servicing right when sold also impacts the net position. The reason for 2009 s larger net position is due to the increase in the number of loans being serviced; thereby new rights are being established without having been offset by accelerated expense. This is evidenced by the year end number of loans and balances being up significantly. In 2010, the income barely offset the amortization expense. As of December 31, 2010 there were 3,647 loans serviced with outstanding balances of $275.7 million, there were 3,571 loans serviced with outstanding balances of $267.8 million for 2009, and 3,472 loans with balances of $277.5 million for 2008. Returning to the expense only portion, expense for 2010 was $250 thousand lower than 2009, 2009 was $563 thousand higher than the expense for 2008.
The impact of mortgage servicing rights to both noninterest income and expense is shown in the following table:

	December 31 2010	December 31 2009	December 31 2008
		(In thousands)	
Capitalized Additions (Noninterest income)	$ 685	$ 1,158	$ 447
Amortizations (Noninterest expense)	(684)	(933)	(370)
Net Noninterest income	$ 1	$ 225	$ 77

Salaries and wages increased $172 thousand in 2010 over 2009. Three main components flow into salaries and wages: base salary, deferred costs from loans and incentive pay. Base salaries decreased during 2010 even with the addition of the Hicksville office by $338 thousand. The deferred costs component actually decreased by $318 thousand which in effect increases salary expense and incentive pay increased $192 thousand. (For further discussion on incentive pay, see note 11 of the consolidated financial statements). During the first part of 2009, some of the Bank s lending officers were also very busy in auto loan financing. This activity was spurred by government and auto manufacturer incentives along with large banks exiting the market in the first half of the year. The consumer loan portfolio grew by 26%, or almost $6 million. This increased activity offset the increased salary expense as deferred costs from these loans are

recorded as a deduction to the salary expense when the loans are made. While salaries and wages decreased in 2009

as compared to 2008, it was this component that made it possible. Base salary expense increased just over $400 thousand with the deferred costs offsetting with a $50 thousand increase for 2009. The increases in base salary have been driven by additional offices being opened and increase in revenue generating positions, such as additional staff in the Bank s financial planning division.

Employee benefits decreased $109 thousand in 2010 as compared to 2009 and 2009 ended at $185 less than (or basically even) 2008 s. The Bank is partially self-insured and fluctuations to costs are therefore caused by fluctuations in claims made by employees. Employee s group insurance costs were lower in 2010 than 2009 by $139 thousand and were up $224 for 2009 over 2008. In 2009, the Bank offered a traditional medical plan along with a Health Savings Account (HSA) option. Both options were available in 2009 and the decision was made to implement the HSA plan only bank-wide for 2010. The increase in medical expense in 2009 was offset by a decrease of $201.5 thousand in miscellaneous personnel expense and in the BOLI retirement expense for 2009 as compared to 2008. Miscellaneous personnel expense includes such items as employee outings and the use of employment and executive search agencies. Bank Owned Life Insurance (BOLI) retirement expense represents the yearly cost to fund the liability of post retirement officers upon which the Bank has an insurance policy of which the Bank is the beneficiary. The total of these two expenses increased $47 thousand in 2010 as compared to 2009 and as stated previously was opposite of the movement in 2009 as compared to 2008.

Occupancy expense decreased by only $14 thousand in 2010 as compared to 2009. In 2009 it increased $84 thousand over 2008 with the largest impact stemming from the costs associated with holding Other Real Estate Owned (OREO). The balance in OREO increased from $426.7 thousand as of December 31, 2008 to $1.4 million as of December 31, 2009. The largest expense increase in occupancy was real estate taxes, which was driven by the additional holding of OREO and had increased $82.9 thousand in 2009 and held steady in 2010. OREO increased to $4.5 million in 2010 which included some rental properties and thereby had rental income of $45 thousand to help offset the cost of holding.

A positive reduction in data processing expense of $183 thousand occurred in 2010. This was preceded by a reduction of $98 thousand in 2009 as compared to 2008. The larger reduction in 2010 was mainly due to the reduction of costs as the Bank switched its core service provider in February. In 2009, the decrease is not attributable to just one vendor, but rather a negotiation with multiple vendors. The Company continues to investigate ways to reduce this expense. The pricing on many services, however, is based on number of accounts and the Bank fully expects those to increase with the KASASA additions and an improving economy.

The largest cost increase to the Bank in 2010 and 2009 was the Provision for Loan Losses. A tough economic environment existed for most businesses in our primary market area during 2007 through 2010. In 2010, the provision expense was $1.8 million higher than 2009 and $3.5 million over 2008. Gross charge-offs were $6.4 million for 2010, $3.3 million for 2009, as compared to 2008 s $2.6 million. Recoveries were $795, $242, and $348 thousand for 2010, 2009, and 2008, respectively. Unfortunately, 2010 had the highest charge-off and lowest recovery amounts, making the net charge-offs the highest at $5.6 million. 2009 had a net charge-off position of $3.0 million and 2008 had a net charge-off position of $2.2 million. 2008 was impacted by mostly agricultural business and 2009 and 2010 activity was mainly commercial driven. Further analysis by loan type is presented in the discussion of the allowance for credit losses.

Net Interest Income

The primary source of the Company s traditional banking revenue is net interest income. Net interest income is the difference between interest income on interest earning assets, such as loans and securities, and interest expense on liabilities used to fund those assets, such as interest bearing deposits and other borrowings. Net interest income is affected by changes in both interest rates and the amount and composition of earning assets and liabilities. The change in net interest income is most often measured as a result of two statistics interest spread and net interest margin. The difference between the yields on earning assets and the rates paid for interest bearing liabilities supporting those funds represents the interest spread. Because noninterest bearing sources of funds such as demand deposits and stockholders equity also support earning assets, the net interest margin exceeds the interest spread.

Overall, we continue to see pressure in the net interest margin and spread with the risk remaining fairly constant. The net interest margin decreased by 11 basis points and the net interest spread decreased by 5 basis points in comparing 2010 to 2009, with both sides of the equation having lower yields. In connection with interest concerns was the high level of nonaccruals and watch list loans throughout the year. Major improvement occurred in the decrease of nonaccrual and watch list loans to make the future look bright for 2011. Nonaccruals increased during the first part of the year and decreased due to charge-off and payoff during the second half, specifically the fourth quarter. Sustained improvement in the margin will be helped as a large portion of the nonaccruals have been removed from the books. Short term rates remained flat throughout the year and long term rates lowered during the fourth quarter and have since increased in the first two months of 2011.

Earnings assets increased during the year in actual and average balance. The interest collected on the earning assets decreased; the yield decreasing for 2010 as compared to 2009 in all portfolios. The largest decrease in yield occurred in the taxable investment securities and was due to the large amount of calls on government sponsored agencies and the yield on new purchases as the growth in the portfolio was over $30 million in average. It was not unusual for a called security to be replaced with a new security with a yield lower by 100 basis points or more. Overall, this portfolio s yield was 121 basis points lower in 2010 than in 2009.

Loans which have the highest earning asset yield decreased in average by $8 million when comparing 2010 average to 2009 average balance. The overall change in yield in the loan portfolio for 2010 was due mainly to the change in balance than to the change in rate. Given that the loan portfolio represented only 67% of the earning assets in 2010 as compared to 2009 s 73% and the yield is the highest, it stands to reason that the overall asset yield decreased in 2010 as compared to 2009. Coupling this with the growth in earning assets being invested in securities and Federal Funds Sold and interest bearing bank balances, the overall yield on earning assets decreased 52 basis points as compared to 2009 and 103 basis points lower than 2008.

While the loan portfolio size had remained fairly constant in 2009, the yield, or income, generated had decreased for the second straight year. This was due to the low interest rate environment, with the lending prime rate within 26 basis points of the Company s net interest spread at that time. Spread is the difference between what the Company earns on its assets and pays on its liabilities. It is on this spread that the Company must fund its operations and generate profit. When the asset yield decreases so must the cost of funds to maintain profitability. It becomes increasingly challenging as the asset yield gets closer to the prime lending rate, or the break-even point, of operations. To mitigate the low rate environment, the Bank placed rate floors on most variable loans during 2009, which were typically 125 basis points over the current prime rate. This protected the Bank during a flat rate environment. The challenge will come when rates start to rise and the Bank will be affected by the index spreads also placed on the loans. The Bank worked to increase the spread on loans during 2010 to minimize the impact of an increased prime rate not directly correlating to an increased yield on loans.

Looking at the other side of the balance sheet and the interest cost of funds, a decrease in the cost is apparent for 2010 as compared to both 2009 and 2008. Fortunately, the cost of funds decreased at a faster rate than the asset yield in 2009 and the net interest margin and spread improved over 2008. Unfortunately, in 2010, the asset yield decreased more than the cost of funds and the net interest margin and spread decreased as compared to 2009.

The impact of the change in the portfolio mix was a factor in the liabilities as it was in the assets. All portfolios decreased in cost of funds with the exception of the one, savings deposits, which represented 94% of the growth in average balances between 2010 and 2009. Savings deposits increased $48 million and the cost increased 4 basis points. The growth in balances was related to the growth in the new KASASA product offerings which rewarded customers by paying a higher interest rate for deposits which was offset by noninterest related Bank earnings and savings. By participating in the KASASA Saver product, a customer may have earned as much as 160 basis points more than the Bank s basic savings account. Even with the increased interest cost to the Bank for offering these products, the Bank was still able to decrease its cost of funds by 47 basis points. Time deposits, other borrowed money and securities sold under agreement to repurchase all decreased. The Bank borrowed funds from the Federal Home Loan Bank in the first quarter of 2010, to lock in lower rates to replace maturities coming due in the second through fourth quarter of the year. If the Bank does not borrow any additional funds in 2011, the cost of these funds

will again be lower in 2011since the associated expense of the matured advances will be off for a full year. The average balance will also be lower by $7.5 million.

The following tables present net interest income, interest spread and net interest margin for the three years 2008 through 2010, comparing average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and expense. The table also shows their corresponding average rates of interest earned and paid. The tax-exempt asset yields have been tax affected to reflect a marginal corporate tax rate of 34%. Average outstanding loan balances include non-performing loans and mortgage loans held for sale. Average outstanding security balances are computed based on carrying values including unrealized gains and losses on available-for-sale securities.

The percentage of interest earning assets to total assets decreased in 2010 over 2009 and increased slightly in 2009 over 2008 and remained above 90% at a respectable 90.73% and 93.55% for 2010 and 2009, respectively.

As stated previously, the decreased yield on the assets was outpaced by the decreased cost of funds in 2009. The average balances for interest bearing liabilities increased only $17.4 million compared to 2008. While the balance increased, the costs on those funds were significantly lower. The average cost for 2009 was 2.00% compared to 2008 s 2.82%. The balances in noninterest bearing liabilities also increased during the last three years.

As with the yields on assets for 2009, the largest fluctuation in the cost of funds was in the shorter term liabilities, savings deposits. The cost on savings decreased 66% while on time deposits the cost decreased 38%. The Bank has focused on increasing its core deposit base to lessen the dependency on higher cost time deposits. The Bank has also attempted to increase the duration of the time deposits; however, customers have maintained a short-term, twelve month focus.

The yield on Tax-Exempt investments securities shown in the following charts were computed on a tax equivalent basis. The yield on Loans has been tax adjusted for the portion of tax-exempt IDB loans included in the total. Total Interest Earning Assets is therefore also reflecting a tax equivalent yield in both line items, also with the Net Interest Spread and Margin. The adjustments were based on a 34% tax rate.

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	2010 (In Thousands)		
	Average Balance	Interest / Dividends	Yield/Rate
ASSETS			
Interest Earning Assets:			
Loans (1)	$ 550,698	$ 32,860	6.00%
Taxable investment securities	176,885	4,847	2.74%
Tax-exempt investment securities	59,537	2,091	5.32%
Federal funds sold & interest bearing deposits	35,195	95	0.27%
Total Interest Earning Assets	822,315	$ 39,893	5.00%
Non-Interest Earning Assets:			
Cash and cash equivalents	14,046		
Other assets	42,096		
Total Assets	$ 878,457		
LIABILITIES AND SHAREHOLDERS EQUITY			
Interest Bearing Liabilities:			
Savings deposits	$ 305,426	$ 2,190	0.72%
Other time deposits	321,018	6,936	2.16%
Other borrowed money	37,517	1,459	3.89%
Federal funds purchased and securties sold under agreement to repurchase	46,530	278	0.60%
Total Interest Bearing Liabilities	710,491	$ 10,863	1.53%
Non-Interest Bearing Liabilities:			
Non-interest bearing demand deposits	63,108		
Other	10,207		
Total Liabilities	783,806		
Shareholders Equity	94,651		
Total Liabilities and Shareholders Equity	$ 878,457		
Interest/Dividend income/yield		$ 39,893	5.00%
Interest Expense / yield		$ 10,863	1.53%

Net Interest Spread	$ 29,030	3.47%
Net Interest Margin		3.68%

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	2009		
	(In Thousands)		
	Average Balance	Interest/ Dividends	Yield/Rate
ASSETS			
Interest Earning Assets:			
Loans (1)	$ 558,869	$ 33,585	6.04%
Taxable investment securities	146,872	5,798	3.95%
Tax-exempt investment securities	46,736	1,686	5.47%
Federal funds sold & interest bearing deposits	11,937	45	0.38%
Total Interest Earning Assets	764,414	$ 41,114	5.52%
Non-Interest Earning Assets:			
Cash and cash equivalents	19,209		
Other assets	39,007		
Total Assets	$ 822,630		
LIABILITIES AND SHAREHOLDERS EQUITY			
Interest Bearing Liabilities:			
Savings deposits	$ 257,345	$ 1,755	0.68%
Other time deposits	317,619	9,252	2.91%
Other borrowed money	38,498	1,727	4.49%
Federal funds purchased and securities sold under agreement to repurchase	45,920	486	1.06%
Total Interest Bearing Liabilities	659,382	$ 13,220	2.00%
Non-Interest Bearing Liabilities:			
Non-interest bearing demand deposits	57,630		
Other	13,778		
Total Liabilities	730,790		
Shareholders Equity	91,840		
Total Liabilities and Shareholders Equity	$ 822,630		
Interest/Dividend income/yield		$ 41,114	5.52%

Interest Expense / yield	$ 13,220	2.00%
Net Interest Spread	$ 27,894	3.52%
Net Interest Margin		3.79%

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	2008 (In Thousands)		
	Average Balance	Interest/ Dividends	Yield/Rate
ASSETS			
Interest Earning Assets:			
Loans (1)	$ 544,310	$ 34,994	6.46%
Taxable investment securities	146,877	6,963	4.74%
Tax-exempt investment securities	42,361	1,594	5.70%
Federal funds sold & interest bearing deposits	9,423	273	2.90%
Total Interest Earning Assets	742,971	$ 43,824	6.03%
Non-Interest Earning Assets:			
Cash and cash equivalents	19,399		
Other assets	35,317		
Total Assets	$ 797,687		
LIABILITIES AND SHAREHOLDERS EQUITY			
Interest Bearing Liabilities:			
Savings deposits	$ 240,880	$ 2,760	1.15%
Other time deposits	314,005	12,467	3.97%
Other borrowed money	38,110	1,747	4.58%
Federal funds purchased and securities sold under agreement to repurchase	49,014	1,127	2.30%
Total Interest Bearing Liabilities	642,009	$ 18,101	2.82%
Non-Interest Bearing Liabilities:			
Non-interest bearing demand deposits	53,208		
Other	12,928		
Total Liabilities	708,145		
Shareholders Equity	89,542		
Total Liabilities and Shareholders Equity	$ 797,687		
Interest/Dividend income/yield		$ 43,824	6.03%

Interest Expense / yield	$ 18,101	2.82%
Net Interest Spread	$ 25,723	3.21%
Net Interest Margin		3.60%

The following tables show changes in interest income, interest expense and net interest resulting from changes in volume and rate variances for major categories of earnings assets and interest bearing liabilities.

