

FARMERS & MERCHANTS BANCORP
Form 10-Q
August 08, 2013

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

FORM 10-Q

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

For the quarterly period ended June 30, 2013

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 94-3327828
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

111 W. Pine Street, Lodi, California 95240
(Address of principal Executive offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 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)

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

Number of shares of common stock of the registrant: Par value \$0.01, authorized 7,500,000 shares; issued and outstanding 777,882 as of July 31, 2013.

FARMERS & MERCHANTS BANCORP

FORM 10-Q

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

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

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

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARMERS & MERCHANTS BANCORP

Consolidated Balance Sheets

(in thousands)	June 30, 2013 (Unaudited)	December 31, 2012	June 30, 2012 (Unaudited)
Assets			
Cash and Cash Equivalents:			
Cash and Due From Banks	\$43,917	\$47,366	\$39,673
Interest Bearing Deposits with Banks	1,389	82,060	1,096
Total Cash and Cash Equivalents	45,306	129,426	40,769
Investment Securities:			
Available-for-Sale	475,414	417,991	501,892
Held-to-Maturity	67,059	68,392	70,195
Total Investment Securities	542,473	486,383	572,087
Loans & Leases			
Loans & Leases	1,295,056	1,246,902	1,203,994
Less: Allowance for Credit Losses	34,235	34,217	33,098
Loans & Leases, Net	1,260,821	1,212,685	1,170,896
Premises and Equipment, Net			
Premises and Equipment, Net	22,306	22,901	23,361
Bank Owned Life Insurance	51,180	50,253	48,330
Interest Receivable and Other Assets	84,008	73,038	71,844
Total Assets	\$2,006,094	\$1,974,686	\$1,927,287
Liabilities			
Deposits:			
Demand	\$429,526	\$462,251	\$360,290
Interest Bearing Transaction	248,447	259,141	223,343
Savings and Money Market	588,009	541,526	542,922
Time	444,175	459,108	505,670
Total Deposits	1,710,157	1,722,026	1,632,225
Federal Home Loan Bank Advances			
Federal Home Loan Bank Advances	43,300	-	50,998
Subordinated Debentures			
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities			
Interest Payable and Other Liabilities	39,271	37,317	34,979
Total Liabilities	1,803,038	1,769,653	1,728,512
Shareholders' Equity			
Preferred Stock: No Par Value. 1,000,000 Shares Authorized, None Issued or Outstanding			
Preferred Stock	-	-	-
Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized, 777,882, 777,882 and 778,939 Shares Issued and Outstanding at June 30, 2013, December 31, 2012 and June 30, 2012, respectively			
Common Stock	8	8	8
Additional Paid-In Capital			
Additional Paid-In Capital	75,014	75,014	75,410
Retained Earnings			
Retained Earnings	130,005	123,012	115,838

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Accumulated Other Comprehensive (Loss) Income, Net	(1,971)	6,999	7,519
Total Shareholders' Equity	203,056		205,033	198,775
Total Liabilities & Shareholders' Equity	\$2,006,094		\$1,974,686	\$1,927,287

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

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FARMERS & MERCHANTS BANCORP

Consolidated Statements of Income (Unaudited)

(in thousands except per share data)

