

FARMERS & MERCHANTS BANCORP
Form 10-Q
May 09, 2014

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 March 31, 2014

or

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

For the transition period from _____ to _____

Commission File Number: 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)

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

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 April 30, 2014.

FARMERS & MERCHANTS BANCORP

FORM 10-Q

TABLE OF CONTENTS

<u>PART I. - FINANCIAL INFORMATION</u>	<u>Page</u>
Item 1 - Financial Statements	
<u>Consolidated Balance Sheets (Unaudited) as of March 31, 2014, December 31, 2013 and March 31, 2013.</u>	3
<u>Consolidated Statements of Income (Unaudited) for the Three Months Ended March 31, 2014 and 2013.</u>	4
<u>Consolidated Statements of Comprehensive Income (Unaudited) for the Three Months Ended March 31, 2014 and 2013.</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) for the Three Months Ended March 31, 2014 and 2013.</u>	6
<u>Consolidated Statements of Cash Flows (Unaudited) for the Three Months Ended March 31, 2014 and 2013.</u>	7
<u>Notes to the Consolidated Financial Statements (Unaudited)</u>	8
Item 2 - <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	34
Item 3 - <u>Quantitative and Qualitative Disclosures About Market Risk</u>	53
Item 4 - <u>Controls and Procedures</u>	56
 <u>PART II. - OTHER INFORMATION</u>	
Item 1 - <u>Legal Proceedings</u>	56
Item 1A <u>Risk Factors</u>	56
–	
Item 2 - <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	56
Item 3 - <u>Defaults Upon Senior Securities</u>	57
Item 4 - <u>Mine Safety Disclosures</u>	57
Item 5 - <u>Other Information</u>	57
Item 6 - <u>Exhibits</u>	57
<u>Signatures</u>	57

Index to Exhibits

58

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.

2

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARMERS & MERCHANTS BANCORP

Consolidated Balance Sheets

(in thousands)

	March 31, 2014 (Unaudited)	December 31, 2013	March 31, 2013 (Unaudited)
Assets			
Cash and Cash Equivalents:			
Cash and Due from Banks	\$ 39,042	\$ 40,966	\$ 30,753
Interest Bearing Deposits with Banks	134,685	42,711	12,780
Total Cash and Cash Equivalents	173,727	83,677	43,533
Investment Securities:			
Available-for-Sale	399,743	404,639	515,573
Held-to-Maturity	65,655	68,505	67,708
Total Investment Securities	465,398	473,144	583,281
Loans & Leases:			
Loans & Leases	1,363,030	1,388,236	1,226,695
Less: Allowance for Credit Losses	34,277	34,274	34,255
Loans & Leases, Net	1,328,753	1,353,962	1,192,440
Premises and Equipment, Net	22,692	22,887	22,551
Bank Owned Life Insurance	52,564	52,109	50,711
Interest Receivable and Other Assets	84,167	90,294	79,045
Total Assets	\$ 2,127,301	\$ 2,076,073	\$ 1,971,561
Liabilities			
Deposits:			
Demand	\$ 489,786	\$ 495,963	\$ 417,341
Interest Bearing Transaction	287,174	291,795	257,171
Savings and Money Market	639,370	589,511	590,323
Time	424,284	430,422	450,331
Total Deposits	1,840,614	1,807,691	1,715,166
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	58,426	48,168	36,280
Total Liabilities	1,909,350	1,866,169	1,761,756
Shareholders' Equity			
Preferred Stock: No Par Value. 1,000,000 Shares Authorized, None Issued or Outstanding	-	-	-
Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized, 777,882 Shares Issued and Outstanding at March 31, 2014, December 31, 2013 and March 31, 2013, respectively	8	8	8
Additional Paid-In Capital	75,014	75,014	75,014
Retained Earnings	143,632	137,350	129,263

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Accumulated Other Comprehensive (Loss) Income	(703)	(2,468)	5,520
Total Shareholders' Equity	217,951		209,904		209,805
Total Liabilities and Shareholders' Equity	\$2,127,301		\$2,076,073		\$1,971,561

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

3

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Income (Unaudited)

(in thousands except per share data)

Three Months
 Ended March 31,
 2014 2013

Interest Income

Interest and Fees on Loans & Leases	\$16,271	\$15,445
Interest on Deposits with Banks	64	44
Interest on Investment Securities:		
Taxable	2,115	2,106
Exempt from Federal Tax	597	660
Total Interest Income	19,047	18,255

