

FARMERS & MERCHANTS BANCORP

Form 10-Q

November 04, 2011

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 September 30, 2011

or

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

For the transition period from _____ to _____

Commission File Number: 000-26099

FARMERS & MERCHANTS BANCORP

(Exact name of registrant as specified in its charter)

Delaware

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
☐

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(Do not check if a smaller reporting company)

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

Number of shares of common stock of the registrant: Par value \$0.01, authorized 20,000,000 shares; issued and outstanding 779,424 as of October 31, 2011.

FARMERS & MERCHANTS BANCORP

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PART I. - FINANCIAL INFORMATION

Item 1 - Financial Statements

FARMERS & MERCHANTS BANCORP
Consolidated Balance Sheets (Unaudited)

(in thousands except per share data)	Sept. 30, 2011	December 31, 2010	Sept. 30, 2010
Assets			
Cash and Cash Equivalents:			
Cash and Due From Banks	\$37,829	\$28,484	\$32,453
Interest Bearing Deposits with Banks	74,782	32,176	30,280
Total Cash and Cash Equivalents	112,611	60,660	62,733
Investment Securities:			
Available-for-Sale	427,844	434,856	351,029
Held-to-Maturity	63,803	64,937	67,984
Total Investment Securities	491,647	499,793	419,013
Loans	1,177,505	1,176,002	1,190,872
Less: Allowance for Loan Losses	32,963	32,261	32,006
Loans, Net	1,144,542	1,143,741	1,158,866
Premises and Equipment, Net	24,260	24,214	24,545
Bank Owned Life Insurance	46,959	45,584	45,125
Interest Receivable and Other Assets	60,204	67,499	66,604
Total Assets	\$1,880,223	\$1,841,491	\$1,776,886
Liabilities			
Deposits:			
Demand	\$359,649	\$343,482	\$336,108
Interest Bearing Transaction	210,730	195,576	166,450
Savings and Money Market	497,599	453,531	407,660
Time	521,310	573,914	590,193
Total Deposits	1,589,288	1,566,503	1,500,411
Securities Sold Under Agreement to Repurchase	60,000	60,000	60,000
Federal Home Loan Bank Advances	546	591	606
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	30,859	30,846	29,241
Total Liabilities	1,691,003	1,668,250	1,600,568
Shareholders' Equity			
Common Stock	8	8	8
Additional Paid-In Capital	75,590	75,590	76,198
Retained Earnings	108,174	96,030	95,855
Accumulated Other Comprehensive Gain	5,448	1,613	4,257
Total Shareholders' Equity	189,220	173,241	176,318
Total Liabilities & Shareholders' Equity	\$1,880,223	\$1,841,491	\$1,776,886

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

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Consolidated Statements of Income (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Interest Income				
Interest and Fees on Loans	\$17,949	\$18,342	\$52,946	\$54,480
Interest on Deposits with Banks	28	32	67	68
Interest on Investment Securities:				
Taxable	2,247	1,917	6,988	6,729
Tax-Exempt	637	677	1,926	2,084
Total Interest Income	20,861	20,968	61,927	63,361
Interest Expense				
Deposits	1,337	1,757	4,279	5,472
Borrowed Funds	549	550	1,632	1,634
Subordinated Debentures	82	88	245	250
Total Interest Expense	1,968	2,395	6,156	7,356
Net Interest Income	18,893	18,573	55,771	56,005
Provision for Loan Losses	900	1,315	5,350	10,550
Net Interest Income After Provision for Loan Losses	17,993	17,258	50,421	45,455
Non-Interest Income				
Service Charges on Deposit Accounts	1,356	1,680	4,096	4,964
Net Gain on Investment Securities	-	4	-	2,857
Increase in Cash Surrender Value of Life Insurance	466	462	1,376	1,366
Debit Card and ATM Fees	704	680	2,078	1,930
(Loss) Gain on Non-Qualified Deferred Compensation Plan Investments	(1,198)	998	(808)	463
Other	442	484	1,357	1,513
Total Non-Interest Income	1,770	4,308	8,099	13,093
Non-Interest Expense				
Salaries & Employee Benefits	7,512	7,067	22,217	21,403
(Loss) Gain on Non-Qualified Deferred Compensation Plan Investments	(1,198)	998	(808)	463
Occupancy	674	684	1,920	1,984
Equipment	726	689	2,151	1,948
ORE Holding Costs	364	268	1,256	763
FDIC Insurance	236	496	1,226	1,804
Other	1,507	1,428	4,528	4,464
Total Non-Interest Expense	9,821	11,630	32,490	32,829
Income Before Income Taxes	9,942	9,936	26,030	25,719
Provision for Income Taxes	3,675	3,727	9,482	9,453
Net Income	\$6,267	\$6,209	\$16,548	\$16,266
Earnings Per Share	\$8.04	\$7.95	\$21.23	\$20.83

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

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FARMERS & MERCHANTS BANCORP

Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)