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2013	2012	2013	2012
Interest Income				
Interest and Fees on Loans & Leases	\$ 15,906	\$ 16,303	\$ 31,351	\$ 32,778
Interest on Deposits with Banks	3	15	47	68
Interest on Investment Securities:				
Taxable	2,382	2,835	4,488	5,643
Exempt from Federal Tax	654	660	1,314	1,290
Total Interest Income	18,945	19,813	37,200	39,779
Interest Expense				
Deposits	628	975	1,311	2,032
Borrowed Funds	9	493	9	1,036
Subordinated Debentures	82	87	163	175
Total Interest Expense	719	1,555	1,483	3,243
Net Interest Income	18,226	18,258	35,717	36,536
Provision for Credit Losses	250	280	250	500
Net Interest Income After Provision for Credit Losses	17,976	17,978	35,467	36,036
Non-Interest Income				
Service Charges on Deposit Accounts	1,069	1,201	2,173	2,414
Net Gain on Sale of Investment Securities	154	-	889	-
Increase in Cash Surrender Value of Life Insurance	469	456	926	912
Debit Card and ATM Fees	794	742	1,521	1,465
Net (Loss) Gain on Deferred Compensation Investments	(286)	(312)	1,404	619
Other	764	724	1,548	1,324
Total Non-Interest Income	2,964	2,811	8,461	6,734
Non-Interest Expense				
Salaries and Employee Benefits	8,895	8,021	16,940	15,942
Net (Loss) Gain on Deferred Compensation Investments	(286)	(312)	1,404	619
Occupancy	629	628	1,250	1,269
Equipment	678	878	1,373	1,596
Legal Fees	263	30	460	425
FDIC Insurance	246	243	486	485
Other	1,677	3,183	3,148	4,457
Total Non-Interest Expense	12,102	12,671	25,061	24,793
Income Before Income Taxes	8,838	8,118	18,867	17,977
Provision for Income Taxes	3,273	2,956	7,051	6,625
Net Income	\$ 5,565	\$ 5,162	\$ 11,816	\$ 11,352
Basic Earnings Per Common Share	\$ 7.15	\$ 6.63	\$ 15.19	\$ 14.57

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

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FARMERS & MERCHANTS BANCORP

Consolidated Statements of Comprehensive (Loss) Income (Unaudited)

(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net Income	\$5,565	\$5,162	\$11,816	\$11,352
Other Comprehensive (Loss) Income				
(Decrease) Increase in Net Unrealized (Losses) Gains on Available-for-Sale Securities	(12,771)	3,538	(14,588)	4,921
Reclassification Adjustment for Realized Gains on Available-for-Sale Securities Included in Net Income	(154)	-	(889)	-
Deferred Tax Benefit (Expense)	5,434	(1,488)	6,507	(2,069)
Change in Net Unrealized (Losses) Gains on Available-for-Sale Securities, Net of Tax	(7,491)	2,050	(8,970)	2,852
Total Other Comprehensive (Loss) Income	(7,491)	2,050	(8,970)	2,852
Comprehensive (Loss) Income	\$(1,926)	\$7,212	\$2,846	\$14,204

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

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FARMERS & MERCHANTS BANCORP

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands except share data)

	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Total Shareholders' Equity
Balance, January 1, 2012	779,424	\$ 8	\$ 75,590	\$ 109,081	\$ 4,667	\$ 189,346
Net Income		-	-	11,352	-	11,352
Cash Dividends Declared on Common Stock (\$5.90 per share)		-	-	(4,595)	-	(4,595)
Repurchase of Stock	(485)	-	(180)	-	-	(180)
Change in Net Unrealized Gain on Securities Available for Sale, Net of Tax		-	-	-	2,852	2,852
Balance, June 30, 2012	778,939	\$ 8	\$ 75,410	\$ 115,838	\$ 7,519	\$ 198,775
Balance, January 1, 2013	777,882	\$ 8	\$ 75,014	\$ 123,012	\$ 6,999	\$ 205,033
Net Income		-	-	11,816	-	11,816
Cash Dividends Declared on Common Stock (\$6.20 per share)		-	-	(4,823)	-	(4,823)
Change in Net Unrealized Loss on Securities Available for Sale, Net of Tax		-	-	-	(8,970)	(8,970)
Balance, June 30, 2013	777,882	\$ 8	\$ 75,014	\$ 130,005	\$ (1,971)	\$ 203,056

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

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FARMERS & MERCHANTS BANCORP

Consolidated Statements of Cash Flows (Unaudited)
(in thousands)Six Months Ended
June 30, June 30,
2013 2012

Operating Activities:

Net Income	\$11,816	\$11,352
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Credit Losses	250	500
Depreciation and Amortization	782	876
Net Amortization of Investment Security Discounts & Premium	1,806	1,721
Net Gain on Sale of Investment Securities	(889)	-
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets	(5,297)	(1,221)
Net Increase in Interest Payable and Other Liabilities	1,954	1,678
Net Cash Provided by Operating Activities	10,422	14,906

Investing Activities:

Purchase of Investment Securities Available-for-Sale	(220,941)	(106,797)
Proceeds from Sold, Matured, or Called Securities Available-for-sale	147,050	87,911
Purchase of Investment Securities Held-to-Maturity	(305)	(10,359)
Proceeds from Matured or Called Securities Held-to-Maturity	1,619	3,241
Net Loans & Leases Paid, Originated or Acquired	(48,683)	(41,559)
Principal Collected on Loans & Leases Previously Charged Off	297	224
Additions to Premises and Equipment	(187)	(179)
Net Cash Used by Investing Activities	(121,150)	(67,518)

Financing Activities:

Net (Decrease) Increase in Deposits	(11,869)	6,028
Net Decrease in Securities Sold Under Agreement to Repurchase	-	(60,000)
Net Change in Other Borrowings	43,300	50,468
Common Stock Repurchases	-	(180)
Cash Dividends	(4,823)	(4,595)
Net Cash Provided (Used) By Financing Activities	26,608	(8,279)
Decrease in Cash and Cash Equivalents	(84,120)	(60,891)
Cash and Cash Equivalents at Beginning of Period	129,426	101,660
Cash and Cash Equivalents at End of Period	\$45,306	\$40,769

Supplementary Data

Loans Transferred to Foreclosed Assets (ORE)	\$2,190	\$-
Cash Payments Made for Income Taxes	\$11,706	\$10,586
Interest Paid	\$3,601	\$4,779

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

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FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

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

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

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

Basis of Presentation

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

These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with U.S. GAAP have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012. The results of operations for the three-month and six-month periods ended June 30, 2013 may not necessarily be indicative of future operating results.

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

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

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

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Cash and Cash Equivalents

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

Investment Securities

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

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

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

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

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

Loans & Leases

Loans & leases are reported at the principal amount outstanding net of unearned discounts and deferred loan & lease fees and costs. Interest income on loans & leases is accrued daily on the outstanding balances using the simple interest method. Loan & lease origination fees are deferred and recognized over the contractual life of the loan or lease as an adjustment to the yield. Loans & leases 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 or lease is considered well-secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or lease or is guaranteed by a financially capable party. When a loan or lease 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 & leases placed on non-accrual status are returned to accrual status when the loans or leases 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 or lease.

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A loan or lease 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 & leases are either: (1) non-accrual loans & leases; or (2) restructured loans & leases that are still accruing interest. Loans or leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

A restructuring of a loan or lease 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 & leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans & leases that are reported as TDRs are considered impaired and measured for impairment as described above.

Generally, the Company will not restructure loans or leases for customers unless: (i) the existing loan or lease is brought current as to principal and interest payments; and (ii) the restructured loan or lease 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 or lease amounts. After restructure a determination is made whether the loan or lease will be kept on accrual status based upon the underwriting and historical performance of the restructured credit.

Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance-sheet date. The allowance is established through a provision for credit losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease 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 & leases and general reserves for inherent losses related to loans & leases that are not impaired.

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

The Company maintains a separate allowance for each portfolio segment (loan & lease 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; (8) consumer and other; and (9) leases. The allowance for credit losses attributable to each portfolio segment, which includes both individually evaluated impaired loans & leases and loans & leases that are collectively evaluated for impairment, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases 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 & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. 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 or lease is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

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Special Mention – A special mention loan or lease 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 lease or in the Company's credit position at some future date. Special Mention loans & leases are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

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

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

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

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

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

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

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

Residential 1st Mortgages and Home Equity Lines and Loans – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio

segments, although this is not always true as evidenced by the weakness in residential real estate values over the past five years. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

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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.