	2010 vs 2009 (In Thousands)		
	Net Change	Due to change in Volume	Rate
Interest Earning Assets:			
Loans	$ (725)	$ (494)	$ (231)
Taxable investment securities	(951)	1,185	(2,136)
Tax-exempt investment securities	405	700	(295)
Federal funds sold & interest bearing deposits	50	88	(38)
Total Interest Earning Assets	$ (1,221)	$ 1,479	$ (2,700)
Interest Bearing Liabilities:			
Savings deposits	$ 435	$ 328	$ 107
Other time deposits	(2,316)	99	(2,415)
Other borrowed money	(268)	(44)	(224)
Federal funds purchased and securities sold under agreement to repurchase	(208)	6	(214)
Total Interest Bearing Liabilities	$ (2,357)	$ 389	$ (2,746)

	2009 vs 2008 (In Thousands)		
	Net Change	Due to change in Volume	Rate
Interest Earning Assets:			
Loans	**$ (1,409)**	**$ 941**	**$ (2,350)**
Taxable investment securities	**(1,165)**	**(0)**	**(1,165)**
Tax-exempt investment securities	**92**	**249**	**(157)**
Federal funds sold & interest bearing deposits	**(228)**	**73**	**(301)**
Total Interest Earning Assets	**$ (2,710)**	**$ 1,263**	**$ (3,973)**
Interest Bearing Liabilities:	**$ (1,005)**	**$ 189**	**$ (1,194)**
Savings deposits	**(3,215)**	**143**	**(3,358)**
Other time deposits	**(20)**	**18**	**(38)**
Other borrowed money			
Federal funds purchased and securities sold under agreement to repurchase	**(641)**	**(71)**	**(570)**
Total Interest Bearing Liabilities	**$ (4,881)**	**$ 279**	**$ (5,160)**

As mentioned in the discussion earlier, in reviewing the 2010 to 2009 comparison, an impact in change due to volume is evident, where as the 2009 to 2008 comparison shows the impact was due mainly to rate. What did remain the same in the two comparisons is that the change in interest in total is still due mainly to rate change. The strategy during 2010 and currently is to extend the maturities of time deposit specials to over 24 months to prepare for rising rates. The other strategy employed during 2009 and 2010 was to increase core deposits by offering innovative products focused on customer needs: higher interest rates. In exchange for a high interest-bearing checking account, customers were asked to utilize services that benefited both the Bank and themselves. Smaller time deposit rate shoppers had an option to perhaps change their behavior of banking or those deposits were allowed to run off. The new core deposit products were indeed embraced by our customers and have helped to reach the deposit portfolio mix the Bank was after.

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Allowance for Credit Losses

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

The Bank s ALLL methodology captures trends in leading, current, and lagging indicators which will directly affect the Bank s allocation amount. Trends in such leading indicators as delinquency, unemployment changes in the Bank s service area, experience and ability of staff, regulatory trends, and credit concentrations are referenced. A current indicator such as the total watch list loan amount to Capital, and a lagging indicator such as the charge off amount are referenced as well. A matrix is formed by loan type from these indicators that is responsive in making ALLL adjustments.

The Bank experienced a 7% decrease in Special Mention loan balances as of December 31, 2010 as compared to December 31, 2009. The Bank also experienced a 23% decrease or $8.7 million decrease in Special Mention and Substandard loan balances as of December 31, 2010 as compared to 2009. In response to this decrease, the Bank continued the increase of its ALLL to outstanding loans coverage percentage to 1.08% as of December 31, 2010. As a group, the Special Mention and Substandard loans increased 16.8% or $5.4 million in comparing year-end balances December 31, 2009 to December 31, 2008. In response to this increase, the Bank s ALLL to outstanding loans coverage percentage increased from .97% as of December 31, 2008 to 1.05% as of December 31, 2009.

The above indicators are reviewed quarterly. Some of the indicators are quantifiable and as such will automatically adjust the ALLL once calculated. These indicators include the ratio of past due loans to total loans, loans past due greater than 30 days, and watch list to capital ratios with the watch list made up of loans graded 5,6 or 7 on a 1 to 7 scale, 1 being the best rating. Other indicators use more subjective data to the extent possible to evaluate the potential for inherent losses in the Bank s loan portfolio. For example, the economic indicator uses the unemployment statistics from the communities in our market area to help determine whether the ALLL should be adjusted. At the end of 2010, a slight improvement was noted in unemployment figures and several local firms were calling a small number of employees back from layoff. The current recalls do not begin to approximate the number of positions lost.

All aggregate commercial and agricultural credits include real estate loans of $250,000 and over are reviewed annually by both credit committees and internal loan review to look for early signs of deterioration.

To establish the specific reserve allocation in the instance of real estate, a discount to the market value is established to account for liquidation expenses. The discounting percentage used for real estate mirrors the discounting of real estate as provided for in the Bank s Loan Policy. However, unique or unusual circumstances may be present which will affect the real estate value and, when appropriately identified, can adjust the discounting percentage at the discretion of management.

The ACL decreased $375 thousand during 2010 as compared to 2009. With the decrease in loan balances, the percentage of ACL to the total loan portfolio actually increased from 1.09% as of December 31, 2009 to 1.12% as of December 31, 2010. The ACL increased during 2009 as compared to 2008 as net charge-offs and past due loans had increased during 2009. The increase took into account the high level of nonaccruals and watch list loans and the extended time period it involved for resolution.

Please see Note 4 in the consolidated financial statement for additional tables regarding the composition of the ACL.

Federal Income Taxes

Effective tax rates were 25.44%, 27.26%, and 26.71%, for 2010, 2009, and 2008, respectively. The effect of tax-exempt interest from holding tax-exempt securities and Industrial Development Bonds (IDBs) was $744, $629, and $654 thousand for 2010, 2009, and 2008, respectively.

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Financial Condition

Average earning assets increased $57.9 million during 2010 over 2009 and were higher by $79.3 million as compared to 2008. The main cause of fluctuation was the Hicksville acquisition and the repositioning of the balance sheet. Average interest bearing liabilities increased $51.1 million over 2009 and $68.5 million from 2008. The increase in 2009 over 2008 was due to the success of the Reward Checking product to attract funds into the savings deposit bucket. The increase continued into 2010 with the addition of the full line of KASASA products in 2010. It also included an overlapping of $9 million in loan advances from the Federal Home Loan Bank for a couple of quarters.

Securities

The investment portfolio is first used mainly to provide overall liquidity for the Bank. It is also used to provide required collateral for pledging to the Bank s Ohio public depositors for amounts on deposit over the FDIC coverage limits. It may also be used to pledge for additional borrowings from third parties. Investments are made with the above criteria in mind while still seeking a fair market value of return, and looking for maturities that fall within the projected overall strategy of the Bank. The possible need to fund growth is also a consideration.

All of the Bank s security portfolio is categorized as available for sale, with the exception of stock, and as such is recorded at market value.

Security balances as of December 31 are summarized below:

	(In Thousands)		
	2010	**2009**	**2008**
U.S. Treasury	$ 32,278	$ 5,219	$
U.S. Government agency	165,704	104,676	82,675
Mortgage-backed securities	24,531	36,848	51,826
State and local governments	64,804	60,538	43,160
	$ 287,317	$ 207,281	$ 177,661

The following table sets forth the maturities of investment securities as of December 31, 2010 and the weighted average yields of such securities calculated on the basis of cost and effective yields weighted for the scheduled maturity of each security. Tax-equivalent adjustments, using a thirty-four percent rate have been made in yields on obligations of state and political subdivisions. Stocks of domestic corporations have not been included.

	Maturities (Amounts in Thousands)			
			After One Year Within Five Years	
	Within One Year Amount	**Yield**	**Amount**	**Yield**
U.S. Treasury		$ 0.00%	$ 22,726	1.06%
U.S. Government agency		0.00%	126,890	1.45%
Mortgage-backed securities	1,169	4.25%	2,600	4.31%
State and local governments	2,092	2.21%	15,928	2.77%
Taxable state and local governments		0.00%	1,944	3.14%

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	Maturities (Amounts in Thousands)			
	After Five Years Within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield
U.S. Treasury	$ 9,552	1.62%		$ 0.00%
U.S. Government agency	38,814	2.26%		0.00%
Mortgage-backed securities	2,564	4.70%	18,198	4.63%
State and local governments	28,795	3.31%	15,078	4.23%
Taxable state and local governments	967	3.14%		0.00%

As of December 31, 2010 the Bank did not hold a large block of any one investment security, except for U.S. Government agencies. The Bank also holds stock in the Federal Home Loan Bank of Cincinnati at a cost of $4.2 million. This is required in order to obtain Federal Home Loan Bank Loans. The Bank also acquired stock in the Federal Home Loan Bank of Indianapolis at a cost of $231.4 thousand and Banker s Bancorp, Inc at a cost of $50.8 thousand through its acquisition of Knisely Bank. There were no borrowings at the time of acquisition associated with Federal Home Loan Bank of Indianapolis. The Bank had requested Federal Home Loan Bank of Indianapolis to buy back its stock when the acquisition of Knisely was completed in January 2008. A five year waiting period was imposed and the stock will be redeemed in full by January 3, 2013. An early redemption of 42,000 shares occurred in November 2010, decreasing the holdings to a value of $189.4 thousand. The value of the stock in Banker s Bancorp, Inc was written down to zero at the end of 2009 as the institution was taken over by its regulators. The Bank also owns stock of Farmer Mac with a carrying value of $27.4 thousand which is required to participate loans in the program.

Loan Portfolio

The Bank s various loan portfolios are subject to varying levels of credit risk. Management mitigates these risks through portfolio diversification and through standardization of lending policies and procedures.

Risks are mitigated through an adherence to Loan Policy with any exception being recorded and approved by Senior Management or committees comprised of Senior Management. Loan Policy defines parameters to essential underwriting guidelines such as loan-to-value ratio, cash flow and debt-to-income ratio, loan requirements and covenants, financial information tracking, collection practice and others. Limitation to any one borrower is defined by the Bank s legal lending limits and is stated in policy. On a broader basis, the Bank restricts total aggregate funding in comparison to Bank capital to any one business or agricultural sector by an approved sector percentage to capital limitation.

The following table shows the Bank s loan portfolio by category of loan as of December 31st of each year, including loans held for sale:

	(In Thousands)				
Loans:	**2010**	**2009**	**2008**	**2007**	**2006**
Commercial real estate	$ 185,033	$ 214,849	$ 226,761	$ 181,340	$ 162,363
Agricultural real estate	33,650	41,045	48,607	45,518	49,564
Consumer real estate	95,271	98,599	89,773	102,660	86,688
Commercial and industrial	117,344	120,543	112,526	104,188	101,788
Agricultural	65,400	59,813	56,322	58,809	69,301
Consumer	29,008	32,581	26,469	27,796	27,388
Industrial Development Bonds	1,965	2,552	7,572	9,289	7,335
	$ 527,671	$ 569,982	$ 568,030	$ 529,600	$ 504,427

The following table shows the maturity of loans as of December 31, 2010:

	(In Thousands)			
	Within One Year	After One Year Within Five Years	After Five Years	Total
Commercial Real Estate	$ 36,523	$ 105,168	$ 43,342	$ 185,033
Agricultural Real Estate	2,738	13,546	17,366	33,650
Consumer Real Estate	8,009	23,094	64,168	95,271
Commercial and industrial loans	83,554	25,387	8,403	117,344
Agricultural	48,038	14,196	3,166	65,400
Consumer, Credit Card and Overdrafts	6,002	20,723	2,283	29,008
Industrial Development Bonds	556	446	963	1,965

The following table presents the total of loans due after one year which has either 1) predetermined interest rates (fixed) or 2) floating or adjustable interest rates (variable):

	(In Thousands)		
	Fixed Rate	Variable Rate	Total
Commercial Real Estate	$ 57,162	$ 91,314	$ 148,476
Agricultural Real Estate	18,918	11,682	30,600
Consumer Real Estate	74,095	13,267	87,362
Commercial and industrial loans	26,831	6,324	33,155
Agricultural	17,138	224	17,362
Consumer, Master Card and Overdrafts	23,006	3,664	26,670
Industrial Development Bonds	1,409		1,409

The following table summarizes the Company s nonaccrual and past due loans as of December 31 for each of the last five years:

	(In Thousands)				
	2010	2009	2008	2007	2006
Nonaccrual loans	$ 5,844	$ 14,054	$ 13,575	4918	4254
Accruing loans past due 90 days or more	48	69	2,524		
Total	$ 5,892	$ 14,123	$ 16,099	$ 4,918	$ 4,254

Although loans may be classified as non-performing, some pay on a regular basis, and many continue to pay interest irregularly or at less than original contractual rates. Interest income that would have been recorded under the original terms of these loans was $0.91 million for 2010, $2.0 for 2009, and $1.4 for 2008. Any collections of interest on nonaccrual loans are included in interest income when collected unless it is on an impaired loan with a specific allocation. A collection of interest on an impaired loan with a specific allocation is applied to the loan balance to decrease the allocation needed. Total interest collections amounted to $41 thousand for 2010, $290 thousand for 2009, and $332 thousand for 2008. $3 thousand of interest collected in 2010 was applied to reduce the specific allocation, $6 thousand of interest collected in 2009 and $20 thousand of interest collected in 2008 was applied to reduce the specific

allocations.

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Loans are placed on nonaccrual status in the event that the loan is in past due status for more than 90 days or payment in full of principal and interest is not expected. The loss of interest due to the high balances in nonaccruals as of the last three years has significantly impacted the yield on loans. A lower balance of $5.8 million in nonaccrual as of December 31, 2010 is an improvement which should help the yield going forward. The balance of December 31, 2010 nonaccrual loans of $5.8 million and the $14.1 million of nonaccrual loans as of December 31, 2009 were secured.

As of December 31, 2010 the Bank had $27.4 million of loans which it considers to be potential problem loans in that the borrowers are experiencing financial difficulties compared to December 31, 2009 when the Bank had $25.6 million of these loans. These loans are subject to constant management attention and are reviewed at least monthly.

The amount of the potential problem loans was considered in management s review of the loan loss reserve required at December 31, 2010 and 2009.

In extending credit to families, businesses and governments, banks accept a measure of risk against which an allowance for possible loan loss is established by way of expense charges to earnings. This expense, used to enlarge a bank s allowance for loan losses, is determined by management based on a detailed monthly review of the risk factors affecting the loan portfolio, including general economic conditions, changes in the portfolio mix, past due loan-loss experience and the financial condition of the bank s borrowers.

As of December 31, 2010, the Bank had loans outstanding to individuals and firms engaged in the various fields of agriculture in the amount of $65.4 million with an additional $33.7 million in agricultural real estate loans. The ratio of this segment of loans to the total loan portfolio is not considered unusual for a bank engaged in and servicing rural communities.

Modifications granted are typically for seasonality issues where cash flow is decreased. The time period involved is generally quite short in relation to the loan term. For example, a typical modification may consist of interest only payments for 90 days. We consider this treatment of interest only payments for a short time as an insignificant delay in payment. Consequently, we do not consider these occurrences as troubled debt restructurings . Interest rate modification to reflect a decrease in market interest rates or maintain a relationship with the debtor, where the debtor is not experiencing financial difficulty and can obtain funding from other sources, is not considered a troubled debt restructuring. As of December 31, 2010, the Bank had almost $3.5 million of its impaired loans that were classified as trouble debt restructurings. The Bank did not have any classified as such as of December 31, 2009. The Bank is occasionally ordered by the courts to give terms to a borrower that are better than what the Bank would like for the risk associated with that credit but not below or beyond rates and terms available for better credits in our market. Therefore, the Bank has not done any modifications that it would classify as troubled debt restructurings under those circumstances.

Updated appraisals are required on all collateral dependent loans once they are deemed impaired. The Bank may also require an updated appraisal of a watch list loan which the Bank monitors under their loan policy. On a quarterly basis, Bank management reviews properties supporting asset dependent loans to consider market events that may indicate a change in value has occurred.

To determine observable market price, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the existing collateral value used.

Performing non-watch list customers secured in whole or in part by real estate do not require an updated appraisal unless the loan is rewritten and additional funds advanced. Watch List customers secured in whole or in part by real estate require updated appraisals every two years. All loans are subject to loan to values as found in Loan Policy no matter what their grade. Our watch list is reviewed on a quarterly basis by management and any questions to value are addressed at that time.

The majority of the Bank s loans are made in the market by lenders that live and work in the market. Thus, their evaluation of the independent valuation is also valuable and serves as a double check.

On extremely rare occasions, the Bank will make adjustments to the recorded values of collateral securing commercial real estate loans without acquiring an updated appraisal for the subject property. The Bank has no formalized policy for determining when collateral value adjustments between regularly scheduled appraisals are necessary, nor does it use any specific methodology for applying such adjustments. However, on a quarterly basis as part of its normal operations, the Bank s senior management and the Loan Review Committee will meet to review all commercial credits either deemed to be impaired or on the Bank s Watch List. In addition to analyzing the recent performance of these loans, management and the Loan Review Committee will also consider any general market conditions that might warrant adjustments to the value of particular real estate collateralizing commercial loans. In addition, management conducts annual reviews of all commercial loans exceeding certain outstanding balance thresholds. In each of these situations, any information available to management regarding market conditions impacting a specific property or other relevant factors is considered, and lenders familiar with a particular commercial real estate loan and the underlying collateral may be present to provide their opinion on such factors. If the available information leads management to conclude a valuation adjustment is warranted, such an adjustment may be applied on the basis of the information available. If management concludes that an adjustment is warranted but lacks the specific information needed to reasonably quantify the adjustment, management will order a new appraisal on the subject property even though one may not be required under the Bank s general policies for updating appraisal.

