

FARMERS & MERCHANTS BANCORP  
Form 10-K  
March 15, 2012

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

FORM 10-K

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

For the fiscal year ended December 31, 2011

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number: 000-26099

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

Delaware  
(State or other jurisdiction of incorporation or  
organization)

94-3327828  
(I.R.S. Employer Identification No.)

111 W. Pine Street, Lodi, California  
(Address of principal executive offices)

95240  
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, \$0.01 Par Value Per Share

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if

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any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark 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.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

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

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

The aggregate market value of the Registrant's common stock held by non-affiliates on June 30, 2011 (based on the last reported trade on June 30, 2011) was \$311,769,600.

The number of shares of Common Stock outstanding as of February 29, 2012: 779,424

Documents Incorporated by Reference:

Portions of the definitive Proxy Statement for the 2012 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A are incorporated by reference in Part III, Items 10 through 14.

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FARMERS & MERCHANTS BANCORP  
FORM 10-K

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### Introduction – Forward Looking Statements

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

Such factors include the following: (i) the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto; (ii) the effect of changing regional and national economic conditions including the housing market in the Central Valley of California; (iii) significant changes in interest rates and prepayment speeds; (iv) credit risks of lending and investment activities; (v) changes in federal and state banking laws or regulations; (vi) competitive pressure in the banking industry; (vii) changes in governmental fiscal or monetary policies; (viii) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (ix) other factors discussed in Item 1A. Risk Factors.

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

## PART I

### Item 1. Business

#### General Development of the Business

August 1, 1916, marked the first day of business for Farmers & Merchants Bank of Lodi. The Bank incorporated under the laws of the State of California and was licensed by the California Department of Financial Institutions as a state-chartered bank. Farmers & Merchants’ first venture out of Lodi occurred when the Galt office opened in 1948. Shortly thereafter branches were opened in Linden, Modesto and South Sacramento. In 1957, the Bank’s name was changed to Farmers & Merchants Bank of Central California.

The Bank continued expansion in the Lodi market area and also acquired three offices in Turlock and Hilmar in 1985. The service area was next expanded by opening a branch in Elk Grove and a third office in Modesto. The year 2002 saw the opening of the Company’s first branch in the city of Stockton. In 2003, the Bank opened its fourth office in Modesto.

A second Galt office was opened in 2005 and a new full-service branch in downtown Sacramento was opened in early 2006. In late 2006, the Company opened its sixth Lodi office and its first commercial branch in Stockton. The downtown Turlock branch was relocated to a new facility in April 2008 and the Company’s first branch in Merced was opened in February 2009.

In addition to the preceding 22 full-service branches, the Bank serves the needs of its customers through two stand-alone ATM’s located on the grounds of the Lodi Grape Festival and California State University-Stanislaus. In 2007, the Bank began offering certain products over the internet at [www.fmbonline.com](http://www.fmbonline.com).

On March 10, 1999, the Company, pursuant to a reorganization, acquired all of the voting stock of Farmers & Merchants Bank of Central California (the "Bank"). The Company is a bank holding company incorporated in the State of Delaware and registered under the Bank Holding Company Act of 1956, as amended. The Company's outstanding securities as of December 31, 2011, consisted of 779,424 shares of common stock, \$0.01 par value and no shares of preferred stock issued. The Bank is the Company's principal asset.

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The Bank's two wholly owned subsidiaries are Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Farmers & Merchants Investment Corporation is currently dormant and Farmers/Merchants Corp. acts as trustee on deeds of trust originated by the Bank.

F & M Bancorp, Inc. was created in March 2002 to protect the name "F & M Bank." During 2002, the Company completed a fictitious name filing in California to begin using the streamlined name, "F & M Bank" as part of a larger effort to enhance the Company's image and build brand name recognition. Since 2002, the Company has converted most of its daily operating and image advertising to the "F & M Bank" name and the Company's logo, slogan and signage were redesigned to incorporate the trade name, "F & M Bank."

During 2003, the Company formed a wholly owned Connecticut statutory business trust, FMCB Statutory Trust I, for the sole purpose of issuing trust-preferred securities. See Note 13 located in "Item 8. Financial Statements and Supplementary Data."

The Company's principal business is to serve as a holding company for the Bank and for other banking or banking related subsidiaries, which the Company may establish or acquire. As a legal entity separate and distinct from its subsidiary, the Company's principal source of funds is, and will continue to be, dividends paid by and other funds advanced from the Bank. Legal limitations are imposed on the amount of dividends that may be paid and loans that may be made by the Bank to the Company. See "Supervision and Regulation - Dividends and Other Transfer of Funds."

The Bank's deposit accounts are insured under the Federal Deposit Insurance Act up to applicable limits. See "Supervision and Regulation – Deposit Insurance."

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

### Service Area

The Company services the mid Central Valley of California, including Sacramento, San Joaquin, Stanislaus and Merced counties, with 22 banking offices and two stand-alone ATM's. This area encompasses:

- Sacramento Metropolitan Statistical Area (MSA), with branches in Sacramento, Elk Grove and Galt. This MSA has a Population of 2.2 million and a Per Capita Income of approximately \$41,000. The MSA includes significant employment in the following sectors: state and local government; agriculture; and trade, transportation and utilities. Unemployment currently stands at 12.0% and has increased 7.3% since 2006.
- Stockton MSA, with branches in Lodi, Linden and Stockton. This MSA has a Population of 0.7 million and a Per Capita Income of approximately \$32,000. The MSA includes significant employment in the following sectors: state and local government; agriculture; trade, transportation, and utilities; and education and health services. Unemployment currently stands at 17.1% and has increased 9.7% since 2006.
- Modesto MSA, with branches in Modesto and Turlock. This MSA has a Population of 0.5 million and a Per Capita Income of approximately \$33,000. The MSA includes significant employment in the following sectors: agriculture; trade, transportation and utilities; state and local government; and education and health services. Unemployment currently stands at 17.3% and has increased 9.4% since 2006.
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Merced MSA with branches in Hilmar and Merced. This MSA has a Population of 0.3 million and a Per Capita Income of approximately \$29,000. The MSA includes significant employment in the following sectors: agriculture; state and local government; and trade, transportation and utilities. Unemployment currently stands at 19.3% and has increased 9.9% since 2006.



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All of the Company's service areas are heavily influenced by the agricultural industry, however, with the exception of the State of California in the Sacramento MSA, no single employer represents a material concentration of jobs in any of our service areas.

See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview" and "Financial Condition – Loans" for additional discussion regarding the Company's market conditions.

Through its network of banking offices, the Company emphasizes personalized service along with a full range of banking services to businesses and individuals located in the service areas of its offices. Although the Company focuses on marketing its services to small and medium sized businesses, a full range of retail banking services are made available to the local consumer market.

The Company offers a wide range of deposit instruments. These include checking, savings, money market, time certificates of deposit, individual retirement accounts and online banking services for both business and personal accounts.

The Company provides a full complement of lending products, including commercial, real estate construction, agribusiness, installment, credit card, and real estate loans. Commercial products include lines of credit and other working capital financing and letters of credit. Financing products for individuals include automobile financing, lines of credit, residential real estate, home improvement and home equity lines of credit.

The Company also offers a wide range of specialized services designed for the needs of its commercial accounts. These services include a credit card program for merchants, collection services, lockbox, investment sweep, on-line account access, and electronic funds transfers by way of domestic and international wire and automated clearinghouse.

The Company makes investment products available to customers, including mutual funds and annuities. These investment products are offered through a third party, which employs investment advisors to meet with and provide investment advice to the Company's customers.

## Employees

At December 31, 2011, the Company employed a total of 312 full time equivalent employees. The Company believes that its employee relations are satisfactory.

## Competition

The banking and financial services industry in California generally, and in the Company's market areas specifically, is highly competitive. 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 service providers. The Company competes with other major commercial banks, diversified financial institutions, credit unions, savings and loan associations, money market and other mutual funds, mortgage companies, and a variety of other non-banking financial services and advisory companies. Federal legislation encourages competition between different types of financial service providers and has fostered new entrants into the financial services market. It is anticipated that this trend will continue. Using the financial holding company structure, insurance companies and securities firms may compete more directly with banks and bank holding companies.

Many of our competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader range of financial services than the Company. In order to compete with other financial service providers, the Company relies upon personal contact by its officers, directors, employees, and stockholders, along

with various promotional activities and specialized services. In those instances where the Company is unable to accommodate a customer's needs, the Company may arrange for those services to be provided through its correspondents.

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### Government Policies

The Company's profitability, like most financial institutions, is primarily dependent on interest rate differentials. The difference between the interest rates paid by the Company on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by the Company on its interest-earning assets, such as loans extended to its customers and securities held in its investment portfolio, comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors that are beyond the control of the Company and the Bank, such as inflation, recession and unemployment. The impact that changes in economic conditions might have on the Company and the Bank cannot be predicted.

The business of the Company is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the FRB. The FRB implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target federal funds and discount rates applicable to borrowings by depository institutions. The actions of the FRB in these areas influence the growth of bank loans, investments, and deposits and also affect interest rates earned on interest-earning assets and paid on interest-bearing liabilities. The nature and impact on the Company of any future changes in monetary and fiscal policies cannot be predicted.

From time to time, legislative acts, as well as regulations, are enacted which have the effect of increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies, and other financial institutions and financial services providers are frequently made in the U.S. Congress, in the state legislatures, and before various regulatory agencies. This legislation may change banking statutes and the operating environment of the Company and its subsidiaries in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it, or any implemented regulations, would have on the financial condition or results of operations of the Company or any of its subsidiaries. See "Supervision and Regulation."

### Supervision and Regulation

#### General

Bank holding companies and banks are extensively regulated under both federal and state law. The regulation is intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of stockholders of the Company. Set forth below is a summary description of the material laws and regulations, which relate to the operations of the Company and the Bank. This description does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations.

#### The Company

The Company is a registered bank holding company and is subject to regulation under the Bank Holding Company Act of 1956 ("BHCA"), as amended. Accordingly, the Company's operations are subject to extensive regulation and examination by the FRB. The Company is required to file with the FRB quarterly and annual reports and such additional information as the FRB may require pursuant to the BHCA. The FRB conducts periodic examinations of the Company.

The FRB may require that the Company terminate an activity or terminate control of or liquidate or divest certain subsidiaries of affiliates when the FRB believes the activity or the control of the subsidiary or affiliate constitutes a

significant risk to the financial safety, soundness or stability of any of its banking subsidiaries. The FRB also has the authority to regulate provisions of certain bank holding company debt. Under certain circumstances, the Company must file written notice and obtain approval from the FRB prior to purchasing or redeeming its equity securities.

Under the BHCA and regulations adopted by the FRB, a bank holding company and its non-banking subsidiaries are prohibited from requiring certain tie-in arrangements in connection with an extension of credit, lease or sale of property, or furnishing of services. For example, with certain exceptions, a bank may not condition an extension of credit on a promise by its customer to obtain other services provided by it, its holding company or other subsidiaries, or on a promise by its customer not to obtain other services from a competitor. In addition, federal law imposes certain restrictions on transactions between Farmers & Merchants Bancorp and its subsidiaries. Further, the Company is required by the FRB to maintain certain levels of capital. See “Capital Standards.”

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The Company is prohibited by the BHCA, except in certain statutorily prescribed instances, from acquiring direct or indirect ownership or control of more than 5% of the outstanding voting shares of any company that 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. However, the Company, subject to the prior notice and/or approval of the FRB, may engage in any, or acquire shares of companies engaged in, activities that are deemed by the FRB to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Under FRB regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, it is the FRB's policy that in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. This support may be required at times when a bank holding company may not be able to provide such support. A bank holding company's failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of the FRB's regulations or both.

The Gramm-Leach-Bliley Act of 1999 ("GLBA") eliminated many of the restrictions placed on the activities of bank holding companies that become financial holding companies. Among other things, GLBA repealed certain Glass-Steagall Act restrictions on affiliations between banks and securities firms, and amended the BHCA to permit bank holding companies that are financial holding companies to engage in activities, and acquire companies engaged in activities, that are: financial in nature (including insurance underwriting, insurance company portfolio investment, financial advisory, securities underwriting, dealing and market-making, and merchant banking activities); incidental to financial activities; or complementary to financial activities if the FRB determines that they pose no substantial risk to the safety or soundness of depository institutions or the financial system in general. GLBA also permits national banks to engage in activities considered financial in nature through a financial subsidiary, subject to certain conditions and limitations. The Company has not become a financial holding company.

The Company is also a bank holding company within the meaning of the California Financial Code. As such, the Company and its subsidiaries are subject to examination by, and may be required to file reports with, the DFI.

The Company's securities are registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). As such, the Company is subject to the reporting, proxy solicitation and other requirements and restrictions of the Exchange Act.

### The Bank

The Bank, as a California chartered non-fed member bank, is subject to primary supervision, periodic examination and regulation by the DFI and the FDIC. If, as a result of an examination of the Bank, the FDIC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the Bank's operations are unsatisfactory, or that the Bank or its management is violating or has violated any law or regulation, various remedies are available to the FDIC. Such remedies include the power to enjoin "unsafe or unsound" practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict the growth of the Bank, to assess civil monetary penalties, to remove officers and directors, and ultimately to terminate the Bank's deposit insurance, which for a California chartered bank would result in a revocation of the Bank's charter. The DFI has many of the same remedial powers.

Various requirements and restrictions under the laws of the State of California and the United States affect the operations of the Bank. State and federal statutes and regulations relate to many aspects of the Bank's operations,

including reserves against deposits, ownership of deposit accounts, interest rates payable on deposits, loans, investments, mergers and acquisitions, borrowings, dividends, locations of branch offices, and capital requirements. Further, the Bank is required to maintain certain levels of capital. See “Capital Standards.”

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### The USA Patriot Act

Title III of the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”) includes numerous provisions for fighting international money laundering and blocking terrorism access to the U.S. financial system. The USA Patriot Act requires certain additional due diligence and record keeping practices, including, but not limited to, new customers, correspondent, and private banking accounts.

Part of the USA Patriot Act requires covered financial institutions to: (i) establish an anti-money laundering program; (ii) establish appropriate anti-money laundering policies, procedures and controls; (iii) appoint a Bank Secrecy Act officer responsible for day-to-day compliance; and (iv) conduct independent audits. The Patriot Act also expands penalties for violation of the anti-money laundering laws, including expanding the circumstances under which funds in a bank account may be forfeited. The Patriot Act also requires covered financial institutions to respond, under certain circumstances, to requests for information from federal banking agencies within 120 hours.

### Privacy Restrictions

The GLBA, in addition to the previous described changes in permissible, non-banking activities permitted to banks, bank holding companies, and financial holding companies, also requires financial institutions in the U.S. to provide certain privacy disclosures to customers and consumers, to comply with certain restrictions on the sharing and usage of personally identifiable information, and to implement and maintain commercially reasonable customer information safeguarding standards.

The Company believes that it complies with all provisions of the GLBA and all implementing regulations and the Bank has developed appropriate policies and procedures to meet its responsibilities in connection with the privacy provisions of GLBA.

### Dividends and Other Transfer of Funds

Dividends from the Bank constitute the principal source of income to the Company. The Company is a legal entity separate and distinct from the Bank. The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends to the Company. Under such restrictions, the amount available for payment of dividends to the Company by the Bank totaled \$33.5 million at December 31, 2011.

The FDIC and the DFI also have authority to prohibit the Bank from engaging in activities that, in their opinion, constitute unsafe or unsound practices in conducting its business. It is possible, depending upon the financial condition of the bank in question and other factors, that the FDIC and the DFI could assert that the payment of dividends or other payments might, under some circumstances, be an unsafe or unsound practice. Further, the FRB and the FDIC have established guidelines with respect to the maintenance of appropriate levels of capital by banks or bank holding companies under their jurisdiction. Compliance with the standards set forth in such guidelines and the restrictions that are or may be imposed under the prompt corrective action provisions of federal law could limit the amount of dividends which the Bank or the Company may pay. An insured depository institution is prohibited from paying management fees to any controlling persons or, with certain limited exceptions, making capital distributions if after such transaction the institution would be undercapitalized. The DFI may impose similar limitations on the Bank. See “Prompt Corrective Regulatory Action and Other Enforcement Mechanisms” and “Capital Standards” for a discussion of these additional restrictions on capital distributions.

### Transactions with Affiliates

The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of the Company or other affiliates, the purchase of, or investments in stock or other securities thereof, the taking of such securities as collateral for loans, and the purchase of assets of the Company or other affiliates. Such restrictions prevent the Company and other affiliates from borrowing from the Bank unless

the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by the Bank to or in the Company or to or in any other affiliates are limited, individually, to 10% of the Bank's capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20% of the Bank's capital and surplus (as defined by federal regulations).



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In addition, the Company and its operating subsidiaries generally may not purchase a low-quality asset from an affiliate, and other specified transactions between the Company or its operating subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

Also, the Company and its operating subsidiaries may engage in transactions with affiliates only on terms and under conditions that are substantially the same, or at least as favorable to the Company or its subsidiaries, as those prevailing at the time for comparable transactions with (or that in good faith would be offered to) non-affiliated companies.

California law also imposes certain restrictions with respect to transactions with affiliates. Additionally, limitations involving the transactions with affiliates may be imposed on the Bank under the prompt corrective action provisions of federal law. See “Prompt Corrective Action and Other Enforcement Mechanisms.”

### Capital Standards

The FRB and the FDIC have established risk-based capital guidelines with respect to the maintenance of appropriate levels of capital by United States banking organizations. These guidelines are intended to provide a measure of capital that reflects the risk associated with a banking organization’s operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit and recourse arrangements, which are recorded as off balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as commercial loans.

The federal banking agencies require a minimum ratio of qualifying total capital to risk-weighted assets of 8% and a minimum ratio of Tier 1 capital to risk-weighted assets of 4%. In addition to the risk-based guidelines, federal banking regulators require banking organizations to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets must be 4%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the regulators have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above minimum guidelines and ratios. For further information on the Company and the Bank’s risk-based capital ratios see Note 14 located in “Item 8. Financial Statements and Supplementary Data.”

The current risk-based capital guidelines which apply to the Bank are based upon the 1988 capital accord of international Basel Committee referred to as “Basel I.” A new international accord, referred to as Basel II evolved from 2004 to 2006 out of the efforts to revise capital adequacy standards for internationally active banks. In January 2009, the Basel Committee proposed to reconsider regulatory-capital standards, supervisory and risk-management requirements and additional disclosures to further strengthen the Basel II framework in response to recent worldwide economic developments.

The Basel III standards, if adopted, could lead to significantly higher capital requirements, higher capital charges and more restrictive leverage and liquidity ratios. Federal banking regulators have recently issued proposed rules relating to the Basel III requirements. In the proposed rule it is anticipated that the Basel III requirements will be applicable to all U.S. bank holding companies with consolidated assets of \$50 billion or more and any nonbank financial firms that may be designated as systemically important companies. The Company is uncertain as to what eventual effect this will have on a companies such as ourselves, with less than \$50 billion in consolidated assets. There is always the possibility that some of the Basel III requirements may be implemented by bank regulators for banks with less than \$50 billion in consolidated assets as a “best practice.”

Prompt Corrective Action and Other Enforcement Mechanisms

The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective Federal regulatory agencies to implement systems for “prompt corrective action” for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management, and capital distributions, depending on the category in which an institution is classified.

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Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An “undercapitalized” institution must develop a capital restoration plan. At December 31, 2011, the Bank exceeded all of the required ratios for classification as “well capitalized.” It should be noted; however, that the Bank’s capital category is determined solely for the purpose of applying the federal banking agencies’ prompt corrective action regulations and the capital category may not constitute an accurate representation of the Bank’s overall financial condition or prospects.

An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions.

Banking agencies have also adopted regulations which mandate that regulators take into consideration: (i) concentrations of credit risk; (ii) interest rate risk (when the interest rate sensitivity of an institution’s assets does not match the sensitivity of its liabilities or its off-balance-sheet position); and (iii) risks from non-traditional activities, as well as an institution’s ability to manage those risks, when determining the adequacy of an institution’s capital. That evaluation will be made as a part of the institution’s regular safety and soundness examination. In addition, the banking agencies have amended their regulatory capital guidelines to incorporate a measure for market risk. In accordance with the amended guidelines, the Company and any company with significant trading activity must incorporate a measure for market risk in its regulatory capital calculations.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal banking agencies for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, any condition imposed in writing by the agency, or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders based upon a judicial determination that the agency would be harmed if such equitable relief was not granted. Additionally, a holding company's inability to serve as a source of strength to its subsidiary banking organizations could serve as an additional basis for a regulatory action against the holding company.

Federal banking regulators have also issued final guidance regarding commercial real estate (“CRE”) lending. This guidance suggests that institutions that are potentially exposed to significant CRE concentration risk will be subject to increased regulatory scrutiny. Institutions that have experienced rapid growth in CRE lending, have notable exposure to a specific type of CRE lending, or are approaching or exceed certain supervisory criteria that measure an institution’s CRE portfolio against its capital levels, may be subject to such increased regulatory scrutiny. The Company’s CRE portfolio may be viewed as falling within one or more of the foregoing categories, and accordingly may become subject to increased regulatory scrutiny because of the CRE portfolio. Institutions that are determined by their regulator to have an undue concentration in CRE lending may be required to maintain levels of capital in excess of the statutory minimum requirements and/or be required to reduce their concentration in CRE loans. The FDIC has determined that the Company does not have any undue concentrations in CRE lending.

### Safety and Soundness Standards

The federal banking agencies have adopted guidelines designed to assist in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems, and internal audit systems; (ii) loan documentation;

(iii) credit underwriting; (iv) asset growth; (v) earnings; and (vi) compensation, fees, and benefits. In addition, the federal banking agencies have also adopted safety and soundness guidelines with respect to asset quality and earnings standards. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, any insured depository institution should: (i) conduct periodic asset quality reviews to identify problem assets; (ii) estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb estimated losses; (iii) compare problem asset totals to capital; (iv) take appropriate corrective action to resolve problem assets; (v) consider the size and potential risks of material asset concentrations; and (vi) provide periodic asset quality reports with adequate information for management and the Board of Directors to assess the level of asset risk. These guidelines also set forth standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves.

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### Deposit Insurance

The deposits of the Bank have historically been insured by the FDIC up to \$100,000 per insured depositor, except certain types of retirement accounts, which were insured up to \$250,000 per insured depositor. On October 3, 2008, the maximum amount insured under FDIC deposit insurance was temporarily increased from \$100,000 to \$250,000 per insured depositor. This increase was part of the Emergency Economic Stabilization Act of 2008, and was made permanent with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). The Dodd-Frank Act also provides unlimited deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts.

The Federal Deposit Insurance Reform Act of 2005 provided the FDIC Board of Directors the authority to set the designated reserve ratio for the Deposit Insurance Fund (“DIF”) between 1.15% and 1.50%. The FDIC must adopt a restoration plan when the reserve ratio falls below 1.15% and begin paying dividends when the reserve ratio exceeds 1.35%.

Through the later part of 2008 and into 2009 the number of bank failures began to rise significantly. This placed considerable strain on the DIF. As a result, on September 29, 2009 the FDIC adopted an Amended Restoration Plan to allow the DIF to return to a ratio of 1.15% within eight years. The FDIC also adopted risk-based assessment rates beginning in January of 2011. On November 12, 2009 the FDIC also adopted a final rule amending the assessment regulations to require insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012, on December 30, 2009, except for those institutions where the FDIC grants an exemption. The prepaid assessment was collected December 30, 2009, and resulted in a prepayment by the Bank of \$7,258,000.

Under the Dodd-Frank Act, the minimum designated reserve ratio of the DIF increased from 1.15% to 1.35% of estimated insured deposits. Additionally, the Dodd-Frank Act revised the assessment base against which an insured depository institution’s deposit insurance premiums paid to the DIF will be calculated. On February 7, 2011, the FDIC approved a final rule, as mandated by Dodd-Frank, changing the deposit insurance assessment system from one that is based on total domestic deposits to one that is based on average consolidated total assets minus average tangible equity. The new rule took effect for the quarter beginning April 1, 2011.

The Bank’s FDIC premiums were \$1.5 million in 2011 compared to \$2.3 million in 2010. Future increases in insurance premiums could have adverse effects on the operating expenses and results of operations of the Company. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC or the Bank’s primary regulator. Management of the Company is not aware of any practice, condition or violation that might lead to termination of the Company’s deposit insurance.

### Community Reinvestment Act (“CRA”) and Fair Lending

The Bank is subject to certain fair lending requirements involving lending, investing, and other CRA activities. CRA requires each insured depository institution to identify the communities served by the institution’s offices and to identify the types of credit and investments the institution is prepared to extend within such communities including low and moderate-income neighborhoods. It also requires the institution’s regulators to assess the institution’s performance in meeting the credit needs of its community and to take such assessment into consideration in reviewing applications for mergers, acquisitions, relocation of existing branches, opening of new branches, and other transactions. A bank may be subject to substantial penalties and corrective measures for a violation of certain fair lending laws.



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A bank's compliance with the Community Reinvestment Act is assessed using an evaluation system, which bases CRA ratings on an institution's lending, service and investment performance. An unsatisfactory rating may be the basis for denying a merger application. The Bank's latest CRA examination was completed by the Federal Deposit Insurance Corporation in July 2010 and the Bank received an overall Satisfactory rating in complying with its CRA obligations.

### The Sarbanes-Oxley Act of 2002

This legislation addresses certain accounting oversight and corporate governance matters, including but not limited to:

- required executive certification of financial presentations;
- increased requirements for board audit committees and their members;
- enhanced disclosure of controls and procedures and internal control over financial reporting;
- enhanced controls over, and reporting of, insider trading; and
- increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

As a public reporting company, the Company is subject to the requirements of this legislation and related rules and regulations issued by the Securities and Exchange Commission (the "SEC"). Compliance with the Act (the "Act") did not have a material impact upon its business. However, other non-interest expense items, including professional expenses and other costs related to compliance with the reporting requirements of the securities laws have significantly increased and can be expected to continue to increase.

### Consumer Protection Regulations

The Company's lending activities are subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act, Equal Credit Opportunity Act, the Fair Housing Act, and the Truth-in-Lending Act. Deposit operations are also subject to laws and regulations that protect consumer rights including Funds Availability, Truth in Savings, and Electronic Funds Transfers. Additional rules govern check writing ability on certain interest earning accounts and prescribe procedures for complying with administrative subpoenas of financial records. Additionally, a provision of the Federal Reserve Regulation E has been changed effective July 1, 2010 that puts restrictions on institutions assessing overdraft fees on consumer's accounts relating to debit card usage or other forms of transfers.

### Recent Governmental Actions in Response to the Financial Crises

#### Emergency Economic Stabilization Act

In response to the financial crisis affecting the banking system and financial markets, the Emergency Economic Stabilization Act ("EESA") was signed into law on October 3, 2008, which among other things: (1) temporarily increased FDIC insurance coverage from \$100,000 to \$250,000 through December 31, 2009 (subsequently extended through December 31, 2013); and (2) established the Troubled Asset Relief Program ("TARP"). As part of TARP, the United States Department of the Treasury ("Treasury") established the Capital Purchase Program ("CPP") to provide up to \$700 billion of funding to eligible financial institutions through the purchase of capital stock and other financial instruments for the purpose of stabilizing and providing liquidity to the U.S. financial markets. In connection with EESA, there have been numerous actions by the FRB, Congress, and the Treasury, the FDIC, the SEC and others to further the economic and banking industry stabilization efforts under EESA. It remains unclear at this time what further legislative and regulatory measures will be implemented under EESA affecting the Company.

The Company decided not to participate in the TARP CPP.

Temporary Liquidity Guarantee Program

On October 14, 2008, the FDIC announced the establishment of the Temporary Liquidity Guarantee Program (“TLGP”) to provide: (1) full deposit insurance on all non-interest bearing transaction account balances through December 31, 2009 (Transaction Account Guarantee Program); and (2) guarantees of certain newly issued senior unsecured debt issued by financial institutions and bank holding companies through June 30, 2012 (Debt Guarantee Program). The Bank participated in the Transaction Account Guarantee Program through June 30, 2010, but not the Debt Guarantee Program.



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### Financial Stability Plan

On February 10, 2009, Treasury announced the Financial Stability Plan (“FSP”) which, among other things, established a new Capital Assistance Program (“CAP”) through which eligible banking institutions will have access to Treasury capital as a bridge to private capital until market conditions normalize, and extended the Debt Guarantee Program of the TLGP to October 31, 2009, and the Transaction Account Guarantee Program of the TLGP to June 30, 2010. As a complement to CAP, a new Public-Private Investment Fund on an initial scale of up to \$500 billion, which was later revised to be \$30 billion, was announced to catalyze the removal of legacy assets from the balance sheets of financial institutions. This fund will combine public and private capital with government financing to help free up capital to support new lending. In addition, the existing Term Asset-Backed Securities Lending Facility (“TALF”) would be expanded (up to \$1 trillion) in order to reduce credit spreads and restart the securitized credit markets that in recent years supported a substantial portion of lending to households, students, small businesses, and others. Furthermore, the FSP proposed a new framework of governance and oversight to help ensure that banks receiving funds are held responsible for appropriate use of those funds through stronger conditions on lending, dividends and executive compensation along with enhanced reporting to the public.

### American Recovery and Reinvestment Act of 2009

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (“ARRA”) was signed into law. ARRA is intended to provide tax breaks for individuals and businesses, direct aid to distressed states and individuals, and provide infrastructure spending. In addition, ARRA imposes new executive compensation and expenditure limits on all previous and future TARP CPP recipients and expands the class of employees to whom the limits and restrictions apply. ARRA also provides the opportunity for additional repayment flexibility for existing TARP CPP recipients. Among other things, ARRA prohibits the payment of bonuses, other incentive compensation and severance to certain highly paid employees (except in the form of restricted stock subject to specified limitations and conditions), and requires each TARP CPP recipient to comply with certain other executive compensation related requirements. These provisions modify the executive compensation provisions that were included in EESA, and in most instances apply retroactively for so long as any obligation arising from financial assistance provided to the recipient under TARP CPP remains outstanding.