Leases – Equipment leases subject the Company, as Lessor, to both the credit risk of the Lessee and the residual value risk of the equipment. Credit risks are underwritten using the same credit criteria the Company would make an equipment term loan under. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

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

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

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

Premises and Equipment

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

Other Real Estate

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

Income Taxes

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

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

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

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

Dividends and Basic Earnings Per Common Share

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

Segment Reporting

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

Derivative Instruments and Hedging Activities

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

From time to time, the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps, and collars. These instruments are purchased and/or sold to reduce the Company's exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments as of or for the period ended June 30, 2013, December 31, 2012 or June 30, 2012.

Comprehensive Income

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

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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.

2. Investment Securities

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

	Amortized Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
June 30, 2013				
Government Agency & Government-Sponsored Entities	\$ 26,327	\$ 155	\$ -	\$ 26,482
Obligations of States and Political Subdivisions	5,612	-	-	5,612
Mortgage Backed Securities ⁽¹⁾	396,041	4,373	7,840	392,574
Corporate Securities	49,647	180	267	49,560
Other	1,186	-	-	1,186
Total	\$ 478,813	\$ 4,708	\$ 8,107	\$ 475,414

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

	Amortized Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
June 30, 2012				
Government Agency & Government-Sponsored Entities	\$ 56,764	\$ 314	\$ -	\$ 57,078
Obligations of States and Political Subdivisions	5,724	-	-	5,724
Mortgage Backed Securities ⁽¹⁾	414,990	12,647	-	427,637
Corporate Securities	8,983	29	17	8,995
Other	2,458	-	-	2,458
Total	\$ 488,919	\$ 12,990	\$ 17	\$ 501,892

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

	Book	Gross		Fair
	Value	Unrealized	Losses	Value
		Gains		
June 30, 2013				
Obligations of States and Political Subdivisions	\$64,648	\$1,252	\$ 531	\$65,369
Mortgage Backed Securities ⁽¹⁾	217	3	-	220
Other	2,194	-	-	2,194
Total	\$67,059	\$1,255	\$ 531	\$67,783

	Book	Gross		Fair
	Value	Unrealized	Losses	Value
		Gains		
December 31, 2012				
Obligations of States and Political Subdivisions	\$65,694	\$2,296	\$ 3	\$67,987
Mortgage Backed Securities ⁽¹⁾	484	12	-	496
Other	2,214	-	-	2,214
Total	\$68,392	\$2,308	\$ 3	\$70,697

	Book	Gross		Fair
	Value	Unrealized	Losses	Value
		Gains		
June 30, 2012				
Obligations of States and Political Subdivisions	\$67,159	\$2,498	\$ 51	\$69,606
Mortgage Backed Securities ⁽¹⁾	806	25	-	831
Other	2,230	-	-	2,230
Total	\$70,195	\$2,523	\$ 51	\$72,667

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

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

The amortized cost and estimated fair values of investment securities at June 30, 2013 by contractual maturity are shown in the following tables (in thousands):

	Available-for-Sale		Held-to-Maturity	
	Amortized	Fair/Book	Book	Fair
	Cost	Value	Value	Value
June 30, 2013				
Within One Year	\$11,680	\$11,718	\$2,075	\$2,084
After One Year Through Five Years	64,383	64,378	13,317	13,627
After Five Years Through Ten Years	1,310	1,345	36,228	37,161
After Ten Years	5,399	5,399	15,222	14,691
	82,772	82,840	66,842	67,563
Investment Securities Not Due at a Single Maturity Date:				
Mortgage Backed Securities	396,041	392,574	217	220
Total	\$478,813	\$475,414	\$67,059	\$67,783