Interest Expense

Deposits	600	683
Subordinated Debentures	80	81
Total Interest Expense	680	764

Net Interest Income	18,367	17,491
Provision for Credit Losses	-	-
Net Interest Income After Provision for Credit Losses	18,367	17,491

Non-Interest Income

Service Charges on Deposit Accounts	938	1,104
Net Gain on Sale of Investment Securities	3	735
Increase in Cash Surrender Value of Life Insurance	455	457
Debit Card and ATM Fees	735	727
Net Gain on Deferred Compensation Investments	443	1,690
Other	588	784
Total Non-Interest Income	3,162	5,497

Non-Interest Expense

Salaries and Employee Benefits	8,237	8,045
Net Gain on Deferred Compensation Investments	443	1,690
Occupancy	622	621
Equipment	703	695
Legal Fees	47	197
FDIC Insurance	252	240
Other	1,336	1,471
Total Non-Interest Expense	11,640	12,959

Income Before Income Taxes	9,889	10,029
Provision for Income Taxes	3,607	3,778
Net Income	\$6,282	\$6,251
Basic Earnings Per Common Share	\$8.08	\$8.04

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

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)

	Three Months Ended March 31,	
	2014	2013
Net Income	\$6,282	\$6,251
Other Comprehensive Income		
Increase (Decrease) in Net Unrealized Gain (Loss) on Available-for-Sale Securities	3,048	(1,817)
Reclassification Adjustment for Realized Gains on Available-for-Sale Securities Included in Net Income	(3)	(735)
Deferred Tax (Expense) Benefit	(1,280)	1,073
Change in Net Unrealized Gain (Loss) on Available-for-Sale Securities, Net of Tax	1,765	(1,479)
Total Other Comprehensive Income (Loss)	1,765	(1,479)
Comprehensive Income	\$8,047	\$4,772

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

Table of Contents

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, 2013	777,882	\$ 8	\$ 75,014	\$ 123,012	\$ 6,999	\$ 205,033
Net Income		-	-	6,251	-	6,251
Change in Net Unrealized Gains on Securities Available-for-Sale		-	-	-	(1,479)	(1,479)
Balance, March 31, 2013	777,882	\$ 8	\$ 75,014	\$ 129,263	\$ 5,520	\$ 209,805
Balance, January 1, 2014	777,882	\$ 8	\$ 75,014	\$ 137,350	\$ (2,468)	\$ 209,904
Net Income		-	-	6,282	-	6,282
Change in Net Unrealized Gains on Securities Available-for-Sale		-	-	-	1,765	1,765
Balance, March 31, 2014	777,882	\$ 8	\$ 75,014	\$ 143,632	\$ (703)	\$ 217,951

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

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Cash Flows (Unaudited)

	Three Months Ended	
	March	March 31,
(in thousands)	31,	2013
	2014	
Operating Activities:		
Net Income	\$6,282	\$6,251
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Credit Losses	-	-
Depreciation and Amortization	340	395
Net Amortization of Investment Security Premiums & Discounts	404	957
Net Gain on Sale of Investment Securities	(3)	(735)
Net Change in Operating Assets & Liabilities:		
Net (Increase) Decrease in Interest Receivable and Other Assets	4,360	(5,322)
Net (Decrease) Increase in Interest Payable and Other Liabilities	10,258	(1,037)
Net Cash Provided by Operating Activities	21,641	509
Investing Activities:		
Purchase of Investment Securities Available-for-Sale	(14,636)	(219,545)
Proceeds from Sold, Matured or Called Securities Available-for-Sale	22,208	119,128
Purchase of Investment Securities Held-to-Maturity	(565)	(115)
Proceeds from Matured or Called Securities Held-to-Maturity	3,415	790
Net Loans & Leases Paid, Originated or Acquired	25,176	20,172
Principal Collected on Loans & Leases Previously Charged Off	33	73
Additions to Premises and Equipment	(145)	(45)
Net Cash Provided (Used) by Investing Activities	35,486	(79,542)
Financing Activities:		
Net (Decrease) Increase in Deposits	32,923	(6,860)
Net Cash Provided (Used) by Financing Activities	32,923	(6,860)
Increase (Decrease) in Cash and Cash Equivalents	90,050	(85,893)
Cash and Cash Equivalents at Beginning of Period	83,677	129,426
Cash and Cash Equivalents at End of Period	\$173,727	\$43,533
Supplementary Data		
Loans Transferred to Foreclosed Assets (ORE)	\$-	\$2,190
Cash Payments Made for Income Taxes	\$-	\$4,900
Interest Paid	\$687	\$835

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

Table of Contents

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, 2013. The results of operations for the three-month period ended March 31, 2014 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.