	Three Months Ended Sept 30,		Nine Months Ended Sept 30,	
	2011	2010	2011	2010
Net Income	\$6,267	\$6,209	\$16,548	\$16,266
Other Comprehensive Income -				
Unrealized Gains (Losses) on Securities:				
Unrealized holding gains (losses) arising during the period, net of income tax provision of \$ 1,341 and \$(462) for the quarters ended September 30, 2011 and 2010, respectively, and of \$2,782 and \$840 for the nine months ended September 30, 2011 and 2010, respectively.	1,849	(636)	3,835	1,159
Reclassification adjustment for realized gains included in net income, net of related income tax effects of \$0 and \$(1)for the quarters ended September 30, 2011 and 2010, respectively, and of \$0 and \$ (1,201) for the nine months ended September 30, 2011 and 2010, respectively.	-	(3)	-	(1,656)
Total Other Comprehensive Income	1,849	(639)	3,835	(497)
Comprehensive Income	\$8,116	\$5,570	\$20,383	\$15,769
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 Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, January 1, 2010	780,944	\$8	\$76,198	\$83,767	\$ 4,754	\$ 164,727
Net Income		-	-	16,266	-	16,266
Cash Dividends Declared on Common Stock (\$5.35 per share)		-	-	(4,178)	-	(4,178)
Change in Net Unrealized Gain on Securities Available for Sale		-	-	-	(497)	(497)
Balance, September 30, 2010	780,944	\$8	\$76,198	\$95,855	\$ 4,257	\$ 176,318
Balance, January 1, 2011	779,424	\$8	\$75,590	\$96,030	\$ 1,613	\$ 173,241
Net Income		-	-	16,548		16,548
Cash Dividends Declared on Common Stock (\$5.65 per share)		-	-	(4,404)		(4,404)
Change in Net Unrealized Gain on Securities Available for Sale		-	-		3,835	3,835
Balance, September 30, 2011	779,424	\$8	\$75,590	\$108,174	\$ 5,448	\$ 189,220

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)

	Nine Months Ended	
	Sept 30, 2011	Sept 30, 2010
Operating Activities:		
Net Income	\$ 16,548	\$ 16,266
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	5,350	10,550
Depreciation and Amortization	1,358	1,414
Net Amortization (Accretion) of Investment Security Discounts & Premium	624	(611)
Net Gain on Investment Securities	-	(2,857)
Net Gain on Sale of Property & Equipment	(5)	(19)
Net Change in Operating Assets & Liabilities:		
Net Decrease (Increase) in Interest Receivable and Other Assets	3,147	(7,943)
Net Increase in Interest Payable and Other Liabilities	13	1,537
Net Cash Provided by Operating Activities	27,035	18,337
Investing Activities:		
Purchase of Investment Securities Available-for-Sale	(137,086)	(209,449)
Proceeds from Sold, Matured, or Called Securities Available-for-sale	150,104	226,582
Purchase of Investment Securities Held-to-Maturity	(1,300)	-
Proceeds from Matured or Called Securities Held-to-Maturity	2,412	1,629
Net Loans Paid, Originated or Acquired	(6,234)	13,329
Principal Collected on Loans Previously Charged Off	83	160
Additions to Premises and Equipment	(1,419)	(1,074)
Proceeds from Sale of Property and Equipment	20	21
Net Cash Provided by Investing Activities	6,580	31,198
Financing Activities:		
Net Increase in Deposits	22,785	2,287
Net Change in Other Borrowings	(45)	(19,543)
Cash Dividends	(4,404)	(4,178)
Net Cash Provided (Used in) by Financing Activities	18,336	(21,434)
Increase in Cash and Cash Equivalents	51,951	28,101
Cash and Cash Equivalents at Beginning of Period	60,660	34,632
Cash and Cash Equivalents at End of Period	\$ 112,611	\$ 62,733

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 (“GAAP”) and was formed for the sole purpose of issuing Trust Preferred Securities.

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

Basis of Presentation

The accompanying unaudited 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 accounting principles generally accepted in the United States of America (“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, 2010. The results of operations for the nine-month period ended September 30, 2011 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 unaudited financial statements reflect all adjustments (consisting only of normal recurring adjustments), which are necessary for a fair

presentation of financial results for the interim 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.

An investment security is impaired when its carrying value is greater than its fair value. Investment securities that are impaired are evaluated on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether such a decline in their fair value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Company to retain its investment in the securities for a period of time sufficient to allow for an anticipated recovery in fair value, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, and management does not intend to sell the security or it is more likely than not that the Company will not be required to sell the security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the security or it is more likely than not that the Company will be required to sell the security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

Loans

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

principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan.

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are either: (1) non-accrual loans; or (2) restructured loans that are still accruing interest. A restructuring of a loan constitutes a troubled debt restructuring 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. When a loan is impaired, the recorded amount of the loan in the Consolidated Balance Sheet is based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the observable or estimated market price of the loan, or on the fair value of the collateral if the loan is collateral dependent. If the restructured loan was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, the loan can remain on accrual.