In addition, ARRA directs the Treasury to review previously-paid bonuses, retention awards and other compensation paid to the senior executive officers and certain other highly-compensated employees of each TARP CPP recipient to determine whether any such payments were excessive, inconsistent with the purposes of ARRA or the TARP, or otherwise contrary to the public interest. If the Treasury determines that any such payments have been made by a TARP CPP recipient, the Treasury will seek to negotiate with the TARP CPP recipient and the subject employee for appropriate reimbursements to the U.S. government (not the TARP CPP recipient) with respect to any such compensation or bonuses. ARRA also permits the Treasury, subject to consultation with the appropriate federal banking agency, to allow a TARP CPP recipient to repay any assistance previously provided to such TARP CPP recipient under the TARP, without regard to whether the TARP CPP recipient has replaced such funds from any source, and without regard to any waiting period. Any TARP CPP recipient that repays its TARP assistance pursuant to this provision would no longer be subject to the executive compensation provisions under ARRA.

Since the Company elected not to participate in the TARP CPP, the preceding compensation limitations do not apply.

### Homeowner Affordability and Stability Plan

On February 18, 2009, the Treasury announced the Homeowner Affordability and Stability Plan (“HASP”), which proposes to provide refinancing for certain homeowners, to support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac, and to establish a Homeowner Stability Initiative to reach at-risk homeowners. Among other things, the Homeowner Stability Initiative would offer monetary incentive to mortgage servicers and mortgage holders for certain modifications of at-risk loans, and would establish an insurance fund designed to reduce foreclosures.



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### The Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed into law the sweeping financial regulatory reform, Dodd-Frank Act, that implements significant changes to the regulation of the financial services industry, including provisions that, among other things:

- Centralize responsibility for consumer financial protection by creating a new agency within the Federal Reserve Board, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and thrifts.
- Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to bank holding companies.
- Require the FDIC to seek to make its capital requirements for banks countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction.
- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital.
- Implement corporate governance revisions, including executive compensation and proxy access by stockholders.
- Make permanent the \$250,000 limit for federal deposit insurance and increase the cash limit of Securities Investor Protection Corporation protection from \$100,000 to \$250,000, and provide unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts at all insured depository institutions.
- Repeal the federal prohibitions on the payment of interest on demand deposits effective July 21, 2011, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Many aspects of the Dodd-Frank Act are subject to rulemaking by various regulatory agencies and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers or the financial industry more generally. The elimination of the prohibition on the payment of interest on demand deposits could materially increase our interest expense, depending on our competitors' responses.

### Future Legislation and Regulatory Initiatives

Various legislative and regulatory initiatives are from time to time introduced in Congress and state legislatures, as well as regulatory agencies. Future legislation regarding financial institutions may change banking statutes and the operating environment of the Company and the Bank in substantial and unpredictable ways, and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance depending upon whether any of this potential legislation will be enacted, and if enacted, the effect that it or any implementing regulations, would have on the financial condition or results of operations of the Company or the Bank. The nature and extent of future legislative and regulatory changes affecting financial institutions is unpredictable at this time. The Company cannot determine the ultimate effect that such potential legislation, if enacted, would have upon its financial condition or operations.

### Available Information

Company reports filed with the SEC including the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and ownership reports filed by directors, executive officers and principal stockholders can be accessed through the Company's web site at <http://www.fmbonline.com>. The link to the SEC is on the About Us page.



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### Item 1A. Risk Factors

An investment in our common stock is subject to risks inherent in our business. The material risks and uncertainties that management believes may affect our business are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing our business. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

#### Risks Associated With Our Business

Difficult Economic And Market Conditions Have Adversely Affected The Banking Industry - since the fourth quarter of 2007, the United States economy and the economy of the Central Valley of California, the Company's primary market area, has experienced difficult economic and market conditions. This has been reflected in: (1) public sector financial stress, both at the local and statewide level (See "Item 1. Business – Service Area" - the State of California, a large employer in one of the Company's market territories is experiencing a budget crisis that has yet to be solved); and (2) significant private sector business failures and job losses. In addition, over the past four years, the domestic and foreign financial markets, securities trading markets and economies generally have experienced significant turmoil including, without limitation, government takeovers of troubled institutions, government brokered mergers of such firms to avoid bankruptcy or failures, bankruptcies of securities trading firms and insurance companies, failures of financial institutions and securities brokerage firms, declines in real property values, and wide fluctuations in energy prices, all of which have contributed to reduced availability of credit for businesses and consumers, elevated foreclosures on residential and commercial properties, falling home prices, reduced liquidity and a lack of stability across the entire financial sector.

Despite the stability of our earnings over the last several years and the improvement in our asset quality during 2011, these recent events and the corresponding uncertainty in the economy and the financial markets may continue for the foreseeable future. The full extent of the repercussions to our nation's, our state's and our local economies in general and our business in particular; therefore, are not fully known at this time. Such events may have a negative effect on: (i) our ability to service our existing customers and attract new customers; (ii) the ability of our borrowers to operate their business as successfully as in the past; (iii) the financial security and net worth of our customers; and (iv) the ability of our customers to repay their loans with us in accordance with the terms thereof.

Recently Enacted Legislation And Other Measures Undertaken By The Treasury, The FRB And Other Governmental Agencies May Not Help Stabilize The U.S. Financial System Or Improve The Housing Market – Since 2008 the Federal Government has enacted many pieces of legislation designed to stabilize the economy and regulate the financial services industry. See "Item 1. Business – Supervision and Regulation – Recent Government Actions in Response to the Financial Crises."

The actual impact that any of this legislation and other related measures undertaken to alleviate the economic crises will have generally on the financial markets is still substantially unknown. The failure of such measures, or any future measures, to help stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect our business, financial condition, results of operations, access to credit or the trading price of our common stock.

Recent Levels Of Market Volatility Have Been Unprecedented - The capital and credit markets have been experiencing volatility and disruption for more than three years. At times the volatility and disruption reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers' underlying financial strength. If recent levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

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**Nonperforming Assets Take Significant Time To Resolve And Adversely Affect Our Company's Results Of Operations And Financial Condition -** Nonperforming assets adversely affect our net income in various ways. Until economic and market conditions improve, we expect to continue to incur additional losses relating to an increase in non-performing loans. We do not record interest income on non-accrual loans or other real estate owned, thereby adversely affecting our income and increasing our loan administration costs. When we take collateral in foreclosures and similar proceedings, we are required to mark the related loan to the then fair market value of the collateral, which may result in a loss. While we have tried to reduce our problem assets through workouts, restructurings and otherwise, decreases in the value of these assets, or the underlying collateral, or in these borrowers' performance or financial conditions, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management, which can be detrimental to the performance of other responsibilities. There can be no assurance that we will not experience further increases in nonperforming loans in the future.

**Our Allowance For Loan Losses May Not Be Adequate To Cover Actual Losses -** A significant source of risk arises from the possibility that losses could be sustained because borrowers, guarantors, and related parties may fail to perform in accordance with the terms of their loans and leases. The underwriting and credit monitoring policies and procedures that we have adopted to address this risk may not prevent unexpected losses that could have a material adverse effect on our business, financial condition, results of operations and cash flows. Unexpected losses may arise from a wide variety of specific or systemic factors, many of which are beyond our ability to predict, influence, or control.

Like all financial institutions, we maintain an allowance for loan losses to provide for loan defaults and non-performance. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Provision and Allowance for Credit Losses." The allowance is funded from a provision for loan losses, which is a charge to our income statement. Our allowance for loan losses may not be adequate to cover actual loan losses, and future provisions for loan losses could materially and adversely affect our business, financial condition, results of operations and cash flows. The allowance for loan losses reflects our estimate of the probable losses in our loan portfolio at the relevant balance sheet date. Our allowance for loan losses is based on prior experience, as well as an evaluation of the known risks in the current portfolio, composition and growth of the loan portfolio and other economic factors. The determination of an appropriate level of loan loss allowance is an inherently difficult process and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, that may be beyond our control and these losses may exceed current estimates.

The process we use to estimate losses inherent in our credit exposure requires difficult, subjective and complex judgments, including forecasts of economic conditions and how these economic conditions might impair the ability of our borrowers to repay their loans. The level of uncertainty concerning current economic conditions may adversely affect the accuracy of our estimates, which may, in turn, impact the reliability of the allowance for loan losses.

While we believe that our allowance for loan losses is adequate to cover current losses, we cannot assure you that we will not increase the allowance for loan losses further or that regulators will not require us to increase this allowance. Either of these occurrences could materially adversely affect our business, financial condition, results of operations and cash flows.

**We Are Dependent On Real Estate And Further Downturns In The Real Estate Market Could Hurt Our Business -** Although our regulators have determined that we do not have significant CRE concentration risk, a significant portion of our loan portfolio is dependent on real estate. See "Item 1. Business – Supervision and Regulation - Prompt Corrective Action and Other Enforcement Mechanisms." At December 31, 2011, real estate served as the principal

source of collateral with respect to approximately 71% of our loan outstandings and 22% of loans outstanding were secured by production agricultural properties. A continuing decline in current economic conditions or rising interest rates could have an adverse effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing loans and the value of real estate owned by us, as well as our financial condition and results of operations in general and the market value of our common stock.



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Acts of nature, including earthquakes, floods and fires, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also negatively impact our financial condition.

**Our Real Estate Lending Also Exposes Us To The Risk Of Environmental Liabilities** - In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third persons for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be materially and adversely affected.

**Our Business Is Subject To Interest Rate Risk And Changes In Interest Rates May Adversely Affect Our Performance And Financial Condition** - Our earnings are impacted by changing interest rates. Changes in interest rates impact the demand for new loans, the credit profile of our borrowers, the rates received on loans and securities and rates paid on deposits and borrowings. The difference between the rates received on loans and securities and the rates paid on deposits and borrowings is known as interest rate margin. Although we believe our current level of interest rate sensitivity is reasonable, significant fluctuations in interest rates and increasing competition may have an adverse effect on our business, financial condition and results of operations. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Net Interest Income/Net Interest Margin” and “Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk.”

Sustained low levels of market interest rates could adversely affect our earnings. The Board of Governors of the Federal Reserve System regulates the supply of money and credit in the United States. Its policies determine, in large part, the cost of funds for lending and investing and the yield earned on those loans and investments, both of which impact the Company’s net interest margin. Beginning in September 2007 the FRB implemented a series of rate reductions in response to the current state of the national economy and housing market as well as the volatility of financial markets. Rates have remained low ever since, and show no signs of significantly increasing in the near future. When interest rates decline, borrowers tend to refinance higher-rate, fixed-rate loans at lower rates, and prepaying their existing loans. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our CRE and commercial loans, which carry interest rates that, in general, adjust in accordance with changes in the prime rate, will adjust to lower rates. We are also significantly affected by the level of loan demand available in our market. The inability to make sufficient loans directly affects the interest income we earn. Lower loan demand will generally result in lower interest income realized as we place funds in lower yielding investments. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2012 and Beyond.”

**Failure To Successfully Execute Our Strategy Could Adversely Affect Our Performance** - Our financial performance and profitability depends on our ability to execute our corporate growth strategy. Continued growth however, may present operating and other problems that could adversely affect our business, financial condition and results of operations. Accordingly, there can be no assurance that we will be able to execute our growth strategy or maintain the level of profitability that we have recently experienced. Factors that may adversely affect our ability to attain our long-term financial performance goals include those stated elsewhere in this section, as well as the:

- inability to maintain or increase net interest margin;
-

inability to control non-interest expense, including, but not limited to, rising employee and healthcare costs and the costs of regulatory compliance;

- inability to maintain or increase non-interest income; and
- continuing ability to expand through de novo branching or otherwise.

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Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses - Our retail and commercial banking operations are concentrated primarily in Sacramento, San Joaquin, Stanislaus and Merced Counties. See “Item 1. Business – Service Area.” As a result of this geographic concentration, our results of operations depend largely upon economic conditions in this area and this area has experienced a significant deterioration in real estate values. A significant source of risk arises from the possibility that losses will be sustained if a significant number of our borrowers, guarantors and related parties fail to perform in accordance with the terms of their loans. This risk increases when the economy is weak as it is presently. We have adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for loan losses, that management believes are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying our credit portfolio. These policies and procedures; however, may not prevent unexpected losses that could materially adversely affect our results of operations in general and the market value of our stock. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2012 and Beyond.”

This Company’s service areas can be significantly impacted by the seasonal and cyclical operations of the agricultural industry. As a result, the Company’s financial results can be influenced by the banking needs of its agricultural customers (e.g., generally speaking during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and the planting of crops. Correspondingly, deposit balances are replenished and loans repaid in late fall and winter as crops are harvested and sold). Additionally, although the Company’s loan portfolio is believed to be well diversified, at various times during 2011 approximately 37% of the Company’s loan balances were outstanding to agricultural borrowers. Commitments are well diversified across various commodities, including dairy, grapes, walnuts, almonds, cherries, apples, pears, walnuts, and various row crops. Additionally, many individual borrowers are themselves diversified across commodity types, reducing their exposure, and therefore the Company’s, to cyclical downturns in any one commodity.

Our Ability To Access Markets For Funding And Acquire And Retain Customers Could Be Adversely Affected By The Deterioration Of Other Financial Institutions Or The Financial Service Industry’s Reputation - Reputation risk is the risk to liquidity, earnings and capital arising from negative publicity regarding the financial services industry. The financial services industry continues to be featured in negative headlines about the global and national credit crisis and the resulting stabilization legislation enacted by the U.S. federal government. These reports can be damaging to the industry’s image and potentially erode consumer confidence in insured financial institutions. Recent bank failures in California and throughout the United States have also had a negative impact. In addition, our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions.

Our Interest Expense May Increase Following The Repeal Of The Federal Prohibition On Payment Of Interest On Demand Deposits - The federal prohibition on the ability of financial institutions to pay interest on demand deposit accounts has been repealed. As a result, beginning on July 21, 2011, financial institutions could commence offering interest on demand deposits to compete for clients. We do not yet know what interest rates other institutions may offer. Our interest expense will increase and our net interest margin will decrease if the Company begins offering interest on demand deposits to attract additional customers or maintain current customers, which could have a material adverse effect on our financial condition, net income and results of operations.

We Face Strong Competition From Financial Service Companies And Other Companies That Offer Banking Services That Could Adversely Impact Our Business - The financial services business in our market areas is highly competitive. It is becoming increasingly competitive due to changes in regulation, technological advances, and the

accelerating pace of consolidation among financial services providers. We face competition both in attracting deposits and in making loans. We compete for loans principally through the interest rates and loan fees we charge and the efficiency and quality of services we provide. Increasing levels of competition in the banking and financial services business may reduce our market share, decrease loan demand, cause the prices we charge for our services to fall, or decrease our net interest margin by forcing us to offer lower lending interest rates and pay higher deposit interest rates. Therefore, our results may differ in future periods depending upon the nature or level of competition.

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Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as “disintermediation,” could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

Deposit Insurance Assessments Could Increase At Any Time, Which Will Adversely Affect Profits - FDIC deposit insurance expense for the years 2011, 2010, and 2009 was \$1.5 million, \$2.3 million, and \$2.5 million, respectively. The FDIC has recently changed its methodology for calculating deposit premiums, See “Item 1. Business – Supervision and Regulation – Deposit Insurance.” While FDIC deposit insurance assessments decreased in 2011, they remain well above the pre-recession level of \$144,000 the Company paid in 2007, and additional increases could take place at any time due to continuing strains on the FDIC deposit insurance fund resulting from the cost of recent bank failures. Any increases could have adverse effects on the operating expenses and results of operations of the Company.

We May Not Be Able To Attract And Retain Skilled People - Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most of our activities can be intense and we may not be able to hire people or to retain them. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Our Internal Operations Are Subject To A Number Of Risks - We are subject to certain operations risks, including, but not limited to, information 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.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Operations in several of our markets could be disrupted by both the evacuation of large portions of the population as well as damage and or lack of access to our banking and operation facilities. While we have not experienced such an occurrence to date, other severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

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**We Depend On Cash Dividends From Our Subsidiary Bank To Meet Our Cash Obligations -** As a holding company, dividends from our subsidiary bank provide a substantial portion of our cash flow used to service the interest payments on our Trust Preferred Securities and our other obligations, including cash dividends. See “Item 5. Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.” Various statutory provisions restrict the amount of dividends our subsidiary bank can pay to us without regulatory approval.

### Risks Associated With Our Industry

**We Are Subject To Government Regulation That Could Limit Or Restrict Our Activities, Which In Turn Could Adversely Impact Our Financial Performance -** The financial services industry is regulated extensively. Federal and state regulations are designed primarily to protect the deposit insurance funds and consumers, and not to benefit our stockholders. These regulations can sometimes impose significant limitations on our operations and increase our cost of doing business.

Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects economic conditions for us.

**New Legislative And Regulatory Proposals May Affect Our Operations And Growth -** Proposals to change the laws and regulations governing the operations and taxation of, and federal insurance premiums paid by, banks and other financial institutions and companies that control such institutions are frequently raised in the U.S. Congress, the California legislature and before bank regulatory authorities. The likelihood of any major changes in the future and the impact such changes, including EESA, ARRA, HASP and the Dodd-Frank Act, might have on us or our subsidiaries are impossible to determine. Similarly, proposals to change the accounting treatment applicable to banks and other depository institutions are frequently raised by the SEC, the federal banking agencies, the IRS and other appropriate authorities. The likelihood and impact of any additional future changes in law or regulation and the impact such changes might have on us or the Bank are impossible to determine at this time. See “Item 1. Business – Supervision and Regulation – Recent Government Actions in Response to the Financial Crises.”

### Risks Associated With Our Stock

**Our Stock Trades Less Frequently Than Others -** The Company’s common stock is not widely held or listed on any exchange. However, trades may be reported on the OTC Bulletin Board under the symbol "FMCB.OB." Management is aware that there are private transactions in the Company’s common stock. However, the limited trading market for the Company’s common stock may make it difficult for stockholders to dispose of their shares.

**Our Stock Price Is Affected By A Variety Of Factors -** Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly in response to a variety of factors discussed in this section, including, among other things:

- actual or anticipated variations in quarterly results of operations;
- operating and stock price performance of other companies that investors deem comparable to our Company;
- news reports relating to trends, concerns and other issues in the financial services industry;
- available investment liquidity in our market area since our stock is not listed on any exchange; and





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- perceptions in the marketplace regarding our Company and/or its competitors.

Our Common Stock Is Not An Insured Deposit - Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this “Risk Factors” section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire our common stock, you may lose some or all of your investment.

Item 1B. Unresolved Staff Comments

The Company has no unresolved comments received from staff at the SEC.

Item 2. Properties

Farmers & Merchants Bancorp along with its subsidiaries are headquartered in Lodi, California. Executive offices are located at 111 W. Pine Street. Banking services are provided in twenty-two branch locations in the Company's service area. Of the twenty-two branches, sixteen are owned and six are leased. The expiration of these leases occurs between the years 2012 and 2016. See Note 19 located in “Item 8. Financial Statements and Supplementary Data.”

Item 3. Legal Proceedings

Certain lawsuits and claims arising in the ordinary course of business have been filed or are pending against the Company or its subsidiaries. Based upon information available to the Company, its review of such lawsuits and claims and consultation with its counsel, the Company believes the liability relating to these actions, if any, would not have a material adverse effect on its consolidated financial statements.

There are no material proceedings adverse to the Company to which any director, officer or affiliate of the Company is a party.

Item 4. Mine Safety Disclosures

Not Applicable

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades may be reported on the OTC Bulletin Board under the symbol “FMCB.OB.” Additionally, management is aware that there are private transactions in the Company’s common stock.

The following table summarizes the actual high, low, and close sale prices for the Company's common stock since the first quarter of 2010. These figures are based on activity posted on the OTC Bulletin Board and on private transactions between individual stockholders that are reported to the Company.

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|      | Calendar Quarter | High   | Low    | Close  | Cash Dividends Declared (Per Share) |
|------|------------------|--------|--------|--------|-------------------------------------|
| 2011 | Fourth quarter   | \$ 400 | \$ 345 | \$ 400 | \$ 6.10                             |
|      | Third quarter    | 425    | 360    | 375    | -                                   |
|      | Second quarter   | 410    | 383    | 410    | 5.65                                |
|      | First quarter    | 425    | 400    | 400    | -                                   |

|      | Calendar Quarter | High   | Low    | Close  | Cash Dividends Declared (Per Share) |
|------|------------------|--------|--------|--------|-------------------------------------|
| 2010 | Fourth quarter   | \$ 425 | \$ 400 | \$ 415 | \$ 6.00                             |
|      | Third quarter    | 425    | 400    | 415    | -                                   |
|      | Second quarter   | 450    | 355    | 380    | 5.35                                |
|      | First quarter    | 385    | 355    | 380    | -                                   |

As of January 31, 2012, there were approximately 1,483 stockholders of record of the Company's common stock.

The Company and, before the Company was formed, the Bank, have paid cash dividends for the past 77 consecutive years. There are limitations under Delaware corporate law as to the amounts of cash dividends that may be paid by the Company. Additionally, if we decided to defer interest on our subordinated debentures, we would be prohibited from paying cash dividends on the Company's common stock. The Company is dependent on cash dividends paid by the Bank to fund its cash dividend payments to its stockholders. There are regulatory limitations on cash dividends that may be paid by the Bank under state and federal laws. See "Item 1. Business – Supervision and Regulation."

In 1998, the Board approved the Company's first stock repurchase program. This program was extended and expanded in both 2004 and 2006. Most recently, on November 12, 2008, the Board of Directors approved increasing the funds available for the Company's Common Stock Repurchase Program. The Board's resolution authorized up to \$20 million in repurchases over the four-year period ending October 31, 2012.

Repurchases under the program will continue to be made on the open market or through private transactions. The repurchase program also requires that no purchases may be made if the Bank would not remain "well-capitalized" after the repurchase.

The following table indicates the number of shares repurchased by the Company during the fourth quarter of 2011.

| Period        | Number of Shares | Average Price per Share | Number of Shares Purchased as Part of a Publicly Announced Plan or Program | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan or Program |
|---------------|------------------|-------------------------|--|--|
| October 2011  | -                | -                       | -  | \$ 16,015,500  |
| November 2011 | 1,725            | \$374                   | -  | 16,015,500   |
| December 2011 | -                | -                       | -  | 16,015,500   |
| Total         | 1,725            | \$374                   | -  | \$ 16,015,500  |

The above shares were not repurchased under the Stock Repurchase Program. They were purchased on the open market for the purpose of investing contributions previously made to the Equity Component of the Executive Retirement Plan. See Note 16 located in “Item 8. Financial Statements and Supplementary Data” for further information on the Executive Retirement Plan.

On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Registrar and Transfer Company, as Rights Agent, and the Company declared a dividend of a right to acquire one preferred share purchase right (a “Right”) for each outstanding share of the Company’s common stock, \$0.01 par value per share, to stockholders of record at the close of business on August 15, 2008. Generally, the Rights are only triggered and become exercisable if a person or group (the “Acquiring Person”) acquires beneficial ownership of 10 percent or more of the Company’s common stock or announces a tender offer for 10 percent or more of the Company’s common stock.

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The Rights Plan is similar to plans adopted by many other publicly traded companies. The effect of the Rights Plan is to discourage any potential acquirer from triggering the Rights without first convincing Farmers & Merchants Bancorp's Board of Directors that the proposed acquisition is fair to, and in the best interest of, all of the shareholders of the Company. The provisions of the Plan will substantially dilute the equity and voting interest of any potential acquirer unless the Board of Directors approves of the proposed acquisition. Each Right, if and when exercisable, will entitle the registered holder to purchase from the Company one one-hundredth of a share of Series A Junior Participating Preferred Stock, no par value, at a purchase price of \$1,200 for each one one-hundredth of a share, subject to adjustment. Each holder of a Right (except for the Acquiring Person, whose Rights will be null and void upon such event) shall thereafter have the right to receive, upon exercise, that number of Common Shares of the Company having a market value of two times the exercise price of the Right. At any time before a person becomes an Acquiring Person, the Rights can be redeemed, in whole, but not in part, by Farmers and Merchants Bancorp's Board of Directors at a price of \$0.001 per Right. The Rights Plan will expire on August 5, 2018.

Performance Graphs

The following graph compares the Company's cumulative total stockholder return on common stock from December 31, 2006 to December 31, 2011 to that of: (i) the Morningstar Banks Index - Regional (US) Industry Group; and (ii) the cumulative total return of the New York Stock Exchange market index. The graph assumes an initial investment of \$100 on December 31, 2006 and reinvestment of dividends. The stock price performance set forth in the following graph is not necessarily indicative of future price performance. The Company's stock price data is based on activity posted on the OTC Bulletin Board and on private transactions between individual stockholders that are reported to the Company. This data was furnished by Morningstar, Inc.

This graph shall not be deemed filed or incorporated by reference into any filing under the Securities Act of 1933.

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## Item 6. Selected Financial Data

Farmers & Merchants Bancorp  
Five Year Financial Summary of Operations  
(in thousands except per share data)

| Summary of Income:                                  | 2011        | 2010        | 2009        | 2008        | 2007        |   |
|---|-------------|-------------|-------------|-------------|-------------|---|
| Total Interest Income                               | \$82,354    | \$84,461    | \$91,314    | \$93,208    | \$95,775    |   |
| Total Interest Expense                              | 7,974       | 9,685       | 16,331      | 24,784      | 32,225      |   |
| Net Interest Income                                 | 74,380      | 74,776      | 74,983      | 68,424      | 63,550      |   |
| Provision for Loan Losses                           | 6,775       | 14,735      | 15,420      | 7,998       | 1,495       |   |
| Net Interest Income After Provision for Loan Losses | 67,605      | 60,041      | 59,563      | 60,426      | 62,055      |   |
| Total Non-Interest Income                           | 12,274      | 17,185      | 18,194      | 16,064      | 15,455      |   |
| Total Non-Interest Expense                          | 45,028      | 43,939      | 46,429      | 40,103      | 41,945      |   |
| Income Before Income Taxes                          | 34,851      | 33,287      | 31,328      | 36,387      | 35,565      |   |
| Provision for Income Taxes                          | 12,642      | 12,169      | 11,315      | 13,597      | 12,870      |   |
| Net Income  | \$22,209    | \$21,118    | \$20,013    | \$22,790    | \$22,695    |   |
| Balance Sheet Data:                                 |             |             |             |             |             |   |
| Total Assets  | \$1,919,684 | \$1,841,491 | \$1,781,014 | \$1,684,437 | \$1,519,172 |   |
| Loans   | 1,163,078   | 1,176,002   | 1,212,718   | 1,177,364   | 1,140,969   |   |
| Allowance for Loan Losses                           | 33,017      | 32,261      | 29,813      | 20,034      | 18,483      |   |
| Investment Securities                               | 542,912     | 493,581     | 435,166     | 363,729     | 247,637     |   |
| Deposits  | 1,626,197   | 1,566,503   | 1,498,124   | 1,432,702   | 1,310,790   |   |
| Federal Home Loan Bank Advances                     | 530         | 591         | 20,149      | 703         | 28,954      |   |
| Shareholders' Equity                                | 189,346     | 173,241     | 164,727     | 156,545     | 143,418     |   |
| Selected Ratios:                                    |             |             |             |             |             |   |
| Return on Average Assets                            | 1.19        | % 1.19      | % 1.15      | % 1.44      | % 1.56      | % |
| Return on Average Equity                            | 12.10       | % 12.25     | % 12.33     | % 15.23     | % 16.26     | % |
| Dividend Payout Ratio                               | 41.24       | % 41.93     | % 42.95     | % 36.99     | % 34.51     | % |
| Average Loans to Average Deposits                   | 74.48       | % 79.03     | % 80.12     | % 84.16     | % 86.86     | % |
| Average Equity to Average Assets                    | 9.85        | % 9.74      | % 9.34      | % 9.46      | % 9.60      | % |
| Period-end Shareholders' Equity to Total Assets     | 9.86        | % 9.41      | % 9.25      | % 9.29      | % 9.44      | % |
| Per Share Data:                                     |             |             |             |             |             |   |
| Net Income (1)                                      | \$28.49     | \$27.05     | \$25.57     | \$28.69     | \$28.05     |   |
| Cash Dividends Per Share                            | \$11.75     | \$11.35     | \$11.00     | \$10.65     | \$9.70      |   |

(1) Based on the weighted average number of shares outstanding of 779,424, 780,619, 782,754, 794,239, and 809,057 for the years ended December 31, 2011, 2010, 2009, 2008, and 2007, respectively.

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## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

## Overview

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

## The Five-Year Period: 2007 through 2011

For much of 2007 the economy was strong, the stock market rising and individuals and businesses doing well. Then in October 2007 the financial markets started what would become a major adjustment and an economic recession began that continues even today in the Central Valley of California. The Central Valley has been one of the hardest hit areas in the country during this recession. Housing prices in many areas are down as much as 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels remain above 15% in many areas.

Despite this difficult economic environment, in management's opinion, the Company's operating performance was exceptionally strong throughout this timeframe.