Note 4 of the Consolidated Financial Statements may also be reviewed for additional tables dealing with the Bank s loans and ALLL.

ALLL is evaluated based on an assessment of the losses inherent in the loan portfolio. This assessment results in an allowance consisting of two components, allocated and unallocated.

Management considers several different risk assessments in determining ALLL. The allocated component of ALLL reflects expected losses resulting from an analysis of individual loans, developed through specific credit allocations for individual loans and historical loss experience for each loan category. For those loans where the internal credit rating is at or below a predetermined classification and management can reasonably estimate the loss that will be sustained based upon collateral, the borrowers operating activity and economic conditions in which the borrower operates, a specific allocation is made. For those borrowers that are not currently behind in their payment, but for which management believes based on economic conditions and operating activities of the borrower, the possibility exists for future collection problems, a reserve is established. The amount of reserve allocated to each loan portfolio is based on past loss experiences and the different levels of risk within each loan portfolio. The historical loan loss portion is determined using a historical loss analysis by loan category.

The unallocated portion of the reserve for loan losses is determined based on management s assessment of general economic conditions as well as specific economic factors in the Bank s marketing area. This assessment inherently involves a higher degree of uncertainty. It represents estimated inherent but undetected losses within the portfolio that are probable due to uncertainties in economic conditions, delays in obtaining information, including unfavorable information about a borrower s financial condition and other current risk factors that may not have yet manifested themselves in the Bank s historical loss factors used to determine the allocated component of the allowance.

Actual charge-off of loan balances is based upon periodic evaluations of the loan portfolio by management. These evaluations consider several factors, including, but not limited to, general economic conditions, financial condition of the borrower, and collateral.

As presented below, charge-offs increased to $6.4 million for 2010 preceded by an increase to $3.3 million for 2009. The provision also increased each year for the three years shown. 2010 had provision expense of $5.3 million, 2009 had $3.6 million and 2008 had provision expense of $1.8 million. The Commercial and Industrial portfolio was the only segment in a net recovery for 2008; however it had the largest net charge-off position in 2009 and 2010. The ratio of net charge offs to average loans outstanding is evidence of the recognition of troubled loans and the write down of

collateral values. The improvement in asset quality during the periods shown is reflected in the increased percentage of the allowance for loan loss to nonperforming loans.

With the charge-offs going higher in 2009, it became prudent to increase the ALLL for 2009. The increase provides for the high level of nonaccrual and watch list loans and recognizes the extended time period with which it has taken to achieve resolution and/or collection of these loans. The ALLL for 2010 decreased due to the improvement in the asset quality as the balances in impaired loans and nonaccruals were drastically reduced over the same time periods. A smaller portion of the allowance was needed to fund the impaired loans as collateral remained sufficient to cover the outstanding amounts in most cases.

The following table presents a reconciliation of the allowance for credit losses:

		(In Thousands)	
	2010	**2009**	**2008**
Loans	$ 527,589	$ 569,919	$ 568,030
Daily average of outstanding loans	$ 550,698	$ 558,869	$ 544,859
Allowance for Loan Losses-Jan 1	$ 6,008	$ 5,496	$ 5,922
Loans Charged off:			
Commercial Real Estate	1,147		
Ag Real Estate			
Consumer Real Estate	507	452	194
Commercial and Industrial	4,188	2,235	71
Agricultural	136	230	1,912
Consumer & other loans	444	371	384
	6,422	3,288	2,561
Loan Recoveries:			
Commercial Real Estate	52		
Ag Real Estate			
Consumer Real Estate	55	11	87
Commercial and Industrial	515	72	78
Agricultural	17	6	4
Consumer & other loans	156	153	179
	795	242	348
Net Charge Offs	5,627	3,046	2,213
Provision for loan loss	5,325	3,558	1,787
Acquisition provision for loan loss			
Allowance for Loan & Lease Losses Dec 31	$ 5,706	$ 6,008	$ 5,496
Allowance for Unfunded Loan Commitments & Letters of Credit Dec 31	153	227	226
Total Allowance for Credit Losses Dec 31	$ 5,859	$ 6,235	$ 5,722

Ratio of net charge-offs to average Loans outstanding	1.02%	0.55%	0.41%
Ratio of the Allowance for Loan Loss to Nonperforming Loans	97.63%	42.75%	40.48%

* Nonperforming loans are defined as all loans on nonaccrual, plus any loans past due 90 days not on nonaccrual.
Allocation of ALLL per Loan Category in terms of dollars and percentage of loans in each category to total loans is as follows:

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	2010 Amount (000 s)	%	2009 Amount (000 s)	%	2008 Amount (000 s)	%	2007 Amount (000 s)	%	2006 Amount (000 s)	%
Balance at End of Period Applicable To:										
Commercial Real Estate	$ 1,868	35.07	$ 1,810	37.69	$ 1,810	39.92	$ 1,358	34.24	$ 1,221	32.19
Ag Real Estate	122	6.38	120	7.20	130	8.56	117	8.59	162	9.83
Consumer Real Estate	258	16.31	439	17.30	386	15.80	381	19.38	288	17.19
Commercial and Industrial	2,354	14.23	2,494	21.15	2,278	19.81	1,859	19.67	2,721	20.18
Agricultural	327	22.24	647	10.49	413	9.92	1,676	11.10	250	13.74
Consumer, Overdrafts and other loans	777	5.77	498	6.16	479	5.99	531	7.00	634	6.88
Unallocated									318	
Allowance for Loan & Lease Losses	5,706	100.00	6,008	100.00	5,496	100.00	5,922	100.00	5,594	100.00
Off Balance Sheet Commitments	153		227		226		156		168	
Total Allowance for Credit Losses	$ 5,859		$ 6,235		$ 5,722		$ 6,078		$ 5,762	

Deposits

The amount of outstanding time certificates of deposits and other time deposits in amounts of $100,000 or more by maturity as of December 31, 2010 are as follows:

	(In Thousands)			
	Under Three Months	Over Three Months Less than Six Months	Over Six Months Less Than One Year	Over One Year
Time Deposits	$ 30,925	$ 25,178	$ 24,969	$ 51,299

The following table presents the average amount of and average rate paid on each deposit category:

	(In Thousands)			
	Non-Interest DDAs	Interest DDAs	Savings Accounts	Time Accounts

December 31, 2010:				
Average balance	$ 60,489	$ 167,382	$ 138,044	$ 321,018
Average rate	0.00%	0.96%	0.42%	2.16%
December 31, 2009:				
Average balance	$ 55,793	$ 145,259	$ 112,086	$ 317,619
Average rate	0.00%	1.02%	0.24%	2.91%
December 31, 2008:				
Average balance	$ 52,152	$ 130,887	$ 109,993	$ 314,005
Average rate	0.00%	1.46%	0.77%	3.97%

Liquidity

Liquidity remains high with the Bank also having access to $27 million of unsecured borrowings through correspondent banks and $76 million of unpledged securities which may be sold or used as collateral. An additional $6.2 million is also available from the Federal Home Loan Bank based on current collateral pledging with up to $115 million available provided adequate collateral is pledged.

Maintaining sufficient funds to meet depositor and borrower needs on a daily basis continues to be among our management s top priorities. This is accomplished not only by the immediately liquid resources of cash, due from banks and federal funds sold, but also by the Bank s available for sale securities portfolio. The average aggregate balance of these assets was $274 million for 2010, compared to $216 million for 2009, and $220 million for 2008. This represented 31.25 percent, 26.3 percent, and 28.0 percent of total average assets, respectively. Of the almost $288 million of debt securities in the company s portfolio as of December 31, 2010, $39 million or 13.7 percent of the portfolio is expected to receive payments or mature in 2011. Taking into consideration possible calls of the debt

securities, the amount climbs to $62 million or 21.7 percent of the portfolio becomes a source of funds. The availability of the funds may be reduced by the need to utilize securities for pledging purposes on public deposits. This liquidity provides the opportunity to fund loan growth without having to aggressively price deposits.

Historically, the primary source of liquidity has been core deposits that include noninterest bearing and interest bearing demand deposits, savings, money market accounts and time deposits of individuals. Core deposits increased as of year end balances in 2010, in all categories. Overall deposits increased an average of $53.2 million during 2010 compared to 2009 s increase over 2008 of $29.3 million in average deposits. These represent changes of 8.3 percent and 4.8 percent in average total deposits, respectively. The Bank also utilized Federal Funds purchased at times during 2010. The average balance for 2010 was $13 thousand.

Again, historically, the primary use of new funds is placing the funds back into the community through loans for the acquisition of new homes, consumer products and for business development. The use of new funds for loans is measured by the loan to deposit ratio. The Company s average loan to deposit ratio for 2010 was 78.13 percent, 2009 was 85.95 percent, and 2008 was 87.81 percent. The lower ratio in 2010 and 2009 was due to the success of the deposit gathering function and the residential mortgage loans being sold in the secondary market. The lower ratio in 2008 is due to the lower loan to deposit ratio of the acquisition and utilizing excess funds to grow loans. 2007 represented the increased loan growth outpacing deposit growth. The Company s goal is for this ratio to be higher with loan growth the driver; however, this was difficult to achieve in 2009 with borrowers taking a conservative approach to increasing their liabilities.

Short-term debt such as federal funds purchased and securities sold under agreement to repurchase also provides the Company with liquidity. Short-term debt for both federal funds purchased and securities sold under agreement to repurchase amounted to $51.2 million at the end of 2010 compared to $43.3 million at the end of 2009 and to $48.2 million at the end of 2008. Though no federal funds were purchased at year end, the Bank does have arrangements with correspondent Banks that can be utilized when necessary. Following is a table showing the daily securities sold under agreement to repurchase activity for 2010, 2009, and 2008. These accounts are used to provide a sweep product to the Bank s commercial customers. The decrease in balances during 2009 was due to business discontinuing the sweep as the cost of fees were higher than the interest benefit on lower balance accounts. These funds may return in the future when short-term rates increase.

Daily Securities Sold Under Agreement to Repurchase

	Amount Outstanding at End of Period (000 S)	Weighted Average Rate End of Period	Maximum Amount Borrowings Outstanding Month End (000 s)	Approximate Average Outstanding in Period (000 s)	Approximate Weighted Average Interest Rate For the period
2010	$ 37,191	0.36%	$ 37,501	$ 34,046	0.36%
2009	$ 33,457	0.42%	$ 40,530	$ 37,696	0.48%
2008	$ 40,014	0.50%	$ 47,644	$ 40,113	1.96%

Other borrowings are also a source of funds. Other borrowings consist of loans from the Federal Home Loan Bank of Cincinnati. These funds are then used to provide fixed rate mortgage loans secured by homes in our community. Borrowings from this source decreased by $4.3 million to $29.9 million at December 31, 2010. This compares to decreased borrowings during 2009 of $11.4 million to $34.2 million at December 31, 2009 and increased borrowings during 2008 of $13.8 million to $45.6 million to end at December 31, 2008. The increased borrowings in 2008 and 2007 were used to fund loan growth and were a cheaper source of funds than certificate of deposits. The decreased borrowings were payoffs of matured notes in 2009. Sufficient funds were available to fund growth so new advances

were not needed in 2009.

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Asset/Liability Management

The primary functions of asset/liability management are to assure adequate liquidity and maintain an appropriate balance between interest earning assets and interest bearing liabilities. It involves the management of the balance sheet mix, maturities, re-pricing characteristics and pricing components to provide an adequate and stable net interest margin with an acceptable level of risk. Interest rate sensitivity management seeks to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates.

Changes in net income, other than those related to volume arise when interest rates on assets re-price in a time frame or interest rate environment that is different from that of the re-pricing period for liabilities. Changes in net interest income also arise from changes in the mix of interest-earning assets and interest-bearing liabilities.

Historically, the Bank has maintained liquidity through cash flows generated in the normal course of business, loan repayments, maturing earning assets, the acquisition of new deposits, and borrowings. The Bank s asset and liability management program is designed to maximize net interest income over the long term while taking into consideration both credit and interest rate risk. Interest rate sensitivity varies with different types of interest-earning assets and interest-bearing liabilities. Overnight federal funds on which rates change daily and loans that are tied to the market rate differ considerably from long-term investment securities and fixed rate loans. Similarly, time deposits over $100,000 and money market certificates are much more interest rate sensitive than passbook savings accounts. The Bank utilizes shock analysis to examine the amount of exposure an instant rate change of 100, 200, and 300 basis points in both increasing and decreasing directions would have on the financials. Acceptable ranges of earnings and equity at risk are established and decisions are made to maintain those levels based on the shock results.

Impact of Inflation and Changing Prices

The consolidated financial statements and notes thereto presented herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Company s operations. Unlike most industrial companies, nearly all the assets and liabilities of the Company are monetary in nature. As a result, interest rates have a greater impact on the Company s performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and service.

Contractual Obligations

Contractual Obligations of the Company totaled $399.4 million as of December 31, 2010. Time deposits represent contractual agreements for certificates of deposits held by its customers. Long term debt represents the borrowings with the Federal Home Loan Bank and is further defined in Note 4 and 9 of the Consolidated Financial Statements.

	Payment Due by Period (In Thousands)				
Contractual Obligations	**Total**	**Less than 1 year**	**1-3 Years**	**3-5 Years**	**More than 5 years**
Securities sold under agreement to repurchase	$ 51,241	$ 51,241	$	$	$
Time Deposits	317,364	176,254	106,498	33,211	1,401
Dividends Payable	894	894			
Long Term Debt	29,874	13,212	12,162	4,500	
Total	$ 399,373	$ 241,601	$ 118,660	$ 37,711	$ 1,401

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Capital Resources

Stockholders   equity was $94.4 million as of December 31, 2010 compared to $93.6 million at December 31, 2009. Dividends declared during 2010 were $0.73 per share totaling $3.44 million and 2009 were $0.72 per share totaling $3.41 million. During 2010, the Company purchased 48,130 shares and awarded 10,150 restricted shares to 53 employees under its long term incentive plan. During 2009, the Company purchased 28,907 shares and awarded 10,000 restricted shares to 49 employees. For a summary of activity as it relates to the Company   s restricted stock awards, please refer to Note 11: Employee Benefit Plans in the consolidated financial statements. At year end 2010, the Company held 477,106 shares in Treasury stock and 28,925 shares in unearned stock awards as compared to 2009, the Company held 437,551 shares in Treasury stock and 27,775 in unearned stock awards. On January 21, 2011 the Company announced the authorization by its Board of Directors for the Company   s repurchase, either on the open market, or in privately negotiated transactions, of up to 200,000 shares of its outstanding common stock commencing January 21, 2011 and ending December 31, 2011.

The Company continues to have a strong capital base and to maintain regulatory capital ratios that are significantly above the defined regulatory capital ratios.

At December 31, 2010, The Farmers & Merchants State Bank and Farmers & Merchants Bancorp, Inc had total risk-based capital ratios of 14.88% and 14.95%, respectively. Core capital to risk-based asset ratios of 11.56% and 14.02% are well in excess of regulatory guidelines. The Bank   s leverage ratio of 8.1% is also substantially in excess of regulatory guidelines as is the Company   s at 9.82%.

The Company   s subsidiaries are restricted by regulations from making dividend distributions in excess of certain prescribed amounts.

ITEM 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

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

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

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The shocks presented below assume an immediate change of rate in the percentages and directions shown:

Interest Rate Shock on Net Interest Margin				Interest Rate Shock on Net Interest Income	
Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate changes by	Cumulative Total ($000)	% Change to Flat Rate
2.91%	-0.19%	Rising	-6.10%	24,633	-6.54%
2.98%	-0.13%	Rising	-4.02%	25,221	-4.31%
3.04%	-0.07%	Rising	-2.19%	25,739	-2.34%
3.10%	0.00%	Flat	0	26,356	0.00%
3.13%	0.03%	Falling	0.86%	26,607	0.95%
3.03%	-0.07%	Falling	-2.34%	25,733	-2.36%
2.92%	-0.18%	Falling	-5.87%	24,765	-6.04%

The shock chart currently shows a tightening in net interest margin over the next twelve months in a rising rate environment. It shows expansion of net interest margin should rates fall. Both directional changes are well within risk exposure guidelines. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index.