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Allowance for Loan Losses

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

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

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

Generally, the Company will not restructure loans for customers unless: (1) the existing loan is brought current as to principal and interest payments; and (2) the restructured loan can be underwritten to reasonable underwriting standards. If these standards are not met other actions will be pursued (e.g., foreclosure) to collect outstanding loan amounts. After restructure a determination is made whether the loan will be kept on accrual status based upon the underwriting of the restructured credit.

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

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

The Company assigns a risk rating to all loans and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

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

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

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

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

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

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

Real Estate Construction – Real Estate Construction 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 which 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.

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Residential 1st Mortgages and Home Equity – 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 over the past several 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.

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 accrued interest payable and other liabilities on the 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 loan losses at the time of acquisition. Subsequent declines in value from the recorded amounts, routine holding costs, and gains or losses upon disposition, if any, are included in non-interest income or expense as incurred.

Income Taxes

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

year. This amount, combined with the current taxes payable or refundable, results in the income tax expense for the current year.

The Company follows the standards set forth in the “Income Taxes” topic of the FASB Accounting Standards 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 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 are classified as income tax expense in the Consolidated Statement of Income.

Dividends and Earnings Per Share

The Company's common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. See Note 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 discernable lines of business and prefers to work as an integrated unit to customize solutions for its customers, with business line emphasis and product offerings changing over time as needs and demands change. Therefore, the Company only reports one segment.

Derivative Instruments and Hedging Activities

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

From time to time, the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps, and collars. These instruments are purchased and/or sold to reduce the Company's exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments as of September 30, 2011, December 31, 2010 and September 30, 2010.

Comprehensive Income

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

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2. Investment Securities

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

	Amortized Cost	Gains	Gross Unrealized Losses	Fair/Book Value
September 30, 2011				
Securities of U.S. Government Agencies	\$ 162,115	\$ 635	\$ -	\$ 162,750
Obligations of States and Political Subdivisions	5,813	-	-	5,813
Mortgage Backed Securities	243,121	8,787	22	251,886
Other	7,395	-	-	7,395
Total	\$ 418,444	\$ 9,422	\$ 22	\$ 427,844

	Amortized Cost	Gains	Gross Unrealized Losses	Fair/Book Value
December 31, 2010				
Securities of U.S. Government Agencies	\$ 237,944	\$ 305	\$ 1,930	\$ 236,319
Obligations of States and Political Subdivisions	6,378	-	-	6,378
Mortgage Backed Securities	181,228	6,028	1,619	185,637
Other	6,522	-	-	6,522
Total	\$ 432,072	\$ 6,333	\$ 3,549	\$ 434,856

	Amortized Cost	Gains	Gross Unrealized Losses	Fair/Book Value
September 30, 2010				
Securities of U.S. Government Agencies	\$ 205,177	\$ 582	\$ 36	\$ 205,723
Obligations of States and Political Subdivisions	6,416	-	-	6,416
Mortgage Backed Securities	125,567	6,800	-	132,367
Other	6,523	-	-	6,523
Total	\$ 343,683	\$ 7,382	\$ 36	\$ 351,029

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	Gains	Gross Unrealized Losses	Fair Value
September 30, 2011				
Obligations of States and Political Subdivisions	\$60,130	\$2,437	\$-	\$62,567
Mortgage Backed Securities	1,418	62	-	1,480
Other	2,255	-	-	2,255
Total	\$63,803	\$2,499	\$-	\$66,302

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

	Book Value	Gains	Gross Unrealized Losses	Fair Value
September 30, 2010				
Obligations of States and Political Subdivisions	\$63,471	\$2,777	\$-	\$66,248

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Mortgage Backed Securities	2,524	118	-	2,642
Other	1,989	-	-	1,989
Total	\$67,984	\$2,895	\$-	\$70,879

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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 September 30, 2011 by contractual maturity are shown below (in thousands).

Securities Available-for-Sale September 30, 2011	Within 1 Year	After 1 but Within 5	After 5 but Within 10	Over 10 years	Total Fair Value
Securities of U.S. Government Agencies	\$10,194	\$146,385	\$6,171	\$-	\$162,750
Obligations of States and Political Subdivisions	-	-	227	5,586	5,813
Mortgage Backed Securities	-	-	97,109	154,777	251,886
Other	7,395	-	-	-	7,395
Total	\$17,589	\$146,385	\$103,507	\$160,363	\$427,844

Securities Held-to-Maturity September 30, 2011	Within 1 Year	After 1 but Within 5	After 5 but Within 10	Over 10 years	Total Book Value
Obligations of States and Political Subdivisions	\$700	\$7,073	\$43,171	\$9,186	\$60,130
Mortgage Backed Securities	-	1,418	-	-	1,418
Other	-	7	2,248	-	2,255
Total	\$700	\$8,498	\$45,419	\$9,186	\$63,803

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

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

September 30, 2011	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities of U.S. Government Agencies	\$-	\$-	\$-	\$-	\$-	\$-
Obligations of States and Political Subdivisions	-	-	-	-	-	-
Mortgage Backed Securities	10,130	22	-	-	10,130	22
Total	\$10,130	\$22	\$-	\$-	\$10,130	\$22