(in thousands, except per share data)

| Financial Performance Indicator             | 2011        |   | 2010        |   | 2009        |   | 2008        |   | 2007        |   |
|---|-------------|---|-------------|---|-------------|---|-------------|---|-------------|---|
| Net Income                                  | \$22,209    |   | \$21,118    |   | \$20,013    |   | \$22,790    |   | \$22,695    |   |
| Total Assets                                | \$1,919,684 |   | \$1,841,491 |   | \$1,781,014 |   | \$1,684,437 |   | \$1,519,172 |   |
| Total Loans                                 | \$1,163,078 |   | \$1,176,002 |   | \$1,212,718 |   | \$1,177,364 |   | \$1,140,969 |   |
| Total Deposits                              | \$1,626,197 |   | \$1,566,503 |   | \$1,498,124 |   | \$1,432,702 |   | \$1,310,790 |   |
| Total Shareholders' Equity                  | \$189,346   |   | \$173,241   |   | \$164,727   |   | \$156,545   |   | \$143,418   |   |
| Total Consolidated Risk-Based Capital Ratio | 14.86       | % | 13.82       | % | 12.48       | % | 12.59       | % | 12.21       | % |
| Non-Performing Loans as a % of Total Loans  | 0.35        | % | 0.45        | % | 0.76        | % | 0.45        | % | 0.01        | % |
| Net Charge-Offs to Average Loans            | 0.51        | % | 1.04        | % | 0.48        | % | 0.57        | % | 0.10        | % |
| Loan Loss Allowance as a % of Total Loans   | 2.83        | % | 2.74        | % | 2.45        | % | 1.70        | % | 1.62        | % |
| Return on Average Assets                    | 1.19        | % | 1.19        | % | 1.15        | % | 1.44        | % | 1.56        | % |
| Return on Average Equity                    | 12.10       | % | 12.25       | % | 12.33       | % | 15.23       | % | 16.26       | % |
| Earnings Per Share                          | \$28.49     |   | \$27.05     |   | \$25.57     |   | \$28.69     |   | \$28.05     |   |
| Cash Dividends Per Share                    | \$11.75     |   | \$11.35     |   | \$11.00     |   | \$10.65     |   | \$9.70      |   |
| Cash Dividends Declared                     | \$9,158     |   | \$8,855     |   | \$8,596     |   | \$8,430     |   | \$7,831     |   |
| # Shares Repurchased During Year            | -           |   | 1,520       |   | 6,016       |   | 13,152      |   | 11,821      |   |
| Average Share Price of Repurchased Shares   | -           |   | \$400       |   | \$387       |   | \$449       |   | \$460       |   |
| High Stock Price – Fourth Quarter           | \$400       |   | \$425       |   | \$425       |   | \$450       |   | \$460       |   |

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|                                      |       |       |       |       |       |
|--------------------------------------|-------|-------|-------|-------|-------|
| Low Stock Price – Fourth Quarter     | \$345 | \$400 | \$325 | \$385 | \$381 |
| Closing Stock Price – Fourth Quarter | \$400 | \$415 | \$380 | \$420 | \$460 |

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Although the Company was not entirely immune to the pressures that a struggling economy brought to bear, management believes that the Company's performance compared very favorably to its peer banks during the five-year period ending December 31, 2011:

- Net income totaled \$108.8 million and never dropped below \$20 million in any single year.
- Return on Average Assets never dropped below 1.15% in any single year.
- Total assets increased 36.0% to \$1.9 billion.
- Total loans increased 11.1% to \$1.2 billion.
- Total deposits increased 35.7% to \$1.6 billion.

More recently:

- In 2011, the Company earned \$22.2 million for a return on average assets of 1.19%, and our return on average assets averaged 1.31% over the five-year period. Importantly, these strong results were generated at the same time the Company strengthened its loan loss allowance by \$14.9 million, to \$33.0 million or 2.84% of total loans.
- In 2011, the Company increased its cash dividend per share by 3.5% over 2010 levels, and our strong financial performance allowed us to increase dividends every year during this five-year period, even as many banks eliminated or significantly reduced their dividends.
- The Company's risk based capital ratio was --14.86% at December 31, 2011, and the Company achieved the highest regulatory classification of "well capitalized" in each of the five years. See "Financial Condition – Capital."
- Despite economic conditions in the Company's local markets, the Company's asset quality remains very strong compared to peer banks at the present time, when measured by: (1) net charge-offs of 0.54% of average loans during this five-year period; and (2) non-performing loans totaling 0.35% of total loans at December 31, 2011. See "Results of Operations – Provision and Allowance for Loan Losses" and "Financial Condition – Classified Loans and Non-Performing Assets."

As a result of this strong earnings performance, capital position, and asset quality, stockholders have benefited well in excess of overall bank and bank holding company stock market returns over the past five years:

- Cash dividends per share have increased 37.4% since 2006, and totaled \$54.45 per share over the five-year period.
- The total return on the Company's stock over the past five years compares very favorably to overall stock market returns of other banks and bank holding companies. See "Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Security - Performance Graphs."
- The Company did not dilute existing common stockholders by participating in the Federal Government's 2008 TARP Capital Purchase Program. See "Item 1. Business – Supervision and Regulation - Recent Governmental Actions in Response to the Financial Crises."



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### Looking Forward: 2012 and Beyond

In management's opinion, the following key issues will influence the financial results of the Company in 2012 and future years:

- The Company's earnings are heavily dependent on its net interest margin, which is sensitive to both changes in market interest rates and competitor pricing strategies. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."
  - During the third quarter of 2007, the FRB began decreasing short-term market rates, resulting in pressure on the Company's net interest margin, which declined from 4.89% in the second quarter of 2007 to 4.26% for the fourth quarter of 2011. Market rates remain low, and the FRB has recently stated that they expect them to remain that way well into 2014, placing continued downward pressure on the Company's net interest margin.
  - The Company's net interest margin has come under pressure from aggressive competitor pricing strategies for both loans and deposits to which the Company needs to respond in order to retain key customers.
    - The Company expects both of these factors to push net interest margin lower in 2012.
- The Company's results can be significantly influenced by changes in the credit quality of its borrowers. Non-performing loans totaled \$4.1 million or 0.35% of total loans at December 31, 2011. Management believes based on information currently available that these levels are adequately covered by the Company's \$33.0 million allowance for loan losses as of December 31, 2011. See "Results of Operations - Provision and Allowance for Loan Losses" and "Financial Condition – Classified Loans and Non-Performing Assets." The Company's provision for loan losses was \$6.8 million in 2011, a significant decrease from \$14.7 million in 2010 and \$15.4 million in 2009, but still remains above the pre-recession levels of \$1.5 million in 2007. Given the continued recessing economy in the Central Valley of California, many of the Company's borrowers continue to feel the impact of the recession. See "Item 1A. Risk Factors."
- FDIC deposit insurance expense for the years 2011, 2010, and 2009 was \$1.5 million, \$2.3 million, and \$2.5 million, respectively. The FDIC has recently changed its methodology for calculating deposit premiums. See "Item 1. Business – Supervision and Regulation – Deposit Insurance." While FDIC deposit insurance assessments decreased in 2011, they remain well above the pre-recession level of \$144,000 the Company paid in 2007, and additional increases could take place at any time due to continuing strains on the FDIC deposit insurance fund resulting from the cost of recent bank failures. Any increases could have adverse effects on the operating expenses and results of operations of the Company.
- Congress and the Obama Administration have implemented, or are preparing to implement, broad changes to the regulation of consumer financial products and the financial services industry as a whole. These changes could significantly affect the Company's product offerings, pricing and profitability in areas such as debit and credit cards, home mortgages and deposit service charges, particularly fees associated with the Company's Overdraft Privilege Service. See "Results of Operations – Non-Interest Income."

### Results of Operations

The following discussion and analysis is intended to provide a better understanding of Farmers & Merchants Bancorp and its subsidiaries' performance during each of the years in the three-year period ended December 31, 2011, and the material changes in financial condition, operating income, and expense of the Company and its subsidiaries as shown in the accompanying financial statements.

### Net Interest Income/Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the years ending 2011, 2010, and 2009. Average balance amounts for assets and liabilities are the computed average of daily balances.

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

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

The Company’s earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix. See “Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk.”

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

| Assets  | Year Ended December 31, 2011 |          |      |   |
|---|------------------------------|----------|------|---|
|   | Balance                      | Interest | Rate |   |
| Interest Bearing Deposits with Banks              | \$46,694                     | \$117    | 0.25 | % |
| Investment Securities Available-for-Sale          |                              |          |      |   |
| Government Agency & Government-Sponsored Entities | 201,666                      | 2,292    | 1.14 | % |
| Municipals - Non-Taxable                          | 5,981                        | 451      | 7.53 | % |
| Mortgage Backed Securities                        | 229,292                      | 7,102    | 3.10 | % |
| Other   | 329                          | 10       | 3.04 | % |
| Total Investment Securities Available-for-Sale    | 437,268                      | 9,855    | 2.25 | % |
| Investment Securities Held-to-Maturity            |                              |          |      |   |
| Municipals - Non-Taxable                          | 60,161                       | 3,470    | 5.77 | % |
| Mortgage Backed Securities                        | 1,701                        | 65       | 3.82 | % |
| Other   | 2,264                        | 21       | 0.93 | % |
| Total Investment Securities Held-to-Maturity      | 64,126                       | 3,556    | 5.55 | % |
| Loans   |                              |          |      |   |
| Real Estate                                       | 720,402                      | 45,146   | 6.27 | % |
| Home Equity                                       | 54,964                       | 3,198    | 5.82 | % |
| Agricultural                                      | 215,001                      | 12,013   | 5.59 | % |
| Commercial  | 173,837                      | 9,345    | 5.38 | % |
| Consumer  | 7,338                        | 465      | 6.34 | % |
| Other   | 243                          | 13       | 5.35 | % |
| Total Loans                                       | 1,171,785                    | 70,180   | 5.99 | % |
| Total Earning Assets                              | 1,719,873                    | \$83,707 | 4.87 | % |
| Unrealized Gain on Securities Available-for-Sale  | 5,172                        |          |      |   |
| Allowance for Loan Losses                         | (32,651 )                    |          |      |   |
| Cash and Due From Banks                           | 30,808                       |          |      |   |
| All Other Assets                                  | 140,902                      |          |      |   |
| Total Assets                                      | \$1,864,104                  |          |      |   |
| Liabilities & Shareholders' Equity                |                              |          |      |   |
| Interest Bearing Deposits                         |                              |          |      |   |
| Interest Bearing DDA                              | \$206,572                    | \$249    | 0.12 | % |
| Savings and Money Market                          | 488,540                      | 1,586    | 0.32 | % |
| Time Deposits                                     | 543,547                      | 3,627    | 0.67 | % |
| Total Interest Bearing Deposits                   | 1,238,659                    | 5,462    | 0.44 | % |
| Securities Sold Under Agreement to Repurchase     | 60,000                       | 2,148    | 3.58 | % |
| Other Borrowed Funds                              | 1,816                        | 33       | 1.82 | % |
| Subordinated Debt                                 | 10,310                       | 330      | 3.20 | % |
| Total Interest Bearing Liabilities                | 1,310,785                    | \$7,973  | 0.61 | % |
| Interest Rate Spread                              |                              |          | 4.26 | % |
| Demand Deposits                                   | 334,698                      |          |      |   |

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|   |             |      |   |
|---|-------------|------|---|
| All Other Liabilities   | 35,085      |      |   |
| Total Liabilities   | 1,680,568   |      |   |
| Shareholders' Equity  | 183,536     |      |   |
| Total Liabilities & Shareholders' Equity                      | \$1,864,104 |      |   |
| Impact of Non-Interest Bearing Deposits and Other Liabilities |             | 0.14 | % |
| Net Interest Income and Margin on Total Earning Assets        | 75,734      | 4.40 | % |
| Tax Equivalent Adjustment                                     | (1,354 )    |      |   |
| Net Interest Income   | \$74,380    | 4.32 | % |

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$2.3 million for the year ended December 31, 2011.

Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

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

|   | Year Ended December 31, 2010 |          |      |   |
|---|------------------------------|----------|------|---|
|   | Balance                      | Interest | Rate |   |
| <b>Assets</b>                                     |                              |          |      |   |
| Interest Bearing Deposits with Banks              | \$37,909                     | \$91     | 0.24 | % |
| <b>Investment Securities Available-for-Sale</b>   |                              |          |      |   |
| Government Agency & Government-Sponsored Entities | 179,442                      | 2,438    | 1.36 | % |
| Municipals - Non-Taxable                          | 6,801                        | 520      | 7.64 | % |
| Mortgage Backed Securities                        | 153,269                      | 6,345    | 4.14 | % |
| Other   | 4,120                        | 30       | 0.73 | % |
| Total Investment Securities Available-for-Sale    | 343,632                      | 9,333    | 2.72 | % |
| <b>Investment Securities Held-to-Maturity</b>     |                              |          |      |   |
| Municipals - Non-Taxable                          | 63,602                       | 3,682    | 5.79 | % |
| Mortgage Backed Securities                        | 2,893                        | 111      | 3.84 | % |
| Other   | 2,022                        | 46       | 2.27 | % |
| Total Investment Securities Held-to-Maturity      | 68,517                       | 3,839    | 5.60 | % |
| <b>Loans</b>                                      |                              |          |      |   |
| Real Estate                                       | 716,558                      | 45,438   | 6.34 | % |
| Home Equity                                       | 63,025                       | 3,711    | 5.89 | % |
| Agricultural                                      | 214,614                      | 12,827   | 5.98 | % |
| Commercial  | 175,991                      | 10,184   | 5.79 | % |
| Consumer  | 9,277                        | 469      | 5.06 | % |
| Other   | 249                          | 14       | 5.62 | % |
| Total Loans                                       | 1,179,714                    | 72,643   | 6.16 | % |
| Total Earning Assets                              | 1,629,772                    | \$85,906 | 5.27 | % |
| Unrealized Gain on Securities Available-for-Sale  | 7,572                        |          |      |   |
| Allowance for Loan Losses                         | (32,133 )                    |          |      |   |
| Cash and Due From Banks                           | 29,950                       |          |      |   |
| All Other Assets                                  | 133,582                      |          |      |   |
| Total Assets                                      | \$1,768,743                  |          |      |   |
| <b>Liabilities &amp; Shareholders' Equity</b>     |                              |          |      |   |
| <b>Interest Bearing Deposits</b>                  |                              |          |      |   |
| Interest Bearing DDA                              | \$174,741                    | \$222    | 0.13 | % |
| Savings and Money Market                          | 441,289                      | 1,954    | 0.44 | % |
| Time Deposits                                     | 575,516                      | 4,992    | 0.87 | % |
| Total Interest Bearing Deposits                   | 1,191,546                    | 7,168    | 0.60 | % |
| Securities Sold Under Agreement to Repurchase     | 60,000                       | 2,148    | 3.58 | % |
| Other Borrowed Funds                              | 1,223                        | 36       | 2.94 | % |
| Subordinated Debt                                 | 10,310                       | 333      | 3.23 | % |
| Total Interest Bearing Liabilities                | 1,263,079                    | \$9,685  | 0.77 | % |
| Interest Rate Spread                              |                              |          | 4.50 | % |
| Demand Deposits                                   | 301,250                      |          |      |   |

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|   |             |      |   |
|---|-------------|------|---|
| All Other Liabilities   | 32,082      |      |   |
| Total Liabilities   | 1,596,411   |      |   |
| Shareholders' Equity  | 172,332     |      |   |
| Total Liabilities & Shareholders' Equity                      | \$1,768,743 |      |   |
| Impact of Non-Interest Bearing Deposits and Other Liabilities |             | 0.17 | % |
| Net Interest Income and Margin on Total Earning Assets        | 76,221      | 4.68 | % |
| Tax Equivalent Adjustment                                     | (1,445 )    |      |   |
| Net Interest Income   | \$74,776    | 4.59 | % |

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$1.1 million for the year ended December 31, 2010. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

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

| Assets  | Year Ended December 31, 2009 |          |      |   |
|---|------------------------------|----------|------|---|
|   | Balance                      | Interest | Rate |   |
| Interest Bearing Deposits with Banks              | \$36,767                     | \$96     | 0.26 | % |
| Investment Securities Available-for-Sale          |                              |          |      |   |
| Government Agency & Government-Sponsored Entities | 59,760                       | 1,036    | 1.73 | % |
| Municipals - Non-Taxable                          | 9,194                        | 704      | 7.66 | % |
| Mortgage Backed Securities                        | 243,280                      | 12,100   | 4.97 | % |
| Other   | 8,312                        | 42       | 0.51 | % |
| Total Investment Securities Available-for-Sale    | 320,546                      | 13,882   | 4.33 | % |
| Investment Securities Held-to-Maturity            |                              |          |      |   |
| Municipals - Non-Taxable                          | 64,121                       | 3,717    | 5.80 | % |
| Mortgage Backed Securities                        | 4,365                        | 167      | 3.83 | % |
| Other   | 1,991                        | 51       | 2.56 | % |
| Total Investment Securities Held-to-Maturity      | 70,477                       | 3,935    | 5.58 | % |
| Loans   |                              |          |      |   |
| Real Estate                                       | 697,377                      | 45,555   | 6.53 | % |
| Home Equity                                       | 65,802                       | 3,984    | 6.05 | % |
| Agricultural                                      | 208,678                      | 12,684   | 6.08 | % |
| Commercial  | 200,560                      | 11,902   | 5.93 | % |
| Consumer  | 10,666                       | 762      | 7.14 | % |
| Other   | 1,077                        | 14       | 1.30 | % |
| Total Loans                                       | 1,184,160                    | 74,901   | 6.33 | % |
| Total Earning Assets                              | 1,611,950                    | \$92,814 | 5.76 | % |
| Unrealized Gain on Securities Available-for-Sale  | 9,467                        |          |      |   |
| Allowance for Loan Losses                         | (23,396 )                    |          |      |   |
| Cash and Due From Banks                           | 31,373                       |          |      |   |
| All Other Assets                                  | 109,461                      |          |      |   |
| Total Assets                                      | \$1,738,855                  |          |      |   |
| Liabilities & Shareholders' Equity                |                              |          |      |   |
| Interest Bearing Deposits                         |                              |          |      |   |
| Interest Bearing DDA                              | \$155,000                    | \$308    | 0.20 | % |
| Savings and Money Market                          | 392,770                      | 2,569    | 0.65 | % |
| Time Deposits                                     | 652,787                      | 10,869   | 1.67 | % |
| Total Interest Bearing Deposits                   | 1,200,557                    | 13,746   | 1.14 | % |
| Securities Sold Under Agreement to Repurchase     | 60,000                       | 2,148    | 3.58 | % |
| Other Borrowed Funds                              | 1,817                        | 40       | 2.20 | % |
| Subordinated Debt                                 | 10,310                       | 397      | 3.85 | % |
| Total Interest Bearing Liabilities                | 1,272,684                    | \$16,331 | 1.28 | % |
| Interest Rate Spread                              |                              |          | 4.47 | % |
| Demand Deposits                                   | 277,398                      |          |      |   |



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|   |             |      |   |
|---|-------------|------|---|
| All Other Liabilities   | 26,414      |      |   |
| Total Liabilities   | 1,576,496   |      |   |
| Shareholders' Equity  | 162,359     |      |   |
| Total Liabilities & Shareholders' Equity                      | \$1,738,855 |      |   |
| Impact of Non-Interest Bearing Deposits and Other Liabilities |             | 0.27 | % |
| Net Interest Income and Margin on Total Earning Assets        | 76,483      | 4.74 | % |
| Tax Equivalent Adjustment                                     | (1,500 )    |      |   |
| Net Interest Income   | \$74,983    | 4.65 | % |

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$1.5 million for the year ended December 31, 2009.

Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

Table of ContentsFarmers & Merchants Bancorp  
Volume and Rate Analysis of Net Interest Revenue

| (Interest and Rates on a Taxable Equivalent Basis)<br>(in thousands) | 2011 versus 2010<br>Amount of Increase<br>(Decrease) Due to Change in: |            |          |
|--|--|------------|----------|
|  | Volume   | Rate       | Net Chg. |
| Interest Earning Assets  |  |            |          |
| Interest Bearing Deposits with Banks                                 | \$22   | \$4        | \$26     |
| Investment Securities Available-for-Sale                             |  |            |          |
| Government Agency & Government-Sponsored Entities                    | 281  | (427 )     | (146 )   |
| Municipals - Non-Taxable   | (62 )  | (7 )       | (69 )    |
| Mortgage Backed Securities   | 2,622  | (1,865 )   | 757      |
| Other  | (47 )  | 27         | (20 )    |
| Total Investment Securities Available-for-Sale                       | 2,794  | (2,272 )   | 522      |
| Investment Securities Held-to-Maturity                               |  |            |          |
| Municipals - Non-Taxable   | (199 )   | (14 )      | (213 )   |
| Mortgage Backed Securities   | (46 )  | -          | (46 )    |
| Other  | 5  | (30 )      | (25 )    |
| Total Investment Securities Held-to-Maturity                         | (240 )   | (44 )      | (284 )   |
| Loans:   |  |            |          |
| Real Estate  | 243  | (535 )     | (292 )   |
| Home Equity  | (469 )   | (44 )      | (513 )   |
| Agricultural   | 23   | (837 )     | (814 )   |
| Commercial   | (124 )   | (715 )     | (839 )   |
| Consumer   | (109 )   | 105        | (4 )     |
| Other  | -  | (1 )       | (1 )     |
| Total Loans  | (436 )   | (2,027 )   | (2,463 ) |
| Total Earning Assets   | 2,140  | (4,339 )   | (2,199 ) |
| Interest Bearing Liabilities   |  |            |          |
| Interest Bearing Deposits:   |  |            |          |
| Interest Bearing DDA   | 38   | (11 )      | 27       |
| Savings and Money Market   | 193  | (561 )     | (368 )   |
| Time Deposits  | (265 )   | (1,100 )   | (1,365 ) |
| Total Interest Bearing Deposits                                      | (34 )  | (1,672 )   | (1,706 ) |
| Other Borrowed Funds   | 14   | (17 )      | (3 )     |
| Subordinated Debt  | -  | (3 )       | (3 )     |
| Total Interest Bearing Liabilities                                   | (20 )  | (1,692 )   | (1,712 ) |
| Total Change   | \$2,160  | \$(2,647 ) | \$(487 ) |

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

Table of ContentsFarmers & Merchants Bancorp  
Volume and Rate Analysis of Net Interest Revenue

| (Interest and Rates on a Taxable Equivalent Basis)<br>(in thousands) | 2010 versus 2009<br>Amount of Increase<br>(Decrease) Due to Change in: |          |          |
|--|--|----------|----------|
|  | Volume   | Rate     | Net Chg. |
| <b>Interest Earning Assets</b>                                       |  |          |          |
| Interest Bearing Deposits with Banks                                 | \$3  | \$(8 )   | \$(5 )   |
| Investment Securities Available-for-Sale                             |  |          |          |
| Government Agency & Government-Sponsored Entities                    | 1,670  | (268 )   | 1,402    |
| Municipals - Non-Taxable   | (183 )   | (1 )     | (184 )   |
| Mortgage Backed Securities   | (3,960 )   | (1,795 ) | (5,755 ) |
| Other  | (27 )  | 15       | (12 )    |
| Total Investment Securities Available-for-Sale                       | (2,500 )   | (2,049 ) | (4,549 ) |
| <b>Investment Securities Held-to-Maturity</b>                        |  |          |          |
| Municipals - Non-Taxable   | (30 )  | (5 )     | (35 )    |
| Mortgage Backed Securities   | (56 )  | -        | (56 )    |
| Other  | 1  | (6 )     | (5 )     |
| Total Investment Securities Held-to-Maturity                         | (85 )  | (11 )    | (96 )    |
| <b>Loans:</b>  |  |          |          |
| Real Estate  | 1,235  | (1,352 ) | (117 )   |
| Home Equity  | (166 )   | (107 )   | (273 )   |
| Agricultural   | 357  | (214 )   | 143      |
| Commercial   | (1,428 )   | (290 )   | (1,718 ) |
| Consumer   | (90 )  | (203 )   | (293 )   |
| Other  | (18 )  | 18       | -        |
| Total Loans  | (110 )   | (2,148 ) | (2,258 ) |
| Total Earning Assets   | (2,692 )   | (4,216 ) | (6,908 ) |
| <b>Interest Bearing Liabilities</b>                                  |  |          |          |
| Interest Bearing Deposits:   |  |          |          |
| Interest Bearing DDA   | 35   | (121 )   | (86 )    |
| Savings and Money Market   | 289  | (904 )   | (615 )   |
| Time Deposits  | (1,164 )   | (4,713 ) | (5,877 ) |
| Total Interest Bearing Deposits                                      | (840 )   | (5,738 ) | (6,578 ) |
| Other Borrowed Funds   | (15 )  | 11       | (4 )     |
| Subordinated Debt  | -  | (64 )    | (64 )    |
| Total Interest Bearing Liabilities                                   | (855 )   | (5,791 ) | (6,646 ) |
| Total Change   | \$(1,837 )   | \$1,575  | \$(262 ) |

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

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2011 Compared to 2010

Net interest income decreased 0.53% to \$74.4 million during 2011. On a fully tax equivalent basis, net interest income decreased 0.64% and totaled \$75.7 million during 2011 compared to \$76.2 million for 2010. As more fully discussed below, the decrease in net interest income was primarily due to a decrease in the net interest margin, offset somewhat by growth in average earning assets.

Net interest income on a tax equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For 2011, the Company's net interest margin was 4.40% compared to 4.68% in 2010. This decrease in net interest margin was due primarily to a decrease in loans as a percentage of total earning assets combined with lower yields on all earning assets.

Loans, generally the Company's highest earning assets, decreased \$12.9 million as of December 31, 2011, compared to December 31, 2010. See "Financial Condition – Loans" for further discussion of this decrease. On an average balance basis, loans decreased by \$7.9 million for the year ended December 31, 2011. Loans decreased from 72.4% of average earning assets during 2010 to 68.1% in 2011. As a result of the impact of decreases in market interest rates from mid-September 2007 through December 2008, and the continuing low rate environment since then, the year-to-date yield on the loan portfolio declined to 5.99% for the year ended December 31, 2011, compared to 6.16% for the year ended December 31, 2010. The decrease in loan balances combined with the lower yield resulted in interest revenue from loans decreasing 3.4% to \$70.2 million for 2011. The Company has been experiencing aggressive competitor pricing for loans to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. The Company invests primarily in: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans. Importantly, the Company never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC," securities that caused many banks to incur losses in recent years.

Average investment securities increased \$89.2 million in 2011 compared to the average balance during 2010. As of year-end 2011 investment securities were \$49.3 million greater than at year-end 2010. As a result, tax equivalent interest income on securities increased \$238,000 to \$13.4 million for the year ended December 31, 2011, compared to \$13.2 million for the year ended December 31, 2010. The average yield, on a tax equivalent basis, in the investment portfolio was 2.7% in 2011 compared to 3.2% in 2010. This decrease in yield was primarily due to: (1) the sale of higher yielding mortgage-backed securities in early 2010; and (2) a decline in market interest rates. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2011. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statements of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. The FRB currently pays interest on the deposits that banks maintain in their FRB account, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during 2011 and 2010. These balances earn interest at the Fed Funds rate, which has been 0.25% since December, 2008. Average interest bearing deposits with banks for the year ended December 31, 2011 was \$46.7 million, an increase of \$8.8 million from the average balance for the year ended December 31, 2010.

Average interest-bearing liabilities increased \$47.7 million or 3.8% during the twelve months ended December 31, 2011. Of that increase: (1) interest-bearing deposits increased \$47.1 million; (2) FHLB Advances increased \$593,000; and (3) securities sold under agreement to repurchase and subordinated debt remained unchanged.

The \$47.1 million increase in average interest-bearing deposits was primarily in lower cost interest bearing DDA, and savings and money market deposits, which increased \$79.1 million since 2010, as higher cost time deposits decreased by \$32.0 million. See “Financial Condition – Deposits” for a discussion of trends in the Company’s deposit base. Total interest expense on deposits was \$5.5 million for 2011 as compared to \$7.2 million for 2010. As a result of the impact of decreases in market interest rates from mid September 2007 through December 2008, and the continuing low rate environment since then. The average rate paid on interest-bearing deposits was 0.44% in 2011 and 0.60% in 2010. Since most of the Company’s interest bearing deposits are priced off of short-term market rates, the Company is benefiting from the impact of these lower market rates. The Company anticipates that this decline in deposit rates, if any, will be much more modest in 2012. See “Overview – Looking Forward: 2012 and Beyond” for a discussion of factors impacting the Company’s future deposit rates and their impact on net interest margin.

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Section 627 of the Dodd-Frank Act repealed Regulation Q effective July 21, 2011, thereby eliminating the prohibition on the payment of interest on demand deposits. The impact of this change on the Company's future cost of deposits, particularly business checking accounts, cannot yet be determined.

2010 Compared to 2009

Net interest income decreased 0.3% to \$74.8 million during 2010. On a fully tax equivalent basis, net interest income decreased 0.3% and totaled \$76.2 million during 2010 compared to \$76.5 million for 2009. As more fully discussed below, the decrease in net interest income was primarily due to a decrease in the net interest margin.

Net interest income on a tax equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For 2010, the Company's net interest margin was 4.68% compared to 4.74% in 2009. This decrease in net interest margin was due primarily to: (1) a decline in loans as a percentage of total earning assets; (2) a drop in mortgage backed securities as a percentage of total investment securities; and (3) a decline in the average yield on government agency & government-sponsored entity securities as maturing amounts were reinvested at rates below those rates available 12-24 months ago.

Loans, generally the Company's highest earning assets, decreased \$36.7 million as of December 31, 2010, compared to December 31, 2009. On an average balance basis, loans decreased by \$4.4 million for the year ended December 31, 2010. Loans decreased from 73.5% of average earning assets during 2009 to 72.4% in 2010. As a result of the lagging impact of decreases in market interest rates from mid-September 2007 through December 2008 the year-to-date yield on the loan portfolio declined to 6.16% for the year ended December 31, 2010, compared to 6.33% for the year ended December 31, 2009. The decrease in loan balances combined with the lower yield resulted in interest revenue from loans decreasing 3.0% to \$72.6 million for 2010.