Table of Contents

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 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.

9

Table of Contents

A loan or leases 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 or 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 three primary components, specific reserves related to impaired loans & leases, general reserves for inherent losses related to loans & leases that are not impaired and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

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) equipment 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 & leases, such as consumer and residential real estate, and then updated only when the loan or lease 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:

10

Table of Contents

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

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.

Table of Contents

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.

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, DBO 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. 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 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 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.

12

Table of Contents

The Company follows the standards set forth in the “Income Taxes” topic of the Financial Accounting Standards Board (“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.

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 March 31, 2014, December 31, 2013 or March 31, 2013.

13

Table of Contents

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.

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 Gains	Unrealized Losses	Fair/Book Value
March 31, 2014				
Government Agency & Government-Sponsored Entities	\$ 18,242	\$ 184	\$-	\$ 18,426
Mortgage Backed Securities ⁽¹⁾	331,434	3,674	5,378	329,730
Corporate Securities	49,045	370	63	49,352
Other	2,235	-	-	2,235
Total	\$ 400,956	\$ 4,228	\$ 5,441	\$ 399,743

	Amortized Cost	Gross Gains	Unrealized Losses	Fair/Book Value
December 31, 2013				
Government Agency & Government-Sponsored Entities	\$ 28,287	\$ 149	\$-	\$ 28,436
Mortgage Backed Securities ⁽¹⁾	329,469	3,026	7,566	324,929
Corporate Securities	49,247	280	147	49,380
Other	1,894	-	-	1,894
Total	\$ 408,897	\$ 3,455	\$ 7,713	\$ 404,639

	Amortized Cost	Gross Gains	Unrealized Losses	Fair/Book Value
March 31, 2013				
Government Agency & Government-Sponsored Entities	\$ 26,436	\$ 256	\$-	\$ 26,692
Obligations of States and Political Subdivisions	5,643	-	-	5,643
Mortgage Backed Securities ⁽¹⁾	423,298	10,273	1,286	432,285
Corporate Securities	49,846	321	39	50,128
Other	825	-	-	825
Total	\$ 506,048	\$ 10,850	\$ 1,325	\$ 515,573

⁽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.

Table of Contents

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

	Book Value	Gross Unrealized		Fair Value
		Gains	Losses	
March 31, 2014				
Obligations of States and Political Subdivisions	\$62,890	\$711	\$257	\$63,344
Mortgage Backed Securities ⁽¹⁾	4	-	-	4
Other	2,761	-	-	2,761
Total	\$65,655	\$711	\$257	\$66,109

	Book Value	Gross Unrealized		Fair Value
		Gains	Losses	
December 31, 2013				
Obligations of States and Political Subdivisions	\$65,685	\$812	\$627	\$65,870
Mortgage Backed Securities ⁽¹⁾	45	-	-	45
Other	2,775	-	-	2,775
Total	\$68,505	\$812	\$627	\$68,690

	Book Value	Gross Unrealized		Fair Value
		Gains	Losses	
March 31, 2013				
Obligations of States and Political Subdivisions	\$65,165	\$1,896	\$22	\$67,039
Mortgage Backed Securities ⁽¹⁾	341	8	-	349
Other	2,202	-	-	2,202
Total	\$67,708	\$1,904	\$22	\$69,590

⁽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 March 31, 2013 by contractual maturity are shown in the following table (in thousands):

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair/Book Value	Book Value	Fair Value
March 31, 2014				
Within one year	\$26,719	\$26,793	\$2,211	\$2,224
After one year through five years	39,547	39,837	19,482	19,830
After five years through ten years	3,256	3,383	23,727	24,049
After ten years	-	-	20,231	20,002
	69,522	70,013	65,651	66,105

Investment securities not due at a single maturity date:

Mortgage-backed securities	331,434	329,730	4	4
Total	\$400,956	\$399,743	\$65,655	\$66,109

Table of Contents

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.