December 31, 2010	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities of U.S. Government Agencies	\$145,844	\$1,930	\$-	\$-	\$145,844	\$1,930
Obligations of States and Political Subdivisions	6,165	241	-	-	6,165	241

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Mortgage Backed Securities	44,479	1,619	-	-	44,479	1,619
Total	\$196,488	\$3,790	\$-	\$-	\$196,488	\$3,790
	Less Than 12 Months		12 Months or More		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Loss	Value	Loss	Value	Loss
September 30, 2010						
Obligations of States and						
Political Subdivisions	\$18,381	\$36	\$-	\$-	\$18,381	\$36
Total	\$18,381	\$36	\$-	\$-	\$18,381	\$36

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As of September 30, 2011, the Company held 267 investment securities of which one was in a loss position for less than twelve months. No securities were in a continuous 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 U.S. Government Agencies

The unrealized losses on the Company's investments in securities of U.S. government agencies were caused by interest rate increases. Repayment of these investments is guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2011.

Mortgage Backed Securities

The unrealized losses on the Company's investment in mortgage backed securities were caused by interest rate increases. The contractual cash flows of these investments are guaranteed by an agency 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 September 30, 2011.

Obligations of States and Political Subdivisions

The continuing financial problems being experienced by certain municipalities, along with the financial stresses exhibited by some of the large monoline bond insurers, have increased the overall risk associated with bank-qualified municipal bonds. As of September 30, 2011 over eighty percent of the Company's bank-qualified municipal bonds have an underlying credit rating, and all of these ratings are "investment grade." For those bonds in the portfolio that are not rated, the Company monitors the status of these issuers 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.

Management believes that the unrealized losses on the Company's investments in obligations of states and political subdivisions were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company 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 September 30, 2011.

Pledged Securities

As of September 30, 2011, securities carried at \$382.9 million were pledged to secure public deposits, FHLB borrowings, and other government agency deposits as required by law. This amount at December 31, 2010, was \$346.3 million.

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3. Allowance for Loan Losses

The following table shows the allocation of the allowance for loan losses at September 30, 2011 and December 31, 2010 by portfolio segment and by impairment methodology (in thousands):

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity	Agricultural	Commercial	Consumer & Other	Unallocated	Total
September 30, 2011										
Year-To-Date Allowance for Credit Losses:										
Beginning Balance- January 1, 2011	\$7,631	\$1,539	\$2,160	\$1,164	\$3,724	\$6,733	\$9,084	\$216	\$10	\$32,261
Charge-Offs	(25)	(384)	-	(398)	(701)	(2,750)	(324)	(149)	-	(4,731)
Recoveries	-	-	-	3	11	10	14	45	-	83
Provision	(1,790)	1,233	196	341	497	2,646	738	80	1,409	5,350
Ending Balance- September 30, 2011	\$5,816	\$2,388	\$2,356	\$1,110	\$3,531	\$6,639	\$9,512	\$192	\$1,419	\$32,963
Third Quarter Allowance for Credit Losses:										
Beginning Balance- July 1, 2011	\$5,726	\$2,813	\$2,362	\$1,198	\$3,450	\$6,284	\$10,794	\$252	\$63	\$32,942
Charge-Offs	(12)	(384)	-	(58)	(239)	-	(148)	(62)	-	(903)
Recoveries	-	-	-	-	5	-	5	14	-	24
Provision	102	(41)	(6)	(30)	315	355	(1,139)	(12)	1,356	900
Ending Balance- September 30, 2011	\$5,816	\$2,388	\$2,356	\$1,110	\$3,531	\$6,639	\$9,512	\$192	\$1,419	\$32,963
Ending Balance Individually Evaluated for Impairment	702	46	-	-	40	827	103	24	-	1,742
Ending Balance Collectively Evaluated for Impairment	5,114	2,342	2,356	1,110	3,491	5,812	9,409	168	1,419	31,221

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Loans:										
Ending Balance	\$300,918	\$284,149	\$28,979	\$104,130	\$52,451	\$219,670	\$180,329	\$6,879	\$-	\$1,177,505
Ending Balance Individually Evaluated for Impairment	3,841	1,413	-	1,273	262	1,671	349	24	-	8,833
Ending Balance Collectively Evaluated for Impairment	297,077	282,736	28,979	102,857	52,189	217,999	179,980	6,855	-	1,168,672
	Commercial	Agricultural	Real Estate	Residential	Home			Consumer		
December 31, 2010	Real Estate	Real Estate	Construction	1st Mortgages	Equity	Agricultural	Commercial	& Other	Unallocated	Total
Allowance for Credit Losses:										
Ending Balance Allocated to Portfolio Segments	\$7,631	\$1,539	\$2,160	\$1,164	\$3,724	\$6,733	\$9,084	\$216	\$10	\$32,261
Ending Balance Individually Evaluated for Impairment	3,425	365	850	298	-	150	84	-	-	5,172
Ending Balance Collectively Evaluated for Impairment	4,206	1,174	1,310	866	3,724	6,583	9,000	216	10	27,089
Loans:										
Ending Balance	\$316,271	\$254,575	\$37,486	\$103,574	\$58,971	\$231,150	\$165,263	\$8,712	\$-	\$1,176,002
Ending Balance Individually Evaluated for Impairment	22,107	1,797	6,193	1,824	13	750	277	-	-	32,961
	294,164	252,778	31,293	101,750	58,958	230,400	164,986	8,712	-	1,143,041