The investment portfolio is the other main component of the Company's earning assets. The Company invests primarily in: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans. Importantly, the Company never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC," securities that caused many banks to incur losses in recent years.

Average investment securities increased \$21.1 million in 2010 compared to the average balance during 2009. As of year-end 2010 investment securities were \$58.4 million greater than at year-end 2009. In order to reduce the Company's exposure to rising market interest rates, during 2010 the mix of investment securities was shifted away from longer-term higher yielding mortgage backed securities to shorter-term lower yielding government agency and government-sponsored entity securities. As a result, tax equivalent interest income on securities decreased \$4.6 million to \$13.2 million for the year ended December 31, 2010, compared to \$17.8 million for the year ended December 31, 2009. The average yield, on a tax equivalent basis, in the investment portfolio was 3.2% in 2010 compared to 4.5% in 2009. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statements of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. The FRB currently pays interest on the deposits that banks maintain in their FRB account, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during 2010 and 2009. These balances earn interest at the Fed Funds rate, which has been 0.25% since December, 2008. Average interest

bearing deposits with banks for the year ended December 31, 2010 was \$37.9 million, an increase of \$1.1 million from the average balance for the year ended December 31, 2009.

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Average interest-bearing liabilities decreased \$9.6 million or 0.7% during the twelve months ended December 31, 2010. Of that decrease: (1) interest-bearing deposits decreased \$9.0 million; (2) FHLB Advances decreased \$594,000; and (3) securities sold under agreement to repurchase and subordinated debt remained unchanged.

The \$9.0 million decrease in average interest-bearing deposits was primarily in time deposits, which declined \$77.3 million since 2009, as lower cost interest bearing DDA and Savings increased by \$68.3 million. Total interest expense on deposits was \$7.2 million for 2010 as compared to \$13.7 million for 2009. The average rate paid on interest-bearing deposits was 0.60% in 2010 and 1.14% in 2009. In September 2007 the FRB began lowering short-term market interest rates and has continued to keep these rates very low. Since most of the Company's interest bearing deposits are priced off of short-term market rates, the Company is benefiting from the impact of these lower market rates.

### Provision and Allowance for Loan Losses

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

### Allowance for Loan Losses

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

Residential 1st Mortgages and Home Equity Lines and Loans – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments, although this is not always true as evidenced by the period 2007 through 2011. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

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

In addition, the Company's and Bank's regulators, including the FRB, DFI and FDIC, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

### Provision for Loan Losses

Changes in the provision for loan losses between years are the result of management's evaluation, based upon information currently available, of the adequacy of the allowance for loan losses relative to factors such as the credit quality of the loan portfolio, loan growth, current loan losses, and the prevailing economic climate and its effect on borrowers' ability to repay loans in accordance with the terms of the notes.

The Central Valley of California continues to be one of the hardest hit areas in the country during this recession. Housing prices in many areas are down as much as 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels remain above 15% in many areas. Accordingly, during 2009, management and the Board of Directors began significantly increasing the Company's loan loss allowance and as of December 31, 2011, the balance was \$33.0 million or 2.83% of total loans.

This represents a \$756,000 or 2.3% increase over December 31, 2010. Although, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of December 31, 2011, compare very favorably to our peers at the present time, no significant recovery has yet begun in our local markets and this has resulted in continuing borrower stress.

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The provision for loan losses totaled \$6.8 million in 2011 compared to \$14.7 million in 2010 and \$15.4 million in 2009. Net charge-offs during 2011 were \$6.0 million compared to \$12.3 million in 2010 and \$5.6 million in 2009. Net charge-offs represented 0.51% of average loans during 2011, a level that in management's opinion compares very favorably to the Company's peers at the present time. See "Overview – Looking Forward: 2012 and Beyond." "Critical Accounting Policies and Estimates – Allowance for Loan Losses" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk." The following tables summarize the activity and the allocation of the allowance for losses for the years indicated. (in thousands)

|   | 2011     | 2010      | 2009     | 2008     | 2007     |
|---|----------|-----------|----------|----------|----------|
| Allowance for Loan Losses Beginning of Year | \$32,261 | \$29,813  | \$20,034 | \$18,483 | \$18,099 |
| Provision Charged to Expense                | 6,775    | 14,735    | 15,420   | 7,998    | 1,495    |
| Charge Offs:                                |          |           |          |          |          |
| Commercial Real Estate                      | 25       | 1,629     | -        | -        | -        |
| Agricultural Real Estate                    | 384      | 559       | -        | -        | -        |
| Real Estate Construction                    | -        | 4,095     | 641      | 4,648    | -        |
| Residential 1st Mortgages                   | 449      | 759       | 749      | 192      | -        |
| Home Equity Lines and Loans                 | 751      | 310       | 391      | -        | -        |
| Agricultural                                | 3,559    | 916       | 123      | 209      | 254      |
| Commercial                                  | 788      | 4,143     | 3,868    | 1,405    | 722      |
| Consumer & Other                            | 190      | 112       | 159      | 323      | 397      |
| Total Charge Offs                           | 6,146    | 12,523    | 5,931    | 6,777    | 1,373    |
| Recoveries:                                 |          |           |          |          |          |
| Commercial Real Estate                      | -        | -         | -        | -        | -        |
| Agricultural Real Estate                    | 18       | 2         | -        | -        | -        |
| Real Estate Construction                    | -        | -         | -        | -        | -        |
| Residential 1st Mortgages                   | 4        | 7         | 3        | -        | -        |
| Home Equity Lines and Loans                 | 13       | -         | 1        | -        | -        |
| Agricultural                                | 10       | 68        | 50       | 60       | 79       |
| Commercial                                  | 21       | 92        | 104      | 143      | 30       |
| Consumer & Other                            | 61       | 67        | 132      | 127      | 153      |
| Total Recoveries                            | 127      | 236       | 290      | 330      | 262      |
| Net Charge-Offs                             | (6,019 ) | (12,287 ) | (5,641 ) | (6,447 ) | (1,111 ) |
| Total Allowance for Loan Losses             | \$33,017 | \$32,261  | \$29,813 | \$20,034 | \$18,483 |
| Ratios:                                     |          |           |          |          |          |
| Allowance for Loan Losses to:               |          |           |          |          |          |
| Total Loans at Year End                     | 2.83     | % 2.74    | % 2.45   | % 1.70   | % 1.62   |
| Average Loans                               | 2.82     | % 2.73    | % 2.52   | % 1.77   | % 1.70   |
| Consolidated Net Charge-Offs to:            |          |           |          |          |          |
| Loans at Year End                           | 0.52     | % 1.04    | % 0.46   | % 0.55   | % 0.10   |
| Average Loans                               | 0.51     | % 1.04    | % 0.48   | % 0.57   | % 0.10   |

| December 31, 2011 | Commercial Real Estate | Agricultural Real Estate | Real Estate Construction | Residential 1st Mortgages | Home Equity | Agricultural | Commercial | Consumer & Other | Unallocated | Total |
|-------------------|------------------------|--------------------------|--------------------------|---------------------------|-------------|--------------|------------|------------------|-------------|-------|
|-------------------|------------------------|--------------------------|--------------------------|---------------------------|-------------|--------------|------------|------------------|-------------|-------|

Year-To-Date  
Allowance  
for Credit

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Losses:

|  |           |           |          |           |          |           |           |         |       |             |
|--|-----------|-----------|----------|-----------|----------|-----------|-----------|---------|-------|-------------|
| Beginning<br>Balance-<br>January 1,<br>2011                      | \$7,631   | \$1,539   | \$2,160  | \$1,164   | \$3,724  | \$6,733   | \$9,084   | \$216   | \$10  | \$32,261    |
| Charge-Offs  | (25 )     | (384 )    | -        | (449 )    | (751 )   | (3,559 )  | (788 )    | (190 )  | -     | (6,146 )    |
| Recoveries   | -         | 18        | -        | 4         | 13       | 10        | 21        | 61      | -     | 127         |
| Provision  | (1,783 )  | 1,410     | (227 )   | 532       | 760      | 4,943     | 416       | 120     | 604   | 6,775       |
| Ending<br>Balance-<br>December<br>31, 2011                       | \$5,823   | \$2,583   | \$1,933  | \$1,251   | \$3,746  | \$8,127   | \$8,733   | \$207   | \$614 | \$33,017    |
| Ending<br>Balance<br>Individually<br>Evaluated for<br>Impairment | 686       | -         | -        | -         | 80       | 793       | 54        | 23      | -     | 1,636       |
| Ending<br>Balance<br>Collectively<br>Evaluated for<br>Impairment | 5,137     | 2,583     | 1,933    | 1,251     | 3,666    | 7,334     | 8,679     | 184     | 614   | 31,381      |
| Loans:<br>Ending<br>Balance                                      | \$305,704 | \$280,139 | \$29,607 | \$107,421 | \$50,956 | \$217,227 | \$165,089 | \$6,935 | \$-   | \$1,163,078 |

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The negative provision of \$1.78 million in Commercial Real Estate Loans is primarily due to the year-over-year decline of \$17.5 million in impaired loans in this category. See “Item 8. Financial Statements and Supplementary Data - Note 5 – Allowance for Loan Losses.”

| (in thousands)              | 2011 Amount | Allowance Allocation at December 31,             |             |  |             |  |             |  |  |
|-----------------------------|-------------|--|-------------|--|-------------|--|-------------|--|--|
|                             |             | Percent of Loans in Each Category to Total Loans | 2010 Amount | Percent of Loans in Each Category to Total Loans | 2009 Amount | Percent of Loans in Each Category to Total Loans | 2008 Amount | Percent of Loans in Each Category to Total Loans |  |
| Commercial Real Estate      | \$5,823     | 26.4   | % \$7,631   | 27.0   | % \$12,845  | 23.9   | % \$3,547   | 23.0   |  |
| Agricultural Real Estate*   | 2,583       | 24.0   | % 1,539     | 21.6   | % 1,099     | 21.4   | % 1,683     | 19.3   |  |
| Real Estate Construction    | 1,933       | 2.5  | % 2,160     | 3.2  | % 4,089     | 5.9  | % 1,514     | 6.4  |  |
| Residential 1st Mortgages   | 1,251       | 9.2  | % 1,164     | 8.8  | % 552       | 8.7  | % 992       | 9.0  |  |
| Home Equity Lines and Loans | 3,746       | 4.4  | % 3,724     | 5.0  | % 1,349     | 5.4  | % 1,781     | 5.6  |  |
| Agricultural Commercial     | 8,127       | 18.6   | % 6,733     | 19.6   | % 2,298     | 17.9   | % 4,432     | 18.4   |  |
| Commercial                  | 8,733       | 14.2   | % 9,084     | 14.0   | % 6,449     | 15.8   | % 4,933     | 17.2   |  |
| Consumer & Other            | 207         | 0.6  | % 216       | 0.7  | % 325       | 0.9  | % 926       | 1.2  |  |
| Unallocated                 | 614         |  | 10          |  | 807         |  | 226         |  |  |
| Total                       | \$33,017    | 100.0  | % \$32,261  | 100.0  | % \$29,813  | 100.0  | % \$20,034  | 100.0  |  |

\* Prior to 2008 the allowance related to Agricultural Real Estate was included with Commercial Real Estate

As of December 31, 2011, the allowance for loan losses was \$33.0 million, which represented 2.83% of the total loan balance. At December 31, 2010, the allowance for loan losses was \$32.3 million or 2.74% of the total loan balance. After reviewing all factors above, based upon information currently available, management concluded that the allowance for loan losses as of December 31, 2011, was adequate.

**Non-Interest Income**

Non-interest income includes: (1) service charges and fees from deposit accounts; (2) net gains and losses from investment securities; (3) increases in the cash surrender value of bank owned life insurance; (4) debit card and ATM fees; (5) net gains and losses on non-qualified deferred compensation plan investments; and (6) fees from other miscellaneous business services. See “Overview – Looking Forward: 2012 and Beyond.”

**2011 Compared to 2010**

Non-interest income totaled \$12.3 million, a decrease of \$4.9 million or 28.6% from non-interest income of \$17.2 million for 2010.

Service charges on deposit accounts totaled \$5.4 million, a decrease of \$1.1 million or 17.4% from service charges on deposit accounts of \$6.5 million in 2010. This was due primarily to a decrease in fees related to the Company’s Overdraft Privilege Service.



Net gain on investment securities was \$95,000 in 2011 compared to a net gain of \$2.9 million for 2010. See “Financial Condition-Investment Securities” for a discussion of the Company’s investment strategy.

Debit Card and ATM fees totaled \$2.8 million, an increase of \$169,000 or 6.5% over fees in 2010. These are: (1) fees earned by the Company when non-customers use our ATM’s; and (2) fees paid to the Company by VISA merchants when the Company’s VISA Money Card holders use their card to complete a purchase.

Gains on deferred compensation investments were \$199,000 in 2011 compared to gains of \$1.4 million in 2010. See Note 16. located in “Item 8. Financial Statements and Supplementary Data” for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company’s net income.

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2010 Compared to 2009

Non-interest income totaled \$17.2 million, a decrease of \$1.0 million or 5.6% from non-interest income of \$18.2 million for 2009.

Service charges on deposit accounts totaled \$6.5 million, a decrease of \$427,000 or 6.1% from service charges on deposit accounts of \$6.9 million in 2009. This was due primarily to a decrease in fees related to the Company's Overdraft Privilege Service.

Net gain on investment securities was \$2.9 million in 2010 compared to a net gain of \$3.5 million for 2009. During 2009 and 2010 the Company sold mortgage-backed securities at a gain and, in anticipation of rising rates, invested the funds primarily in shorter-term government agency & government-sponsored entity securities.

Debit Card and ATM fees totaled \$2.6 million, an increase of \$346,000 or 15.4% over fees in 2009. These are: (1) fees earned by the Company when non-customers use our ATM's; and (2) fees paid to the Company by VISA merchants when the Company's VISA Money Card holders use their card to complete a purchase.

Gains on deferred compensation investments were \$1.4 million in 2010 compared to gains of \$1.8 million in 2009. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company's net income.

Other non-interest income totaled \$2.0 million in 2010, an increase of \$141,000 or 7.7% from 2009. This increase was primarily due to the gain on sale of three properties classified as other real estate.

Non-Interest Expense

Non-interest expense for the Company includes expenses for: (1) salaries and employee benefits; (2) net gains and losses on non-qualified deferred compensation plan investments; (3) occupancy; (4) equipment; (5) supplies; (6) legal fees; (7) professional services; (8) data processing; (9) marketing; (10) deposit insurance; and (11) other miscellaneous expenses.

2011 Compared to 2010

Overall, non-interest expense totaled \$45.0 million, an increase of \$1.1 million or 2.5% for the year ended December 31, 2011.

Salaries and employee benefits increased \$1.3 million or 4.7% primarily related to salary increases for officers that took place in April, 2011.

Gains on deferred compensation investments were \$199,000 in 2011 compared to gains of \$1.4 million in 2010. See Note 16. located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest expense, an offsetting entry is also required to be made to non-interest income resulting in no effect on the Company's net income.

Occupancy expense in 2011 totaled \$2.6 million, an increase of \$157,000 or 6.5% from 2010. This increase was due to adjustments to the property tax accruals.

Equipment expense in 2011 totaled \$2.8 million, an increase of \$239,000 or 9.2% from 2010. This increase is due to increases in software maintenance contracts.

ORE holding costs in 2011 totaled \$1.8 million, an increase of \$538,000 or 43.1% as compared to \$1.2 million in 2010. This increase is primarily due to an increase in the required reserve for ORE valuation adjustments.

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The Company's total FDIC insurance costs decreased \$825,000 in 2011 to \$1.5 million, a 36.1% decrease from \$2.3 million in 2010. The FDIC changed to a new methodology for determining assessment rates in second quarter 2011. See "Supervision and Regulation – Deposit Insurance" for further discussion of the Company's deposit insurance.

Other non-interest expense increased \$819,000, or 14.4%, to \$6.5 million in 2011 compared to \$5.7 million in 2010. This increase was primarily due to: (1) increase legal fees in the amount of \$476,000; (2) losses on sale of ORE properties that amount to \$471,000. These increases were partially offset by decreased ORE property tax expense due to the sale of some ORE properties.

### 2010 Compared to 2009

Overall, non-interest expense totaled \$43.9 million, a decrease of \$2.5 million or 5.4% for the year ended December 31, 2010.

Salaries and employee benefits decreased \$439,000 or 1.5% primarily related to reduced staffing costs and decreased security guard expense, partially offset by increased health insurance costs.

Gains on deferred compensation investments were \$1.4 million in 2010 compared to gains of \$1.8 million in 2009. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest expense, an offsetting entry is also required to be made to non-interest income resulting in no effect on the Company's net income.

Occupancy expense in 2010 totaled \$2.4 million, a decrease of \$293,000 or 10.8% from 2009. This decrease was due to reduced property taxes.

Equipment expense in 2010 totaled \$2.6 million, an increase of \$188,000 or 7.8% from 2009. This increase is due to increases in hardware and software maintenance contracts.

ORE holding costs totaled \$1.2 million in 2010 as compared to \$1.5 million in 2009. Due to the economic climate over the past two years the Company has acquired \$8.0 million of other real estate, which includes a mix of raw land, residential finished lots and commercial buildings. Included in the \$1.2 million for 2010 is \$716,000 related to the establishment of a reserve for ORE valuation adjustments, as compared to \$1.0 million in 2009.

The Company's total FDIC insurance costs decreased \$210,000 in 2010 to \$2.3 million, an 8.4% decrease from \$2.5 million in 2009. The FDIC did not levy any special assessments in 2010.

Other non-interest expense declined \$1.0 million, or 15.6%, to \$5.7 million in 2010 compared to \$6.7 million in 2009. This decrease was due to: (1) reduced advertising and promotional costs; (2) reduced legal fees related to problem credits; (3) reduced cost of credit review services; and (4) reduced correspondent bank fees.

### Income Taxes

The provision for income taxes increased \$473,000 during 2011. The effective tax rate in 2011 was 36.3% compared to 36.6% in 2010 and 36.1% in 2009. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance, California enterprise zone interest income exclusion, and tax-exempt interest income on municipal securities and loans.

Current tax law causes the Company's current taxes payable to approximate or exceed the current provision for taxes on the income statement. Three provisions have had a significant effect on the Company's current income tax liability: (1) the restrictions on the deductibility of loan losses; (2) deductibility of pension and other long-term employee

benefits only when paid; and (3) the statutory deferral of deductibility of California franchise taxes on the Company's federal return.

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### Financial Condition

#### Investment Securities

The investment portfolio provides the Company with an income alternative to loans. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. Importantly, the Company never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC," classes of securities that resulted in losses for many banks in recent years.

The Company's investment portfolio at the end of 2011 was \$542.9 million, an increase of \$49.3 million or 10.0% from 2010 and \$107.7 million or 24.7% from 2009. The investment portfolio has increased over the past three years as deposit growth has exceeded loan growth. Additionally, the mix of the investment portfolio has changed over the past three years. To protect against future increases in market interest rates, the Company has reduced the weighted average maturity on its investment portfolio by selling primarily longer term (30 year) mortgage-backed securities and reinvesting in lower yielding, shorter term government agency & government-sponsored entity securities and shorter term (10, 15, and 20 year) mortgage-backed securities.

As of December 31, 2011, the Company held \$65.4 million of municipal investments, of which \$50.7 million were bank-qualified municipal bonds, all classified as held-to-maturity. No purchases of bank-qualified municipal bonds have been made for several years, but the continuing financial problems being experienced by certain municipalities, along with the financial stresses exhibited by some of the large monoline bond insurers, has increased the overall risk associated with bank-qualified municipal bonds. As of December 31, 2011 ninety-two percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of the eight percent (\$3.8 million) of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. In 2011 average interest bearing deposits with banks were \$46.7 million compared to \$37.9 million in 2010. These balances earn interest at the Fed Funds rate, which has been 0.25% since December, 2008.

The Company classifies its investments as held-to-maturity, trading, or available-for-sale. Securities are classified as held-to-maturity and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of December 31, 2011 and 2010, there were no securities in the trading portfolio. Securities classified as available-for-sale include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes.

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## Investment Portfolio

The following table summarizes the balances and distributions of the investment securities held on the dates indicated.

| December 31: (in thousands)                          | Available<br>for Sale<br>2011 | Held to<br>Maturity<br>2011 | Available<br>for Sale<br>2010 | Held to<br>Maturity<br>2010 | Available<br>for Sale<br>2009 | Held to<br>Maturity<br>2009 |
|--|-------------------------------|-----------------------------|-------------------------------|-----------------------------|-------------------------------|-----------------------------|
| Government Agency &<br>Government Sponsored Entities | \$ 82,595                     | \$ -                        | \$ 236,319                    | \$ -                        | \$ 136,168                    | \$ -                        |
| Municipal  | 5,782                         | 59,640                      | 6,378                         | 60,439                      | 8,365                         | 64,044                      |
| Mortgage-backed Securities                           | 391,033                       | 1,205                       | 185,637                       | 2,218                       | 215,327                       | 3,583                       |
| Other  | 410                           | 2,247                       | 310                           | 2,280                       | 5,689                         | 1,990                       |
| Total Book Value                                     | \$ 479,820                    | \$ 63,092                   | \$ 428,644                    | \$ 64,937                   | \$ 365,549                    | \$ 69,617                   |
| Fair Value   | \$ 479,820                    | \$ 65,890                   | \$ 428,644                    | \$ 66,039                   | \$ 365,549                    | \$ 71,010                   |

## Analysis of Investment Securities Available-for-Sale

The following table is a summary of the relative maturities and yields of the Company's investment securities Available-for-Sale as of December 31, 2011. Non-taxable municipal securities have been calculated on a fully taxable equivalent basis.

| December 31, 2011 (in thousands)                        | Fair<br>Value | Average<br>Yield |   |
|---|---------------|------------------|---|
| Government Agency & Government Sponsored Entities       |               |                  |   |
| One year or less  | \$20,252      | 1.08             | % |
| After one year through five years                       | 61,165        | 1.02             | % |
| After five years through ten years                      | 1,178         | 2.75             | % |
| Total Government Agency & Government Sponsored Entities | 82,595        | 1.06             | % |
| Municipal - Non-Taxable                                 |               |                  |   |
| After five years through ten years                      | 225           | 1.92             | % |
| After ten years   | 5,557         | 7.83             | % |
| Total Non-Taxable Municipal Securities                  | 5,782         | 7.60             | % |
| Mortgage-backed Securities                              |               |                  |   |
| After five years through ten years                      | 130,102       | 2.54             | % |
| After ten years   | 260,931       | 2.82             | % |
| Total Mortgage-backed Securities                        | 391,033       | 2.73             | % |
| Other   |               |                  |   |
| One year or less  | 410           | 3.03             | % |
| Total Other Securities                                  | 410           | 3.03             | % |
| Total Investment Securities Available-for-Sale          | \$479,820     | 2.50             | % |

Note: The average yield for floating rate securities is calculated using the current stated yield.

## Analysis of Investment Securities Held-to-Maturity

The following table is a summary of the relative maturities and yields of the Company's investment securities Held-to-Maturity as of December 31, 2011. Non-taxable municipal securities have been calculated on a fully taxable equivalent basis.

| December 31, 2011 (in thousands) | Book<br>Value | Average<br>Yield |   |
|----------------------------------|---------------|------------------|---|
| Municipal - Non-Taxable          |               |                  |   |
| One year or less                 | \$1,820       | 2.15             | % |

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|   |                 |             |          |
|---|-----------------|-------------|----------|
| After one year through five years                   | 7,399           | 5.53        | %        |
| After five years through ten years                  | 42,667          | 6.19        | %        |
| After ten years                                     | 7,754           | 4.25        | %        |
| <b>Total Non-Taxable Municipal Securities</b>       | <b>59,640</b>   | <b>5.73</b> | <b>%</b> |
| <b>Mortgage-backed Securities</b>                   |                 |             |          |
| After one year through five years                   | 1,205           | 3.82        | %        |
| <b>Total Mortgage-Backed Securities</b>             | <b>1,205</b>    | <b>3.82</b> | <b>%</b> |
| <b>Other</b>  |                 |             |          |
| After one year through five years                   | 6               | 3.82        | %        |
| After five years through ten years                  | 2,241           | 0.93        | %        |
| <b>Total Other Securities</b>                       | <b>2,247</b>    | <b>0.94</b> | <b>%</b> |
| <b>Total Investment Securities Held-to-Maturity</b> | <b>\$63,092</b> | <b>5.53</b> | <b>%</b> |



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### Loans

Loans can be categorized by borrowing purpose and use of funds. Common examples of loans made by the Company include:

**Commercial and Agricultural Real Estate** - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties within our market area. Commercial mortgage term loans can be made if the property is either income producing or scheduled to become income producing based upon acceptable pre-leasing, and the income will be the Bank's primary source of repayment for the loan. Loans are made both on owner occupied and investor properties; generally do not exceed 15 years (and may have pricing adjustments on a shorter timeframe); have debt service coverage ratios of 1.00 or better with a target of greater than 1.20; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

**Real Estate Construction** - These are loans for development and construction (the Company generally requires the borrower to fund the land acquisition) and are secured by commercial or residential real estate. These loans are generally made only to experienced local developers with whom the Bank has a successful track record; for projects in our service area; with LTV's below 75%; and where the property can be developed and sold within 2 years. Commercial construction loans are made only when there is a written take-out commitment from the Bank or an acceptable financial institution or government agency. Most acquisition, development and construction loans are tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan.

**Residential 1st Mortgages** - These are loans primarily made on owner occupied residences; generally underwritten to income and LTV guidelines similar to those used by FNMA and FHLMC; however, we will make loans on rural residential properties up to 20 acres. Most residential loans have terms from ten to twenty years and carry fixed rates priced off of treasury rates. The Company has always underwritten mortgage loans based upon traditional underwriting criteria and does not make loans that are known in the industry as "subprime," "no or low doc," or "stated income."

**Home Equity Lines and Loans** - These are loans made to individuals for home improvements and other personal needs. Generally, amounts do not exceed \$250,000; CLTV's do not exceed 80%; FICO scores are at or above 670; Total Debt Ratios do not exceed 45%; and in some situations the Company is in a 1st lien position.

**Agricultural** - These are loans and lines of credit made to farmers to finance agricultural production. Lines of credit are extended to finance the seasonal needs of farmers during peak growing periods; are usually established for periods no longer than 12 to 24 months; are often secured by general filing liens on livestock, crops, crop proceeds and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a processing plant, or orchard/vineyard development; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

**Commercial** - These are loans and lines of credit to businesses that are sole proprietorships, partnerships, LLC's and corporations. Lines of credit are extended to finance the seasonal working capital needs of customers during peak business periods; are usually established for periods no longer than 12 to 24 months; are often secured by general filing liens on accounts receivable, inventory and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a plant or purchase of a business; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Consumer - These are loans to individuals for personal use, and primarily include loans to purchase automobiles or recreational vehicles, and unsecured lines of credit. The Company has a very minimal consumer loan portfolio, and loans are primarily made as an accommodation to deposit customers.

See “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk” for a discussion about the credit risks the Company assumes and its overall credit risk management practices.

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Each loan type involves risks specific to the: (i) borrower; (ii) collateral; and (iii) loan structure. See “Results of Operations - Provision and Allowance for Credit Losses” for a more detailed discussion of risks by loan type. The Company’s current underwriting policies and standards are designed to mitigate the risks involved in each loan type. The Company’s policies require that loans are approved only to those borrowers exhibiting a clear source of repayment and the ability to service existing and proposed debt. The Company’s underwriting procedures for all loan types require careful consideration of the borrower, the borrower’s financial condition, the borrower’s management capability, the borrower’s industry, and the economic environment affecting the loan.

Most loans made by the Company are secured, but collateral is the secondary or tertiary source of repayment; cash flow is our primary source of repayment. The quality and liquidity of collateral are important and must be confirmed before the loan is made.

In order to be responsive to borrower needs, the Company prices loans: (i) on both a fixed rate and adjustable rate basis; (ii) over different terms; and (iii) based upon different rate indices; as long as these structures are consistent with the Company’s interest rate risk management policies and procedures. See “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk.”

Overall, the Company's loan portfolio at December 31, 2011, decreased \$12.9 million or 1.1% from December 31, 2010, a reflection of the economic conditions in our marketplace. The Company did experience some growth in the agricultural real estate loans market segment where the Company believes that current market rates and/or credit risks are more reasonable than in other loan segments

Beginning in late 2006 and continuing through 2011, the Company purposely reduced its exposure to real estate construction loans as the residential housing market softened. Additionally, the Company’s residential 1st mortgage portfolio is comprised primarily of 15 and 20-year mortgages to local customers. The Company does not originate sub-prime residential mortgage loans, nor does it hold any in its loan portfolio.