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):

March 31, 2014	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

Securities Available-for-Sale

Mortgage Backed Securities	\$123,313	\$ 4,506	\$15,981	\$ 872	139,294	\$ 5,378
Corporate Securities	3,794	39	2,474	24	6,268	63
Total	\$127,107	\$ 4,545	\$18,455	\$ 896	\$145,562	\$ 5,441

Securities Held-to-Maturity

Obligations of States and Political Subdivisions	\$9,038	\$ 257	\$-	\$ -	\$9,038	\$ 257
Total	\$9,038	\$ 257	\$-	\$ -	\$9,038	\$ 257

December 31, 2013	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

Securities Available-for-Sale

Mortgage Backed Securities	\$195,736	\$ 7,566	\$-	\$ -	\$195,736	\$ 7,566
Corporate Securities	15,297	106	2,457	41	17,754	147
Total	\$211,033	\$ 7,672	\$2,457	\$ 41	\$213,490	\$ 7,713

Securities Held-to-Maturity

Obligations of States and Political Subdivisions	\$9,518	\$ 627	\$-	\$ -	\$9,518	\$ 627
Total	\$9,518	\$ 627	\$-	\$ -	\$9,518	\$ 627

March 31, 2013	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

Securities Available-for-Sale

Mortgage Backed Securities	\$115,238	\$ 1,286	\$-	\$ -	\$115,238	\$ 1,286
Corporate Securities	18,691	39	-	-	18,691	39
Total	\$133,929	\$ 1,325	\$-	\$ -	\$133,929	\$ 1,325

Securities Held-to-Maturity

Obligations of States and Political Subdivisions	\$2,841	\$ 22	\$-	\$ -	\$2,841	\$ 22
Total	\$2,841	\$ 22	\$-	\$ -	\$2,841	\$ 22

As of March 31, 2014, the Company held 346 investment securities of which 47 were in a loss position for less than twelve months. 4 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.

Table of Contents

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 March 31, 2014, December 31, 2013 and March 31, 2013.

Mortgage Backed Securities - The unrealized losses on the Company's investment in mortgage backed securities were \$5.4 million, \$7.6 million, and \$1.3 million at March 31, 2014, December 31, 2013, and March 31, 2013, 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 March 31, 2014, December 31, 2013 and March 31, 2013, respectively.

Obligations of States and Political Subdivisions - The financial problems experienced by certain municipalities over the past six 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 March 31, 2014, over ninety-three 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 seven 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 \$257,000, \$627,000, and \$22,000 at March 31, 2014, December 31, 2013 and March 31, 2013, 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 March 31, 2014, December 31, 2013 and March 31, 2013, respectively.

Corporate Securities - The unrealized losses on the Company's investment in corporate securities were \$63,000, \$147,000, and \$39,000 at March 31, 2014, December 31, 2013, and March 31, 2013. 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 March 31, 2014, December 31, 2013 and March 31, 2013, respectively.

Proceeds from sales and calls of securities were as follows:

(in thousands)	Proceeds	Gains	Losses
Three Months Ended March 31, 2014	\$2,988	\$3	\$ -
Three Months Ended March 31, 2013	45,259	749	14

Pledged Securities

As of March 31, 2014, securities carried at \$332.0 million were pledged to secure public deposits, FHLB borrowings, and other government agency deposits as required by law. This amount at December 31, 2013, was \$334.8 million.

Table of Contents

3. Loans & Leases and 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):

March 31, 2014	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, 2014	\$5,178	\$3,576	\$654	\$1,108	\$2,767	\$12,205	\$5,697	\$176	\$639	\$2,274	\$34,2
Charge-Offs	-	-	-	(3)	-	-	-	(27)	-	-	(30
Recoveries	-	-	-	-	12	1	5	15	-	-	33
Provision	1,248	(189)	423	(5)	(131)	(2,605)	724	7	282	246	-
Ending Balance- March 31, 2014	\$6,426	\$3,387	\$1,077	\$1,100	\$2,648	\$9,601	\$6,426	\$171	\$921	\$2,520	\$34,2
Ending Balance Individually Evaluated for Impairment	245	-	226	340	313	118	814	48	-	-	2,10
Ending Balance Collectively Evaluated for Impairment	6,181	3,387	851	760	2,335	9,483	5,612	123	921	2,520	32,1
Ending Balance Individually Evaluated for Impairment	\$402,865	\$326,112	\$55,751	\$156,094	\$34,289	\$209,228	\$155,802	\$4,721	\$18,168	\$-	\$1,36
Ending Balance Collectively Evaluated for Impairment	22,046	-	4,473	1,701	2,055	587	5,100	48	-	-	36,0
Ending Balance Collectively Evaluated for Impairment	380,819	326,112	51,278	154,393	32,234	208,641	150,702	4,673	18,168	-	1,32

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
December 31, 2013											
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	\$ 34,217
Charge-Offs	(6)	(575)	-	(16)	(91)	(23)	(60)	(120)	-	-	(891)
Recoveries	-	-	-	-	115	42	312	54	-	-	523