Ending
Balance
Collectively
Evaluated
for
Impairment

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The following table shows the loan portfolio allocated by management's internal risk ratings at September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011	Pass	Special Mention	Substandard	Total Loans
Loans:				
Commercial Real Estate	\$ 260,662	\$ 15,482	\$ 24,774	\$ 300,918
Agricultural Real Estate	259,428	19,315	5,406	284,149
Real Estate Construction	20,781	3,217	4,981	28,979
Residential 1st Mortgages	101,230	1,503	1,397	104,130
Home Equity	51,559	-	892	52,451
Agricultural	202,323	12,285	5,062	219,670
Commercial	172,702	5,971	1,656	180,329
Consumer & Other	6,479	-	400	6,879
Total	\$ 1,075,164	\$ 57,773	\$ 44,568	\$ 1,177,505

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

See "Note 1. Significant Accounting Policies - Allowance for Loan Losses" for a description of the internal risk ratings used by the Company. There were no loans outstanding at September 30, 2011 and December 31, 2010 rated doubtful or loss.

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The following table shows an aging analysis of the loan portfolio by the time past due at September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Loans:						
Commercial Real Estate	\$-	\$-	\$811	\$811	\$300,107	\$300,918
Agricultural Real Estate	-	-	1,413	1,413	282,736	284,149
Real Estate Construction	-	-	-	-	28,979	28,979
Residential 1st Mortgages	-	-	347	347	103,783	104,130
Home Equity	359	-	190	549	51,902	52,451
Agricultural	3,854	-	1,531	5,385	214,285	219,670
Commercial	-	-	348	348	179,981	180,329
Consumer & Other	15	-	24	39	6,840	6,879
Total	\$4,228	\$-	\$4,664	\$8,892	\$1,168,613	\$1,177,505

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

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The following table shows information related to impaired loans at and for the three and nine month periods ended September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011	Recorded Investment	Unpaid Principal Balance	Related Allowance	Three Months Ended Sept. 30, 2011 Average Recorded Investment	Interest Income Recognized	Nine Months Ended Sept. 30, 2011 Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:							
Commercial Real Estate	\$816	\$811	\$-	\$ 530	\$ -	\$ 453	\$ -
Agricultural Real Estate	935	974	-	1,717	-	1,470	-
Real Estate Construction	-	-	-	-	-	-	-
Residential 1st Mortgages	1,278	1,469	-	861	1	842	3
Home Equity	190	191	-	218	-	230	1
Agricultural	140	140	-	143	3	111	6
Commercial	186	182	-	188	-	197	-
Consumer & Other	-	-	-	-	-	7	-
	\$3,545	\$3,767	\$-	\$ 3,657	\$ 4	\$ 3,310	\$ 10
With an allowance recorded:							
Commercial Real Estate	\$3,033	\$3,030	\$702	\$ 3,041	\$ 44	\$ 2,035	\$ 46
Agricultural Real Estate	463	823	46	645	-	705	-
Real Estate Construction	-	-	-	-	-	-	-
Residential 1st Mortgages	-	-	-	-	-	-	-
Home Equity	73	82	40	74	1	118	2
Agricultural	1,533	1,548	827	2,732	2	2,065	25
Commercial	168	206	103	155	-	125	-
Consumer & Other	24	24	24	31	-	33	-
	\$5,294	\$5,713	\$1,742	\$ 6,678	\$ 47	\$ 5,081	\$ 73
Total	\$8,839	\$9,480	\$1,742	\$ 10,335	\$ 51	\$ 8,391	\$ 83

December 31, 2010	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance					

recorded:

Commercial Real Estate	\$ 12,218	\$ 12,442	\$ -	\$ 9,259	\$ 227
Agricultural Real Estate	975	974	-	867	-
Real Estate Construction	3,092	3,093	-	3,276	71
Residential 1st Mortgages	857	1,197	-	742	26
Home Equity	36	42	-	359	2
Agricultural	-	-	-	430	-
Commercial	140	140	-	1,124	-
Consumer & Other	-	-	-	1	-
	\$ 17,318	\$ 17,888	\$ -	\$ 16,058	\$ 326

With an allowance

recorded:

Commercial Real Estate	\$ 9,907	\$ 9,909	\$ 3,425	\$ 5,141	\$ 360
Agricultural Real Estate	826	823	365	417	27
Real Estate Construction	3,100	3,100	850	1,308	41
Residential 1st Mortgages	952	997	298	294	8
Home Equity	-	-	-	3	-
Agricultural	750	750	150	188	24
Commercial	137	136	84	34	3
Consumer & Other	-	-	-	-	-
	\$ 15,672	\$ 15,715	\$ 5,172	\$ 7,385	\$ 463
Total	\$ 32,990	\$ 33,603	\$ 5,172	\$ 23,443	\$ 789