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

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

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
June 30, 2013						
<u>Securities Available-for-Sale</u>						
Mortgage Backed Securities	\$205,363	\$ 7,840	\$ -	\$ -	\$205,363	\$ 7,840
Corporate Securities	30,597	267	-	-	30,597	267
Total	\$235,960	\$ 8,107	\$ -	\$ -	\$235,960	\$ 8,107
<u>Securities Held-to-Maturity</u>						
Obligations of States and Political Subdivisions	\$9,626	\$ 531	\$ -	\$ -	\$9,626	\$ 531
Total	\$9,626	\$ 531	\$ -	\$ -	\$9,626	\$ 531
December 31, 2012						
<u>Securities Available-for-Sale</u>						
Mortgage Backed Securities	\$4,542	\$ 10	\$ -	\$ -	\$4,542	\$ 10
Corporate Securities	3,442	12	-	-	3,442	12
Total	\$7,984	\$ 22	\$ -	\$ -	\$7,984	\$ 22
<u>Securities Held-to-Maturity</u>						
Obligations of States and Political Subdivisions	\$528	\$ 3	\$ -	\$ -	\$528	\$ 3
Total	\$528	\$ 3	\$ -	\$ -	\$528	\$ 3
June 30, 2012						
<u>Securities Available-for-Sale</u>						
Corporate Securities	\$3,405	\$ 17	\$ -	\$ -	\$3,405	\$ 17
Total	\$3,405	\$ 17	\$ -	\$ -	\$3,405	\$ 17
<u>Securities Held-to-Maturity</u>						
Obligations of States and Political Subdivisions	\$4,774	\$ 51	\$ -	\$ -	\$4,774	\$ 51
Total	\$4,774	\$ 51	\$ -	\$ -	\$4,774	\$ 51

As of June 30, 2013, the Company held 363 investment securities of which 82 were in a loss position for less than twelve months. No securities were in a loss position for twelve months or more. Management periodically evaluates each investment security for other-than-temporary impairment relying primarily on industry analyst reports and observations of market conditions and interest rate fluctuations. Management believes it will be able to collect all amounts due according to the contractual terms of the underlying investment securities.

Securities of Government Agency and Government Sponsored Entities – There were no unrealized losses on the Company's investments in securities of government agency and government sponsored entities at June 30, 2013, December 31, 2012 and June 30, 2012.

Mortgage Backed Securities - The unrealized losses on the Company's investment in mortgage backed securities were \$7.8 million, \$10,000, and \$0 at June 30, 2013, December 31, 2012, and June 30, 2012, respectively. The unrealized losses on the Company's investment in mortgage backed securities were caused by interest rate fluctuations. The contractual cash flows of these investments are guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2013 and December 31, 2012, respectively.

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Obligations of States and Political Subdivisions - The financial problems experienced by certain municipalities over the past five years, along with the financial stresses exhibited by some of the large monoline bond insurers have increased the overall risk associated with bank-qualified municipal bonds. As of June 30, 2013, over ninety-four 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 six 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 \$531,000, \$3,000, and \$51,000 at June 30, 2013, December 31, 2012 and June 30, 2012, respectively. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were primarily caused by interest rate fluctuations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2013, December 31, 2012 and June 30, 2012.

Corporate Securities - The unrealized losses on the Company's investment in corporate securities were \$267,000, \$12,000, and \$17,000 at June 30, 2013, December 31, 2012, and June 30, 2012. Changes in the prices of corporate securities are primarily influenced by: (1) changes in market interest rates; (2) changes in perceived credit risk in the general economy or in particular industries; (3) changes in the perceived credit risk of a particular company; and (4) day to day trading supply, demand and liquidity. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2013, December 31, 2012 and June 30, 2012.

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

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
(in thousands)	2013	2012	2013	2012
Proceeds	\$4,356	\$1,530	\$49,615	\$26,530
Gains	154	-	903	-
Losses	-	-	14	-

Pledged Securities

As of June 30, 2013, securities carried at \$290.6 million were pledged to secure public deposits, FHLB borrowings, and other government agency deposits as required by law. This amount at December 31, 2012, was \$296.9 million.