ITEM 8. FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheet at December 31, 2010 and 2009
Consolidated Statements of Income for the years ended December 31, 2010, 2009 and 2008
Consolidated Statements of Changes in Shareholders Equity for the years ended December 31, 2010, 2009 and 2008
Consolidated Statements of Cash Flow for the years ended December 31, 2010, 2009 and 2008
Notes to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Farmers & Merchants Bancorp, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Farmers & Merchants Bancorp, Inc. and Subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2010. We also have audited the Company s internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying financial statements. Our responsibility is to express an opinion on these financial statements and an opinion on the company s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Farmers & Merchants Bancorp, Inc. and Subsidiaries as of December 31, 2010 and 2009, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Farmers & Merchants Bancorp, Inc. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ Plante & Moran, PLLC
Plante & Moran, PLLC

February 25, 2011
Columbus, Ohio

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Farmers & Merchants Bancorp, Inc and Subsidiaries

Consolidated Balance Sheet
December 31, 2010 and 2009
(000 s Omitted, Except Per Share Data)

Farmers & Merchants Bancorp, Inc and Subsidiaries
Consolidated Balance Sheet
December 31, 2010 and 2009

	2010	2009
Assets		
Assets		
Cash and due from banks (Note 1)	$ 28,987	$ 28,691
Federal Funds Sold	14,392	4,957
Total cash and cash equivalents	43,379	33,648
Securities available for sale (Note 3)	287,317	207,281
Other Securities, at cost (Note 3)	4,406	4,448
Loans, net (Note 4)	521,883	563,911
Premises and equipment (Note 5)	17,202	16,053
Goodwill (Note 2)	4,074	4,074
Mortgage Servicing Rights (Note 6)	2,178	2,177
Other Real Estate Owned	4,468	1,438
Other assets (Note 2)	21,456	20,830
Total Assets	$ 906,363	$ 853,860
Liabilities and Stockholders Equity		
Liabilities		
Deposits		
Noninterest-bearing	$ 70,554	$ 65,302
Interest-bearing		
NOW accounts	176,897	160,432
Savings	159,698	123,753
Time (Note 7)	317,364	326,957
Total deposits	724,513	676,444
Securities sold under agreement to repurchase (Note 8)	51,241	43,257
FHLB Advances (Note 9)	29,874	34,199
Dividend payable	894	853
Accrued expenses and other liabilities (Note 10)	5,438	5,523
Total liabilities	811,960	760,276
Stockholders Equity (Note 14 and 15)		
Common stock No par value - 6,500,000 shares authorized; 5,200,000 shares issued & outstanding	12,677	12,677
Treasury Stock - 477,106 Shares 2010, 437,551 Shares 2009	(9,799)	(9,082)

Unearned Stock Awards - 28,925 Shares 2010, 27,775 Shares 2009	(580)	(573)
Retained earnings	91,567	88,048
Accumulated other comprehensive income	538	2,514
Total stockholders equity	94,403	93,584
Total Liabilities and Stockholders Equity	$ 906,363	$ 853,860

See Notes to Consolidated Financial Statements

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Farmers & Merchants Bancorp, Inc and Subsidiaries

Consolidated Statement of Income
Years Ended December 31, 2010, 2009 and 2008
(000 s Omitted, Except Per Share Data)

Farmers & Merchants Bancorp, Inc. and Subsidiaries
Consolidated Statement of Income
December 31, 2010, 2009 and 2008

	2010	2009	2008
Interest Income			
Loans, including fees	$ 32,860	$ 33,585	$ 34,994
Debt securities:			
U.S. Treasury and government agency	4,583	5,496	6,634
Municipalities	2,167	1,788	1,697
Dividends	188	200	226
Federal funds sold	26	19	273
Other	69	26	
Total interest income	39,893	41,114	43,824
Interest Expense			
Deposits	9,126	11,007	15,227
Federal funds purchased and securities sold under agreements to repurchase	278	486	1,127
Borrowed funds	1,459	1,727	1,747
Total interest expense	10,863	13,220	18,101
Net Interest Income Before provision for loan losses	29,030	27,894	25,723
Provision for Loan Losses (Note 4)	5,325	3,558	1,787
Net Interest Income After Provision For Loan Losses	23,705	24,336	23,936
Noninterest Income			
Customer service fees	3,464	3,276	3,436
Other service charges and fees	3,062	2,541	2,322
Net gain on sale of loans	1,395	1,776	708
Net gain on sale of securities (Note 3)	956	230	15
Total noninterest income	8,877	7,823	6,481
Noninterest Expenses			
Salaries and Wages	8,773	8,601	8,715
Employee benefits (Note 11)	2,909	3,018	3,018
Net occupancy expense	1,099	1,113	1,029
Furniture and equipment	1,504	1,504	1,443
Data processing	953	1,136	1,234
Franchise taxes	904	914	863
FDIC Assessment	1,053	1,306	151
Mortgage servicing rights amortization (Note 6)	683	933	370

Other general and administrative	5,341	4,554	4,421
Total other operating expenses	23,219	23,079	21,244
Income Before Income Taxes	9,363	9,080	9,173
Income Taxes (Note 10)	2,382	2,475	2,450
Net Income	$ 6,981	$ 6,605	$ 6,723
Earnings Per Share Basic and Diluted	$ 1.48	$ 1.39	$ 1.39
Weighted Average Shares Outstanding	4,721,235	4,741,392	4,846,310

See Notes to Consolidated Financial Statements

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Farmers & Merchants Bancorp, Inc. and Subsidiaries

Consolidated Statement of Changes in Shareholders Equity
For the Years Ended December 31, 2010, 2009 and 2008
(000 s Omitted, Except per Share Data)

	Shares of Common Stock	Common Stock	Treasury Stock	Unearned Stock Awards	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance January 01, 2008	4,943,840	$ 12,677	$ (5,366)	$ (391)	$ 81,575	$ 880	$ 89,375
Cumulative effect of adoption of EITF 06-4 for post retirement liability					(152)		(152)
Comprehensive income (Note 1):							
Net income					6,723		6,723
Change in net unrealized gain on securities sale, net of reclassification adjustment and tax						1,356	1,356
Total comprehensive income							8,079
Purchase of Treasury Stock	(171,889)		(3,576)				(3,576)
Shares issued for vested stock awards				98			98
Grant of Restricted Stock Awards-10,000 shares (Net of Forfeiture 245)	9,755		215	(210)			5
Cash dividends declared $0.68 per share					(3,282)		(3,282)
Balance December 31, 2008	4,781,706	$ 12,677	$ (8,727)	$ (503)	$ 84,864	$ 2,236	$ 90,547
Comprehensive income (Note 1):							
Net income					6,605		6,605
Change in net unrealized gain on securities sale, net of						278	278

reclassification adjustment and tax							
Total comprehensive income							6,883
Purchase of Treasury Stock	(28,907)		(555)				(555)
Shares issued for vested stock awards				123			123
Grant of Restricted Stock Awards-10,000 shares (Net of Forfeiture 350)	9,650		200	(193)	(8)		(1)
Cash dividends declared $0.72 per share					(3,413)		(3,413)
Balance December 31, 2009	4,762,449	$ 12,677	$ (9,082)	$ (573)	$ 88,048	$ 2,514	$ 93,584
Comprehensive income (Note 1):							
Net income					6,981		6,981
Change in net unrealized gain on securities sale, net of reclassification adjustment and tax						(1,976)	(1,976)
Total comprehensive income							5,005
Purchase of Treasury Stock	(48,130)		(894)				(894)
Shares issued for vested stock awards				151			151
Grant of Restricted Stock Awards-10,150 shares (Net of Forfeiture 1,575)	8,575		177	(158)	(18)		1
Cash dividends declared $0.73 per share					(3,444)		(3,444)
Balance December 31, 2010	4,722,894	$ 12,677	$ (9,799)	$ (580)	$ 91,567	$ 538	$ 94,403

See notes to Consolidated Financial Statements

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Farmers & Merchants Bancorp, Inc and Subsidiaries

Consolidated Statement of Cash Flows

Years Ended December 31, 2010, 2009 and 2008

(000 s Omitted)

	2010	2009	2008
Cash Flows from Operating Activities			
Net income	$ 6,981	$ 6,605	$ 6,723
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation	1,147	1,171	1,132
Amortization of servicing rights	684	933	370
Amortization of Core Deposit Intangible	235	157	157
Provision for loan loss	5,325	3,558	1,787
Gain on sale of loans held for sale	(1,392)	(1,203)	(968)
Originations of loans held for sale	(83,705)	(118,491)	(36,765)
Proceeds from sale of loans held for sale	82,315	118,284	37,735
Accretion and amortization of securities	1,595	809	300
Deferred income tax expense (benefit)	210	142	(39)
Loss on sale of other assets	109	75	194
Gain on sales of securities	(956)	(230)	(15)
Change in other assets and other liabilities, net	(1,113)	(6,026)	(1,943)
Net cash provided by operating activities	11,435	5,784	8,668
Cash Flows from Investing Activities			
Activity in securities:			
Sales	55,700	16,333	25
Maturities, prepayments and calls	104,602	78,292	75,084
Purchases	(244,812)	(124,354)	(65,580)
Loan and lease originations and principal collections, net	38,094	(3,723)	(41,268)
Proceeds from sales of assets	716	494	1,102
Additions to premises and equipment	(2,294)	(412)	(1,081)
Net cash paid for acquisition	(1,141)		
Net cash used in investing activities	(49,135)	(33,370)	(31,718)
Cash Flows from Financing Activities			
Net increase (decrease) in deposits	48,069	60,712	(18,861)
Net change in federal funds purchased and securities sold under agreements to repurchase	7,984	(4,957)	6,885
Proceeds from issuance of long-term debt	9,000		19,600
Repayment of long-term debt	(13,326)	(11,436)	(5,781)
Purchase of Treasury Stock	(894)	(555)	(3,576)
Cash dividends paid on common stock	(3,402)	(3,417)	(3,217)
Net cash provided by (used) financing activities	47,431	40,347	(4,950)
Net Increase (Decrease) in Cash and Cash Equivalents	9,731	12,761	(28,000)

Cash and Cash Equivalents Beginning of Year	33,648	20,887	48,887
Cash and Cash Equivalents End of Year	$ 43,379	$ 33,648	$ 20,887
Supplemental Information Cash paid during the year for:			
Interest	$ 11,244	$ 13,275	$ 18,756
Income taxes	$ 1,875	$ 2,725	$ 2,445

See Notes to Consolidated Financial Statements

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Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 1 Summary of Significant Accounting Policies

Nature of Operations

The Farmers & Merchants Bancorp, Inc. (the Company) through its bank subsidiary, The Farmers & Merchants State Bank (the Bank) provides a variety of financial services to individuals and small businesses through its offices in Northwest Ohio and Northeast Indiana.

Consolidation Policy

The consolidated financial statements include the accounts of Farmers & Merchants Bancorp, Inc. and its wholly-owned subsidiary, The Farmers & Merchants State Bank (the Bank), a commercial banking institution. All significant inter-company balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of mortgage servicing rights, goodwill, other real estate owned and impaired loans. Actual results could differ from those estimates.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral. The Bank s loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Bank has a diversified loan portfolio, a substantial portion of its debtors ability to honor their contracts is dependent on local economic conditions in the agricultural industry.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Cash and Cash Equivalents

For purposes of the consolidated statement of cash flows, the Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. This includes cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are purchased and sold for one day periods.

Restrictions on Cash and Amounts Due from Banks

The Bank is required to maintain average balances on hand with the Federal Reserve Bank. The aggregate reserve was $3.3 million for December 31, 2010 and it was $4.0 million for December 31, 2009.

The Company and its subsidiary maintain cash balances with high quality credit institutions. At times such balances may be in excess of the federally insured limits.

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Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 1 Summary of Significant Accounting Policies (Continued)

Securities

Debt securities are classified as available-for-sale. Securities available-for-sale are carried at fair value with unrealized gains and losses reported in other comprehensive income. Realized gains and losses on securities available for sale are included in other income (expense) and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income. Gains and losses on sales of securities are determined on the specific-identification method.

Declines in the fair value of securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The related write-downs are included in earnings as realized losses.

Other Securities

Other Securities consists of Federal Home Loan Bank of Cincinnati and Indianapolis stock and Farmer Mac stock. These stocks are carried at cost and are held to enable the Bank to conduct business with the entities. The Federal Home Loan Banks sell and purchase their stock at par; therefore cost approximates market value. The Federal Home Loan Bank of Cincinnati stock is held as collateral security for all indebtedness of the Bank to the Federal Home Loan Bank.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at the amount of unpaid principal, reduced by unearned discounts and deferred loan fees and costs, as well as, by the allowance for loan losses. Interest income is accrued on a daily basis based on the principal outstanding. Generally, a loan is classified as nonaccrual and the accrual of interest income is generally discontinued when a loan becomes ninety days past due as to principal or interest and these loans are placed on a cash basis for purposes of income recognition. Management may elect to continue the accrual of interest when the estimated net realizable value of collateral is sufficient to cover the principal and accrued interest, and the loan is in the process of collection. When a loan is placed on nonaccrual status, all previously accrued and unpaid interest receivable is charged against income. Loan origination and commitment fees and certain direct loan origination costs are deferred and amortized as a net adjustment to the related loan s yield. The Bank is generally amortizing these costs over the contractual life of such loans.

Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses charged to income. Loans deemed to be uncollectable and changes in the allowance relating to loans are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based on management s periodic review of the collectability of the loans in light of historical experiences, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are subject to revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market

Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 1 Summary of Significant Accounting Policies (Continued)

price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. The unallocated component is maintained to cover uncertainties that could affect management s estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Impairment is measured on a loan by loan basis for commercial and agricultural loans by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

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.

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

Large groups of homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer loans for impairment disclosures.

For more information regarding the actual composition and classification of loans involved in the establishment of the allowance for loan loss, please see Note 4 provided here with the notes to consolidated financial statements.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses, if any, are recognized in a valuation allowance by charges to income.

Servicing Assets

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest expense in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum. Fees received for servicing loans owned by investors are based on a percentage of the outstanding monthly principal balance of such loans and are included in operating income as loan payments are received. Costs of servicing loans are charged to expense as incurred.

Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 1 Summary of Significant Accounting Policies (Continued)

Goodwill and other Intangible Assets

Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually with the assistance of an independent third party for impairment and any such impairment is recognized in the period identified. No impairment has been recognized from the goodwill established from the Bank s acquisition which occurred on December 31, 2007.

Other intangible assets consist of core deposit intangible assets arising from business acquisitions. They are initially measured at fair value and then are amortized on a straight line method over their estimated useful lives.

Off Balance Sheet Instruments

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Foreclosed Real Estate

Foreclosed real estate held for sale is carried at the lower of fair value minus estimated costs to sell, or cost. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and an allowance is established by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell. Foreclosed real estate is classified as other real estate owned. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At December 31, 2010, the Bank s holding of other real estate owned totaled approximately $4.5 million.

Bank Premises and Equipment

Land is carried at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is based on the estimated useful lives of the various properties and is computed using straight line and accelerated methods. Costs for maintenance and repairs are charged to operations as incurred. Gains and losses on dispositions are included in current operations.

Federal Income Tax

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Earnings Per Share

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Basic and dilutive earnings per share are the same as the restricted stock grants are primarily anti-dilutive. As of December 31, 2010, the Company held 28,925 shares of anti-dilutive restricted stock awards.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of comprehensive income.

Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 1 Summary of Significant Accounting Policies (Continued)

The components of other comprehensive income and related tax effects are as follows:

	(In Thousands)		
	2010	**2009**	**2008**
Net unrealized gain (loss) on available-for-sale securities	$ (2,037)	$ 701	$ 2,055
Reclassification adjustment for gain on sale of available-for-sale securities	(956)	(281)	
Net unrealized gains (losses)	(2,993)	420	2,055
Tax effect	(1,017)	142	699
Other comprehensive income (loss)	$ (1,976)	$ 278	$ 1,356

Other securities, not classified as available for sale, had a realized loss of $51 thousand for 2009 and a $15 thousand gain in 2008. Those amounts are not included in the above table.

Post Retirement Liability

Effective in 2008, liability and related compensation costs are recognized for endorsement split-dollar life insurance policies that provide a benefit to an employee extending to postretirement periods. This accounting pronouncement was applied as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of January 01, 2008 approximating $152,000.

Reclassification

Certain amounts in the 2009 and 2008 consolidated financial statements have been reclassified to conform with the 2010 presentation.

Recent Accounting Pronouncements

In July 2010, FASB issued ASU No. 2010-20 Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses . The standard requires the Company to expand disclosures about the credit quality of our loans and the related reserves against them. The additional disclosures will include details on our past due loans and credit quality indicators. For public entities, ASU 2010-20 disclosures of period-end balances are effective for interim and annual reporting periods ending on or after December 15, 2010 and are included in Note 4 of the financial statements. Disclosures related to activity that occurs during the reporting period are required for interim and annual reporting periods beginning on or after December 15, 2010. The Company will adopt the disclosures related to the activity that occurs during the reporting period beginning with our March 31, 2011 consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06 Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends the fair value disclosure guidance. The amendments include new disclosures and changes to clarify existing disclosure requirements. ASU 2010-06 was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements of Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The impact of ASU 2010-06 on the Company s disclosures is reflected in Note 16 (Fair Value of Financial Instruments) of the consolidated financial statements.