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

The Company has allocated \$904,000 and \$4.6 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2011 and December 31, 2010. The Company had no commitments at September 30, 2011 and December 31, 2010 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

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During the period ending September 30, 2011, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

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

The following table presents loans by class modified as troubled debt restructured loans for the three and nine months ended September 30, 2011 (in thousands):

	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings						
Commercial Real Estate	-	\$ -	\$ -	2	\$ 3,032	\$ 3,032
Agricultural Real Estate	-	-	-	-	-	-
Real Estate Construction	-	-	-	-	-	-
Residential 1st Mortgages	4	897	847	4	897	847
Home Equity Lines & Loans	-	-	-	2	55	51
Agricultural Commercial	-	-	-	1	140	140
Commercial	-	-	-	2	82	82
Consumer & Other	-	-	-	1	24	24
Total	4	\$ 897	\$ 847	12	\$ 4,230	\$ 4,176

The troubled debt restructurings described above increased the allowance for loan losses by \$0 and \$126,000 and resulted in charge-offs of \$50,000 and \$54,000 during the three and nine month periods ending September 30, 2011.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three and nine months ended September 30, 2011 (in thousands):

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
Troubled Debt Restructurings That Subsequently Defaulted				
Commercial Real Estate	-	\$ -	-	\$ -
Agricultural Real Estate	-	-	-	-
Real Estate Construction	-	-	-	-
Residential 1st Mortgages	-	-	-	-
Home Equity Lines & Loans	-	-	1	12
Agricultural Commercial	-	-	-	-
Commercial	-	-	-	-

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Consumer & Other	-	-	-	-
Total	-	\$ -	1	\$ 12

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

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The troubled debt restructurings that subsequently defaulted did not increase the allowance for loan losses but did result in charge offs of \$0 and \$12,000 during the three and nine month periods ending September 30, 2011.

4. Fair Value of Financial Instruments

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

The following table summarizes the book value and estimated fair value of financial instruments as follows:

(in thousands)	September 30, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
ASSETS:				
Cash and Cash Equivalents	\$112,611	\$112,611	\$60,660	\$60,660
Investment Securities Held-to-Maturity	63,803	66,659	64,937	65,279
Investment Securities Available-for-Sale	427,844	427,844	434,856	434,856
Loans, Net of Deferred Loan Fees & Allowance	1,144,542	1,183,033	1,143,741	1,177,026
Bank Owned Life Insurance	46,959	46,959	45,584	45,584
Accrued Interest Receivable	7,454	7,454	7,104	7,104
LIABILITIES:				
Deposits:				
Non-Interest Bearing	359,649	359,649	343,482	343,482
Interest-Bearing	1,229,639	1,231,089	1,223,021	1,224,760
FHLB Advances & Securities Sold Under Agreement to Repurchase	60,546	63,626	60,591	64,640
Subordinated Debentures	10,310	5,751	10,310	4,372
Accrued Interest Payable	907	907	1,411	1,411

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

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

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

Loans: For variable-rate loans that reprice frequently, fair values are based on carrying values. The fair values for fixed-rate loans are estimated using discounted cash flow analyses using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest receivable approximates its fair value.

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

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

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

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

Fair value estimates presented herein are based on pertinent information available to management as of September 30, 2011. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above.

5. Fair Value Measurements

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

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

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

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

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

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

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

The Company does not record all loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Once a loan is identified as individually impaired, management measures impairment in accordance with the “Receivable” topic of the FASB ASC. The fair value of

impaired loans is estimated using one of several methods, including collateral value when the loan is collateral dependent, market value of similar debt, enterprise value, and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2011, substantially all impaired loans were evaluated based on the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses observable data, the Company records the impaired loan as nonrecurring Level 2. Otherwise, the Company records the impaired loan as nonrecurring Level 3.

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

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

		Fair Value Measurements At September 30, 2011, Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Fair Value Total					
Available-for-Sale Securities:						
Securities of U.S. Government Agencies	\$162,750	\$-			\$162,750	\$ -
Obligations of States and Political Subdivisions	5,813	-			5,813	-
Mortgage Backed Securities	251,886	-			251,886	-
Other	7,395	-			7,395	-
Total Assets Measured at Fair Value On a Recurring Basis	\$427,844	\$-			\$427,844	\$ -

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

		Fair Value Measurements At September 30, 2010, Using Quoted Prices in Active Markets for Identical Assets			Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Fair Value Total					

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(Level 1)

Available-for-Sale Securities:

Securities of U.S. Government Agencies	\$205,723	\$-	\$205,723	\$ -
Obligations of States and Political Subdivisions	6,416	-	6,416	-
Mortgage Backed Securities	132,367	-	132,367	-
Other	6,523	-	6,523	-
Total Assets Measured at Fair Value On a Recurring Basis	\$351,029	\$-	\$351,029	\$ -

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The following tables present information about the Company's impaired loans and ORE measured at fair value on a non-recurring basis and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the years indicated.