On an average balance basis, loans have decreased \$7.9 million or 0.7%. In 2010 average balances decreased 0.4% or \$4.4 million from the prior year. The following table sets forth the distribution of the loan portfolio by type and percent as of December 31st of the years indicated. (in thousands)

|              | 2011      |         | 2010      |         | 2009      |         | 2008      |         | 2007      |         |
|--------------|-----------|---------|-----------|---------|-----------|---------|-----------|---------|-----------|---------|
|              | Amount    | Percent | Amount    | Percent | Amount    | Percent | Amount    | Percent | Amount    | Percent |
| Commercial   |           |         |           |         |           |         |           |         |           |         |
| Real Estate  | \$307,670 | 26.4 %  | \$318,341 | 27.0 %  | \$290,473 | 23.9 %  | \$271,856 | 23.0 %  | \$245,926 | 21.5 %  |
| Agricultural |           |         |           |         |           |         |           |         |           |         |
| Real Estate  | 280,139   | 24.0 %  | 254,575   | 21.6 %  | 260,000   | 21.4 %  | 227,166   | 19.3 %  | 207,889   | 18.2 %  |
| Real Estate  |           |         |           |         |           |         |           |         |           |         |
| Construction | 29,607    | 2.5 %   | 37,486    | 3.2 %   | 71,647    | 5.9 %   | 75,472    | 6.4 %   | 80,651    | 7.1 %   |
| Residential  |           |         |           |         |           |         |           |         |           |         |
| 1st          |           |         |           |         |           |         |           |         |           |         |
| Mortgages    | 107,421   | 9.2 %   | 103,574   | 8.8 %   | 105,850   | 8.7 %   | 105,980   | 9.0 %   | 109,764   | 9.6 %   |
| Home Equity  |           |         |           |         |           |         |           |         |           |         |
| Lines and    |           |         |           |         |           |         |           |         |           |         |
| Loans        | 50,956    | 4.4 %   | 58,971    | 5.0 %   | 65,541    | 5.4 %   | 66,159    | 5.6 %   | 65,953    | 5.8 %   |
| Agricultural | 217,227   | 18.6 %  | 231,150   | 19.6 %  | 217,989   | 17.9 %  | 216,610   | 18.4 %  | 215,798   | 18.9 %  |
| Commercial   | 165,089   | 14.2 %  | 165,263   | 14.0 %  | 191,949   | 15.8 %  | 202,636   | 17.2 %  | 197,108   | 17.2 %  |
| Consumer &   |           |         |           |         |           |         |           |         |           |         |
| Other        | 6,935     | 0.6 %   | 8,712     | 0.7 %   | 11,400    | 0.8 %   | 13,612    | 1.0 %   | 20,061    | 1.1 %   |

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|             |             |        |             |        |             |        |             |        |             |        |
|-------------|-------------|--------|-------------|--------|-------------|--------|-------------|--------|-------------|--------|
| Total Gross |             |        |             |        |             |        |             |        |             |        |
| Loans       | 1,165,044   | 100.0% | 1,178,072   | 100.0% | 1,214,849   | 100.0% | 1,179,491   | 100.0% | 1,143,150   | 100.0% |
| Less:       |             |        |             |        |             |        |             |        |             |        |
| Unearned    |             |        |             |        |             |        |             |        |             |        |
| Income      | 1,966       |        | 2,070       |        | 2,131       |        | 2,127       |        | 2,181       |        |
| Subtotal    | 1,163,078   |        | 1,176,002   |        | 1,212,718   |        | 1,177,364   |        | 1,140,969   |        |
| Less:       |             |        |             |        |             |        |             |        |             |        |
| Allowance   |             |        |             |        |             |        |             |        |             |        |
| for Loan    |             |        |             |        |             |        |             |        |             |        |
| Losses      | 33,017      |        | 32,261      |        | 29,813      |        | 20,034      |        | 18,483      |        |
| Loans, Net  | \$1,130,061 |        | \$1,143,741 |        | \$1,182,905 |        | \$1,157,330 |        | \$1,122,486 |        |

There were no concentrations of loans exceeding 10% of total loans which were not otherwise disclosed as a category of loans in the above table.

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The following table shows the maturity distribution and interest rate sensitivity of the loan portfolio of the Company on December 31, 2011.

| (in thousands)                 | One Year<br>or Less | Over One<br>Year to<br>Five<br>Years | Over<br>Five<br>Years | Total               |
|--------------------------------|---------------------|--------------------------------------|-----------------------|---------------------|
| Commercial Real Estate         | \$ 30,904           | \$ 73,589                            | \$ 201,211            | \$ 305,704          |
| Agricultural Real Estate       | 9,208               | 91,335                               | 179,596               | 280,139             |
| Real Estate Construction       | 12,548              | 15,204                               | 1,855                 | 29,607              |
| Residential 1st Mortgages      | 402                 | 9,185                                | 97,834                | 107,421             |
| Home Equity Lines and<br>Loans | 12                  | 2,124                                | 48,820                | 50,956              |
| Agricultural                   | 127,221             | 78,412                               | 11,594                | 217,227             |
| Commercial                     | 67,047              | 66,174                               | 31,868                | 165,089             |
| Consumer & Other               | 2,082               | 4,217                                | 636                   | 6,935               |
| <b>Total</b>                   | <b>\$ 249,424</b>   | <b>\$ 340,240</b>                    | <b>\$ 573,414</b>     | <b>\$ 1,163,078</b> |
| Rate Sensitivity:              |                     |                                      |                       |                     |
| Fixed Rate                     | \$ 44,592           | \$ 138,706                           | \$ 198,549            | \$ 381,847          |
| Variable Rate                  | 204,831             | 201,535                              | 374,865               | 781,231             |
| <b>Total</b>                   | <b>\$ 249,423</b>   | <b>\$ 340,241</b>                    | <b>\$ 573,414</b>     | <b>\$ 1,163,078</b> |
| Percent                        | 21.45 %             | 29.25 %                              | 49.30 %               | 100.00 %            |

In the ordinary course of business, the Company enters into commitments to extend credit to its customers. These commitments are not reflected in the accompanying consolidated financial statements. As of December 31, 2011, the Company had entered into loan commitments amounting to \$300.6 million compared to \$316.1 million at December 31, 2010. In addition, letters of credit issued by the Company to guarantee the performance of a customer to a third party at December 31, 2011, and December 31, 2010, were \$5.1 million and \$5.6 million, respectively.

**Classified Loans and Non-Performing Assets**

All loans are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See “Results of Operations - Provision and Allowance for Loan Losses” for more detail on risk grades. The Company utilizes the services of a third-party independent loan review firm to perform evaluations of individual loans and review the credit risk grades the Company places on loans. Loans that are judged to exhibit a higher risk profile are referred to as “classified loans,” and these loans receive increased management attention. As of December 31, 2011, classified loans totaled \$42.8 million compared to \$40.0 million at December 31, 2010.

Classified loans with higher levels of credit risk can be further designated as “impaired” loans. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. See “Results of Operations - Provision and Allowance for Loan Losses” for further details. Impaired loans consist of: (1) non-accrual loans; and/or (2) restructured loans that are still performing (i.e., accruing interest).

**Non-Accrual Loans** - Accrual of interest on loans is generally discontinued when a loan becomes contractually past due by 90 days or more with respect to interest or principal. When loans are 90 days past due, but in management's judgment are well secured and in the process of collection, they may not be classified as non-accrual. When a loan is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. As of December 31, 2011 and 2010, non-accrual loans totaled \$4.1 million and \$5.3 million, net of guarantees of the U.S.

government, including its agencies and its government-sponsored entities, respectively.

Restructured Loans - A restructuring of a loan constitutes a troubled debt restructuring (“TDR”) if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan on accrual. As of December 31, 2011, restructured loans on accrual totaled \$4.7 million as compared to \$27.7 million as of December 31, 2010. This decline was primarily a result of multiple commercial real estate and real estate construction loans to one borrower that totaled \$24.5 million as of December 31, 2010 no longer being classified as a TDR since they were restructured at a market rate in a prior calendar year and are currently in compliance with their modified terms.

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Other Real Estate - Loans where the collateral has been repossessed are classified as other real estate ("ORE") or, if the collateral is personal property, the loan is classified as other assets on the Company's financial statements.

The following table sets forth the amount of the Company's non-performing loans and ORE as of the dates indicated. These balances are reported net of guarantees of the U.S. government, including its agencies and its government-sponsored entities, in the amounts of \$113,000, \$0, \$0, \$473,000 and \$134,000 for the years 2011 through 2007, respectively:

| (in thousands)  | December 31,   |                 |                 |                 |               |
|---|----------------|-----------------|-----------------|-----------------|---------------|
|   | 2011           | 2010            | 2009            | 2008            | 2007          |
| <b>Non-Accrual Loans</b>                                |                |                 |                 |                 |               |
| Commercial Real Estate                                  | \$1,354        | \$2,348         | \$1,294         | \$3,635         | \$-           |
| Agricultural Real Estate                                | 954            | 1,797           | 2,589           | -               | -             |
| Real Estate Construction                                | -              | -               | 1,225           | 400             | -             |
| Residential 1st Mortgages                               | 284            | 954             | -               | 176             | -             |
| Home Equity Lines and Loans                             | 194            | -               | 325             | 191             | -             |
| Agricultural  | 1,202          | -               | 1,080           | -               | -             |
| Commercial  | 104            | 207             | 2,696           | 55              | 45            |
| Consumer & Other  | 23             | 2               | -               | 41              | 7             |
| <b>Total Non-Accrual Loans</b>                          | <b>4,115</b>   | <b>5,308</b>    | <b>9,209</b>    | <b>4,498</b>    | <b>52</b>     |
| <b>Accruing Loans Past Due 90 Days or More</b>          |                |                 |                 |                 |               |
| Commercial Real Estate                                  | -              | -               | -               | 769             | -             |
| Agricultural Real Estate                                | -              | -               | -               | -               | -             |
| Real Estate Construction                                | -              | -               | -               | -               | -             |
| Residential 1st Mortgages                               | -              | -               | -               | -               | -             |
| Home Equity Lines and Loans                             | -              | -               | -               | -               | -             |
| Agricultural  | -              | -               | -               | -               | -             |
| Commercial  | -              | -               | -               | -               | -             |
| Consumer & Other  | -              | -               | -               | -               | 17            |
| <b>Total Accruing Loans Past Due 90 Days or More</b>    | <b>-</b>       | <b>-</b>        | <b>-</b>        | <b>769</b>      | <b>17</b>     |
| <b>Total Non-Performing Loans</b>                       | <b>\$4,115</b> | <b>\$5,308</b>  | <b>\$9,209</b>  | <b>\$5,267</b>  | <b>\$69</b>   |
| <b>Other Real Estate Owned</b>                          | <b>\$2,924</b> | <b>\$8,039</b>  | <b>\$8,418</b>  | <b>\$4,817</b>  | <b>\$251</b>  |
| <b>Total Non-Performing Assets</b>                      | <b>\$7,039</b> | <b>\$13,347</b> | <b>\$17,627</b> | <b>\$10,084</b> | <b>\$320</b>  |
| <b>Restructured Loans (Performing)</b>                  | <b>\$4,710</b> | <b>\$27,652</b> | <b>\$556</b>    | <b>\$-</b>      | <b>\$-</b>    |
| <b>Non-Performing Loans as a Percent of Total Loans</b> | <b>0.35</b>    | <b>% 0.45</b>   | <b>% 0.76</b>   | <b>% 0.45</b>   | <b>% 0.01</b> |

Although management believes that non-performing loans are generally well-secured and that potential losses are provided for in the Company's allowance for loan losses, there can be no assurance that future deterioration in economic conditions and/or collateral values will not result in future credit losses. See Note 5 located in "Item 8. Financial Statements and Supplementary Data" for an allocation of the allowance classified to impaired loans.

The Company reported \$2.9 million of ORE at December 31, 2011, and \$8.0 million at December 31, 2010. The decrease in ORE during 2011 was a result of the Company selling three of its ORE properties. The December 31, 2011, carrying value of \$2.9 million is net of a \$4.1 million reserve for ORE valuation adjustments. ORE at December 31, 2011 includes a mix of raw land, residential finished lots and single-family residences.





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Except for those classified and non-performing loans discussed above, the Company's management is not aware of any loans as of December 31, 2011, for which known financial problems of the borrower would cause serious doubts as to the ability of these borrowers to materially comply with their present loan repayment terms, or any known events that would result in the loan being designated as non-performing at some future date. However, the Central Valley of California continues to be one of the hardest hit areas in the country during this recession. Housing prices in many areas are down as much as 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels remain above 15% in many areas. As a result of this combination of: (1) significant declines in real estate values over the past 48 months; and (2) continuing uncertainty in general economic conditions leading to increased unemployment and business failures; borrowers who up until this time have been able to keep current in their payments may experience deterioration in their overall financial condition, increasing the potential of default. See "Part I, Item 1A. Risk Factors."

## Deposits

One of the key sources of funds to support earning assets is the generation of deposits from the Company's customer base. The ability to grow the customer base and subsequently deposits is a significant element in the performance of the Company.

The following table sets forth, by time remaining to maturity, the Company's time deposits in amounts of \$100,000 or more at December 31, 2011.

(in thousands)

## Time Deposits of \$100,000 or More

|  |           |
|--|-----------|
| Three Months or Less                     | \$201,217 |
| Over Three Months Through Six Months     | 44,439    |
| Over Six Months Through Twelve Months    | 85,337    |
| Over Twelve Months                       | 35,965    |
| Total Time Deposits of \$100,000 or More | \$366,958 |

Refer to the Year-To-Date Average Balances and Rate Schedules located in this "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" for information on separate deposit categories.

At December 31, 2011, deposits totaled \$1.6 billion. This represents an increase of 3.8% or \$59.7 million from December 31, 2010. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) the Federal government's decision to permanently increase FDIC deposit insurance limits from \$100,000 to \$250,000 per depositor (unlimited for non-interest bearing transaction accounts); and (2) the Company's strong financial results and position and F&M Bank's reputation as one of the most safe and sound banks in its market territory. The Company expects that, at some point, deposit customers may begin to diversify how they invest their money (e.g., move funds back into the stock market or other investments) and this could impact future deposit growth.

Although total deposits have increased 3.8% since December 31, 2010, the Company's focus has been on increasing low cost transaction and savings accounts, which have grown at a much faster pace:

- Demand and interest-bearing transaction accounts increased \$71.3 million or 13.2% since December 31, 2010.
- Savings and money market accounts have increased \$44.5 million or 9.8% since December 31, 2010.
- Time deposit accounts have decreased \$56.1 million or 9.8% since December 31, 2010. This decline was the continuing result of an explicit pricing strategy adopted by the Company beginning in the second quarter of 2009 based upon the recognition that market CD rates were greater than the yields that the Company could obtain

reinvesting these funds in short-term government agency & government-sponsored entity securities or overnight Fed Funds. Beginning in April 2009, management carefully reviewed time deposit customers and reduced our deposit rates to customers that did not also have transaction, money market, and/or savings balances with us (i.e., depositors who were not “relationship customers”). Given the Company’s strong deposit growth in transaction, savings and money market accounts, this time deposit decline has not presented any liquidity issues and it has significantly enhanced the Company’s net interest margin and earnings.

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### Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings

Lines of Credit with the Federal Reserve Bank and Federal Home Loan Bank are other key sources of funds to support earning assets. These sources of funds are also used to manage the Bank's interest rate risk exposure; and, as opportunities arise, to borrow and invest the proceeds at a positive spread through the investment portfolio. FHLB advances as of December 31, 2011, were \$530,000 compared to \$591,000 as of December 31, 2010. The average rate on FHLB advances during 2011 was 1.8% compared to 2.9% in 2010. There were no Federal Funds purchased or advances from the FRB at December 31, 2011.

### Securities Sold Under Agreement to Repurchase

Securities Sold Under Agreement to Repurchase are used as secured borrowing alternatives to FHLB Advances or FRB Borrowings, and totaled \$60 million at December 31, 2011 and December 31, 2010.

On March 13, 2008, the Bank entered into a \$40 million medium term repurchase agreement with Citigroup as part of the Bank's interest rate risk management strategy. The repurchase agreement pricing rate is 3.20% with an embedded 3-year cap tied to 3 month Libor with a strike price of 3.3675%. The repurchase agreement matures March 13, 2013, and is secured by investments in agency pass through securities.

On May 30, 2008, the Company entered into a second \$20 million medium term repurchase agreement with Citigroup. The repurchase agreement pricing rate is 4.19% with an embedded 3-year cap tied to 3 month Libor with a strike price of 3.17%. The repurchase agreement matures June 5, 2013, and is secured by investments in agency pass through securities.

### Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities. See Note 13 located in "Item 8. Financial Statements and Supplementary Data." Although this amount is reflected as subordinated debt on the Company's balance sheet, under applicable regulatory guidelines, trust preferred securities qualify as regulatory capital. See "Capital." These securities accrue interest at a variable rate based upon 3-month LIBOR plus 2.85%. Interest rates reset quarterly (the next reset is March 18, 2012) and the rate was 3.4% as of December 31, 2011. The average rate paid for these securities was 3.2% in 2011 and 2010. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company's common stock.

### Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders' Equity totaled \$189.3 million at December 31, 2011, and \$173.2 million at the end of 2010.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain actions by regulators that, if undertaken, could have a material effect on the Company and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets (as defined in the

regulations), and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of December 31, 2011, that the Company and the Bank meet all capital adequacy requirements to which they are subject. In addition, the most recent notification from the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank’s category. For further information on the Company’s and the Bank’s risk-based capital ratios, see Note 14 located in “Item 8. Financial Statements and Supplementary Data.”

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As previously discussed (see “Subordinated Debentures”), in order to supplement its regulatory capital base, during December 2003 the Company issued \$10 million of trust preferred securities. See Note 13 located in “Item 8. Financial Statements and Supplementary Data.” On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of trust preferred securities (“TPS”) by bank holding companies (“BHCs”). Under the final rule BHCs may include TPS in Tier 1 capital in an amount equal to 25% of the sum of core capital net of goodwill. Any portion of trust-preferred securities not qualifying as Tier 1 capital would qualify as Tier 2 capital subject to certain limitations. The Company has received notification from the Federal Reserve Bank of San Francisco that all of the Company’s trust preferred securities currently qualify as Tier 1 capital.

In accordance with the provisions of the “Consolidation” topic of the FASB Accounting Standards Codification (“ASC”), the Company does not consolidate the subsidiary trust, which has issued the trust-preferred securities.

In 1998, the Board approved the Company’s first stock repurchase program. This program was extended and expanded in both 2004 and 2006. Most recently, on November 12, 2008, the Board of Directors approved increasing the funds available for the Company’s Common Stock Repurchase Program. The Board’s resolution authorized up to \$20 million in repurchases over the four-year period ending October 31, 2012. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.”

During 2011, the Company did not repurchase any shares under the Stock Repurchase Program. In 2010, the Company repurchased 1,520 shares at an average share price of \$400. The remaining dollar value of shares that may yet be purchased under the Company’s Stock Repurchase Program is approximately \$16.0 million.

On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Registrar and Transfer Company as Rights Agent. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” for further explanation.

Based upon the Company’s strong capital position and continued earnings strength, the Company elected not to participate in the Federal Government’s 2008 TARP capital purchase program. See “Item 1A. Risk Factors.”

### Critical Accounting Policies and Estimates

This “Management’s Discussion and Analysis of Financial Condition and Results of Operations” is based upon the Company’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing the Company’s financial statements management makes estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses. Management believes that the most significant subjective judgments that it makes include the following:

**Allowance for Loan Losses** - As a financial institution, which assumes lending and credit risks as a principal element in its business, the Company anticipates that credit losses will be experienced in the normal course of business. Accordingly, the allowance for loan losses is maintained at a level considered adequate by management to provide for losses that are inherent in the portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Management employs a systematic methodology for determining the allowance for loan losses. On a quarterly basis, management reviews the credit quality of the loan portfolio and considers problem loans, delinquencies, internal credit reviews, current economic conditions, loan loss experience, and other factors in determining the adequacy of the allowance balance.

While the Company utilizes a systematic methodology in determining its allowance, the allowance is based on estimates, and ultimate losses may vary from current estimates. The estimates are reviewed periodically and, as

adjustments become necessary, are reported in earnings in the periods in which they become known. For additional information, see Note 5 located in “Item 8. Financial Statements and Supplementary Data.”

Fair Value - The Company discloses the fair value of financial instruments and the methods and significant assumptions used to estimate those fair values. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization. For additional information, see “Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Credit Risk” and Notes 17 and 18 located in “Item 8. Financial Statements and Supplementary Data.”

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**Income Taxes** - The Company uses the liability method of accounting for income taxes. This method results in the recognition of deferred tax assets and liabilities that are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The deferred provision for income taxes is the result of the net change in the deferred tax asset and deferred tax liability balances during the year. This amount combined with the current taxes payable or refundable results in the income tax expense for the current year. For additional information, see Note 1 located in “Item 8. Financial Statements and Supplementary Data.”

## **Off-Balance Sheet Arrangements**

Off-balance sheet arrangements are any contractual arrangement to which an unconsolidated entity is a party, under which the Company has: (1) any obligation under a guarantee contract; (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity, or market risk support to that entity for such assets; (3) any obligation under certain derivative instruments; or (4) any obligation under a material variable interest held by us in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to the Company, or engages in leasing, hedging, or research and development services with the Company.

Our most significant off-balance sheet arrangements are limited to: (1) the full and unconditional payment guarantee of accrued distributions relating to \$10 million of Trust Preferred Securities issued by FMCB Statutory Trust, but only to the extent that FMCB Statutory has funds available therefore (see Note 13 located in “Item 8. Financial Statements and Supplementary Data”); (2) obligations under guarantee contracts such as financial and performance standby letters of credit for our credit customers (see Note 19 located in “Item 8. Financial Statements and Supplementary Data”); (3) unfunded commitments to lend (see Note 19 located in “Item 8. Financial Statements and Supplementary Data”); and (4) lease contracts (see Note 19 located in “Item 8. Financial Statements and Supplementary Data”). It is our belief that none of these arrangements expose us to any greater risk of loss than is already reflected on our balance sheet. We do not have any off-balance-sheet arrangements in which we have any retained or contingent interest as we do not transfer or sell our assets to entities in which we have a continuing involvement, any exposure to derivative instruments that are indexed to stock indices, nor any variable interests in any unconsolidated entity to which we may be a party.

## **Aggregate Contractual Obligations and Commitments**

The following table presents, as of December 31, 2011, our significant and determinable contractual obligations by payment date. The payment amounts represent those amounts contractually due to the recipient and do not include any unamortized premiums or discounts, hedge basis adjustments, or other similar carrying value adjustments. For further information on the nature of each obligation type, see applicable note disclosures located in “Item 8. Financial Statements and Supplementary Data.”

Table of ContentsPayments Due By Period  
(in thousands)

|  | Total    | 1 Year or<br>Less | 2-3 Years | 4-5 Years | More Than 5<br>Years |
|--|----------|-------------------|-----------|-----------|----------------------|
| Contractual Obligations                          |          |                   |           |           |                      |
| Operating Lease Obligations                      | \$1,277  | \$369             | \$536     | \$372     | \$ -                 |
| Securities Sold Under Agreement to<br>Repurchase | 60,000   | -                 | 60,000    | -         | -                    |
| FHLB Advances                                    | 530      | -                 | -         | -         | 530                  |
| Long-Term Subordinated Debentures                | 10,310   | -                 | -         | -         | 10,310               |
| Deferred Compensation (1)                        | 23,016   | 386               | 598       | 445       | 21,587               |
| Total  | \$95,133 | \$755             | \$61,134  | \$817     | \$ 32,427            |

(1) These amounts represent payments to participants under the Company's non-qualified Deferred Compensation and Executive Retirement Plans. See Notes 16 located in "Item 8. Financial Statements and Supplementary Data."

## Quarterly Unaudited Financial Data

The following tables set forth certain unaudited historical quarterly financial data for each of the eight consecutive quarters in 2011 and 2010. This information is derived from unaudited consolidated financial statements that include, in management's opinion, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation when read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Form 10-K.

| 2011<br>(in thousands except per share data)           | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total    |
|--|------------------|-------------------|------------------|-------------------|----------|
| Total Interest Income                                  | \$20,531         | \$20,535          | \$20,861         | \$20,427          | \$82,354 |
| Total Interest Expense                                 | 2,165            | 2,023             | 1,968            | 1,818             | 7,974    |
| Net Interest Income                                    | 18,366           | 18,512            | 18,893           | 18,609            | 74,380   |
| Provision for Loan Losses                              | 525              | 3,925             | 900              | 1,425             | 6,775    |
| Net Interest Income After<br>Provision for Loan Losses | 17,841           | 14,587            | 17,993           | 17,184            | 67,605   |
| Total Non-Interest Income                              | 3,334            | 2,995             | 1,770            | 4,175             | 12,274   |
| Total Non-Interest Expense                             | 11,436           | 11,233            | 9,821            | 12,538            | 45,028   |
| Income Before Income Taxes                             | 9,739            | 6,349             | 9,942            | 8,821             | 34,851   |
| Provision for Income Taxes                             | 3,613            | 2,194             | 3,675            | 3,160             | 12,642   |
| Net Income   | \$6,126          | \$4,155           | \$6,267          | \$5,661           | \$22,209 |
| Earnings Per Share                                     | \$7.86           | \$5.33            | \$8.04           | \$7.26            | \$28.49  |

| 2010<br>(in thousands except per share data)           | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total    |
|--|------------------|-------------------|------------------|-------------------|----------|
| Total Interest Income                                  | \$21,474         | \$20,919          | \$20,968         | \$21,100          | \$84,461 |
| Total Interest Expense                                 | 2,595            | 2,366             | 2,395            | 2,329             | 9,685    |
| Net Interest Income                                    | 18,879           | 18,553            | 18,573           | 18,771            | 74,776   |
| Provision for Loan Losses                              | 4,115            | 5,120             | 1,315            | 4,185             | 14,735   |
| Net Interest Income After<br>Provision for Loan Losses | 14,764           | 13,433            | 17,258           | 14,586            | 60,041   |
| Total Non-Interest Income                              | 6,243            | 2,542             | 4,308            | 4,092             | 17,185   |
| Total Non-Interest Expense                             | 11,353           | 9,846             | 11,630           | 11,110            | 43,939   |



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|                            |         |         |         |         |          |
|----------------------------|---------|---------|---------|---------|----------|
| Income Before Income Taxes | 9,654   | 6,129   | 9,936   | 7,568   | 33,287   |
| Provision for Income Taxes | 3,604   | 2,122   | 3,727   | 2,716   | 12,169   |
| Net Income                 | \$6,050 | \$4,007 | \$6,209 | \$4,852 | \$21,118 |
| Earnings Per Share         | \$7.75  | \$5.13  | \$7.95  | \$6.22  | \$27.05  |

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Farmers & Merchants Bancorp stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Based on information from shareholders and from Company stock transfer records, the prices paid in 2011, 2010, and 2009 ranged from \$475.00 to \$310.00 per share.

### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

#### Risk Management

The Company has adopted risk management policies and procedures, which aim to ensure the proper control and management of all risk factors inherent in the operation of the Company, most importantly credit risk, interest rate risk and liquidity risk. These risk factors are not mutually exclusive. It is recognized that any product or service offered by the Company may expose the Company to one or more of these risk factors.

#### Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance.

Credit risk in the investment portfolio and correspondent bank accounts is addressed through defined limits in the Company's policy statements. In addition, certain securities carry insurance to enhance credit quality of the bond.

In order to control credit risk in the loan portfolio the Company has established credit management policies and procedures that govern both the approval of new loans and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans to one borrower, and by restricting loans made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. However, as a financial institution that assumes lending and credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The allowance for loan losses is maintained at a level considered by management to be adequate to provide for risks inherent in the loan portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs.

The Company's methodology for assessing the appropriateness of the allowance is applied on a regular basis and considers all loans. The systematic methodology consists of two major parts.

Part 1: includes a detailed analysis of the loan portfolio in two phases. The first phase is conducted in accordance with the "Receivables" topic of the FASB ASC. Individual loans are reviewed to identify loans for impairment. A loan is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan. Impairment is measured as either the expected future cash flows discounted at each loan's effective interest rate, the fair value of the loan's collateral if the loan is collateral dependent, or an observable market price of the loan, if one exists. Upon measuring the impairment, the Company will ensure an appropriate level of allowance is present or established.

Central to the first phase of the analysis of the loan portfolio is the loan risk rating system. The originating credit officer assigns borrowers an initial risk rating, which is based primarily on a thorough analysis of each borrower's financial position in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior credit administration personnel. Credits are monitored by credit administration personnel for deterioration in a borrower's financial condition, which would impact the ability of the borrower to perform under the contract. Risk ratings are adjusted as

necessary. Risk ratings are reviewed by both the Company's independent third-party credit examiners and bank examiners from the DFI and FDIC.

Based on the risk rating system, specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicates that the loan is impaired and there is a probability of loss. Management performs a detailed analysis of these loans, including, but not limited to, cash flows, appraisals of the collateral, conditions of the marketplace for liquidating the collateral, and assessment of the guarantors. Management then determines the inherent loss potential and allocates a portion of the allowance for losses as a specific allowance for each of these credits.

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The second phase is conducted by segmenting the loan portfolio by risk rating and into groups of loans with similar characteristics in accordance with the “Contingency” topic of the FASB ASC. In this second phase, groups of loans with similar characteristics are reviewed and the appropriate allowance factor is applied based on the historical average charge-off rate for each particular group of loans.

Part 2: considers qualitative internal and external factors that may affect a loan’s collectability, is based upon management’s evaluation of various conditions, the effects of which are not directly measured in the determination of the historical and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. The conditions evaluated in connection with the second element of the analysis of the allowance include, but are not limited to the following conditions that existed as of the balance sheet date:

- § general economic and business conditions affecting the key lending areas of the Company;
- § credit quality trends (including trends in collateral values, delinquencies and non-performing loans);
- § loan volumes, growth rates and concentrations;
- § loan portfolio seasoning;
- § specific industry and crop conditions;
- § recent loss experience; and
- § duration of the current business cycle.

Management reviews these conditions in discussion with the Company’s senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management’s estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management’s evaluation of the inherent loss related to such condition is reflected in the second major element of the allowance.

Management believes that based upon the preceding methodology, and using information currently available, the allowance for loan losses at December 31, 2011 was adequate. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans, or net loan charge-offs that would require increases in the provision for loan losses and thereby adversely affect the results of operations.

### Interest Rate Risk

The mismatch between maturities of interest sensitive assets and liabilities results in uncertainty in the Company’s earnings and economic value and is referred to as interest rate risk. The Company does not attempt to predict interest rates and positions the balance sheet in a manner, which seeks to minimize, to the extent possible, the effects of changing interest rates.