Note 2 Business Combination & Asset Purchase

On December 31, 2007, the Bank acquired 100% of the outstanding shares of Knisely Bank. Knisely Bank was merged with and into the Bank, and the Knisely Bank offices now operate as branches of the Bank. The merger enabled the Company to increase its market share in a community contiguous to its existing markets.

The aggregate acquisition cost of Knisely Bank was $10.4 million, which was all paid in cash. Direct acquisition costs approximated $222 thousand. The acquisition cost in excess of the net assets and identifiable intangible

Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 2 Business Combination & Asset Purchase (Continued)

assets acquired, has been recorded as goodwill of $4.1 million. Goodwill that is deductible for tax purposes is approximately $3.85 million.

On July 9, 2010 the Bank completed its purchase of a branch office in Hicksville, Ohio from First Place Bank. Deposits of approximately $28 million and loans of $14 million were included in the purchase. The new office is located within the Bank s current market area, shortening the distance between offices in the Ohio and Indiana market area. The following table summarizes the estimated values of the assets acquired and the liabilities assumed:

(Dollars in Thousands)	
Cash	$ 114
Loans, Net of Discount	13,792
Accrued Interest on Loans	64
Premises and Equipment	1,803
Core Deposit Intangible Asset	1,087
Other Assets	11
Total Assets Acquired	$ 16,871
Deposits	$ 27,749
Accrued Interest on Deposits	13
Other Liabilities	10
Total Liabilities Assumed	$ 27,772
Net Liabilities Assumed	$ (10,901)

In connection with the 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. These are being amortized over an estimated remaining economic useful life of the deposits of 7 years on a straight line basis.

The estimated amortization expense for the years ended December 31, 2010, 2009 and 2008 was $235, $157 and $157 thousand, respectively. Amortization expense of the core deposit intangible assets remaining is as follows:

	(In Thousands)		
	Knisley	**Hicksville**	**Total**
2011	$ 157	$ 155	$ 312
2012	157	155	312
2013	157	155	312
2014	157	155	312
2015		155	155
Thereafter		235	235
Total	$ 628	$ 1,010	$ 1,638

Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 3 Securities

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

	(In Thousands) 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
Available-for-Sale:				
U.S. Treasury	$ 32,698	$	$ (420)	$ 32,278
U.S. Government agency	166,000	1,308	(1,604)	165,704
Mort gage-backed securities	23,282	1,249		24,531
St ate and local governments	64,522	792	(510)	64,804
Total available-for-sale securities	$ 286,502	$ 3,349	$ (2,534)	$ 287,317

	(In Thousands) 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
Available-for-Sale:				
U.S. Treasury	$ 5,244	$	$ (25)	$ 5,219
U.S. Government agency	103,311	1,501	(136)	104,676
Mort gage-backed securities	35,209	1,639		36,848
St ate and local governments	59,708	1,009	(179)	60,538
Total available-for-sale securities	$ 203,472	$ 4,149	$ (340)	$ 207,281

Investment securities will at times depreciate to an unrealized loss position. The Bank 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 Bank currently does not hold any securities with other than temporary impairment.

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Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 3 Securities (Continued)

Information pertaining to securities with gross unrealized losses at December 31, 2010 and 2009, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

	2010			
	(In Thousands) Less Than Twelve Months		(In Thousands) Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ (420)	$ 32,278	$	$
U.S. Government agency	(1,604)	88,026		
Mortgage-backed securities				
State and local governments	(411)	20,386	(99)	11,302
Total available-for-sales securities	$ (2,435)	$ 140,690	$ (99)	$ 11,302

	2009			
	(In Thousands) Less Than Twelve Months		(In Thousands) Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ (25)	$ 5,219	$	$
U.S. Government agency	(136)	14,355		
Mortgage-backed securities				
State and local governments	(179)	15,754		
Total available-for-sales securities	$ (340)	$ 35,328	$	$

Unrealized losses on securities have not been recognized into income because the issuers bonds are of high credit quality, the Bank has the intent and ability to hold the securities for the foreseeable future, and the decline in fair value is primarily due to increased market interest rates. The fair value is expected to recover as the bonds approach the maturity date.

The gross realized gains and losses for the years ended December 31, are presented below:

	(In Thousands)		
	2010	2009	2008
Gross realized gains	$ 956	$ 281	$ 15
Gross realized losses		(51)	

Net realized gains	$ 956	$ 230	$ 15
Tax expense related to net realized gains	$ 325	$ 78	$ 5

Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 3 Securities (Continued)

The amortized cost and fair value of debt securities at December 31, 2010, 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	$ 2,067	$ 2,092
After one year through five years	167,779	167,488
After five years through ten years	78,167	78,128
After ten years	15,207	15,078
Total	$ 263,220	$ 262,786
Mortgage-backed securities	23,282	24,531
Total	$ 286,502	$ 287,317

Investments with a carrying value and fair value of $186.8 million at December 31, 2010 and $167.3 million at December 31, 2009 were pledged to secure public deposits and securities sold under repurchase agreements.
Other securities include Federal Home Loan Bank of Cincinnati and Indianapolis stock and Farmer Mac stock as of December 31, 2010. The stock is carried at cost, which approximates fair value. The loss recognized in 2009 was Bankers Bank stock which was written down to a carrying value of zero in December 2009 for a loss of $51 thousand.

Note 4 Loans

Loans at December 31 are summarized below:

	(In Thousands)	
Loans:	**2010**	**2009**
Commercial real estate	$ 185,033	$ 214,849
Agricultural real estate	33,650	41,045
Consumer real estate	95,271	98,599
Commercial and industrial	117,344	120,543
Agricultural	65,400	59,813
Consumer	29,008	32,581
Industrial Development Bonds	1,965	2,552
	527,671	569,982
Less: Net deferred loan fees and costs	(82)	(63)
	527,589	569,919
Less: Allowance for loan losses	(5,706)	(6,008)
Loans Net	$ 521,883	$ 563,911

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Farmers & Merchants Bancorp, Inc and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2010, 2009, and 2008

Note 4 Loans (Continued)

The following is a maturity schedule by major category of loans:

	(In Thousands)			
	Within One Year	After One Year Within Five Years	After Five Years	Total
Commercial Real Estate	$ 36,523	$ 105,168	$ 43,342	$ 185,033
Agricultural Real Estate	2,738	13,546	17,366	33,650
Consumer Real Estate	8,009	23,094	64,168	95,271
Commercial and industrial	83,554	25,387	8,403	117,344
Agricultural	48,038	14,196	3,166	65,400
Consumer	6,002	20,723	2,283	29,008
Industrial Development Bonds	556	446	963	1,965
	$ 185,420	$ 202,560	$ 139,691	$ 527,671

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of December 31, 2010:

	(In Thousands)	
	Fixed Rate	Variable Rate
Commercial Real Estate	$ 67,936	$ 117,097
Agricultural Real Estate	19,983	13,667
Consumer Real Estate	76,161	19,110
Commercial and industrial	92,950	24,394
Agricultural	58,939	6,461
Consumer	23,959	5,049

	-	(206,688)	-	(394,032)
Income attributable to noncontrolling interest in Operating Partnership	-	(10,737,100)	-	(11,713,200)
Net loss from continuing operations available to common shareholders	$(244,358)	$(17,953,878)	$(317,970)	$(26,542,622)
Discontinued operations	$(4,582)	$25,917,715	$(162,551)	$25,389,269
Net income (loss) available to common shareholders	$(248,940)	$7,963,837	$(480,521)	$(1,153,353)
	$(0.17)	$(12.77)	$(0.23)	$(18.88)

Net loss from continuing operations attributable to Parent Company per common share available to common shareholders, basic and diluted				
Net income (loss) from discontinued operations attributable to Parent Company per common share available to common shareholders, basic and diluted	$(0.01)	$18.43	$(0.11)	$18.06
Net income (loss) attributable to Parent Company per common share, basic and diluted	$(0.18)	$5.66	$(0.34)	$(0.82)
Weighted average number of common shares outstanding, basic and diluted	1,406,196	1,406,196	1,406,196	1,406,196

For the six months ended June 30, 2009 and 2008, the Company did not have any common stock equivalents; therefore basic and dilutive earnings per share were the same.

9. COMMITMENTS AND CONTINGENCIES

The Company is party to certain legal actions arising in the ordinary course of its business, such as those relating to tenant issues. All such proceedings taken together are not expected to have a material adverse effect on the Company. While the resolution of these matters cannot be predicted with certainty, management believes that the final outcome of such legal proceedings and claims will not have a material adverse effect on the Company's liquidity, financial position or results of operations.

The Company entered into two irrevocable letters of credit arrangements with a bank in relation to the JV BIR/Holland transaction. The irrevocable letters of credit were a requirement of the lender, who issued the debt secured by the property substantially owned by JV BIR/Holland, in order for the new ownership structure contemplated by the transaction to move forward. The irrevocable letters of credit are in place as a guarantee for two separate principal reduction payments of $9,500,000 due in 2009 and $2,710,000 due in 2010. The letters of credit are backed by cash segregated in accounts maintained at the bank. The cash is reflected as restricted cash on the balance sheet of the Company as of June 30, 2009.

The Company entered into an irrevocable letter of credit arrangement with a bank in relation to an appeal of a judgment rendered by a court pursuant to an ongoing lawsuit. In order to move forward with an appeal of the judgment before the Appeals Court, the process required the Company to post an appeal bond in the amount of $800,000. The bond is backed by the irrevocable letter of credit which is in place as a guarantee of payment of the outstanding damages awarded by the lower court should the Company be unsuccessful in its appeal. The letter of credit is backed by cash segregated in accounts maintained at the bank. The cash is reflected as restricted cash on the balance sheet of the Company as of June 30, 2009.

In July 2009, the court ruled against the Company on its appeal and upheld the judgment in favor of the plaintiff in the amount of $774,292. Operating cash of the Company was used to pay the judgment plus legal fees, costs and interest of approximately $163,700. The Company expects to cancel the letter of credit at which time the segregated cash on deposit with the bank will be released and be returned to operating cash.

10. DERIVATIVE FINANCIAL INSTRUMENTS

Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment to FASB Statement No. 133 ("SFAS No. 161"), amends and expands the disclosure requirements of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS No. 133") with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments. SFAS No. 133, as amended and interpreted, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. As required by SFAS No. 133, derivatives are recorded on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. Hedge ineffectiveness is measured by comparing the changes in fair value or cash flows of the derivative hedging instrument with the changes in fair value or cash flows of the designated hedged item or transaction. For derivatives not designated as hedges, changes in fair value are recognized in earnings.

We do not use derivatives for trading or speculative purposes. When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, we have not sustained a material loss from these hedges.

We have utilized interest rate caps to add stability to interest expense, to manage our exposure to interest rate movements and as required by our lenders when entering into variable interest mortgage debt. Interest rate caps designated as cash flow hedges involve the receipt of variable-rate amounts if interest rates rise above a certain level in exchange for an up front premium.

During the six months ended June 30, 2009, we acquired an interest rate cap through our investment in JV BIR/Holland. The derivative instrument was obtained as a requirement by the lender under the terms of the financing and limits increases in interest costs of the variable rate debt. The Company assessed the fair value of the derivative instrument, which reflects the estimated amount the Company would receive, or pay, for the same instrument in a current exchange at the reporting date. The valuation considers, among other things, interest rates at the time of the valuation, credit worthiness and risk of non performance of the counterparties considered in the valuation transaction. The resulting fair value of the derivative interest rate cap contract was deemed to be immaterial and no adjustment was made to reflect the fair value of the derivative instrument at June 30, 2009.

11. RELATED PARTY TRANSACTIONS

Amounts accrued or paid to the Company's affiliates are as follows:

	Three months ended June 30,	Six months ended June 30,

	2009	2008	2009	2008
Property management fees	$ 761,310	$ 815,545	$ 1,506,943	$ 1,653,233
Expense reimbursements	50,226	48,975	100,452	97,950
Salary reimbursements	2,226,156	2,187,625	4,612,091	4,570,924
Asset management fees	412,314	418,361	824,628	836,721
Acquisition fees	-	-	427,500	-
Construction management fees	55,638	125,131	204,030	219,005
Development fees	79,500	127,000	159,000	254,000
Interest on revolving credit facility	-	22,488	-	22,488
Total	$ 3,585,144	$ 3,745,125	$ 7,834,644	$ 7,654,321

Amounts due to affiliates of $2,660,326 and $2,291,250 are included in “Due to affiliates, net” at June 30, 2009 and December 31, 2008, respectively, in the accompanying Consolidated Balance Sheets.

Expense reimbursements due to affiliates of $4,726,246 and $2,920,573 are included in “Due to affiliates, net” at June 30, 2009 and December 31, 2008, respectively, in the accompanying Consolidated Balance Sheets.

Expense reimbursements due from affiliates of $2,065,920 and $629,323 are included in “Due to affiliates, net” at June 30, 2009 and December 31, 2008, respectively, in the accompanying Consolidated Balance Sheets and represent intercompany development fees and related party reimbursements.

The Company pays property management fees to an affiliate for property management services. The fees are payable at a rate of 4% of gross income.

The Company pays asset management fees to an affiliate, Berkshire Advisor, for asset management services. These fees are payable quarterly, in arrears, and may be paid only after all distributions currently payable on the Company’s Preferred Shares have been paid. Effective April 4, 2003, under the advisory services agreement, the Company will pay Berkshire Advisor an annual asset management fee equal to 0.40%, up to a maximum of $1,600,000 in any calendar year, as per an amendment to the management agreement, of the purchase price of real estate properties owned by the Company, as adjusted from time to time to reflect the then current fair market value of the properties. The purchase price is defined as the capitalized basis of an asset under GAAP, including renovation or new construction costs, or other items paid or received that would be considered an adjustment to basis. Annual asset management fees earned by the affiliate in excess of the $1,600,000 maximum payable by the Company represent fees incurred and paid by the minority partners in the properties. The Company also reimburses affiliates for certain expenses incurred in connection with the operation of the properties, including administrative expenses and salary reimbursements.

The Company pays acquisition fees to an affiliate, Berkshire Advisor, for acquisition services. These fees are payable upon the closing of an acquisition of real property. The fee is equal to 1% of the purchase price of any new property acquired directly or indirectly by the Company. The purchase price is defined as the capitalized basis of an asset under GAAP, including renovations or new construction costs, or other items paid or received that would be considered an adjustment to basis. The purchase price does not include acquisition fees and capital costs of a recurring nature. The Company paid a fee on the acquisition of the Glo Apartments. Pursuant to the Company’s adoption of SFAS No. 141R as of January 1, 2009, the acquisition fee was charged to operating expenses for the six

months ended June 30, 2009.

The Company pays a construction management fee to an affiliate, Berkshire Advisor, for services related to the management and oversight of renovation and rehabilitation projects at its properties. The Company paid or accrued $204,030 and $219,005 in construction management fees for the six months ended June 30, 2009 and 2008, respectively. The fees are capitalized as part of the project cost in the year they are incurred.

The Company pays development fees to an affiliate, Berkshire Residential Development, for property development services. As of June 30, 2009, the Company has one property under development and has incurred fees totaling $159,000 and $254,000 in the six month period ended June 30, 2009 and 2008, respectively. The fees, all of which are related to the development phase as the project is currently under construction, are based on the project's development/construction costs. As of June 30, 2009, $0 has been paid to the affiliate for the current year fees and $159,000 remained payable related to the Arboretum Land development project.

During the six months ended June 30, 2009 and 2008, the Company borrowed $0 and $5,000,000, respectively, related to the acquisition activities of the Company and repaid advances of $0 and $5,000,000, respectively, during the same periods. There were no borrowings outstanding as of June 30, 2009 and December 31, 2008 under the facility. The Company incurred interest and fees of $0 and $22,488 related to the facility during the six months ended June 30, 2009 and 2008, respectively.

12. LEGAL PROCEEDINGS

The Company was party to a legal proceeding initiated by a seller/developer from whom the Company acquired a property in 2005. The dispute involved the interpretation of certain provisions of the purchase and sales agreement related to post acquisition construction activities. Specifically, the purchase and sales agreement provided that if certain conditions were met, the seller/developer would develop a vacant parcel of land contiguous to the acquired property with 18 new residential apartment units (the "New Units") for the benefit of the Company at an agreed-upon price. The purchase and sales agreement also provided the opportunity for the seller/developer to build a limited number of garages (the "Garages") for the existing apartment units for the benefit of the Company at an agreed-upon price.

In 2006, the Company accrued $190,000 with respect to the New Units matter based on a settlement offer extended to the plaintiff, which was not accepted at that time. On November 9, 2007, the judge issued a summary judgment against the Company with respect to the construction of the New Units. On February 13, 2008, the court entered judgment related to the New Units on the seller/developer's behalf awarding them a judgment in the amount of $774,292 for costs and damages. As condition of the appeals process, the Company was required to post an appeals bond with the court. The bond is backed by a letter of credit in the amount of $800,000 and is reflected as restricted cash on the balance sheet as of June 30, 2009.