Fair Value Measurements At September 30, 2011, Using				
(in thousands)	Fair Value September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans:				
Commercial Real Estate	\$ 2,329	\$ -	\$ 2,329	\$ -
Agricultural Real Estate	1,367	-	1,367	-
Residential 1st Mortgage	926	-	926	-
Home Equity	33	-	33	-
Agricultural	704	-	-	704
Commercial	64	-	-	64
Other Real Estate	3,513	-	3,513	-
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 8,936	\$ -	\$ 8,168	\$ 768

Impaired loans with a partial charge-off or where an allowance was established were \$7.1 million with an allowance for loan losses of \$1.7 million. Impaired loans are collateral dependent and have been adjusted to fair value based on the estimated fair value of the underlying collateral, less estimated selling costs. If the Company determines that the value of an impaired loan is less than the recorded investment in the loan, the carrying value is adjusted through a charge-off recorded through the allowance for loan losses.

ORE was \$7.1 million with a valuation allowance of \$3.6 million. ORE has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, foreclosed assets are recorded at the lower of the carrying amount of the loan or the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in non-interest expense on the Consolidated Statements of Income.

Fair Value Measurements At December 31, 2010, Using				
(in thousands)	Fair Value December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans:				

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

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

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ORE was \$11.7 million with a valuation allowance of \$3.7 million. ORE has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, foreclosed assets are recorded at the lower of the carrying amount of the loan or the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in non-interest expense on the Consolidated Statements of Income.

		Fair Value Measurements At September 30, 2010, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Fair Value Total			
Impaired Loans	\$ 3,068	\$ -	\$ 3,068	\$ -
Other Real Estate	9,510	-	9,510	-
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 12,578	\$ -	\$ 12,578	\$ -

Impaired loans where an allowance was established were \$5.4 million with an allowance for loan losses of \$2.4 million. Impaired loans are collateral dependent and have been adjusted to fair value based on the estimated fair value of the underlying collateral, less estimated selling costs. If the Company determines that the value of an impaired loan is less than the recorded investment in the loan, the carrying value is adjusted through a charge-off recorded through the allowance for loan losses.

ORE was \$12.9 million with a valuation allowance of \$3.4 million. ORE has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, foreclosed assets are recorded at the lower of the carrying amount of the loan or the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in non-interest expense on the Consolidated Statements of Income.

6. Dividends and Earnings Per Share

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. On May 16, 2011, the Board of Directors of Farmers & Merchants Bancorp announced a mid-year cash dividend of \$5.65 per share, a 6.0% increase over the \$5.35 per share paid on July 1, 2010. The cash dividend was paid on June 30, 2011, to shareholders of record on June 1, 2011.

Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the earnings per share for the three and nine months ended September 30, 2011 and 2010.

(net income in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net Income	\$6,267	\$6,209	\$16,548	\$16,266

Average Number of Common Shares Outstanding	779,424	780,944	779,424	780,944
Per Share Amount	\$8.04	\$7.95	\$21.23	\$20.83

7. Recent Accounting Pronouncements

In May 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. This ASU amends the FASB Accounting Standards CodificationTM (Codification) to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments to the Codification in the ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income.

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ASU 2011-05 should be applied retrospectively. These amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. Management does not believe that the adoption of this ASU will have a material impact on the Company's financial position, results of operation, cash flows, or disclosure.

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

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

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

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Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three and nine months ended September 30, 2011. This analysis should be read in conjunction with our 2010 Annual Report to Shareholders on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

Forward-Looking Statements

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

Such factors include the following: (1) the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto; (2) the effect of changing regional and national economic conditions including the housing market in the Central Valley of California; (3) significant changes in interest rates and prepayment speeds; (4) credit risks of lending and investment activities; (5) changes in federal and state banking laws or regulations; (6) competitive pressure in the banking industry; (7) changes in governmental fiscal or monetary policies; (8) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (9) other factors discussed in Item 1A. Risk Factors located in the Company's 2010 Annual Report on Form 10-K.

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

Introduction

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California state-chartered bank formed in 1916. The Bank serves the mid Central Valley of California through twenty-two banking offices and two stand-alone ATM's. The service area includes Sacramento, San Joaquin, Stanislaus and Merced Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock, Hilmar, and Merced. Substantially all of the Company's business activities are conducted within its market area.

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

Overview

The Company's primary service area encompasses the mid Central Valley of California, a region that can be significantly impacted by the seasonal needs of the agricultural industry. Accordingly, the Company's Financial Condition and Results of Operations are influenced by the seasonal banking needs of our agricultural customers (e.g.,

during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and planting of crops. Correspondingly, deposit balances are replenished and loans repaid in fall and winter as crops are harvested and sold). As a result of these seasonal patterns, discussion of the Company's financial condition and operating results for the current reporting period is often more meaningful when compared to the same period in the prior year, as opposed to the prior year-end or the prior period in the current year.