The Company measures interest rate risk in terms of potential impact on both its economic value and earnings. The methods for governing the amount of interest rate risk include: (1) analysis of asset and liability mismatches (Gap analysis); (2) the utilization of a simulation model; and (3) limits on maturities of investment, loan, and deposit products, which reduces the market volatility of those instruments.

The Gap analysis measures, at specific time intervals, the divergence between earning assets and interest bearing liabilities for which repricing opportunities will occur. A positive difference, or Gap, indicates that earning assets will reprice faster than interest-bearing liabilities. This will generally produce a greater net interest margin during periods of rising interest rates and a lower net interest margin during periods of declining interest rates. Conversely, a negative Gap will generally produce a lower net interest margin during periods of rising interest rates and a greater net interest margin during periods of decreasing interest rates.

The interest rates paid on deposit accounts do not always move in unison with the rates charged on loans. In addition, the magnitude of changes in the rates charged on loans is not always proportionate to the magnitude of changes in the rate paid for deposits. Consequently, changes in interest rates do not necessarily result in an increase or decrease in the net interest margin solely as a result of the differences between repricing opportunities of earning assets or interest bearing liabilities.

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The Company also utilizes the results of a dynamic simulation model to quantify the estimated exposure of net interest income to sustained interest rate changes. The sensitivity of the Company's net interest income is measured over a rolling one-year horizon.

The simulation model estimates the impact of changing interest rates on interest income from all interest earning assets and the interest expense paid on all interest bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 100 basis point downward shift in interest rates. A shift in rates over a 12-month period is assumed. Results that exceed policy limits, if any, are analyzed for risk tolerance and reported to the Board with appropriate recommendations. At December 31, 2011, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was a decrease in net interest income of 0.44% if rates increase by 200 basis points and a decrease in net interest income of 0.17% if rates decline 100 basis points.

The estimated sensitivity does not necessarily represent a Company forecast and the results may not be indicative of actual changes to the Company's net interest income. These estimates are based upon a number of assumptions including: the nature and timing of interest rate levels including yield curve shape; prepayments on loans and securities; pricing strategies on loans and deposits; replacement of asset and liability cash flows; and other assumptions. While the assumptions used are based on current economic and local market conditions, there is no assurance as to the predictive nature of these conditions including how customer preferences or competitor influences might change.

### Liquidity Risk

Liquidity risk is the risk to earnings or capital resulting from the Company's inability to meet its obligations when they come due without incurring unacceptable losses. It includes the ability to manage unplanned decreases or changes in funding sources and to recognize or address changes in market conditions that affect the Company's ability to liquidate assets or acquire funds quickly and with minimum loss of value. The Company endeavors to maintain a cash flow adequate to fund operations, handle fluctuations in deposit levels, respond to the credit needs of borrowers, and to take advantage of investment opportunities as they arise.

The Company's principal operating sources of liquidity include (see "Item 8. Financial Statements and Supplementary Data – Consolidated Statements of Cash Flows") cash and cash equivalents, cash provided by operating activities, principal payments on loans, proceeds from the maturity or sale of investments, and growth in deposits. To supplement these operating sources of funds the Company maintains Federal Funds credit lines of \$66.0 million and repurchase lines of \$100.3 million with major banks. In addition, as of December 31, 2011 the Company has available borrowing capacity of \$218.6 million at the Federal Home Loan Bank and \$293.8 million at the Federal Reserve Bank.

At December 31, 2011, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities of approximately \$252.9 million, which represents 13.3% of total assets.

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Farmers & Merchants Bancorp

Report of Management on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting at Farmers & Merchants Bancorp (“the Company”). Internal control over financial reporting includes controls over the preparation of financial statements in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to comply with the reporting requirements of Part 363 of the Federal Deposit Insurance Corporation Rules and Regulations.

Management has assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2011, based on criteria described in “Internal Control-Integrated Framework” issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on that assessment, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2011.

Crowe Horwath LLP, the independent registered public accounting firm that audited the financial statements included in this Annual Report, was engaged to express an opinion as to the fairness of presentation of such financial statements. Crowe Horwath LLP was also engaged to assess the effectiveness of the Company’s internal control over financial reporting. The report of Crowe Horwath LLP follows this report.

/s/ Kent A. Steinwert

/s/ Stephen W. Haley

Kent A. Steinwert  
Chairman, President & Chief Executive Officer

Stephen W. Haley  
Executive Vice President & Chief Financial Officer



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors  
Farmers & Merchants Bancorp  
Lodi, California

We have audited the accompanying consolidated balance sheet of Farmers & Merchants Bancorp and subsidiaries (the "Company") as of December 31, 2011, and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and cash flows for the year then ended. We also have audited the Company's internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). The Company's management is responsible for these consolidated 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 Report of Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the consolidated 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.

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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.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Farmers & Merchants Bancorp and subsidiaries as of December 31, 2011, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, Farmers & Merchants Bancorp and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

/s/ Crowe Horwath LLP

Sacramento, California  
March 6, 2012

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors  
Farmers & Merchants Bancorp  
Lodi, California

We have audited the accompanying consolidated balance sheet of Farmers & Merchants Bancorp and subsidiaries (the "Company") as of December 31, 2010, and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and cash flows for each of the two years in the period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Farmers & Merchants Bancorp and subsidiaries as of December 31, 2010, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2010 in conformity with U.S. generally accepted accounting principles.

/s/ Perry Smith LLP

Sacramento, California  
March 8, 2011

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Farmers & Merchants Bancorp  
 Consolidated Statements of Income  
 (in thousands except per share data)

|  | Year Ended December 31, |                 |                 |
|--|-------------------------|-----------------|-----------------|
|  | 2011                    | 2010            | 2009            |
| <b>Interest Income</b>                                     |                         |                 |                 |
| Interest and Fees on Loans                                 | \$70,180                | \$72,643        | \$74,901        |
| Interest on Deposits with Banks                            | 117                     | 91              | 96              |
| <b>Interest on Investment Securities:</b>                  |                         |                 |                 |
| Taxable  | 9,490                   | 8,971           | 13,396          |
| Exempt from Federal Tax                                    | 2,567                   | 2,756           | 2,921           |
| <b>Total Interest Income</b>                               | <b>82,354</b>           | <b>84,461</b>   | <b>91,314</b>   |
| <b>Interest Expense</b>                                    |                         |                 |                 |
| Deposits   | 5,463                   | 7,168           | 13,746          |
| Borrowed Funds   | 2,181                   | 2,184           | 2,188           |
| Subordinated Debentures                                    | 330                     | 333             | 397             |
| <b>Total Interest Expense</b>                              | <b>7,974</b>            | <b>9,685</b>    | <b>16,331</b>   |
| <b>Net Interest Income</b>                                 | <b>74,380</b>           | <b>74,776</b>   | <b>74,983</b>   |
| Provision for Loan Losses                                  | 6,775                   | 14,735          | 15,420          |
| <b>Net Interest Income After Provision for Loan Losses</b> | <b>67,605</b>           | <b>60,041</b>   | <b>59,563</b>   |
| <b>Non-Interest Income</b>                                 |                         |                 |                 |
| Service Charges on Deposit Accounts                        | 5,395                   | 6,529           | 6,956           |
| Net Gain on Investment Securities                          | 95                      | 2,895           | 3,524           |
| Increase in Cash Surrender Value of Life Insurance         | 1,834                   | 1,825           | 1,794           |
| Debit Card and ATM Fees                                    | 2,760                   | 2,591           | 2,245           |
| Net Gain on Deferred Compensation Investments              | 199                     | 1,376           | 1,847           |
| Other  | 1,991                   | 1,969           | 1,828           |
| <b>Total Non-Interest Income</b>                           | <b>12,274</b>           | <b>17,185</b>   | <b>18,194</b>   |
| <b>Non-Interest Expense</b>                                |                         |                 |                 |
| Salaries and Employee Benefits                             | 29,670                  | 28,332          | 28,771          |
| Net Gain on Deferred Compensation Investments              | 199                     | 1,376           | 1,847           |
| Occupancy  | 2,579                   | 2,422           | 2,715           |
| Equipment  | 2,844                   | 2,605           | 2,417           |
| ORE Holding Costs  | 1,785                   | 1,247           | 1,464           |
| FDIC Insurance   | 1,461                   | 2,286           | 2,496           |
| Other  | 6,490                   | 5,671           | 6,719           |
| <b>Total Non-Interest Expense</b>                          | <b>45,028</b>           | <b>43,939</b>   | <b>46,429</b>   |
| <b>Income Before Income Taxes</b>                          | <b>34,851</b>           | <b>33,287</b>   | <b>31,328</b>   |
| Provision for Income Taxes                                 | 12,642                  | 12,169          | 11,315          |
| <b>Net Income</b>  | <b>\$22,209</b>         | <b>\$21,118</b> | <b>\$20,013</b> |
| <b>Earnings Per Share</b>                                  | <b>\$28.49</b>          | <b>\$27.05</b>  | <b>\$25.57</b>  |

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



Table of ContentsFarmers & Merchants Bancorp  
Consolidated Balance Sheets  
(in thousands except share data)

|   | December 31, |             |
|---|--------------|-------------|
|   | 2011         | 2010        |
| Assets  |              |             |
| Cash and Cash Equivalents:  |              |             |
| Cash and Due from Banks   | \$45,112     | \$28,484    |
| Interest Bearing Deposits with Banks  | 56,548       | 32,176      |
| Total Cash and Cash Equivalents   | 101,660      | 60,660      |
| Investment Securities:  |              |             |
| Available-for-Sale  | 479,820      | 428,644     |
| Held-to-Maturity  | 63,092       | 64,937      |
| Total Investment Securities   | 542,912      | 493,581     |
| Loans:  | 1,163,078    | 1,176,002   |
| Less: Allowance for Loan Losses   | 33,017       | 32,261      |
| Loans, Net  | 1,130,061    | 1,143,741   |
| Premises and Equipment, Net   | 24,058       | 24,214      |
| Bank Owned Life Insurance   | 47,418       | 45,584      |
| Interest Receivable and Other Assets  | 73,575       | 73,711      |
| Total Assets  | \$1,919,684  | \$1,841,491 |
| Liabilities   |              |             |
| Deposits:   |              |             |
| Demand  | \$389,639    | \$343,482   |
| Interest-Bearing Transaction  | 220,736      | 195,576     |
| Savings and Money Market  | 498,011      | 453,531     |
| Time  | 517,811      | 573,914     |
| Total Deposits  | 1,626,197    | 1,566,503   |
| Securities Sold Under Agreement to Repurchase   | 60,000       | 60,000      |
| Federal Home Loan Bank Advances   | 530          | 591         |
| Subordinated Debentures   | 10,310       | 10,310      |
| Interest Payable and Other Liabilities  | 33,301       | 30,846      |
| Total Liabilities   | 1,730,338    | 1,668,250   |
| Commitments & Contingencies (See Note 19)   |              |             |
| Shareholders' Equity  |              |             |
| Preferred Stock: No Par Value. 1,000,000 Authorized, None Issued or Outstanding   | -            | -           |
| Common Stock: Par Value \$0.01, 20,000,000 Shares Authorized, 779,424 Issued and Outstanding for both December 31, 2011 and 2010. | 8            | 8           |
| Additional Paid-In Capital  | 75,590       | 75,590      |
| Retained Earnings   | 109,081      | 96,030      |
| Accumulated Other Comprehensive Gain  | 4,667        | 1,613       |
| Total Shareholders' Equity  | 189,346      | 173,241     |

|  |             |             |
|--|-------------|-------------|
| Total Liabilities and Shareholders' Equity | \$1,919,684 | \$1,841,491 |
|--|-------------|-------------|

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

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Farmers & Merchants Bancorp  
 Consolidated Statements of Changes in Shareholders' Equity  
 (in thousands except share and per share data)

|  | Common<br>Shares<br>Outstanding | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Gain | Total<br>Shareholders'<br>Equity |
|--|---------------------------------|-----------------|----------------------------------|----------------------|---|----------------------------------|
| Balance, January 1, 2009   | 786,960                         | \$8             | \$78,527                         | \$72,350             | \$ 5,660                                      | \$ 156,545                       |
| Net Income   |                                 |                 |                                  | 20,013               |   | 20,013                           |
| Cash Dividends Declared on<br>Common Stock (\$11.00 per<br>share)    |                                 |                 |                                  | (8,596 )             |   | (8,596 )                         |
| Repurchase of Stock  | (6,016 )                        |                 | (2,329 )                         |                      |   | (2,329 )                         |
| Change in Net Unrealized<br>Gain on Securities<br>Available-for-Sale |                                 |                 |                                  |                      | (906 )  | (906 )                           |
| Balance, December 31, 2009   | 780,944                         | 8               | 76,198                           | 83,767               | 4,754   | 164,727                          |
| Net Income   |                                 |                 |                                  | 21,118               |   | 21,118                           |
| Cash Dividends Declared on<br>Common Stock (\$11.35 per<br>share)    |                                 |                 |                                  | (8,855 )             |   | (8,855 )                         |
| Repurchase of Stock  | (1,520 )                        |                 | (608 )                           |                      |   | (608 )                           |
| Change in Net Unrealized<br>Gain on Securities<br>Available-for-Sale |                                 |                 |                                  |                      | (3,141 )                                      | (3,141 )                         |
| Balance, December 31, 2010   | 779,424                         | 8               | 75,590                           | 96,030               | 1,613   | 173,241                          |
| Net Income   |                                 |                 |                                  | 22,209               |   | 22,209                           |
| Cash Dividends Declared on<br>Common Stock (\$11.75 per<br>share)    |                                 |                 |                                  | (9,158 )             |   | (9,158 )                         |
| Repurchase of Stock  |                                 |                 |                                  |                      |   | -                                |
| Change in Net Unrealized<br>Gain on Securities<br>Available-for-Sale |                                 |                 |                                  |                      | 3,054   | 3,054                            |
| Balance, December 31, 2011   | 779,424                         | \$8             | \$75,590                         | \$109,081            | \$ 4,667                                      | \$ 189,346                       |

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



Table of ContentsFarmers & Merchants Bancorp  
Consolidated Statements of Comprehensive Income  
(in thousands)

|  | Year Ended December 31, |          |          |
|--|-------------------------|----------|----------|
|  | 2011                    | 2010     | 2009     |
| Net Income   | \$22,209                | \$21,118 | \$20,013 |
| Other Comprehensive Income (Loss)  |                         |          |          |
| Unrealized Gains (Losses) on Securities:   |                         |          |          |
| Unrealized holding gains (losses) arising during the period, net of income tax effects of \$2,255, \$(1,062) and \$824 for the years ended December 31, 2011, 2010 and 2009, respectively.                             | 3,109                   | (1,463 ) | 1,136    |
| Less: Reclassification adjustment for realized gains included in net income, net of related income tax effects of \$(40), \$(1,217), and \$(1,482) for the years ended December 31, 2011, 2010 and 2009, respectively. | (55 )                   | (1,678 ) | (2,042 ) |
| Total Other Comprehensive Income (Loss)  | 3,054                   | (3,141 ) | (906 )   |
| Comprehensive Income   | \$25,263                | \$17,977 | \$19,107 |

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

Table of ContentsFarmers & Merchants Bancorp  
Consolidated Statements of Cash Flows  
(in thousands)

|   | Year Ended December 31, |            |            |
|---|-------------------------|------------|------------|
|   | 2011                    | 2010       | 2009       |
| <b>Operating Activities</b>   |                         |            |            |
| Net Income  | \$22,209                | \$21,118   | \$20,013   |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                         |            |            |
| Provision for Loan Losses   | 6,775                   | 14,735     | 15,420     |
| Depreciation and Amortization   | 1,801                   | 1,867      | 1,894      |
| Provision for Deferred Income Taxes   | (1,260 )                | (1,877 )   | (7,412 )   |
| Net Amortization (Accretion) of Investment Security Premium & Discounts           | 1,230                   | 289        | (2,719 )   |
| Net Gain on Investment Securities   | (95 )                   | (2,895 )   | (3,524 )   |
| Net Gain on Sale of Property & Equipment  | (5 )                    | (19 )      | (11 )      |
| Net Change in Operating Assets & Liabilities:                                     |                         |            |            |
| Net Increase in Interest Receivable and Other Assets                              | (2,750 )                | (6,360 )   | (14,405 )  |
| Net Increase in Interest Payable and Other Liabilities                            | 2,455                   | 3,142      | 3,527      |
| Net Cash Provided by Operating Activities   | 30,360                  | 30,000     | 12,783     |
| <b>Investing Activities</b>   |                         |            |            |
| Purchase of Investment Securities Available-for-Sale                              | (296,852 )              | (379,795 ) | (271,757 ) |
| Proceeds from Sold, Matured, or Called Securities Available-for-Sale              | 249,930                 | 308,504    | 202,742    |
| Purchase of Investment Securities Held-to-Maturity                                | (1,580 )                | (2,277 )   | (1,870 )   |
| Proceeds from Matured, or Called Securities Held-to-Maturity                      | 3,402                   | 6,984      | 4,129      |
| Net Loans Paid, Originated or Acquired  | 6,778                   | 24,193     | (41,285 )  |
| Principal Collected on Loans Previously Charged Off                               | 127                     | 236        | 290        |
| Additions to Premises and Equipment   | (1,660 )                | (1,196 )   | (5,133 )   |
| Proceeds from Sale of Property & Equipment  | 20                      | 21         | 16         |
| Net Cash Used by Investing Activities   | (39,835 )               | (43,330 )  | (112,868 ) |
| <b>Financing Activities</b>   |                         |            |            |
| Net Increase in Deposits  | 59,694                  | 68,379     | 65,422     |
| Net Change in Other Borrowings  | (61 )                   | (19,558 )  | 19,446     |
| Stock Repurchases   | -                       | (608 )     | (2,329 )   |
| Cash Dividends  | (9,158 )                | (8,855 )   | (8,596 )   |
| Net Cash Provided by Financing Activities   | 50,475                  | 39,358     | 73,943     |
| Increase (Decrease) in Cash and Cash Equivalents                                  | 41,000                  | 26,028     | (26,142 )  |
| Cash and Cash Equivalents at Beginning of Year                                    | 60,660                  | 34,632     | 60,774     |
| Cash and Cash Equivalents at End of Year  | \$101,660               | \$60,660   | \$34,632   |
| <b>Supplementary Data</b>   |                         |            |            |
| Loans Transferred to Foreclosed Assets (ORE)                                      | \$1,092                 | \$3,407    | \$5,571    |
| Cash Payments Made for Income Taxes   | \$12,070                | \$16,025   | \$15,950   |
| Interest Paid   | \$8,474                 | \$9,829    | \$17,843   |

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

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### Notes to Consolidated Financial Statements

#### 1. Significant Accounting Policies

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

The Company’s other subsidiaries include F & M Bancorp, Inc. and FMCB Statutory Trust I. F & M Bancorp, Inc. was created in March 2002 to protect the name F & M Bank. During 2002 the Company completed a fictitious name filing in California to begin using the streamlined name “F & M Bank” as part of a larger effort to enhance the Company’s image and build brand name recognition. In December 2003 the Company formed a wholly owned subsidiary, FMCB Statutory Trust I. FMCB Statutory Trust I is a non-consolidated subsidiary per generally accepted accounting principles (GAAP) and was formed for the sole purpose of issuing Trust Preferred Securities.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and prevailing practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

#### Basis of Presentation

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

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

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

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

#### Cash and Cash Equivalents

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

#### Investment Securities

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

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

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

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

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

### Loans

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

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

repayment of the loan is expected to be provided solely by the underlying collateral.

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

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

### Allowance for Loan Losses

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

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

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

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

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

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

**Substandard** – A substandard loan is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack

of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

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



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

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

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

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

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

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

**Residential 1st Mortgages and Home Equity Lines and Loans** – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments, although this is not always true as evidenced by the period 2007 through 2011. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

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

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

their judgment about information available at the time of their examinations.

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

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

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### Premises and Equipment

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

### Other Real Estate

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

### Income Taxes

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

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

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

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

### Dividends and Earnings Per Share

The Company's common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. See Note 15.

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### Segment Reporting

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

### Derivative Instruments and Hedging Activities

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

From time to time, the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps, and collars. These instruments are purchased and/or sold to reduce the Company’s exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments as of December 31, 2011 and December 31, 2010.

### Comprehensive Income

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

### Loss Contingencies

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

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## 2. Investment Securities

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

| December 31, 2011                                 | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses | Fair/Book<br>Value |
|---|-------------------|---------------------------|--------|--------------------|
| Government Agency & Government-Sponsored Entities | \$82,195          | \$413                     | \$13   | \$82,595           |
| Obligations of States and Political Subdivisions  | 5,782             | -                         | -      | 5,782              |
| Mortgage Backed Securities (1)                    | 383,380           | 7,792                     | 139    | 391,033            |
| Other   | 410               | -                         | -      | 410                |
| Total   | \$471,767         | \$8,205                   | \$152  | \$479,820          |

| December 31, 2010                                 | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses  | Fair/Book<br>Value |
|---|-------------------|---------------------------|---------|--------------------|
| Government Agency & Government-Sponsored Entities | \$237,944         | \$305                     | \$1,930 | \$236,319          |
| Obligations of States and Political Subdivisions  | 6,378             | -                         | -       | 6,378              |
| Mortgage Backed Securities                        | 181,228           | 6,028                     | 1,619   | 185,637            |
| Other   | 310               | -                         | -       | 310                |
| Total   | \$425,860         | \$6,333                   | \$3,549 | \$428,644          |

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

| December 31, 2011                                | Book<br>Value | Gross Unrealized<br>Gains | Losses | Fair<br>Value |
|--|---------------|---------------------------|--------|---------------|
| Obligations of States and Political Subdivisions | \$59,640      | \$2,736                   | \$-    | \$62,376      |
| Mortgage Backed Securities                       | 1,205         | 46                        | -      | 1,251         |
| Other  | 2,247         | -                         | -      | 2,247         |
| Total  | \$63,092      | \$2,782                   | \$-    | \$65,874      |

| December 31, 2010                                | Book<br>Value | Gross Unrealized<br>Gains | Losses | Fair<br>Value |
|--|---------------|---------------------------|--------|---------------|
| Obligations of States and Political Subdivisions | \$60,439      | \$1,258                   | \$241  | \$61,456      |
| Mortgage Backed Securities                       | 2,218         | 85                        | -      | 2,303         |
| Other  | 2,280         | -                         | -      | 2,280         |
| Total  | \$64,937      | \$1,343                   | \$241  | \$66,039      |

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

(1) All Mortgage Backed Securities were issued by an agency or government sponsored entity of the U.S. government.

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The amortized cost and estimated fair values of investment securities at December 31, 2011 by contractual maturity are shown in the following tables (in thousands)

| Securities Available-for-Sale<br>December 31, 2011   | Within<br>1 Year | After 1<br>but<br>Within 5 | After 5<br>but<br>Within 10 | Over<br>10 years | Total<br>Fair<br>Value |
|--|------------------|----------------------------|-----------------------------|------------------|------------------------|
| Government Agency &<br>Government-Sponsored Entities | \$20,252         | \$61,165                   | \$1,178                     | \$-              | \$82,595               |
| Obligations of States and Political<br>Subdivisions  | -                | -                          | 225                         | 5,557            | 5,782                  |
| Mortgage Backed Securities                           | -                | -                          | 130,102                     | 260,931          | 391,033                |
| Other  | 410              | -                          | -                           | -                | 410                    |
| <b>Total</b>   | <b>\$20,662</b>  | <b>\$61,165</b>            | <b>\$131,505</b>            | <b>\$266,488</b> | <b>\$479,820</b>       |

| Securities Held-to-Maturity<br>December 31, 2011    | Within<br>1 Year | After 1<br>but<br>Within 5 | After 5<br>but<br>Within 10 | Over<br>10 years | Total<br>Book<br>Value |
|---|------------------|----------------------------|-----------------------------|------------------|------------------------|
| Obligations of States and Political<br>Subdivisions | \$1,820          | \$7,399                    | \$42,667                    | \$7,754          | \$59,640               |
| Mortgage Backed Securities                          | -                | 1,205                      | -                           | -                | 1,205                  |
| Other   | -                | 6                          | 2,241                       | -                | 2,247                  |
| <b>Total</b>  | <b>\$1,820</b>   | <b>\$8,610</b>             | <b>\$44,908</b>             | <b>\$7,754</b>   | <b>\$63,092</b>        |

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

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

| December 31, 2011                                    | Less Than 12 Months |                    | 12 Months or More |                    | Total            |                    |
|--|---------------------|--------------------|-------------------|--------------------|------------------|--------------------|
|  | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value    | Unrealized<br>Loss |
| Government Agency &<br>Government-Sponsored Entities | \$ 4,987            | \$ 13              | \$ -              | \$ -               | \$ 4,987         | \$ 13              |
| Mortgage Backed Securities                           | 85,090              | 139                | -                 | -                  | 85,090           | 139                |
| <b>Total</b>   | <b>\$ 90,077</b>    | <b>\$ 152</b>      | <b>\$ -</b>       | <b>\$ -</b>        | <b>\$ 90,077</b> | <b>\$ 152</b>      |

| December 31, 2010                                    | Less Than 12 Months |                    | 12 Months or More |                    | Total             |                    |
|--|---------------------|--------------------|-------------------|--------------------|-------------------|--------------------|
|  | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss |
| Government Agency &<br>Government-Sponsored Entities | \$ 145,844          | \$ 1,930           | \$ -              | \$ -               | \$ 145,844        | \$ 1,930           |
| Obligations of States and Political<br>Subdivisions  | 6,165               | 241                | -                 | -                  | 6,165             | 241                |
| Mortgage Backed Securities                           | 44,479              | 1,619              | -                 | -                  | 44,479            | 1,619              |
| <b>Total</b>   | <b>\$ 196,488</b>   | <b>\$ 3,790</b>    | <b>\$ -</b>       | <b>\$ -</b>        | <b>\$ 196,488</b> | <b>\$ 3,790</b>    |

As of December 31, 2011, the Company held 317 investment securities of which 10 were in a loss position for less than twelve months. No securities were in a loss position for twelve months or more. Management periodically evaluates each investment security for other-than-temporary impairment relying primarily on industry analyst reports and observations of market conditions and interest rate fluctuations. Management believes it will be able to collect all amounts due according to the contractual terms of the underlying investment securities.

#### Securities of Government Agency and Government Sponsored Entities

The unrealized losses on the Company's investments in securities of government agency and government sponsored entities were caused by interest rate increases. Repayment of these investments is guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2011.



Table of Contents**Mortgage Backed Securities**

The unrealized losses on the Company's investment in mortgage backed securities were caused by interest rate increases. The contractual cash flows of these investments are guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2011.

**Obligations of States and Political Subdivisions**

The continuing financial problems being experienced by certain municipalities, along with the financial stresses exhibited by some of the large monoline bond insurers have increased the overall risk associated with bank-qualified municipal bonds. As of December 31, 2011, over ninety-two percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of the eight percent of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

The unrealized losses on the Company's investment in obligation of states and political subdivision were \$0 at December 31, 2011 and \$241,000 at December 31, 2010. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company did not intend to sell the securities and it was more likely than not that the Company would not have to sell the securities before recovery of their cost basis, the Company did not consider these investments to be other-than-temporarily impaired at December 31, 2011.

Proceeds from sales of securities available-for-sale were as follows:  
(in thousands)

|      | Gross<br>Proceeds | Gross<br>Gains | Gross<br>Losses |
|------|-------------------|----------------|-----------------|
| 2011 | \$201,135         | \$95           | \$-             |
| 2010 | 268,490           | 2,895          | -               |
| 2009 | 112,765           | 3,524          | -               |

As of December 31, 2011, securities carried at \$373.2 million were pledged to secure public deposits, FHLB borrowings, and other government agency deposits as required by law. This amount at December 31, 2010, was \$346.3 million.

**3. Federal Home Loan Bank of San Francisco Stock**

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. FHLB stock is reported in Other Assets and Interest Receivable on the Company's Consolidated Balance Sheets and totaled \$7.0 million at December 31, 2011 and \$6.2 million at December 31, 2010.

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## 4. Loans

Loans as of December 31 consisted of the following:

| (in thousands)                      | 2011        | 2010        |
|-------------------------------------|-------------|-------------|
| Commercial Real Estate              | \$307,670   | \$318,341   |
| Agricultural Real Estate            | 280,139     | 254,575     |
| Real Estate Construction            | 29,607      | 37,486      |
| Residential 1st Mortgages           | 107,421     | 103,574     |
| Home Equity Lines and Loans         | 50,956      | 58,971      |
| Agricultural                        | 217,227     | 231,150     |
| Commercial                          | 165,089     | 165,263     |
| Consumer & Other                    | 6,935       | 8,712       |
| Total Gross Loans                   | 1,165,044   | 1,178,072   |
| Deferred Loan Origination Fees, Net | (1,966 )    | (2,070 )    |
| Subtotal                            | 1,163,078   | 1,176,002   |
| Allowance for Loan Losses           | (33,017 )   | (32,261 )   |
| Net Loans                           | \$1,130,061 | \$1,143,741 |

At December 31, 2011, the portion of loans that were approved for pledging as collateral on borrowing lines with the Federal Home Loan Bank (“FHLB”) and the Federal Reserve Bank (“FRB”) were \$338.1 million and \$403.3 million, respectively. The borrowing capacity on these loans was \$218.7 million from FHLB and \$293.8 million from the FRB. There was an outstanding borrowing of \$43,000 against the FHLB collateral and no outstanding borrowings against the FRB collateral these loans at December 31, 2011.