In July 2009, the court ruled against the Company on its appeal and upheld the judgment in favor of the plaintiff in the amount of $774,292. Operating cash of the Company was used to pay the judgment plus legal fees, costs and interest of approximately $163,700. The Company expects to cancel the letter of credit at which time the segregated cash on deposit with the bank will be released and be returned to operating cash.

The Company and our properties are not subject to any other material pending legal proceedings.

13. SUBSEQUENT EVENTS

In July 2009, the court ruled against the Company on its appeal and upheld the judgment in favor of the plaintiff in the amount of $774,292. Operating cash of the Company was used to pay the judgment plus legal fees, costs and interest of approximately $163,700.

Pursuant to SFAS No. 165, subsequent events have been evaluated through August 13, 2009, the date these financial statements were issued.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF BERKSHIRE INCOME REALTY, INC

You should read the following discussion in conjunction with the consolidated financial statements of Berkshire Income Realty, Inc (the "Company") and their related notes and other financial information included in this report. For further information please refer to the Company's consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Forward Looking Statements

Certain statements contained in this report, including information with respect to our future business plans, constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements, subject to a number of risks and uncertainties that could cause actual results to differ significantly from those described in this report. These forward-looking statements include statements regarding, among other things, our business strategy and operations, future expansion plans, future prospects, financial position, anticipated revenues or losses and projected costs, and objectives of management. Without limiting the foregoing, the words "may," "will," "should," "could," "expect "plans," "anticipates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of such terms an comparable terminology are intended to identify forward-looking statements. There are a number of important factors that could cause our results to differ materially from those indicated by such forward-looking statements. These factors include, but are not limited to, changes in economic conditions generally and the real estate and bond markets specifically, legislative/regulatory changes (including changes to laws governing the taxation of real estate investment trusts ("REITs")), possible sales of assets, the acquisition restrictions placed on the Company by an affiliated entity Berkshire Multifamily Value Fund II, LP, ("BVF II" or "Fund II"), availability of capital, interest rates and interest rate spreads, changes in accounting principles generally accepted in the United States of America ("GAAP") and policies and guidelines applicable to REITs, those factors set forth in Part I, Item 1A "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended December 31, 2008, as filed with the Securities and Exchange Commission (the "SEC") and other risks and uncertainties as may be detailed from time to time in our public announcements and our reports filed with the SEC.

The foregoing risks are not exhaustive. Other sections of this report may include additional factors that could adversely affect our business and financial performance. Moreover, we operate in a competitive and rapidly changing environment. New risk factors emerge from time to time and it is not possible for management to predict all such risks factors, nor can it assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, undue reliance should not be placed on forward-looking statements as a prediction of actual results.

Current economic conditions have lead to instability and tightening in the credit markets and have lead to increases in spreads and the related pricing of secured and unsecured debt. Prolonged interest rate increases could negatively impact the Company's ability to make future acquisitions, develop or renovate properties or refinance existing debt at acceptable rates. Additionally, prospective buyers of our properties may also have difficulty obtaining debt which might make it more difficult for the Company to sell properties at acceptable pricing levels. Continued disruptions in the credit markets may also indirectly have an adverse effect on the Company's operations or the overall economy in which it operates.

As used herein, the terms "we", "us" or the "Company" refer to Berkshire Income Realty, Inc., a Maryland corporation, incorporated on July 19, 2002. The Company is in the business of acquiring, owning, operating and renovating

multifamily apartment communities. Berkshire Property Advisors, L.L.C. ("Berkshire Advisor" or "Advisor") is an affiliated entity we have contracted with to make decisions relating to the day-to-day management and operation of our business, subject to the oversight of the Company's Board of Directors ("Board"). Refer to Item 13 – Certain Relationships and Related Transactions and Director Independence and Notes to the Consolidated Financial Statements, Note 12 – Related Party Transactions of the Company's Annual Report on Form 10-K for the year ended December 31, 2008 as filed with the SEC for additional information about the Advisor.

Overview

The Company is engaged primarily in the ownership, acquisition, operation and rehabilitation of multifamily apartment communities in the Baltimore/Washington D.C., Southeast, Southwest, Northwest and Midwest areas of the United States. We conduct substantially all of our business and own, either directly or through subsidiaries, substantially all of our assets through Berkshire Income Realty – OP, L.P. (the "Operating Partnership"), a Delaware limited partnership. The Company's wholly owned subsidiary, BIR GP, L.L.C., a Delaware limited liability company, is the sole general partner of the Operating Partnership.

As of August 13, 2009, the Company owns 100% of the preferred limited partner units of the Operating Partnership, whose terms mirror the terms of the Company's Series A 9% Cumulative Redeemable Preferred Stock and, through BIR GP, L.L.C., owns 100% of the general partner interest of the Operating Partnership, which represents approximately 2.39% of the common economic interest of the Operating Partnership.

Our general and limited partner interests in the Operating Partnership entitle us to share in cash distributions from, and in the profits and losses of, the Operating Partnership in proportion to our percentage interest therein. The other partners of the Operating Partnership are affiliates who contributed their direct or indirect interests in certain properties to the Operating Partnership in exchange for common units of limited partnership interest in the Operating Partnership.

Our highlights of the six months ended June 30, 2009 included the following:

§ On January 30, 2009, the Company closed on $5,181,000 of fixed rate supplemental mortgage debt on the Berkshires of Columbia property. The loan is a non-recourse third mortgage note secured by the property with a fixed interest rate of 6.37%. The loan matures on October 1, 2014.

§ On February 24, 2009, the Company, through the Operating Partnership, entered into a Joint Venture Agreement to acquire 89.955% of the ownership interests in a 201 unit mid-rise multifamily apartment community in Los Angeles, California. The purchase price of $47,500,000 and related closing costs consisted of a capital commitment of $12,580,314 plus the assumption of the outstanding mortgage debt secured by the property. The purchase was subject to normal operating pro rations. As of June 30, 2009, the purchase price allocation was final and no further adjustment is contemplated.

SFAS No. 141R requires that identifiable assets acquired and liabilities assumed to be recorded at fair value as of the acquisition date. As of the acquisition date, the amounts recognized for each major class of assets acquired and liabilities assumed is as follows:

Asset Acquired		
Multifamily Apartment Communities	$	41,602,373
Acquired in-place leases		607,893
Prepaid expense and other assets		1,083,422
Total assets acquired	$	43,293,688
Liabilities Assumed:		
Mortgage notes payable	$	42,203,273
Accrued expenses		80,760
Tenant security deposits		159,936
Total liabilities assumed	$	42,443,969

§ On February 26, 2009, the Company, through its wholly owned subsidiary, BIR Laurel Woods Limited Partnership, executed a non-recourse second mortgage note on the Laurel Woods Apartment for $1,900,000, which is secured by the related property. The note has a fixed interest rate of 7.14% and matures on October 1, 2015.

General

The Company detailed a number of significant trends and specific factors affecting the real estate industry in general and the Company's business in particular in Part II, Item 7 - "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2008. The Company believes those trends and factors continue to be relevant to the Company's performance and financial condition.

Liquidity and Capital Resources

Cash and Cash Flows

As of June 30, 2009 and December 31, 2008, the Company had $14,157,039 and $24,227,615 of cash and cash equivalents, respectively. Cash provided and used by the Company for the three and six month periods ended June 30, 2009 and 2008 are as follows:

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Cash provided by operating activities	$ 1,991,109	$ 6,672,683	$ 4,129,333	$ 4,553,869
Cash provided by (used in) investing activities	(857,118)	37,941,588	(20,444,575)	33,130,523
Cash provided by (used in) financing activities	823,548	(28,878,728)	6,244,666	(32,963,717)

During the six months ended June 30, 2009, cash decreased by $10,070,576. The overall decrease was due primarily to transfers of $13,437,818 to restricted cash, while capital expenditures of $7,802,407 were offset by borrowings on mortgage notes payable of $10,465,371. Additionally, the Company paid its regular quarterly distributions to its preferred shareholders in the amount of $3,350,392.

The Company's principal liquidity demands are expected to be distributions to our preferred and common shareholders and Operating Partnership unitholders, capital improvements, rehabilitation projects and repairs and maintenance for the properties, acquisition of additional properties within the investment restrictions placed on it by BVF II, and debt repayment.

The Company intends to meet its short-term liquidity requirements through net cash flows provided by operating activities, cash distributions from its investments, including the Company's investments in the Multifamily Venture, and advances from the revolving credit facility. The Company considers its ability to generate cash to be adequate to meet all operating requirements and make distributions to its stockholders in accordance with the provisions of the Internal Revenue Code of 1986, as amended, applicable to REITs. Funds required to make distributions to our preferred and common shareholders and Operating Partnership unitholders that are not provided by operating activities will be supplemented by property debt financing and refinancing activities.

The Company intends to meet its long-term liquidity requirements through property debt financing and refinancing noting that prolonged interest rate increases resulting from current economic conditions could negatively impact the Company's ability to refinance existing debt at acceptable rates. As of June 30, 2009, approximately $37,084,000 of principal, or 7.7% of the Company's outstanding mortgage debt is due to be repaid within the next three years. During that period, $26,752,000 is due to mature and be repaid in full in 2009, $6,195,000 is due to mature and be repaid in full in 2010, and $4,137,000 is due to mature and be repaid in 2011. All other payments of principal are regular

monthly payments in accordance with the loans amortization schedule. Refer to the “Debt Maturity Summary” schedule on page 32 of this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” discussion. Additionally, the Company may seek to expand its purchasing power through the use of venture relationships with other companies.

The Company has set aside $12,210,000 in restricted cash to pay for the mortgages relate to the Glo Apartments that are due to mature in 2009 and 2010 for $9,500,000 and $2,710,000, respectively. Additionally, the Company has a loan secured by one of its properties in the amount of $15,720,000 that matures in October 2009. The Company is currently in the process of obtaining new financing to replace the maturing loan principle. The Company expects to lock the interest rate on the new loan during the third quarter of 2009. In the event that the Company is unable to obtain the financing, the Company has access to a revolving credit facility and sufficient cash from operations to retire the debt and fund ongoing operations at the property.

As of June 30, 2009, the Company has fixed interest rate mortgage financing on all of the properties in the portfolio with the exception of Glo Apartments, which has a variable interest rate mortgage that is capped at 6% through 2013. The fixed interest rate mortgage financing also includes a fixed rate construction to permanent mortgage on the Arboretum Land Development project, a parcel of vacant land adjacent to the Arboretum Place Apartments that is currently under development and is anticipated to be completed in the third quarter of 2009.

The Company has a $20,000,000 revolving credit facility in place with an affiliate of the Company. As of June 30, 2009, the Company has no borrowings outstanding on the revolving credit facility.

Capital Expenditures

The Company incurred $6,467,104 and $2,030,302 in recurring capital expenditures during the six months ended June 30, 2009 and 2008, respectively. Recurring capital expenditures typically include items such as appliances, carpeting, flooring, HVAC equipment, kitchen and bath cabinets, site improvements and various exterior building improvements.

The Company incurred $1,335,303 and $8,300,427 in renovation and development related capital expenditures during the six months ended June 30, 2009 and 2008, respectively. Renovation related capital expenditures generally include capital expenditures of a significant non-recurring nature, including construction management fees payable to an affiliate of the Company, where the Company expects to see a financial return on the expenditure or where the Company believes the expenditure preserves the status of a property within its sub-market.

In December 2006, the Company, as part of the decision to acquire the Standard at Lenox Park property, approved a rehabilitation project at the 375-unit property of approximately $5,000,000 for interior and exterior improvements. As of June 30, 2009, the exterior improvements have been completed and the interior portion of the project, which includes rehabilitation of the kitchens, bathrooms, lighting and fixtures, was 99% complete as 372 of the 375 units had been completed, of which 366 units, or 98%, of those completed units have been leased. Project costs to date approximate $5,112,000 of the total current estimated costs of $5,131,000.

In December 2007, the Company authorized the renovation of the Hampton House property, a 215 unit high-rise building. Approximately $4,450,000 has been budgeted for 2009 for interior and exterior improvements. Exterior improvements include replacement of windows, sliding doors and balcony railings and interior improvements include updates to apartment units including rehabilitation of the kitchens, bathrooms, lighting and fixtures and updates to common areas and systems, including the lobby, hallways and updates to the buildings central systems. As of June 30, 2009, the interior renovations of the lobby and amenities are complete. Additionally, 80 of the 199 residential units, or 40%, have been renovated and 69 of the renovated units have been leased as of June 30, 2009. The exterior improvements have been completed as of June 30, 2009.

The Company has substantially completed the development of one of the two parcels of vacant land that it owns. The property, known as the Reserves at Arboretum, was approved as of November 1, 2007 and construction of the 143 units and clubhouse began in early 2008. The total project cost is estimated at $17,000,000. As of June 30, 2009, the project costs incurred were approximately $16,752,000 and within budget. Interest costs were capitalized on the development projects until construction was substantially complete. There was $152,188 and $107,721 of interest capitalized in the six months ended June 30, 2009 and 2008, respectively. No development plans are currently in the works for the other vacant parcel.

Pursuant to terms of the mortgage debt on certain properties in the Company’s portfolio, lenders require the Company to fund repair or replacement escrow accounts. The funds in the escrow accounts are disbursed to the Company upon completion of the required repairs or renovations activities. The Company is required to provide to the lender documentation evidencing the completion of the repairs, and in some cases, such repairs are subject to inspection by the lender.

The Company’s capital budgets for 2009 anticipate spending approximately $9,620,000 for ongoing rehabilitation, including the Hampton House project and development of current portfolio properties, including the Silver Hills Apartments, Executive House, Standard at the Lenox Park and the Arboretum Land development project during the year. As of June 30, 2009, the Company has not committed to any new significant rehabilitation projects.

Discussion of acquisitions for the six months ended June 30, 2009

On February 24, 2009, the Company, through the Operating Partnership, entered into a Joint Venture Agreement to acquire 89.955% of the ownership interests in a 201 unit multifamily mid rise community in Los Angeles, California. The purchase price of $47,500,000 and related closing costs consisted of a capital commitment of $12,580,314 plus the assumption of the outstanding mortgage debt secured by the property. The purchase was subject to normal operating pro rations. As of June 30, 2009, the purchase price allocation was final and no further adjustment is contemplated.

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Discussion of dispositions for the six months ended June 30, 2009

The Company did not dispose of any properties during the six month period ended June 30, 2009.

Declaration of Dividends and Distributions

On March 25, 2003, the Board declared a dividend at an annual rate of 9% on the stated liquidation preference of $25 per share of the outstanding Preferred Shares which is payable quarterly in arrears, on February 15, May 15, August 15, and November 15 of each year to shareholders of record in the amount of $0.5625 per share, per quarter. For the six months ended June 30, 2009 and 2008, the Company's aggregate dividends on the Preferred Shares totaled $3,350,392 and $3,350,396, respectively, of which $837,607 was payable and included on the balance sheet in Dividends and Distributions Payable as of June 30, 2009 and December 31, 2008.

During the six months ended June 30, 2009 and 2008, the Company's aggregate distributions and dividends to common general and common limited partners and Class B common stockholders totaled $0 and $12,000,000, respectively.

The Company's policy to provide for common distributions is based on available cash and Board approval.

Results of Operations and Financial Condition

During the six months ended June 30, 2009, the Company's portfolio (the "Total Property Portfolio"), which consists of all properties acquired or placed in service and owned through June 30, 2009, was increased by the purchase of one property – Glo Apartments in Los Angeles, California. As a result of changes in the composition of the property holdings in the Total Property Portfolio over the six-month period ended June 30, 2009, the consolidated financial statements show changes in revenue and expenses from period to period and as a result, the Company does not believe that its period-to-period financial data are comparable. Therefore, the comparison of operating results for the six months ended June 30, 2009 and 2008 reflects the changes attributable to the properties owned by the Company throughout each period presented (the "Same Property Portfolio").

"Net Operating Income" ("NOI") falls within the definition of a "non-GAAP financial measure" as stated in Item 10(e) of Regulation S-K promulgated by the SEC and should not be considered as an alternative to net income (loss), the most directly comparable financial measure of our performance calculated and presented in accordance with GAAP. The Company believes NOI is a measure of operating results that is useful to investors to analyze the performance of a real estate company because it provides a direct measure of the operating results of the Company's multifamily apartment communities. The Company also believes it is a useful measure to facilitate the comparison of operating performance among competitors. The calculation of NOI requires classification of income statement items between operating and non-operating expenses, where operating items include only those items of revenue and expense which are directly related to the income producing activities of the properties. We believe that to achieve a more complete understanding of the Company's performance, NOI should be compared with our reported net income (loss). Management uses NOI to evaluate the operating results of properties without reflecting the effect of capital decisions such as the issuance of mortgage debt and investments in capital items; in turn, these capital decisions have an impact on interest expense and depreciation and amortization.