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3. Allowance for Credit Losses

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

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
Year-To-Date Allowance for Credit Losses:											
Beginning Balance-											
January 1, 2013	\$6,464	\$2,877	\$986	\$1,219	\$3,235	\$10,437	\$7,963	\$182	\$-	\$854	\$34,211
Charge-Offs	-	(400)	-	(16)	(22)	(23)	(4)	(64)	-	-	(529)
Recoveries	-	-	-	-	20	20	236	21	-	-	297
Provision	(732)	1,004	(9)	(166)	(249)	123	880	29	-	(630)	250
Ending Balance-											
June 30, 2013	\$5,732	\$3,481	\$977	\$1,037	\$2,984	\$10,557	\$9,075	\$168	\$-	\$224	\$34,233
Second Quarter Allowance for Credit Losses:											
Beginning Balance-											
April 1, 2013	\$6,671	\$3,795	\$969	\$1,260	\$3,209	\$9,412	\$7,966	\$163	\$-	\$810	\$34,255
Charge-Offs	-	(400)	-	-	(21)	(23)	(4)	(46)	-	-	(494)
Recoveries	-	-	-	-	18	7	189	10	-	-	224
Provision	(939)	86	8	(223)	(222)	1,161	924	41	-	(586)	250
Ending Balance-											
June 30, 2013	\$5,732	\$3,481	\$977	\$1,037	\$2,984	\$10,557	\$9,075	\$168	\$-	\$224	\$34,233
Ending Balance											
Individually Evaluated for Impairment	6	300	-	-	243	596	202	55	-	-	1,402
Ending Balance											
Collectively Evaluated for Impairment	5,726	3,181	977	1,037	2,741	9,961	8,873	113	-	224	32,833
Loans:											
	\$393,159	\$312,588	\$32,718	\$136,473	\$37,498	\$214,760	\$159,647	\$5,546	\$2,667	\$-	\$1,295,000

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Ending Balance Individually Evaluated for Impairment	2,979	5,817	-	528	612	1,500	510	56	-	-	12,000
Ending Balance Collectively Evaluated for Impairment	390,180	306,771	32,718	135,945	36,886	213,260	159,137	5,490	2,667	-	1,283,000

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
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Year-To-Date Allowance for Credit Losses:

Beginning Balance- January 1, 2012	\$5,823	\$2,583	\$1,933	\$1,251	\$3,746	\$8,127	\$8,733	\$207	\$-	\$614	\$33,017
Charge-Offs	-	-	-	(152)	(259)	(294)	(198)	(145)	-	-	(1,048)
Recoveries	-	90	-	53	14	61	117	63	-	-	398
Provision	641	204	(947)	67	(266)	2,543	(689)	57	-	240	1,850
Ending Balance- December 31, 2012	\$6,464	\$2,877	\$986	\$1,219	\$3,235	\$10,437	\$7,963	\$182	\$-	\$854	\$34,217
Ending Balance Individually Evaluated for Impairment	-	-	-	-	173	996	144	61	-	-	1,374
Ending Balance Collectively Evaluated for Impairment	6,464	2,877	986	1,219	3,062	9,441	7,819	121	-	854	32,843
Loans: Ending Balance	\$350,548	\$311,992	\$32,680	\$140,257	\$42,042	\$221,032	\$143,293	\$5,058	\$-	\$-	\$1,246,902
Ending Balance Individually Evaluated for Impairment	289	5,423	-	657	980	3,937	250	61	-	-	11,597

Evaluated
for
Impairment
Ending
Balance
Collectively
Evaluated
for
Impairment

350,259	306,569	32,680	139,600	41,062	217,095	143,043	4,997	-	-	1,235,305
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	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgage	Home Equity & Lines Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2012	\$5,823	\$2,583	\$1,933	\$1,251	\$3,746	\$8,127	\$8,733	\$207	\$-	\$614	\$33,017
Charge-Offs	-	-	-	(1)	(116)	(240)	(198)	(88)	-	-	(643)
Recoveries	-	89	-	-	10	61	32	32	-	-	224
Provision	(1,446)	(39)	(33)	201	(126)	(114)	971	(11)	-	1,097	500
Ending Balance- June 30, 2012	\$4,377	\$2,633	\$1,900	\$1,451	\$3,514	\$7,834	\$9,538	\$140		\$1,711	\$33,098