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## 5. Allowance for Loan Losses

The following table shows the allocation of the allowance for loan losses at December 31, 2011 and December 31, 2010 by portfolio segment and by impairment methodology (in thousands):

| December 31, 2011                                    | Commercial Real Estate | Agricultural Real Estate | Real Estate Construction | Residential 1st Mortgages | Home Equity | Agricultural | Commercial | Consumer & Other | Unallocated | Total     |
|--|------------------------|--------------------------|--------------------------|---------------------------|-------------|--------------|------------|------------------|-------------|-----------|
| Year-To-Date Allowance for Credit Losses:            |                        |                          |                          |                           |             |              |            |                  |             |           |
| Beginning Balance- January 1, 2011                   | \$7,631                | \$1,539                  | \$2,160                  | \$1,164                   | \$3,724     | \$6,733      | \$9,084    | \$216            | \$10        | \$32,261  |
| Charge-Offs  | (25 )                  | (384 )                   | -                        | (449 )                    | (751 )      | (3,559 )     | (788 )     | (190 )           | -           | (6,146 )  |
| Recoveries   | -                      | 18                       | -                        | 4                         | 13          | 10           | 21         | 61               | -           | 127       |
| Provision  | (1,783 )               | 1,410                    | (227 )                   | 532                       | 760         | 4,943        | 416        | 120              | 604         | 6,775     |
| Ending Balance- December 31, 2011                    | \$5,823                | \$2,583                  | \$1,933                  | \$1,251                   | \$3,746     | \$8,127      | \$8,733    | \$207            | \$614       | \$33,017  |
| Ending Balance Individually Evaluated for Impairment | 686                    | -                        | -                        | -                         | 80          | 793          | 54         | 23               | -           | 1,636     |
| Ending Balance Collectively Evaluated for Impairment | 5,137                  | 2,583                    | 1,933                    | 1,251                     | 3,666       | 7,334        | 8,679      | 184              | 614         | 31,381    |
| Ending Balance Individually Evaluated for Impairment | 4,562                  | 954                      | -                        | 1,194                     | 576         | 1,337        | 292        | 23               | -           | 8,938     |
| Ending Balance Collectively Evaluated for Impairment | 301,142                | 279,185                  | 29,607                   | 106,227                   | 50,380      | 215,890      | 164,797    | 6,912            | -           | 1,154,140 |
|  | Commercial             | Agricultural             |                          |                           |             | Agricultural | Commercial | Consumer         | Unallocated | Total     |

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| December<br>31, 2010                                 | Real<br>Estate | Real<br>Estate | Real<br>Estate<br>Construction | Residential<br>1st<br>Mortgages | Home<br>Equity |           |           |         | &<br>Other |             |
|--|----------------|----------------|--------------------------------|---------------------------------|----------------|-----------|-----------|---------|------------|-------------|
| Year-To-Date Allowance for Credit Losses:            |                |                |                                |                                 |                |           |           |         |            |             |
| Beginning Balance- January 1, 2010                   |                |                |                                |                                 |                |           |           |         |            |             |
|  | \$12,845       | \$1,099        | \$4,089                        | \$552                           | \$1,349        | \$2,298   | \$6,449   | \$325   | \$807      | \$29,813    |
| Charge-Offs  | (1,629 )       | (559 )         | (4,095 )                       | (759 )                          | (310 )         | (916 )    | (4,143 )  | (112 )  | -          | (12,523 )   |
| Recoveries   | -              | 2              | -                              | 7                               | -              | 68        | 92        | 67      | -          | 236         |
| Provision  | (3,585 )       | 997            | 2,166                          | 1,364                           | 2,685          | 5,283     | 6,686     | (64 )   | (797)      | 14,735      |
| Ending Balance- December 31, 2010                    |                |                |                                |                                 |                |           |           |         |            |             |
|  | \$7,631        | \$1,539        | \$2,160                        | \$1,164                         | \$3,724        | \$6,733   | \$9,084   | \$216   | \$10       | \$32,261    |
| Ending Balance Individually Evaluated for Impairment |                |                |                                |                                 |                |           |           |         |            |             |
|  | 3,425          | 365            | 850                            | 298                             | -              | 150       | 84        | -       | -          | 5,172       |
| Ending Balance Collectively Evaluated for Impairment |                |                |                                |                                 |                |           |           |         |            |             |
|  | 4,206          | 1,174          | 1,310                          | 866                             | 3,724          | 6,583     | 9,000     | 216     | 10         | 27,089      |
| Loans:   |                |                |                                |                                 |                |           |           |         |            |             |
| Ending Balance                                       |                |                |                                |                                 |                |           |           |         |            |             |
|  | \$316,271      | \$254,575      | \$37,486                       | \$103,574                       | \$58,971       | \$231,150 | \$165,263 | \$8,712 | \$-        | \$1,176,002 |
| Ending Balance Individually Evaluated for Impairment |                |                |                                |                                 |                |           |           |         |            |             |
|  | 22,107         | 1,797          | 6,193                          | 1,824                           | 13             | 750       | 277       | -       | -          | 32,961      |
| Ending Balance Collectively Evaluated for Impairment |                |                |                                |                                 |                |           |           |         |            |             |
|  | 294,164        | 252,778        | 31,293                         | 101,750                         | 58,958         | 230,400   | 164,986   | 8,712   | -          | 1,143,041   |

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The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2011 and December 31, 2010 (in thousands):

| December 31, 2011         | Pass                | Special<br>Mention | Substandard      | Total Loans         |
|---------------------------|---------------------|--------------------|------------------|---------------------|
| Loans:                    |                     |                    |                  |                     |
| Commercial Real Estate    | \$ 265,201          | \$ 15,186          | \$ 25,317        | \$ 305,704          |
| Agricultural Real Estate  | 254,181             | 21,657             | 4,301            | 280,139             |
| Real Estate Construction  | 21,428              | 3,217              | 4,962            | 29,607              |
| Residential 1st Mortgages | 104,609             | 1,483              | 1,329            | 107,421             |
| Home Equity               | 49,631              | -                  | 1,325            | 50,956              |
| Agricultural              | 209,555             | 4,083              | 3,589            | 217,227             |
| Commercial                | 158,273             | 5,240              | 1,576            | 165,089             |
| Consumer & Other          | 6,528               | -                  | 407              | 6,935               |
| <b>Total</b>              | <b>\$ 1,069,406</b> | <b>\$ 50,866</b>   | <b>\$ 42,806</b> | <b>\$ 1,163,078</b> |

| December 31, 2010         | Pass                | Special<br>Mention | Substandard      | Total Loans         |
|---------------------------|---------------------|--------------------|------------------|---------------------|
| Loans:                    |                     |                    |                  |                     |
| Commercial Real Estate    | \$ 281,868          | \$ 9,846           | \$ 24,557        | \$ 316,271          |
| Agricultural Real Estate  | 237,127             | 14,563             | 2,885            | 254,575             |
| Real Estate Construction  | 27,734              | 3,217              | 6,535            | 37,486              |
| Residential 1st Mortgages | 100,709             | 1,099              | 1,766            | 103,574             |
| Home Equity               | 58,632              | -                  | 339              | 58,971              |
| Agricultural              | 218,165             | 11,521             | 1,464            | 231,150             |
| Commercial                | 160,045             | 2,965              | 2,253            | 165,263             |
| Consumer & Other          | 8,498               | -                  | 214              | 8,712               |
| <b>Total</b>              | <b>\$ 1,092,778</b> | <b>\$ 43,211</b>   | <b>\$ 40,013</b> | <b>\$ 1,176,002</b> |

See Note 1. Significant Accounting Policies – Allowance for Loan Losses for a description of the internal risk ratings used by the Company. There were no loans outstanding at December 31, 2011 and 2010 rated doubtful or loss.

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The following table shows an aging analysis of the loan portfolio by the time past due at December 31, 2011 and December 31, 2010 (in thousands):

| December 31, 2011        | 30-89 Days<br>Past Due | 90 Days and<br>Still Accruing | Nonaccrual      | Total Past<br>Due | Current             | Total<br>Loans      |
|--------------------------|------------------------|-------------------------------|-----------------|-------------------|---------------------|---------------------|
| Loans:                   |                        |                               |                 |                   |                     |                     |
| Commercial Real Estate   | \$ -                   | \$ -                          | \$ 1,354        | \$ 1,354          | \$ 304,350          | \$ 305,704          |
| Agricultural Real Estate | -                      | -                             | 954             | 954               | 279,185             | 280,139             |
| Real Estate Construction | -                      | -                             | -               | -                 | 29,607              | 29,607              |
| Residential 1st          |                        |                               |                 |                   |                     |                     |
| Mortgages                | 108                    | -                             | 284             | 392               | 107,029             | 107,421             |
| Home Equity              | 566                    | -                             | 194             | 760               | 50,196              | 50,956              |
| Agricultural             | 284                    | -                             | 1,202           | 1,486             | 215,741             | 217,227             |
| Commercial               | 179                    | -                             | 217             | 396               | 164,693             | 165,089             |
| Consumer & Other         | 101                    | -                             | 23              | 124               | 6,811               | 6,935               |
| <b>Total</b>             | <b>\$ 1,238</b>        | <b>\$ -</b>                   | <b>\$ 4,228</b> | <b>\$ 5,466</b>   | <b>\$ 1,157,612</b> | <b>\$ 1,163,078</b> |

| December 31, 2010        | 30-89 Days<br>Past Due | 90 Days and<br>Still Accruing | Nonaccrual      | Total Past<br>Due | Current             | Total<br>Loans      |
|--------------------------|------------------------|-------------------------------|-----------------|-------------------|---------------------|---------------------|
| Loans:                   |                        |                               |                 |                   |                     |                     |
| Commercial Real Estate   | \$ -                   | \$ -                          | \$ 2,348        | \$ 2,348          | \$ 313,923          | \$ 316,271          |
| Agricultural Real Estate | -                      | -                             | 1,797           | 1,797             | 252,778             | 254,575             |
| Real Estate Construction | -                      | -                             | -               | -                 | 37,486              | 37,486              |
| Residential 1st          |                        |                               |                 |                   |                     |                     |
| Mortgages                | 797                    | -                             | 954             | 1,751             | 101,823             | 103,574             |
| Home Equity              | 526                    | -                             | -               | 526               | 58,445              | 58,971              |
| Agricultural             | 47                     | -                             | -               | 47                | 231,103             | 231,150             |
| Commercial               | 275                    | -                             | 207             | 482               | 164,781             | 165,263             |
| Consumer & Other         | 44                     | -                             | 2               | 46                | 8,666               | 8,712               |
| <b>Total</b>             | <b>\$ 1,689</b>        | <b>\$ -</b>                   | <b>\$ 5,308</b> | <b>\$ 6,997</b>   | <b>\$ 1,169,005</b> | <b>\$ 1,176,002</b> |

Non-accrual loans at December 31, 2011 and 2010 were \$4.2 million and \$5.3 million, respectively. Interest income forgone on loans placed on non-accrual status was \$385,000, \$356,000, and \$618,000 for the years ended December 31, 2011, 2010, and 2009, respectively.

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The following table shows information related to impaired loans at and for the year ended December 31, 2011 and December 31, 2010 (in thousands):

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| December 31, 2011                   |                        |                                |                      |                                   |                                  |
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$1,555                | \$1,547                        | \$-                  | \$729                             | \$-                              |
| Agricultural Real Estate            | 955                    | 974                            | -                    | 1,341                             | -                                |
| Real Estate Construction            | -                      | -                              | -                    | -                                 | -                                |
| Residential 1st Mortgages           | 1,219                  | 1,272                          | -                    | 936                               | 13                               |
| Home Equity                         | 469                    | 484                            | -                    | 290                               | 2                                |
| Agricultural                        | 262                    | 372                            | -                    | 149                               | 9                                |
| Commercial                          | 188                    | 264                            | -                    | 195                               | 1                                |
| Consumer & Other                    | -                      | -                              | -                    | 5                                 | -                                |
|                                     | \$4,648                | \$4,913                        | \$-                  | \$3,645                           | \$25                             |
| With an allowance recorded:         |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$3,017                | \$3,015                        | \$686                | \$2,281                           | \$89                             |
| Agricultural Real Estate            | -                      | -                              | -                    | 529                               | -                                |
| Real Estate Construction            | -                      | -                              | -                    | -                                 | -                                |
| Residential 1st Mortgages           | -                      | -                              | -                    | -                                 | -                                |
| Home Equity                         | 113                    | 119                            | 80                   | 117                               | 2                                |
| Agricultural                        | 1,076                  | 1,791                          | 793                  | 1,818                             | 25                               |
| Commercial                          | 104                    | 107                            | 54                   | 120                               | -                                |
| Consumer & Other                    | 24                     | 24                             | 23                   | 31                                | -                                |
|                                     | \$4,334                | \$5,056                        | \$1,636              | \$4,896                           | \$116                            |
| Total                               | \$8,982                | \$9,969                        | \$1,636              | \$8,541                           | \$141                            |
| December 31, 2010                   |                        |                                |                      |                                   |                                  |
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$12,218               | \$12,442                       | \$-                  | \$9,259                           | \$227                            |
| Agricultural Real Estate            | 975                    | 974                            | -                    | 867                               | -                                |
| Real Estate Construction            | 3,092                  | 3,093                          | -                    | 3,276                             | 71                               |
| Residential 1st Mortgages           | 857                    | 1,197                          | -                    | 742                               | 26                               |
| Home Equity                         | 36                     | 42                             | -                    | 359                               | 2                                |
| Agricultural                        | -                      | -                              | -                    | 430                               | -                                |
| Commercial                          | 140                    | 140                            | -                    | 1,124                             | -                                |
| Consumer & Other                    | -                      | -                              | -                    | 1                                 | -                                |
|                                     | \$17,318               | \$17,888                       | \$-                  | \$16,058                          | \$326                            |
| With an allowance recorded:         |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$9,907                | \$9,909                        | \$3,425              | \$5,141                           | \$360                            |
| Agricultural Real Estate            | 826                    | 823                            | 365                  | 417                               | 27                               |
| Real Estate Construction            | 3,100                  | 3,100                          | 850                  | 1,308                             | 41                               |
| Residential 1st Mortgages           | 952                    | 997                            | 298                  | 294                               | 8                                |
| Home Equity                         | -                      | -                              | -                    | 3                                 | -                                |
| Agricultural                        | 750                    | 750                            | 150                  | 188                               | 24                               |
| Commercial                          | 137                    | 136                            | 84                   | 34                                | 3                                |

|                  |          |          |         |          |       |
|------------------|----------|----------|---------|----------|-------|
| Consumer & Other | -        | -        | -       | -        | -     |
|                  | \$15,672 | \$15,715 | \$5,172 | \$7,385  | \$463 |
| Total            | \$32,990 | \$33,603 | \$5,172 | \$23,443 | \$789 |

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

At December 31, 2011, the Company allocated \$759,000 of specific reserves to \$4.9 million of troubled debt restructured loans, of which \$4.7 million were performing. At December 31, 2010, the Company allocated \$4.6 million of specific reserves to \$28.2 million of troubled debt restructured loans, of which \$27.7 million were performing. The Company had no commitments at December 31, 2011 and December 31, 2010 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.



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During the period ending December 31, 2011, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 2 years to 8 years. Modifications involving an extension of the maturity date were for periods ranging from 3 years to 10 years.

The following table presents loans by class modified as troubled debt restructured loans for period ended December 31, 2011 (in thousands):

|                              | December 31, 2011                   |                                    |  |
|------------------------------|-------------------------------------|------------------------------------|--|
|                              | Number of Pre-Modification<br>Loans | Outstanding<br>Recorded Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Troubled Debt Restructurings |                                     |                                    |  |
| Commercial Real Estate       | 3                                   | \$ 3,224                           | \$ 3,224   |
| Agricultural Real Estate     | -                                   | -                                  | -  |
| Real Estate Construction     | -                                   | -                                  | -  |
| Residential 1st Mortgages    | 5                                   | 995                                | 940  |
| Home Equity Lines & Loans    | 7                                   | 381                                | 362  |
| Agricultural                 | 1                                   | 140                                | 140  |
| Commercial                   | 2                                   | 82                                 | 82   |
| Consumer & Other             | 1                                   | 24                                 | 24   |
| <b>Total</b>                 | <b>19</b>                           | <b>\$ 4,846</b>                    | <b>\$ 4,772</b>  |

The troubled debt restructurings described above increased the allowance for loan losses by \$78,000 and resulted in charge-offs of \$74,000 during the year ended December 31, 2011.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the twelve months ended December 31, 2011 (in thousands):

| Troubled Debt Restructurings That Subsequently<br>Defaulted | December 31, 2011  |                     |
|---|--------------------|---------------------|
|   | Number of<br>Loans | Recorded Investment |
| Commercial Real Estate                                      | -                  | \$ -                |
| Agricultural Real Estate                                    | -                  | -                   |
| Real Estate Construction                                    | -                  | -                   |
| Residential 1st Mortgages                                   | -                  | -                   |
| Home Equity Lines & Loans                                   | 1                  | 12                  |
| Agricultural  | -                  | -                   |
| Commercial  | -                  | -                   |
| Consumer & Other  | -                  | -                   |
| <b>Total</b>  | <b>1</b>           | <b>\$ 12</b>        |

A loan is considered to be in payment default once it is greater than 90 days contractually past due under the modified terms.

The troubled debt restructurings that subsequently defaulted did not increase the allowance for loan losses but did result in charge offs of \$12,000 during the twelve month period ending December 31, 2011.

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## 6. Premises and Equipment

Premises and equipment as of December 31, consisted of the following:

| (in thousands)                                  | 2011     | 2010     |
|---|----------|----------|
| Land and Buildings                              | \$32,832 | \$31,700 |
| Furniture, Fixtures, and Equipment              | 16,710   | 16,763   |
| Leasehold Improvements                          | 2,054    | 2,044    |
| Subtotal  | 51,596   | 50,507   |
| Less: Accumulated Depreciation and Amortization | 27,538   | 26,293   |
| Total   | \$24,058 | \$24,214 |

Depreciation and amortization on premises and equipment included in occupancy and equipment expense amounted to \$1,801,000, \$1,867,000, and \$1,894,000 for the years ended December 31, 2011, 2010, and 2009, respectively. Total rental expense for premises was \$386,000, \$372,000, and \$379,000 for the years ended December 31, 2011, 2010, and 2009, respectively. Rental income was \$130,000, \$157,000, and \$178,000 for the years ended December 31, 2011, 2010, and 2009, respectively.

## 7. Other Real Estate

The Bank reported \$2.9 million, net of \$4.1 million reserve, in other real estate at December 31, 2011, and \$8.0 million, net of \$3.7 million reserve, in 2010. Other real estate includes property no longer utilized for business operations and property acquired through foreclosure proceedings. These properties are carried at the lower of cost or fair value less selling costs determined at the date acquired. Losses, if any, arising from properties acquired through foreclosure are charged against the allowance for loan losses at the time of foreclosure. Subsequent declines in value, periodic holding costs, and net gains or losses on disposition are included in other operating expense as incurred. Other real estate is reported in Interest Receivable and Other Assets on the Company's Consolidated Balance Sheets.

## 8. Time Deposits

Time Deposits of \$100,000 or more as of December 31 were as follows:

| (in thousands) | 2011      | 2010      |
|----------------|-----------|-----------|
| Balance        | \$366,958 | \$397,491 |

At December 31, 2011, the scheduled maturities of time deposits were as follows:

| (in thousands) | Scheduled Maturities |
|----------------|----------------------|
| 2012           | \$466,631            |
| 2013           | 27,376               |
| 2014           | 17,099               |
| 2015           | 442                  |
| 2016           | 6,263                |
| Total          | \$517,811            |

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## 9. Income Taxes

Current and deferred income tax expense (benefit) provided for the years ended December 31 consisted of the following:

| (in thousands)            | 2011     | 2010     | 2009     |
|---------------------------|----------|----------|----------|
| Current                   |          |          |          |
| Federal                   | \$10,168 | \$10,115 | \$13,815 |
| State                     | 3,734    | 3,931    | 4,912    |
| Total Current             | 13,902   | 14,046   | 18,727   |
| Deferred                  |          |          |          |
| Federal                   | (685 )   | (1,323 ) | (5,666 ) |
| State                     | (575 )   | (554 )   | (1,746 ) |
| Total Deferred            | (1,260 ) | (1,877 ) | (7,412 ) |
| Total Provision for Taxes | \$12,642 | \$12,169 | \$11,315 |

The total provision for income taxes differs from the federal statutory rate as follows:

| (in thousands)  | 2011      |         | 2010      |         | 2009      |         |
|---|-----------|---------|-----------|---------|-----------|---------|
|   | Amount    | Rate    | Amount    | Rate    | Amount    | Rate    |
| Tax Provision at Federal Statutory Rate   | \$ 12,198 | 35.0 %  | \$ 11,650 | 35.0 %  | \$ 10,965 | 35.0 %  |
| Interest on Obligations of States and Political Subdivisions Exempt from Federal Taxation | (884 )    | (2.5 )% | (943 )    | (2.8 )% | (980 )    | (3.1 )% |
| State and Local Income Taxes, Net of Federal Income Tax Benefit                           | 2,053     | 5.9 %   | 2,195     | 6.6 %   | 2,058     | 6.5 %   |
| Bank Owned Life Insurance   | (663 )    | (1.9 )% | (664 )    | (2.0 )% | (656 )    | (2.1 )% |
| Other, Net  | (62 )     | (0.2 )% | (69 )     | (0.2 )% | (72 )     | (0.2 )% |
| Total Provision for Taxes   | \$ 12,642 | 36.3 %  | \$ 12,169 | 36.6 %  | \$ 11,315 | 36.1 %  |

The components of net deferred tax assets as of December 31 are as follows:

| (in thousands)                                   | 2011     | 2010     |
|--|----------|----------|
| Deferred Tax Assets                              |          |          |
| Allowance for Loan Losses                        | \$13,942 | \$13,624 |
| Accrued Liabilities                              | 5,766    | 4,468    |
| Deferred Compensation                            | 5,712    | 5,847    |
| State Franchise Tax                              | 1,307    | 1,376    |
| Capital Loss Carry Forward                       | 210      | 192      |
| Interest on Non-Accrual Loans                    | 162      | 150      |
| ORE Writedown and Holding Costs                  | 1,841    | 1,807    |
| Total Deferred Tax Assets                        | \$28,940 | \$27,464 |
| Deferred Tax Liabilities                         |          |          |
| Premises and Equipment                           | \$(639 ) | \$(547 ) |
| Securities Accretion                             | (875 )   | (760 )   |
| Unrealized Gain on Securities Available-for-Sale | (3,386 ) | (1,170 ) |

|                                |          |          |
|--------------------------------|----------|----------|
| Other                          | (748 )   | (739 )   |
| Total Deferred Tax Liabilities | (5,648 ) | (3,216 ) |
| Net Deferred Tax Assets        | \$23,292 | \$24,248 |

The net deferred tax assets are reported in Interest Receivable and Other Assets on the Company's Consolidated Balance Sheet.

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The Company and its subsidiaries file income tax returns in the U.S. federal and California jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2006.

## 10. Short Term Borrowings

As of December 31, 2011 and 2010, the Company had unused lines of credit available for short term liquidity purposes of \$678.7 million and \$490.6 million, respectively. Federal Funds purchased and advances are generally issued on an overnight basis. There were no advances from the FHLB at December 31, 2011. There were no Federal Funds purchased or advances from the FRB at December 31, 2011.

## 11. Securities Sold Under Agreement to Repurchase

Securities Sold Under Agreement to Repurchase are used as secured borrowing alternatives to FHLB Advances or FRB Borrowings, and totaled \$60 million at December 31, 2011 and December 31, 2010.

On March 13, 2008, the Bank entered into a \$40 million term repurchase agreement with Citigroup. The repurchase agreement pricing rate is 3.20% with an embedded 3 year cap tied to 3 month Libor with a strike price of 3.3675%. The repurchase agreement matures March 13, 2013 and is secured by investments in Agency pass through securities.

On May 30, 2008, the Company entered into a \$20 million term repurchase agreement with Citigroup. The repurchase agreement pricing rate is 4.19% with an embedded 3 year cap tied to 3 month Libor with a strike price of 3.17%. The repurchase agreement matures June 5, 2013 and is secured by investments in Agency pass through securities.

## 12. Federal Home Loan Bank Advances

The Company's advances from the Federal Home Loan Bank of San Francisco consist of the following as of December 31,

| (in thousands)   | 2011         | 2010         |
|--|--------------|--------------|
| 5.60% amortizing note, interest and principal payable monthly with final maturity of September 25, 2018. | \$530        | \$591        |
| No fixed rate credit advances at December 31, 2011   | -            | -            |
| <b>Total</b>   | <b>\$530</b> | <b>\$591</b> |

In accordance with the Collateral Pledge and Security Agreement, advances are secured by all FHLB stock held by the Company and by government agency & government-sponsored entity securities and mortgage-backed securities with carrying values of \$511,000. At December 31, 2011, \$338.1 million in loans were approved for pledging as collateral on borrowing lines with the FHLB. The borrowing capacity on these loans was \$218.7 million. There was an outstanding borrowing against these loans of \$43,000 at December 31, 2011.

## 13. Long-term Subordinated Debentures

In December 2003, the Company formed a wholly owned Connecticut statutory business trust, FMCB Statutory Trust I ("Statutory Trust I"), which issued \$10,000,000 of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures (the "Trust Preferred Securities"). The Company is not considered the primary beneficiary of the trust (variable interest entity), therefore the trust is not consolidated in the Company's

financial statements, but rather the subordinated debentures are shown as a liability. These debentures qualify as Tier 1 capital under Federal Reserve Board guidelines. All of the common securities of Statutory Trust I are owned by the Company. The proceeds from the issuance of the common securities and the Trust Preferred Securities were used by FMCB Statutory Trust to purchase \$10,310,000 of junior subordinated debentures of the Company, which carry a floating rate based on three-month LIBOR plus 2.85%. The debentures represent the sole asset of Statutory Trust I. The Trust Preferred Securities accrue and pay distributions at a floating rate of three-month LIBOR plus 2.85% per annum of the stated liquidation value of \$1,000 per capital security. The Company has entered into contractual arrangements which, taken collectively, fully and unconditionally guarantee payment to the extent that Statutory Trust I has funds available therefore of: (i) accrued and unpaid distributions required to be paid on the Trust Preferred Securities; (ii) the redemption price with respect to any Trust Preferred Securities called for redemption by Statutory Trust I; and (iii) payments due upon a voluntary or involuntary dissolution, winding up, or liquidation of Statutory Trust I. The Trust Preferred Securities are mandatorily redeemable upon maturity of the subordinated debentures on December 17, 2033, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the subordinated debentures purchased by Statutory Trust I, in whole or in part, on or after December 17, 2008. As specified in the indenture, if the subordinated debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company's common stock.

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14. Shareholders' Equity

In 1998, the Board approved the Company's first stock repurchase program. This program was extended and expanded in both 2004 and 2006. Most recently, on November 12, 2008, the Board of Directors approved increasing the funds available for the Company's Common Stock Repurchase Program. The Board's resolution authorized up to \$20 million in repurchases over the four-year period ending October 31, 2012.

Repurchases under the program will continue to be made on the open market or through private transactions. The repurchase program also requires that no purchases may be made if the Bank would not remain "well-capitalized" after the repurchase.

Dividends from the Bank constitute the principal source of cash to the Company. The Company is a legal entity separate and distinct from the Bank. Under regulations controlling California state chartered banks, the Bank is, to some extent, limited in the amount of dividends that can be paid to the Company without prior approval of the California DFI. These regulations require approval if total dividends declared by a state chartered bank in any calendar year exceed the bank's net profits for that year combined with its retained net profits for the preceding two calendar years. As of December 31, 2011, the Bank could declare dividends of \$33,457,000 without approval of the California DFI.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios set forth in the following table of Total and Tier 1 capital to risk-weighted assets (as defined in the regulations), and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of December 31, 2011, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

In addition, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Federal Government passed the Emergency Economic Stabilization Act of 2008, which, among other measures, established the TARP capital purchase program, pursuant to which it provides access to Tier 1 capital through a standardized program to acquire preferred stock (accompanied by warrants) from eligible financial institutions. Based upon the Company's strong capital position and continued earnings strength, the Company elected not to participate in the capital purchase program.



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| (in thousands)<br>December 31, 2011                 | Actual    |         | Regulatory Capital Requirements |       | Well Capitalized Under Prompt Corrective Action |        |
|---|-----------|---------|---------------------------------|-------|---|--------|
|   | Amount    | Ratio   | Amount                          | Ratio | Amount  | Ratio  |
| Total Bank Capital to Risk Weighted Assets          | \$212,590 | 14.85 % | \$114,508                       | 8.0 % | \$143,135                                       | 10.0 % |
| Total Consolidated Capital to Risk Weighted Assets  | \$212,761 | 14.86 % | \$114,520                       | 8.0 % | N/A   | N/A    |
| Tier 1 Bank Capital to Risk Weighted Assets         | \$194,509 | 13.59 % | \$57,254                        | 4.0 % | \$85,881  | 6.0 %  |
| Tier 1 Consolidated Capital to Risk Weighted Assets | \$194,679 | 13.60 % | \$57,260                        | 4.0 % | N/A   | N/A    |
| Tier 1 Bank Capital to Average Assets               | \$194,509 | 10.22 % | \$76,146                        | 4.0 % | \$95,182  | 5.0 %  |
| Tier 1 Consolidated Capital to Average Assets       | \$194,679 | 10.22 % | \$76,204                        | 4.0 % | N/A   | N/A    |

| (in thousands)<br>December 31, 2010                 | Actual    |         | Regulatory Capital Requirements |       | Well Capitalized Under Prompt Corrective Action |        |
|---|-----------|---------|---------------------------------|-------|---|--------|
|   | Amount    | Ratio   | Amount                          | Ratio | Amount  | Ratio  |
| Total Bank Capital to Risk Weighted Assets          | \$200,045 | 13.84 % | \$115,673                       | 8.0 % | \$144,591                                       | 10.0 % |
| Total Consolidated Capital to Risk Weighted Assets  | \$199,879 | 13.82 % | \$115,677                       | 8.0 % | N/A   | N/A    |
| Tier 1 Bank Capital to Risk Weighted Assets         | \$181,795 | 12.57 % | \$57,836                        | 4.0 % | \$86,755  | 6.0 %  |
| Tier 1 Consolidated Capital to Risk Weighted Assets | \$181,628 | 12.56 % | \$57,838                        | 4.0 % | N/A   | N/A    |
| Tier 1 Bank Capital to Average Assets               | \$181,795 | 10.00 % | \$72,728                        | 4.0 % | \$90,910  | 5.0 %  |
| Tier 1 Consolidated Capital to Average Assets       | \$181,628 | 9.98 %  | \$72,787                        | 4.0 % | N/A   | N/A    |

## 15. Dividends and Earnings Per Share

Total cash dividends during 2011 were \$9,158,000 or \$11.75 per share of common stock, an increase of 3.5% per share from \$8,855,000 or \$11.35 per share in 2010. In 2009, cash dividends totaled \$8,596,000 or \$11.00 per share.

Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the earnings per share for the periods indicated.

| (net income in thousands)                   | 2011     | 2010     | 2009     |
|---|----------|----------|----------|
| Net Income                                  | \$22,209 | \$21,118 | \$20,013 |
| Average Number of Common Shares Outstanding | 779,424  | 780,619  | 782,754  |
| Per Share Amount                            | \$28.49  | \$27.05  | \$25.57  |

## 16. Employee Benefit Plans

#### Profit Sharing Plan

The Company, through the Bank, sponsors a Profit Sharing Plan for substantially all full-time employees of the Company with one or more years of service. Participants receive up to two annual employer contributions, one is discretionary and the other is mandatory. The discretionary contributions to the Profit Sharing Plan are determined annually by the Board of Directors. The discretionary contributions totaled \$775,000, \$725,000, and \$700,000 for the years ended December 31, 2011, 2010, and 2009, respectively. The mandatory contributions to the Profit Sharing Plan are made according to a predetermined set of criteria. Mandatory contributions totaled \$868,000, \$867,000, and \$885,000 for the years ended December 31, 2011, 2010, and 2009, respectively. Company employees are permitted, within limitations imposed by tax law, to make pretax contributions to the 401(k) feature of the Profit Sharing Plan. The Company does not match employee contributions within the 401(k) feature of the Profit Sharing Plan and the Company can terminate the Profit Sharing Plan at any time. Benefits pursuant to the Profit Sharing Plan vest 0% during the first year of participation, 25% per full year thereafter and after five years such benefits are fully vested.

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Executive Retirement Plan and Life Insurance Arrangements

The Company, through the Bank, sponsors an Executive Retirement Plan for certain employees. The Executive Retirement Plan is a non-qualified defined contribution plan and was developed to supplement the Company's Profit Sharing Plan, which, as a qualified retirement plan, has a ceiling on benefits as set by the Internal Revenue Service. The Plan is comprised of: (1) a Performance Component which makes contributions based upon long-term cumulative profitability and increase in market value of the Company, and vests 50% during the first and second years of participation; (2) a Retention Component applicable to participants employed by the Company as of January 1, 2005 (contributions to this component were frozen effective December 31, 2010); (3) a Salary Component which makes contributions based upon participant salary levels and cliff vests after five years of service; and (4) an Equity Component for which contributions are discretionary and subject to Board of Directors approval and vests 50% during the first and second year of participation. Executive Retirement Plan contributions are invested in a mix of financial instruments; however Equity Component contributions are invested primarily in stock of the Company.

The Company made contributions to the Executive Retirement Plan of \$2.3 million for the year ended December 31, 2011 and \$1.6 million for each of the years ended December 31, 2010 and 2009. The Company's total accrued liability under the Executive Retirement Plan was \$15.6 million and \$13.4 million as of December 31, 2011, and 2010, respectively.

The Company has purchased single premium life insurance policies on the lives of the Executive Retirement Plan participants as well as certain other employees of the Company. These policies provide: (1) financial protection to the Company in the event of the death of a key employee; and (2) since the interest earned on the cash surrender value of the policies is tax exempt as long as the policies are used to finance employee benefits, significant income to the Company to offset the expense associated with the Executive Retirement Plan and other employee benefit plans. As compensation to each employee for agreeing to allow the Company to purchase an insurance policy on his or her life, split dollar agreements have been entered into with those employees. These agreements provide for a division of the life insurance death proceeds between the Company and each employee's designated beneficiary or beneficiaries.

The Company earned tax-exempt interest on the life insurance policies of \$1.8 million for the years ended December 31, 2011, 2010, and 2009. As of December 31, 2011 and 2010, the total cash surrender value of the insurance policies was \$47.4 million and \$45.6 million, respectively.

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## 17. Fair Value of Financial Instruments

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

The following table summarizes the book value and estimated fair value of financial instruments as of December 31 (in thousands):

|   | 2011            |                      | 2010            |                      |
|---|-----------------|----------------------|-----------------|----------------------|
|   | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| <b>Assets:</b>  |                 |                      |                 |                      |
| Cash and Cash Equivalents                                     | \$101,660       | \$101,660            | \$60,660        | \$60,660             |
| Investment Securities Available-for-Sale                      | 479,820         | 479,820              | 428,644         | 428,644              |
| Investment Securities Held-to-Maturity                        | 63,092          | 65,148               | 64,937          | 65,279               |
| Loans, Net of Deferred Loan Fees & Allowance                  | 1,130,061       | 1,162,261            | 1,143,741       | 1,177,026            |
| Bank Owned Life Insurance                                     | 47,418          | 47,418               | 45,584          | 45,584               |
| Accrued Interest Receivable                                   | 6,368           | 6,368                | 7,104           | 7,104                |
| <b>Liabilities:</b>   |                 |                      |                 |                      |
| <b>Deposits:</b>  |                 |                      |                 |                      |
| Non-Interest Bearing  | 389,639         | 389,639              | 343,482         | 343,482              |
| Interest-Bearing  | 1,236,558       | 1,237,849            | 1,223,021       | 1,224,760            |
| FHLB Advances & Securities Sold Under Agreement to Repurchase | 60,530          | 63,000               | 60,591          | 64,640               |
| Subordinated Debentures                                       | 10,310          | 5,953                | 10,310          | 4,372                |
| Accrued Interest Payable                                      | 911             | 911                  | 1,411           | 1,411                |

The methods and assumptions used to estimate the fair value of each class of financial instrument listed in the table above are explained below.

**Cash and Cash Equivalents:** The carrying amounts reported in the balance sheet for cash and due from banks, federal funds sold, and securities purchased under agreements to resell are a reasonable estimate of fair value.

**Investment Securities:** Fair values for investment securities are based on quoted market prices or dealer quotes, where available. If quoted market prices or dealer quotes are not available, fair values are based on quoted market prices of comparable instruments.

**Loans:** For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for fixed-rate loans are estimated using discounted cash flow analyses using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest receivable approximates its fair value.

**Bank Owned Life Insurance:** The fair value of life insurance policies are based on cash surrender values at each reporting date as provided by the insurers.

Deposit Liabilities: The fair value of demand deposits, interest bearing transaction accounts, and savings accounts is the amount payable on demand. The fair value of fixed-maturity certificates of deposit is estimated by discounting expected future cash flows utilizing interest rates currently being offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

Borrowings: The fair value of federal funds purchased and other short-term borrowings is approximated by the book value. The fair value for Federal Home Loan Bank advances is determined using discounted future cash flows.

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Subordinated Debentures: Fair values of subordinated debentures were determined based on the current market value of like-kind instruments of a similar maturity and structure.

Limitations: Fair value estimates presented herein are based on pertinent information available to management as of December 31, 2011, and 2010. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above.

### 18. Fair Value Measurements

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

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

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

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

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

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

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

The Company does not record all loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Once a loan is identified as individually impaired, management measures impairment in accordance with the “Receivable” topic of the FASB ASC. The fair value of impaired loans is estimated using one of several methods, including collateral value when the loan is collateral dependent, market value of similar debt, enterprise value, and discounted cash flows. Those impaired loans not

requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2011, substantially all impaired loans were evaluated based on the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses observable data, the Company records the impaired loan as nonrecurring Level 2. Otherwise, the Company records the impaired loan as nonrecurring Level 3.

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

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

| (in thousands)  | Fair Value<br>Total | Fair Value Measurements<br>At December 31, 2011, Using                           |  |  |
|---|---------------------|--|--|--|
|   |                     | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-Sale Securities:                                  |                     |  |  |  |
| Government Agency & Government-Sponsored Entities               | \$82,595            | \$21,109   | \$61,486                                   | \$ -   |
| Obligations of States and Political Subdivisions                | 5,782               | -  | -  | 5,782  |
| Mortgage Backed Securities                                      | 391,033             | -  | 391,033                                    | -  |
| Other   | 410                 | -  | 410  | -  |
| <b>Total Assets Measured at Fair Value On a Recurring Basis</b> | <b>\$479,820</b>    | <b>\$21,109</b>  | <b>\$452,929</b>                           | <b>\$ 5,782</b>                                    |

| (in thousands)  | Fair Value<br>Total | Fair Value Measurements<br>At December 31, 2010, Using                           |  |  |
|---|---------------------|--|--|--|
|   |                     | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-Sale Securities:                                  |                     |  |  |  |
| Government Agency & Government-Sponsored Entities               | \$236,319           | \$-  | \$236,319                                  | \$ -   |
| Obligations of States and Political Subdivisions                | 6,378               | -  | 6,378                                      | -  |
| Mortgage Backed Securities                                      | 185,637             | -  | 185,637                                    | -  |
| Other   | 6,522               | -  | 6,522                                      | -  |
| <b>Total Assets Measured at Fair Value On a Recurring Basis</b> | <b>\$434,856</b>    | <b>\$-</b>   | <b>\$434,856</b>                           | <b>\$ -</b>  |

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the year ended December 31, 2011, there were transfers out of level 2 to level 3, and no transfers out of Levels 1 and 2 during year 2010. The following table presents information about the transfers.

## Changes in Level 3 Assets Measured at Fair Value on a Recurring Basis

| (in thousands)  | 2011 | 2010 |
|---|------|------|
| Balance at beginning of year                                    | \$-  | \$-  |
| Total realized and unrealized gains/(losses) included in income | -    | -    |



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|  |         |     |
|--|---------|-----|
| Total unrealized gains/(losses) included in other comprehensive income | -       | -   |
| Purchase of Securities   | -       | -   |
| Sales, maturities, and calls of securities                             | -       | -   |
| Net transfers in/(out) of Level 3                                      | 5,782   | -   |
| Balance at December 31 of each year                                    | \$5,782 | \$- |

All transfers in the table above were obligations of states and political subdivisions. These bonds were issued by local housing authorities and have no active market.

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The following tables present information about the Company's assets and liabilities measured at fair value on a non-recurring basis and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the years indicated. During 2011 management observed that the appraised values of impaired loans and ORE were increasingly relying upon discounted cash flow analysis, not observable comparable market sales. This resulted in the shift from Level 2 inputs to Level 3 inputs.

| (in thousands)  | Fair Value<br>December 31,<br>2011 | Fair Value Measurements<br>At December 31, 2011, Using                              |  |  |
|---|------------------------------------|---|--|--|
|   |                                    | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Impaired Loans  |                                    |   |  |  |
| Commercial Real Estate  | \$ 2,328                           | \$-   | \$-  | \$ 2,328   |
| Residential 1st Mortgages                                       | 89                                 | -   | -  | 89   |
| Home Equity Lines and Loans                                     | 166                                | -   | -  | 166  |
| Agricultural  | 409                                | -   | -  | 409  |
| Commercial  | 50                                 | -   | -  | 50   |
| Other Real Estate   | 2,924                              | -   | -  | 2,924  |
| Total Assets Measured at Fair Value On a<br>Non-Recurring Basis | \$ 5,966                           | \$-   | \$-  | \$ 5,966   |

Impaired loans with a partial charge-off or where an allowance was established were \$4.7 million with an allowance for loan losses of \$1.6 million. Impaired loans are collateral dependent and have been adjusted to fair value based on the estimated fair value of the underlying collateral, less estimated selling costs. If the Company determines that the value of an impaired loan is less than the recorded investment in the loan, the carrying value is adjusted through a charge-off recorded through the allowance for loan losses.

ORE was \$2.9 million, net of \$4.1 million reserve. ORE has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, foreclosed assets are recorded at the lower of the carrying amount of the loan or the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in non-interest expense on the Consolidated Statements of Income.

| (in thousands) | Fair Value<br>December 31,<br>2010 | Fair Value Measurements<br>At December 31, 2010, Using                              |  |  |
|----------------|------------------------------------|---|--|--|
|                |                                    | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |

## Impaired Loans

|   |           |     |          |      |
|---|-----------|-----|----------|------|
| Commercial Real Estate  | \$ 7,973  | \$- | \$7,973  | \$ - |
| Agricultural Real Estate  | 458       | -   | 458      | -    |
| Real Estate Construction  | 2,250     | -   | 2,250    | -    |
| Residential 1st Mortgages                                       | 891       | -   | 891      | -    |
| Agricultural  | 600       | -   | 600      | -    |
| Commercial  | 52        | -   | 52       | -    |
| Other Real Estate   | 8,038     | -   | 8,038    | -    |
| Total Assets Measured at Fair Value On a<br>Non-Recurring Basis | \$ 20,262 | \$- | \$20,262 | \$ - |

Impaired loans with a partial charge-off or where an allowance was established were \$17.4 million with an allowance for loan losses of \$5.2 million. Impaired loans are collateral dependent and have been adjusted to fair value based on the estimated fair value of the underlying collateral, less estimated selling costs. If the Company determines that the value of an impaired loan is less than the recorded investment in the loan, the carrying value is adjusted through a charge-off recorded through the allowance for loan losses.

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ORE was \$8.0 million, net of \$3.7 million reserve. ORE has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, foreclosed assets are recorded at the lower of the carrying amount of the loan or the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in non-interest expense on the Consolidated Statements of Income.

### 19. Commitments and Contingencies

In the normal course of business, the Company is a party to financial instruments with off-balance-sheet risk to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These instruments include commitments to extend credit, letters of credit, and financial guarantees that are not reflected in the Consolidated Balance Sheet.

The Company's exposure to credit loss in the event of nonperformance by the other party with regard to standby letters of credit, undisbursed loan commitments, and financial guarantees is represented by the contractual notional amount of those instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. The Company uses the same credit policies in making commitments and conditional obligations as it does for recorded balance sheet items. The Company may or may not require collateral or other security to support financial instruments with credit risk. Evaluations of each customer's creditworthiness are performed on a case-by-case basis.

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. The Company had standby letters of credit outstanding of \$5,087,000 at December 31, 2011, and \$5,632,000 at December 31, 2010. Outstanding standby letters of credit have maturity dates ranging from 1 to 15 months with final expiration in March 2013. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Undisbursed loan commitments totaled \$300,572,000 and \$316,158,000 as of December 31, 2011 and 2010, respectively. Since many of these commitments are expected to expire without fully being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Company is obligated under a number of noncancellable operating leases for premises and equipment used for banking purposes. Minimum future rental commitments under noncancellable operating leases as of December 31, 2011, were \$369,000, \$248,000, \$288,000, \$274,000, and \$98,000 for the years 2012 through 2016.

In the ordinary course of business, the Company becomes involved in litigation arising out of its normal business activities. Management, after consultation with legal counsel, believes that the ultimate liability, if any, resulting from the disposition of such claims would not be material in relation to the financial position of the Company.

The Company may be required to maintain average reserves on deposit with the Federal Reserve Bank primarily based on deposits outstanding. There were no reserve requirements during 2011 or 2010.

### 20. Recent Accounting Developments

In May 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. This ASU amends the FASB Accounting Standards Codification<sup>TM</sup> (Codification) to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component

of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments to the Codification in the ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU 2011-05 should be applied retrospectively. These amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. Management does not believe that the adoption of this ASU will have a material impact on the Company's financial position, results of operation, cash flows, or disclosure.

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In May 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This ASU represents the converged guidance of the FASB and the IASB (the Boards) on fair value measurement, and resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term “fair value.” The amendments to the FASB Accounting Standards Codification™ (Codification) in this ASU are to be applied prospectively. The amendments are effective during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. Management does not believe that the adoption of this ASU will have a material impact on the Company’s financial position, results of operation, cash flows, or disclosure.

In April 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-03, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements. The ASU is intended to improve financial reporting of repurchase agreements (“repos”) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. In a typical repo transaction, an entity transfers financial assets to a counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. FASB Accounting Standards Codification™ (Codification) Topic 860, Transfers and Servicing, prescribes when an entity may or may not recognize a sale upon the transfer of financial assets subject to repo agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred financial assets. The amendments to the Codification in this ASU are intended to improve the accounting for these transactions by removing from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets. The guidance in the ASU is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. Management does not believe that the adoption of this ASU will have a material impact on the Company’s financial position, results of operation, cash flows, or disclosure.

In April 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-02, Receivables (Topic 310): A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring. This ASU clarifies which loan modifications constitute troubled debt restructurings. It is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (1) the restructuring constitutes a concession; and (2) the debtor is experiencing financial difficulties. The amendments to FASB Accounting Standards Codification™ (Codification) Topic 310, Receivables, clarify the guidance on a creditor’s evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. The new guidance is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. Early application is permitted. The adoption of this ASU did not have a material impact on the Company’s financial position, results of operation, cash flows, or disclosure.

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## 21. Parent Company Financial Information

The following financial information is presented as of December 31, 2011 and December 31, 2010.

Farmers & Merchants Bancorp  
Condensed Balance Sheets

| (in thousands)   | 2011       | 2010       |
|--|------------|------------|
| Cash   | \$ 398     | \$ 109     |
| Investment in Farmers & Merchants Bank of Central California | 199,177    | 183,408    |
| Investment Securities  | 410        | 310        |
| Capital Leases   | 1          | 1          |
| Other Assets   | 49         | 46         |
| Total Assets   | \$ 200,035 | \$ 183,874 |
| Subordinated Debentures                                      | \$ 10,310  | \$ 10,310  |
| Liabilities  | 379        | 323        |
| Shareholders' Equity   | 189,346    | 173,241    |
| Total Liabilities and Shareholders' Equity                   | \$ 200,035 | \$ 183,874 |

Farmers & Merchants Bancorp  
Condensed Statements of Income

| (in thousands)   | Year Ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2011                    | 2010      | 2009      |
| Equity in Undistributed Earnings in Farmers & Merchants Bank of Central California | \$ 12,715               | \$ 11,938 | \$ 8,804  |
| Dividends from Subsidiary  | 10,325                  | 10,000    | 12,050    |
| Interest Income  | 10                      | 10        | 12        |
| Other Expenses, Net  | (1,443 )                | (1,425 )  | (1,463 )  |
| Tax Benefit  | 602                     | 595       | 610       |
| Net Income   | \$ 22,209               | \$ 21,118 | \$ 20,013 |

Table of ContentsFarmers & Merchants Bancorp  
Condensed Statements of Cash Flows

| (in thousands)  | Year Ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2011                    | 2010      | 2009      |
| Cash Flows from Operating Activities:   |                         |           |           |
| Net Income  | \$22,209                | \$21,118  | \$20,013  |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                         |           |           |
| Equity in Undistributed Net Earnings from Subsidiary                              | (12,715 )               | (11,938 ) | (8,804 )  |
| Net (Increase) Decrease in Other Assets   | (3 )                    | 52        | -         |
| Net Increase (Decrease) in Liabilities  | 56                      | (1 )      | -         |
| Net Cash Provided by Operating Activities   | 9,547                   | 9,231     | 11,209    |
| Investing Activities:   |                         |           |           |
| Securities Purchased  | (1,296 )                | -         | -         |
| Securities Sold or Matured  | 1,196                   | -         | -         |
| Net Cash Used by Investing Activities   | (100 )                  | -         | -         |
| Financing Activities:   |                         |           |           |
| Stock Repurchased   | -                       | (608 )    | (2,329 )  |
| Cash Dividends  | (9,158 )                | (8,855 )  | (8,596 )  |
| Net Cash Used by Financing Activities   | (9,158 )                | (9,463 )  | (10,925 ) |
| Increase (Decrease) in Cash and Cash Equivalents                                  | 289                     | (232 )    | 284       |
| Cash and Cash Equivalents at Beginning of Year                                    | 109                     | 341       | 57        |
| Cash and Cash Equivalents at End of Year  | \$398                   | \$109     | \$341     |

## Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

## Item 9A. Controls and Procedures

The Company maintains controls and procedures designed to ensure that all relevant information is recorded and reported in all filings of financial reports. Such information is reported to the Company's management, including its Chief Executive Officer and its Chief Financial Officer to allow timely and accurate disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e). In accordance with Rule 13a-15(b) of the Exchange Act, we carried out an evaluation as of December 31, 2011, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective as of December 31, 2011.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Company completed its evaluation.

Management's report on internal control over financial reporting is set forth in "Item 8. Financial Statements and Supplementary Data," and is incorporated herein by reference. Crowe Horwath LLP, the independent registered public accounting firm that audited the financial statements included in this Annual Report, was engaged to assess the effectiveness of the Company's internal control over financial reporting. The report of Crowe Horwath LLP, which is set forth in "Item 8. Financial Statements and Supplementary Data," is incorporated herein by reference.





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## Item 9A(T). Controls and Procedures

Not Applicable

## Item 9B. Other Information

None

## PART III

## Item 10. Directors, Executive Officers and Corporate Governance

Set forth below is certain information regarding the Named Executive Officers of the Company and/or Bank:

| Name and Position(s)   | Age | Principal Occupation during the Past Five Years  |
|--|-----|--|
| Kent A. Steinwert<br>Chairman, President<br>& Chief Executive Officer<br>of the Company and Bank                 | 59  | Chairman, President & Chief Executive Officer of the Company and Bank since May 1, 2010.<br><br>President & Chief Executive Officer of the Company and Bank up to April 30, 2010.                  |
| Richard S. Erichson<br>Executive Vice President<br>& Enterprise Risk Manager<br>of the Company and Bank          | 64  | Executive Vice President & Enterprise Risk Manager of the Company and Bank since May 17, 2011.<br><br>Executive Vice President & Senior Credit Officer of the Company and Bank up to May 16, 2011. |
| Deborah E. Hodkin<br>Executive Vice President & Chief<br>Administrative Officer of the Bank                      | 49  | Executive Vice President & Chief Administrative Officer of the Bank.   |
| Stephen W. Haley<br>Executive Vice President<br>& Chief Financial Officer & Secretary of<br>the Company and Bank | 58  | Executive Vice President & Chief Financial Officer of the Company and Bank.  |
| Kenneth W. Smith<br>Executive Vice President<br>& Senior Credit Officer<br>of the Company and Bank               | 52  | Executive Vice President & Senior Credit Officer of the Company and Bank since August 9, 2011.<br><br>Executive Vice President & Head of Business Markets of the Bank up to August 8, 2011.        |

Also, see "Election of Directors" and "Compliance with Section 16(a) of the Exchange Act" in the Company's definitive proxy statement for the 2012 Annual Meeting of Stockholders which will be filed with the SEC and which is incorporated herein by reference. During 2011 there were no changes in procedures for the election of directors.

The Company has adopted a Code of Conduct which complies with the Code of Ethics requirements of the SEC. A copy of the Code of Conduct is posted on the Company's website. The Company intends to disclose promptly any amendment to, or waiver from any provision of, the Code of Conduct applicable to senior financial officers, and any waiver from any provision of the Code of Conduct applicable to directors, on its website on the About Us page. The Company's website address is [www.fmbonline.com](http://www.fmbonline.com).

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Item 11. Executive Compensation

The information required by Item 11 of Form 10-K is incorporated by reference from the information contained in the Company's definitive proxy statement for the 2012 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by Item 12 of Form 10-K is incorporated by reference from the information contained in the Company's definitive proxy statement for the 2012 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A. The Company does not have any equity compensation plans, which require disclosure under Item 201(d) of Regulation S-K.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by Item 13 of Form 10-K is incorporated by reference from the information contained in the Company's definitive proxy statement for the 2012 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A.

Item 14. Principal Accounting Fees and Services

The information required by Item 14 of Form 10-K is incorporated by reference from the information contained in the Company's definitive proxy statement for the 2012 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

(a)(1) Financial Statements. Incorporated herein by reference, are listed in Item 8 hereof.

(2) Financial Statement Schedules. None

(b) See "Index to Exhibits"

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Farmers & Merchants Bancorp  
(Registrant)

By /s/ Stephen W. Haley  
Stephen W. Haley  
Executive Vice President &  
Chief Financial Officer

Dated: March 9, 2012

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 9, 2012.

/s/ Kent A. Steinwert  
Kent A. Steinwert

Chairman, President & Chief Executive Officer  
(Principal Executive Officer)

/s/ Stephen W. Haley  
Stephen W. Haley

Executive Vice President & Chief Financial Officer  
(Principal Financial and Accounting Officer)

/s/ Bruce A. Mettler  
Bruce A. Mettler, Director

/s/ Calvin Suess  
Calvin Suess, Director

/s/ Stewart C. Adams, Jr.  
Stewart C. Adams, Jr., Director

/s/ Kevin Sanguinetti  
Kevin Sanguinetti, Director

/s/ Edward Corum, Jr.  
Edward Corum, Jr., Director

/s/ Carl Wishek, Jr.  
Carl Wishek, Jr., Director

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Index to Exhibit

| Exhibit No.  | Description   |
|--------------|---|
| 3.1          | Amended Certificate of Incorporation (incorporated by reference to Appendices 1 and 2 to the Registrant's Definitive Proxy Statement on Schedule 14A for its 2007 Annual Meeting of Stockholders and Exhibit 3(i) to the Registrant's Current Report on Form 8-K dated April 30, 1999).   |
| 3.2          | Amended By-Laws (incorporated by reference to the Registrant's Current Report on Form 8-K dated September 19, 2008, Appendix 3 to the Registrant's Definitive Proxy Statement on Schedule 14A for its 2007 Annual Meeting of Stockholders, Exhibit 3.1 to the Registrant's Current Report on Form 8-K dated June 7, 2005, and Exhibit 3(ii) to the Registrant's Current Report on Form 8-K dated April 30, 1999). |
| 3.3          | Certificate of Designation for the Series A Junior Participating Preferred Stock (included as Exhibit A to the Rights Agreement between Farmers & Merchants Bancorp and Registrar and Transfer Company, dated as of August 5, 2008, filed as Exhibit 4.1 below), filed on the Registrant's Form 10-Q for the quarter ended June 30, 2008, is incorporated herein by reference.                                    |
| 4.1          | Rights Agreement between Farmers & Merchants Bancorp and Registrar and Transfer Company, dated as of August 5, 2008, including Form of Right Certificate attached thereto as Exhibit B, filed on the Registrant's Form 10-Q for the quarter ended June 30, 2008, is incorporated herein by reference.   |
| <u>10.1</u>  | Amended and Restated Employment Agreement dated February 14, 2012, between Farmers & Merchants Bank of Central California and Kent A. Steinwert, filed on Registrant's Form 10-K for the year ended December 31, 2011.  |
| 10.3         | Amended and Restated Employment Agreement dated April 1, 2009, between Farmers & Merchants Bank of Central California and Deborah E. Hodkin, filed on Registrant's Form 10-K for the year ended December 31, 2008, is incorporated herein by reference.   |
| 10.4         | Amended and Restated Employment Agreement dated April 1, 2009, between Farmers & Merchants Bank of Central California and Kenneth W. Smith, filed on Registrant's Form 10-K for the year ended December 31, 2008, is incorporated herein by reference.  |
| 10.5         | Amended and Restated Employment Agreement dated April 1, 2009, between Farmers & Merchants Bank of Central California and Richard S. Erichson, filed on Registrant's Form 10-K for the year ended December 31, 2008, is incorporated herein by reference.   |
| 10.6         | Amended and Restated Employment Agreement dated April 1, 2009, between Farmers & Merchants Bank of Central California and Stephen W. Haley, filed on Registrant's Form 10-K for the year ended December 31, 2008, is incorporated herein by reference.  |
| 10.15        | Executive Retirement Plan – Performance Component as amended on November 5, 2010, filed on Registrant's Form 10-Q for the period ended September 30, 2010, is incorporated herein by reference.   |
| 10.16        | Executive Retirement Plan – Retention Component as amended on November 5, 2010, filed on Registrant's Form 10-Q for the period ended September 30, 2010, is incorporated herein by reference.   |
| 10.17        | Executive Retirement Plan – Salary Component as amended on November 5, 2010, filed on Registrant's Form 10-Q for the period ended September 30, 2010, is incorporated herein by reference.  |
| 10.18        | Deferred Compensation Plan of Farmers & Merchants Bank of Central California, as amended on November 5, 2010, filed on Registrant's Form 10-Q for the period ended September 30, 2010, is incorporated herein by reference.   |
| 10.19        | Executive Retirement Plan – Equity Component filed on December 19, 2011 on Registrant's Form 8-K, is incorporated herein by reference.  |
| 14           | Code of Conduct of Farmers & Merchants Bancorp, filed on Registrant's Form 10-K for the year ended December 31, 2003, is incorporated herein by reference.  |
| 21           | Subsidiaries of the Registrant, filed on Registrant's Form 10-K for the year ended December 31, 2003, is incorporated herein by reference.  |
| <u>31(a)</u> | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |



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| <u>31(b)</u> | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| <u>32</u>    | Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS      | XBRL Instance Document   |
| 101.SCH      | XBRL Schema Document   |
| 101.CAL      | XBRL Calculation Linkbase Document   |
| 101.LAB      | XBRL Label Linkbase Document   |
| 101.PREXBRL  | Presentation Linkbase Document   |
| 101.DEF      | XBRL Definition Linkbase Document  |