The most directly comparable financial measure of the Company's NOI, calculated and presented in accordance with GAAP, is net income (loss), shown on the consolidated statement of operations. For the three month period ended June 30, 2009 and 2008, net (loss) income was $(8,784,413) and $20,582,822, respectively. For the six month period

ended June 30, 2009 and 2008, net (loss) income was $(17,001,631) and $14,304,275, respectively. A reconciliation of the Company's NOI to net loss for the three and six month period June 30, 2009 and 2008 is presented as part of the following tables.

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Comparison of the three months ended June 30, 2009 to the three months ended June 30, 2008

The table below reflects selected operating information for the Same Property Portfolio. The Same Property Portfolio consists of the 23 properties acquired or placed in service on or prior to January 1, 2008 and owned through June 30, 2009.

	Same Property Portfolio Three months ended June 30,			
	2009	2008	Increase/ (Decrease)	% Change
Revenue:				
Rental	$16,356,458	$16,038,318	$318,140	1.98 %
Interest, utility reimbursement and other	1,083,867	1,112,623	(28,756)	(2.58)%
Total revenue	17,440,325	17,150,941	289,384	1.69 %
Operating Expenses:				
Operating	3,959,442	3,926,193	33,249	0.85 %
Maintenance	1,430,376	1,659,195	(228,819)	(13.79)%
Real estate taxes	1,877,921	1,705,751	172,170	10.09 %
General and administrative	390,781	349,099	41,682	11.94 %
Management fees	692,185	670,257	21,928	3.27 %
Total operating expenses	8,350,705	8,310,495	40,210	0.48 %
Net Operating Income	9,089,620	8,840,446	249,174	2.82 %
Non-operating expenses:				
Depreciation	7,081,639	6,972,237	109,402	1.57 %
Interest	5,929,118	5,670,772	258,346	4.56 %
Amortization of acquired in-place leases and tenant relationships	5,565	50,498	(44,933)	(88.98)%
Total non-operating expenses	13,016,322	12,693,507	322,815	2.54 %
Loss before equity in loss of Multifamily Limited Partnership and Mezzanine Loan Limited Liability Company and loss from discontinued operations	(3,926,702)	(3,853,061)	(73,641)	1.91 %
Equity in loss of Multifamily Limited Partnership	-	-	-	0.00 %
Equity in loss of Mezzanine Loan Limited Liability Company	-	-	-	0.00 %
Discontinued operations	-	-	-	0.00 %
Net loss	$(3,926,702)	$(3,853,061)	$(73,641)	1.91 %

Comparison of the three months ended June 30, 2009 to the three months ended June 30, 2008

	Total Property Portfolio Three months ended June 30,			
	2009	2008	Increase/ (Decrease)	% Change
Revenue:				
Rental	$18,600,158	$15,991,617	$2,608,541	16.31 %
Interest, utility reimbursement and other	1,304,676	1,258,242	46,434	3.69 %
Total revenue	19,904,834	17,249,859	2,654,975	15.39 %
Operating Expenses:				
Operating	4,758,956	4,102,474	656,482	16.00 %
Maintenance	1,299,285	1,296,485	2,800	0.22 %
Real estate taxes	2,477,680	1,847,200	630,480	34.13 %
General and administrative	1,826,433	572,550	1,253,883	219.00 %
Management fees	1,197,896	1,092,186	105,710	9.68 %
Total operating expenses	11,560,250	8,910,895	2,649,355	29.73 %
Net Operating Income	8,344,584	8,338,964	5,620	0.07 %
Non-operating expenses:				
Depreciation	8,216,923	6,972,237	1,244,686	17.85 %
Interest	6,704,661	5,636,951	1,067,710	18.94 %
Amortization of acquired in-place leases and tenant relationships	372,127	50,498	321,629	636.91 %
Total non-operating expenses	15,293,711	12,659,686	2,634,025	20.81 %
Loss before equity in loss of Multifamily Limited Partnership and Mezzanine Loan Limited Liability Company and loss from discontinued operations	(6,949,127)	(4,320,722)	(2,628,405)	60.83 %
Equity in loss of Multifamily Limited Partnership	(1,056,629)	(1,020,262)	(36,367)	3.56 %
Equity in (loss) income of Mezzanine Loan Limited Liability Company	(774,075)	6,091	(780,166)	(12,808.50) %
Discontinued operations	(4,582)	25,917,715	(25,922,297)	(100.02)%
Net loss	$(8,784,413)	$20,582,822	$(29,367,235)	(142.68)%

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Comparison of the three months ended June 30, 2009 to the three months ended June 30, 2008
(Same Property Portfolio)

Revenue

Rental Revenue

Rental revenue of the Same Property Portfolio increased for the three-month period ended June 30, 2009 in comparison to the similar period of 2008. The increase is mainly attributable to increased occupancy as a result of the completion of the utility conversion at the Seasons of Laurel property where turnover and vacancies have been reduced.

Interest, utility reimbursement and other revenue

Same Property Portfolio interest, utility reimbursement and other revenues decreased for the three-month period ended June 30, 2009 as compared to the three-month period ended June 30, 2008. Decrease in other revenues was due to normal fluctuations in the various other revenue sources offset by increases in utility reimbursement, mainly due to successful increases in usage of bill back programs to tenants.

Operating Expenses

Operating

Overall operating expenses increased in the quarter ended June 30, 2009 as compared to the same period of 2008. Savings in utilities, including electricity and water and sewer were offset by an increase in property insurance. The Seasons of Laurel property has historically contributed significantly to the Company's overall utility expense as the electricity charges at the property have been paid by the Company and were not billed directly to tenants for usage of their apartment unit. The Company has completed a project to modify the utility infrastructure to allow for direct billing of electric costs by individual apartment units. The changes to the infrastructure were completed in the fourth quarter of 2008 with the related direct billing to tenants reaching full implementation in early 2009. As a result of the individual apartments units being migrated to a direct tenant billing, the Company has realized a reduction in electricity expense at Season's and anticipates the reductions and related comparative savings to continue going forward. As a result of its property insurance coverage renewal in April 2009, the Company anticipates an increase in property insurance expenses for the remainder of the year.

Maintenance

Maintenance expense decreased in the three months ended June 30, 2009 as compared to the same period of 2008, mainly due to increased occupancy at the Seasons of Laurel from 2008 to 2009, resulting in less turnover related expenses, and additional spending in repairs related to a fire at Country Place II in 2008. Management continues to employ a proactive maintenance rehabilitation strategy at its apartment communities and considers the strategy an effective program that preserves, and in some cases increases, its occupancy levels through improved consumer appeal of the apartment communities, from both an interior and exterior perspective.

Real Estate Taxes

Real estate taxes increased for the three months ended June 30, 2009 from the comparable period of 2008. The increase is due mainly to the continued escalation of assessed property valuations for properties in the Same Property Portfolio including properties located in Maryland, Texas, Virginia and Georgia. The Company continually

scrutinizes the assessed values of its properties and avails itself of arbitration or similar forums made available by the taxing authority for increases in assessed value that it considers to be unreasonable. The Company has been successful in achieving tax abatements for certain of its properties based on challenges made to the assessed values. The Company anticipates a continued upward trend in real estate tax expense as local and state taxing agencies continue to place significant reliance on property tax revenue.

General and Administrative

General and administrative expenses increased in the three-month period ended June 30, 2009 compared to 2008. The overall increase is due mainly to normal operating expense fluctuations experienced throughout the properties of the Same Property Portfolio including legal expense related to tenant issues.

Management Fees

Management fees of the Same Property Portfolio increased for the three months ended June 30, 2009 compared to the same period of 2008 based on increased levels of revenue of the Same Property Portfolio. Property management fees are assessed on the revenue stream of the properties managed by an affiliate of the Company.

Non Operating Expenses

Depreciation

Depreciation expense of the Same Property Portfolio increased for the three months ended June 30, 2009 as compared to the same period of the prior year. The increased expense is related to the additions to the basis of fixed assets in the portfolio driven by substantial rehabilitation projects ongoing at the Standard of Lenox and Hampton House properties, and the development of the Arboretum Land known as The Reserves at Arboretum, and to a lesser degree, normal recurring capital spending activities over the remaining properties in the Same Property Portfolio.

Interest

Interest expense for the three months ended June 30, 2009 increased over the comparable period of 2008. The increase is attributable to the refinancing of mortgages on properties at an incrementally higher principal level than the related paid-off loan. The majority of the increase is attributable to the pay off of the Briarwood loan balance of $8,600,333 at maturity in April 2008 and a new loan on the same property that was obtained in October 2008, in addition to new mortgage loans on Berkshires of Columbia, Glo Apartments and BIR Laurel Woods properties that were closed in the first quarter of 2009.

Amortization of acquired in-place leases and tenant relationships

Amortization of acquired in-place-leases and tenant relationships decreased significantly in the three months ended June 30, 2009 as compared to the same period in 2008. The decrease is related mainly to the completion of amortization of the acquired-in-place lease intangible assets booked at acquisition and amortized over a 12 month period which did not extend into the three-month period ended June 30, 2009.

Comparison of the three months ended June 30, 2009 to the three months ended June 30, 2008
(Total Property Portfolio)

In general, increases in revenues, operating expenses and non-operating expenses and the related losses of the Total Property Portfolio for the three months ended June 30, 2009 as compared to the three months ended June 30, 2008 are due mainly, in addition to the reasons discussed above, to the fluctuations in the actual properties owned, as the

number of properties remained consistent, by the Company in the comparative periods presented and to the increase in the level of mortgage and revolving credit debt outstanding during the comparative periods. General and administrative expenses for the three months ended June 30, 2009 include costs associated with the acquisition of the Glo property expensed pursuant to the guidance of SFAS 141 (R) adopted by the Company on January 1, 2009 and costs accrued for the judgment in the Lakeridge legal matter.

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Comparison of the six months ended June 30, 2009 to the six months ended June 30, 2008

	Same Property Portfolio Six months ended June 30,			
	2009	2008	Increase/ (Decrease)	% Change
Revenue:				
Rental	$32,561,698	$31,692,088	$869,610	2.74 %
Interest, utility reimbursement and other	2,093,053	2,103,813	(10,760)	(0.51)%
Total revenue	34,654,751	33,795,901	858,850	2.54 %
Operating Expenses:				
Operating	8,433,686	8,341,129	92,557	1.11 %
Maintenance	2,093,188	2,709,023	(615,835)	(22.73)%
Real estate taxes	3,750,263	3,439,820	310,443	9.02 %
General and administrative	724,473	751,148	(26,675)	(3.55)%
Management fees	1,378,303	1,314,237	64,066	4.87 %
Total operating expenses	16,379,913	16,555,357	(175,444)	(1.06)%
Net Operating Income	18,274,838	17,240,544	1,034,294	6.00 %
Non-operating expenses:				
Depreciation	14,097,655	13,853,214	244,441	1.76 %
Interest	11,806,401	11,459,474	346,927	3.03 %
Amortization of acquired in-place leases and tenant relationships	19,473	116,481	(97,008)	(83.28)%
Total non-operating expenses	25,923,529	25,429,169	494,360	1.94 %
Loss before equity in loss of Multifamily Limited Partnership and Mezzanine Loan Limited Liability Company and loss from discontinued operations	(7,648,691)	(8,188,625)	539,934	6.59 %
Equity in loss of Multifamily Limited Partnership	-	-	-	0.00 %
Equity in loss of Mezzanine Loan Limited Liability Company	-	-	-	0.00 %
Discontinued operations	-	-	-	0.00 %
Net loss	$(7,648,691)	$(8,188,625)	$539,934	6.59 %

Comparison of the six months ended June 30, 2009 to the six months ended June 30, 2008

	Total Property Portfolio Six months ended June 30,			
	2009	2008	Increase/ (Decrease)	% Change
Revenue:				
Rental	$36,174,362	$31,662,195	$4,512,167	14.25 %
Interest, utility reimbursement and other	2,497,453	2,416,720	80,733	3.34 %
Total revenue	38,671,815	34,078,915	4,592,900	13.48 %
Operating Expenses:				
Operating	10,003,239	8,765,019	1,238,220	14.13 %
Maintenance	2,284,033	2,346,313	(62,280)	(2.65)%
Real estate taxes	4,559,348	3,598,081	961,267	26.72 %
General and administrative	3,544,356	1,385,612	2,158,744	155.80 %
Management fees	2,363,096	2,159,819	203,277	9.41 %
Total operating expenses	22,754,072	18,254,844	4,499,228	24.65 %
Net Operating Income	15,917,743	15,824,071	93,672	0.59 %
Non-operating expenses:				
Depreciation	16,002,359	13,853,214	2,149,145	15.51 %
Interest	12,951,970	11,395,637	1,556,333	13.66 %
Amortization of acquired in-place leases and tenant relationships	644,316	116,481	527,835	453.15 %
Total non-operating expenses	29,598,645	25,365,332	4,233,313	16.69 %
Loss before equity in loss of Multifamily Limited Partnership and Mezzanine Loan Limited Liability Company and loss from discontinued operations	(13,680,902)	(9,541,261)	(4,139,641)	(43.39)%
Equity in loss of Multifamily Limited Partnership	(2,210,885)	(1,549,824)	(661,061)	(42.65)%
Equity in (loss) income of Mezzanine Loan Limited Liability Company	(947,293)	6,091	(953,384)	(15,652.34)%
Discontinued operations	(162,551)	25,389,269	(25,551,820)	(100.64)%
Net loss	$(17,001,631)	$14,304,275	$(31,305,906)	(218.86)%

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Comparison of the six months ended June 30, 2009 to the six months ended June 30, 2008
(Same Property Portfolio)

Revenue

Rental Revenue

Rental revenue of the Same Property Portfolio increased for the six-month period ended June 30, 2009 in comparison to the similar period of 2008. The increase is mainly attributable to increased occupancy as a result of the completion of the utility conversion at the Seasons of Laurel property where turnover and vacancies have been reduced.

Interest, utility reimbursement and other revenue

Same Property Portfolio interest, utility reimbursement and other revenues decreased for the six-month period ended June 30, 2009 as compared to the six-month period ended June 30, 2008. Decrease in other revenues was due to normal fluctuations in the various other revenue sources offset by increases in utility reimbursement, mainly due to successful increases in usage of bill back programs to tenants.

Operating Expenses

Operating

Overall operating expenses increased in the six months ended June 30, 2009 as compared to the same period of 2008. Savings in utilities, including electricity and water and sewer were offset by an increase in property insurance. The Seasons of Laurel property has historically contributed significantly to the Company's overall utility expense as the electricity charges at the property have been paid by the Company and were not billed directly to tenants for usage of their apartment unit. The Company has completed a project to modify the utility infrastructure to allow for direct billing of electric costs by individual apartment units. The changes to the infrastructure were completed in the fourth quarter of 2008 with the related direct billing to tenants reaching full implementation in early 2009. As a result of the individual apartments units being migrated to a direct tenant billing, the Company has realized a reduction in electricity expense at Season's and anticipates the reductions and related comparative savings to continue going forward. As a result of its property insurance coverage renewal in April 2009, the Company anticipates an increase in property insurance expenses for the remainder of the year.

Maintenance

Maintenance expense decreased in the six months ended June 30, 2009 as compared to the same period of 2008, mainly due to increased occupancy at the Seasons of Laurel from 2008 to 2009, resulting in less turnover related expenses, and additional spending in repairs related to a fire at Country Place II in 2008. Management continues to employ a proactive maintenance rehabilitation strategy at its apartment communities and considers the strategy an effective program that preserves, and in some cases increases, its occupancy levels through improved consumer appeal of the apartment communities, from both an interior and exterior perspective.

Real Estate Taxes

Real estate taxes increased for the six months ended June 30, 2009 from the comparable period of 2008. The increase is due mainly to the continued escalation of assessed property valuations for properties in the Same Property Portfolio including properties located in Maryland, Texas, Virginia and Georgia. The Company continually scrutinizes the

assessed values of its properties and avails itself of arbitration or similar forums made available by the taxing authority for increases in assessed value that it considers to be unreasonable. The Company has been successful in achieving tax abatements for certain of its properties based on challenges made to the assessed values. The Company anticipates a continued upward trend in real estate tax expense as local and state taxing agencies continue to place significant reliance on property tax revenue.

General and Administrative

General and administrative expenses decreased in the six-month period ended June 30, 2009 compared to 2008. The decrease is due mainly to normal operating expense fluctuations experienced throughout the properties of the Same Property Portfolio.

Management Fees

Management fees of the Same Property Portfolio increased for the six months ended June 30, 2009 compared to the same period of 2008 based on increased levels of revenue of the Same Property Portfolio. Property management fees are assessed on the revenue stream of the properties managed by an affiliate of the Company.

Non Operating Expenses

Depreciation

Depreciation expense of the Same Property Portfolio increased for the six months ended June 30, 2009 as compared to the same period of the prior year. The increased expense is related to the additions to the basis of fixed assets in the portfolio driven by substantial rehabilitation projects ongoing at the Standard of Lenox and Hampton House properties, and the development of the Arboretum Land known as The Reserves at Arboretum, and to a lesser degree, normal recurring capital spending activities over the remaining properties in the Same Property Portfolio.

Interest

Interest expense for the six months ended June 30, 2009 increased over the comparable period of 2008. The increase is attributable to the refinancing of mortgages on properties at an incrementally higher principal level than the related paid-off loan. The majority of the increase is attributable to the pay off of the Briarwood loan balance of $8,600,333 at maturity in April 2008 and a new loan on the same property that was obtained in October 2008, in addition to new mortgage loans on Berkshires of Columbia, Glo Apartments and BIR Laurel Woods properties that were closed in the first quarter of 2009.

Amortization of acquired in-place leases and tenant relationships

Amortization of acquired in-place-leases and tenant relationships decreased significantly in the six-month period ended June 30, 2009 as compared to the same period in 2008. The decrease is related mainly to the completion of amortization of the acquired-in-place lease intangible assets booked at acquisition and amortized over a 12 month period which did not extend into the six-month period ended June 30, 2009.

Comparison of the six months ended June 30, 2009 to the six months ended June 30, 2008
(Total Property Portfolio)

In general, increases in revenues, operating expenses and non-operating expenses and the related losses of the Total Property Portfolio for the six months ended June 30, 2009 as compared to the six months ended June 30, 2008 are due mainly, in addition to the reasons discussed above, to the fluctuations in the actual properties owned, as the number of

properties remained consistent, by the Company in the comparative periods presented and to the increase in the level of mortgage and revolving credit debt outstanding during the comparative periods. General and administrative expenses for the six months ended June 30, 2009 include costs associated with the acquisition of the Glo property expensed pursuant to the guidance of SFAS 141 (R) adopted by the Company on January 1, 2009 and costs accrued for the judgment in the Lakeridge legal matter.

Debt to Fair Value of Real Estate Assets

The Company's total debt summary and debt maturity schedule, as of June 30, 2009, is as follows:

Debt Summary

	Balance	Weighted Average Rate
Collateralized – Fixed Rate Debt	$ 440,935,358	5.68 %
Collateralized – Variable Rate Debt	42,203,273	1.56 %
Total - Collateralized Debt	$ 483,138,631	

Debt Maturity Summary

Year	Balance	% of Total
2009	$ 26,751,738	5.54 %
2010	6,195,300	1.28 %
2011	4,137,407	0.86 %
2012	8,839,948	1.83 %
2013	60,947,586	12.61 %
Thereafter	376,266,652	77.88 %
Total	$ 483,138,631	100.00 %

The Company's "Debt-to-Fair Value of Real Estate Assets" as of June 30, 2009 and December 31, 2008 is presented in the following table. Fair value of real estate assets is based on management's best estimate of fair value for properties purchased in prior years or purchase price for properties acquired within the current year. As with any estimate, management's estimate of the fair value of properties purchased in prior years represents only its good faith opinion as to that value, and there can be no assurance that the actual value that might, in fact, be realized for any such property would approximate that fair value. The following information is presented in lieu of information regarding the Company's "Debt-to-Total Market Capitalization Ratio", which is a commonly used measure in our industry, because the Company's market capitalization is not readily determinable since there was no public market for its common equity during the periods presented in this report.

The Board has established investment guidelines under which management may not incur indebtedness such that at the time we incur the indebtedness our ratio of debt to total assets exceeds 75%. This measure is calculated based on the fair value of the assets determined by management as described above.

The information regarding "Debt-to-Fair Value of Real Estate Assets" is presented to allow investors to calculate our loan-to-value ratios in a manner consistent with those used by management and others in our industry, including those used by our current and potential lenders. Management uses this information when making decisions about financing or refinancing properties. Management also uses fair value information when making decisions about selling assets as well as evaluating acquisition opportunities within markets where we have assets.

“Fair Value of Real Estate Assets” is not a GAAP financial measure and should not be considered as an alternative to net book value of real estate assets, the most directly comparable financial measure calculated and presented in accordance with GAAP. The net book value of our real estate assets was $451,658,585 and $419,002,572 at June 30, 2009 and December 31, 2008, respectively, and is presented on the balance sheet as multifamily apartment communities, net of accumulated depreciation.

The following table reconciles the fair value of our real estate assets to the net book value of real estate assets as of June 30, 2009 and December 31, 2008.

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Debt-to-Fair Value of Real Estate Assets as of

	June 30, 2009	December 31, 2008
Net book value of multifamily apartment communities	$ 451,658,585	$ 419,002,572
Accumulated depreciation	152,585,238	136,678,464
Historical cost	604,243,823	555,681,036
Increase in fair value over historical cost	53,846,177	60,205,964
Fair Value – estimated	$ 658,090,000	$ 615,887,000
Mortgage Debt	$ 483,138,631	$ 432,013,999
Debt-to-Fair Value of Real Estate Assets	73.42 %	70.15 %

The Debt-to-Fair Value of Real Estate Assets includes the outstanding borrowings under the Company's revolving credit facility, which were $0 at June 30, 2009 and December 31, 2008. The revolving credit facility contains covenants that require the Company to maintain certain financial ratios, including an indebtedness to value ratio not to exceed 75%. If the Company were to be in violation of this covenant, we would be unable to draw advances from our line, which could have a material impact on the Company's ability to meet its short-term liquidity requirements. Further, if the Company were unable to draw on its revolving credit facility, the Company may have to slow or temporarily stop our rehabilitation projects, which could have a negative impact on its results of operations and cash flows. As of June 30, 2009 and December 31, 2008, the Company was in compliance with the covenants of the revolving credit facility. Fair value of the real estate assets is based on management's most current valuation of properties, which was made for all properties owned at December 31, 2008, acquisition cost of properties acquired subsequent to December 31, 2008, if any, and sales price of assets under contract of sale as of June 30, 2009.

Funds From Operations

The Company follows the revised definition of Funds from Operations ("FFO") adopted by the Board of Governors of the National Association of Real Estate Investment Trusts ("NAREIT"). Management considers FFO to be an appropriate measure of performance of an equity REIT. We calculate FFO by adjusting net income (loss) (computed in accordance with GAAP, including non-recurring items), for gains (or losses) from sales of properties, real estate related depreciation and amortization, and adjustment for unconsolidated partnerships and ventures. Management believes that in order to facilitate a clear understanding of the historical operating results of the Company, FFO should be considered in conjunction with net income as presented in the consolidated financial statements included elsewhere herein. Management considers FFO to be a useful measure for reviewing the comparative operating and financial performance of the Company because, by excluding gains and losses related to sales of previously depreciated operating real estate assets and excluding real estate asset depreciation and amortization (which can vary among owners of identical assets in similar condition based on historical cost accounting and useful life estimates), FFO can help one compare the operating performance of a company's real estate between periods or as compared to different companies.

The Company's calculation of FFO may not be directly comparable to FFO reported by other REITs or similar real estate companies that have not adopted the term in accordance with the current NAREIT definition or that interpret the current NAREIT definition differently. FFO is not a GAAP financial measure and should not be considered as an

alternative to net income (loss), the most directly comparable financial measure of our performance calculated and presented in accordance with GAAP, as an indication of our performance. FFO does not represent cash generated from operating activities determined in accordance with GAAP and is not a measure of liquidity or an indicator of our ability to make cash distributions. We believe that to further understand our performance, FFO should be compared with our reported net income (loss) and considered in addition to cash flows in accordance with GAAP, as presented in our consolidated financial statements.

The following table presents a reconciliation of net income (loss) to FFO for the three and six months ended June 30, 2009 and 2008:

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	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Net income (loss)	$(8,784,413)	$20,582,822	$(17,001,631)	$14,304,275
Add:				
Depreciation of real property	7,210,482	6,113,243	14,011,959	13,276,905
Depreciation of real property included in results of discontinued operations	-	797,039	-	797,039
Amortization of acquired in-place leases and tenant relationships	372,127	50,498	644,316	116,481
Equity in loss of Multifamily Limited Partnership	1,056,629	1,020,262	2,210,885	1,549,824
Funds from operations of Multifamily Venture and Limited Venture	250,499	272,200	452,675	767,609
Less:				
Noncontrolling interest in properties share of funds from operations	(264,898)	(240,135)	(345,955)	(440,670)
Gain on disposition of real estate assets	-	(27,031,898)	-	(27,031,898)
Funds from Operations	$(159,574)	$1,564,031	$(27,751)	$3,339,565

FFO for the three and six months ended June 30, 2009 decreased as compared to FFO for the three and six month periods ended June 30, 2008. The decrease in FFO is due primarily to changes in the accounting for transaction costs under SFAS No. 141R and the write-off of the Company's investment in the Mezzanine Loan LLC in the amount of $1,032,091. SFAS No. 141R requires that costs associated with acquisition transactions be expensed in the period incurred. Prior to the implementation of SFAS No. 141R, transaction costs were capitalized and included in the depreciable basis of acquired properties. Transaction costs for the acquisition of Glo Apartments total approximately $1,183,299, which were included in General and Administrative expense on the Consolidated Statement of Operations. Additionally, interest expense has increased due to the addition of new mortgage debt on certain properties.

Environmental Issues

There are no recorded amounts resulting from environmental liabilities because there are no known contingencies with respect to environmental liabilities. The Company obtains environmental audits through various sources, including lender evaluations and acquisition due diligence, for each of its properties at various intervals throughout a property's useful life. The Company has not been advised by any third party as to the existence of, nor has it identified on its own, any material liability for site restoration or other costs that may be incurred with respect to any of its properties.

Inflation and Economic Conditions

Substantially all of the leases at our properties are for a term of one year or less, which enables the Company to seek increased rents for new leases or upon renewal of existing leases. These short-term leases minimize the potential adverse effect of inflation on rental income, although residents may leave without penalty at the end of their lease terms and may do so if rents are increased significantly.

The United States is currently in the midst of what has been characterized as one of the worst recessions since the 1930's. Unemployment has risen past 9% while single family home prices have dropped leaving many homeowners with homes worth less than their mortgage balances and on the brink of foreclosure. The Company both believes and recognizes that real estate goes through cycles and while the drivers of these cycles can vary greatly from cycle to cycle, the outcome is generally the same with periods of improving values and profit growth followed by periods of stagnant or declining values and profit stagnation. The Company, however, recognizes that real estate investing requires a long-term perspective and, as history suggests, a company's ability to remain resilient during tough economic times will often lead to opportunities. In general, multifamily real estate fundamentals of well located quality real estate have remained relatively steady during the recent economic downturn. Occupancy rates continue to hover in the low to mid-90% range for well located, well managed properties though continued weakness in the economy and/or increasing unemployment rates could have a negative impact on both occupancy and rent levels. Creditworthy borrowers in the multifamily sector have continued to be able to access capital through Fannie Mae and Freddie Mac through 2008 and into early 2009 at attractive rates. Though there is no assurance that under existing or future regulatory restrictions this source of capital, unique to multifamily borrowers, will continue to be available. While the Company believes that 2009 will be a challenging year, with increased competition for price conscious residents, the possibility for continued tight credit markets and illiquidity in the transaction markets, we feel that many of our previous assumptions about future trends will be delayed for a period of time. The Company continues to believe that projected demographic trends will favor the multifamily sector, driven primarily by the continued flow of echo boomers (children of baby boomers, age 20 to 29), the fastest growing segment of the population, and an increasing number of immigrants who are often renters by necessity. In many cases, the current economic climate has delayed many would be residents from entering the rental market and instead choosing to remain at home or to share rental units instead of renting their own space. This trend may be creating a backlog of potential residents who will enter the market as the economy begins to rebound and unemployment rates begin to trend back to historical norms. The Company's properties are generally located in markets where zoning restrictions, scarcity of land and high construction costs create significant barriers to new development. The Company believes it is well positioned to manage its portfolio through the remainder of this economic downturn and is prepared to take advantage of opportunities that present themselves during such times.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's mortgage notes are fixed rate instruments; therefore, the Company's outstanding mortgage debt is not sensitive to changes in the capital market except upon maturity. The Company's revolving credit facility is a variable rate arrangement tied to LIBOR and is therefore sensitive to changes in the capital market. The table below provides information about the Company's financial instruments, specifically debt obligations.

The table presents principal cash flows and related weighted average interest rates by expected maturity dates for the mortgage notes payable as of June 30, 2009.

	2009	2010	2011	2012	2013	Thereafter	Total
Fixed Rate Debt	$17,251,738	$3,485,300	$4,137,407	$8,181,719	$60,146,376	$347,732,818	$440,935,358
Average Interest Rate	5.22 %	5.29 %	5.40 %	5.68 %	5.05 %	5.82 %	5.68 %

	2009	2010	2011	2012	2013	Thereafter	Total
	$9,500,000	$2,710,000	$-	$658,229	$801,210	$28,533,834	$42,203,273

Variable Rate Debt												
Average Interest Rate	1.56	%	1.56	%	-	1.56	%	1.56	%	1.56	%	1.56	%

The level of market interest rate risk remained relatively consistent from December 31, 2008 to June 30, 2009. As of June 30, 2009, $42,203,273 of the Company's debt outstanding is subject to variable interest rates. The Company's variable rate exposure is limited to 6% as the Company holds an interest rate cap contract for the related debt. The variable interest rate on the debt was 1.56% at June 30, 2009. The Company estimates that the effect of a 1% increase or decrease in interest rates would not have a material impact on interest expense.

Item 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Based on their evaluation, as required by the Exchange Act Rules 13a-15(b) and 15d-15(b), the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective as of June 30, 2009 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms and were effective as of June 30, 2009 to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Exchange Act) identified in connection with the evaluation required by paragraph (d) of the Exchange Act Rules 13a-15 or 15d-15 that occurred during the fiscal quarter ended June 30, 2009, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

The Company was party to a legal proceeding initiated by a seller/developer from whom the Company acquired a property in 2005. The dispute involved the interpretation of certain provisions of the purchase and sales agreement related to post acquisition construction activities. Specifically, the purchase and sales agreement provided that if certain conditions were met, the seller/developer would develop a vacant parcel of land contiguous to the acquired property with 18 new residential apartment units (the "New Units") for the benefit of the Company at an agreed-upon price. The purchase and sales agreement also provided the opportunity for the seller/developer to build a limited number of garages (the "Garages") for the existing apartment units for the benefit of the Company at an agreed-upon price.

In 2006, the Company accrued $190,000 with respect to the New Units matter based on a settlement offer extended to the plaintiff, which was not accepted at that time. On November 9, 2007, the judge issued a summary judgment against the Company with respect to the construction of the New Units. The judgment did not specify damages, which the plaintiff will be required to demonstrate at trial. On February 13, 2008, the court entered judgment related to the New Units on the seller/developer's behalf awarding them the amount of $774,292 for costs and damages. As a condition of the appeals process, the Company was required to post an appeals bond with the court. The bond is backed by a letter of credit in the amount of $800,000 and is reflected as restricted cash on the balance sheet as of June 30, 2009.

In July 2009, the court ruled against the Company on its appeal and upheld the judgment in favor of the plaintiff in the amount of $774,292. Operating cash of the Company was used to pay the judgment plus legal fees, costs and interest of approximately $163,700. The Company expects to cancel the letter of credit at which time the segregated cash on deposit with the bank will be released and be returned to operating cash.

The Company and our properties are not subject to any other material pending legal proceedings.

Item 1A. RISK FACTORS

Please read the risk factors disclosed in our Annual Report on Form 10-K for the Company's fiscal year ended December 31, 2008 as filed with the SEC on March 31, 2009. As of June 30, 2009, except for the additional risks associated with the tightening of the credit markets, there have been no material changes to the risk factors as presented therein. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our financial condition and/or operating results.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

- None

Item 3. DEFAULTS UPON SENIOR SECURITIES

- None

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

- None

Item 5. OTHER INFORMATION

- None

Item 6. EXHIBITS

31.1 Certification of Principal Executive Officer Pursuant of 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Principal Executive Officer Pursuant of 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Principal Financial Officer Pursuant of 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

BERKSHIRE INCOME REALTY, INC.

August 13, 2009

/s/ David C. Quade
David C. Quade
President, Chief Financial Officer and
Principal Executive Officer

August 13, 2009

/s/ Christopher M. Nichols
Christopher M. Nichols
Vice President and Principal Accounting
Officer