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For the three and nine months ended September 30, 2011, Farmers & Merchants Bancorp reported net income of \$6,267,000 and \$16,548,000, earnings per share of \$8.04 and \$21.23 and return on average assets of 1.35% and 1.20%, respectively. Return on average shareholders' equity was 13.62% and 12.24% for the three and nine months ended September 30, 2011.

For the three and nine months ended September 30, 2010, Farmers & Merchants Bancorp reported net income of \$6,209,000 and \$16,266,000, earnings per share of \$7.95 and \$20.83 and return on average assets of 1.40% and 1.24%, respectively. Return on average shareholders' equity was 14.38% and 12.72% for the three and nine months ended September 30, 2010.

The following is a summary of the financial results for the nine month period ended September 30, 2011 compared to September 30, 2010.

- Net income increased 1.7% to \$16.5 million from \$16.3 million.
- Earnings per share increased 1.9% to \$21.23 from \$20.83.
- Total assets increased 5.8% to \$1.88 billion.
- Total loans decreased 1.1% to \$1.18 billion.
- Allowance for loan losses increased 3.0% to \$33.0 million.
- Total deposits increased 5.9% to \$1.6 billion.

Factors impacting the Company's improved earnings performance in the first nine months of 2011 as compared to the same period last year were: (1) a \$5.2 million decrease in the provision for loan losses; and (2) a \$1.2 million decrease in interest expense on deposits. These factors were partially offset by: (1) a \$1.5 million decrease in interest and fee income on loans; (2) a \$2.9 million decrease in gain on investment securities; (3) an \$868,000 decrease in service charges on deposit accounts; and (4) an \$814,000 increase in salaries & employee benefits.

Results of Operations

This section discusses material changes in the Company's income statement for the three and nine month periods ended September 30, 2011 as compared to the three and nine month periods ended September 30, 2010.

Net Interest Income / Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the three and nine month periods ended September 30, 2011 and 2010.

The average yields on earning assets and average rates paid on interest-bearing liabilities have been computed on an annualized basis for purposes of comparability with full year data. Average balance amounts for assets and liabilities are the computed average of daily balances.

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

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

The Company's earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix (see Item 3. "Quantitative and Qualitative Disclosures about Market Risk – Interest Rate Risk").

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Farmers & Merchants Bancorp
Quarterly Average Balances and Interest Rates
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Three Months Ended Sept 30, 2011				Three Months Ended Sept 30, 2010			
Assets	Balance	Interest	Rate		Balance	Interest	Rate	
Interest Bearing Deposits with Banks	\$44,158	\$28	0.25	%	\$50,713	\$32	0.25	%
Investment Securities								
Available-for-Sale:								
U.S. Agencies	201,893	562	1.11	%	182,381	557	1.22	%
Municipals - Non-Taxable	5,759	108	7.52	%	6,425	123	7.63	%
Mortgage Backed Securities	208,586	1,663	3.19	%	130,993	1,312	4.01	%
Other	5,154	3	0.22	%	4,425	9	0.67	%
Total Investment Securities								
Available-for-sale	421,392	2,336	2.22	%	324,224	2,001	2.47	%
Investment Securities								
Held-to-Maturity:								
Municipals - Non-Taxable	59,906	863	5.76	%	63,501	904	5.69	%
Mortgage Backed Securities	1,571	14	3.56	%	2,731	26	3.81	%
Other	2,260	5	0.88	%	1,989	12	2.41	%
Total Investment Securities								
Held-to-Maturity	63,737	882	5.53	%	68,221	942	5.52	%
Loans:								
Real Estate	724,776	11,610	6.36	%	711,403	11,314	6.31	%
Home Equity	53,538	780	5.78	%	62,578	917	5.81	%
Agricultural	224,454	3,078	5.44	%	229,041	3,458	5.99	%
Commercial	175,116	2,374	5.38	%	172,754	2,518	5.78	%
Consumer	7,137	104	5.78	%	8,856	132	5.91	%
Other	242	3	4.92	%	248	3	4.80	%
Total Loans	1,185,263	17,949	6.01	%	1,184,880	18,342	6.14	%
Total Earning Assets	1,714,550	\$21,195	4.90	%	1,628,038	\$21,316	5.19	%
Unrealized Loss on Securities								
Available-for-Sale	7,572				8,281			
Allowance for Loan Losses	(32,971)				(31,857)			
Cash and Due From Banks	30,724				31,131			
All Other Assets	134,459				136,821			
Total Assets	\$1,854,334				\$1,772,414			
Liabilities & Shareholders'								
Equity								
Interest Bearing Deposits:								
Interest Bearing DDA	\$199,767	\$57	0.11	%	\$169,961	\$47	0.11	%
Savings and Money Market	491,899	411	0.33	%	442,100	488	0.44	%
Time Deposits	534,048	869	0.65	%	575,010	1,222	0.84	%

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Total Interest Bearing Deposits	1,225,714	1,337	0.43	%	1,187,071	1,757	0.59	%
Securities Sold Under Agreement to Repurchase	60,000	541	3.58	%	60,000	541	3.58	%
Other Borrowed Funds	555	8	5.72	%	615	9	5.81	%
Subordinated Debentures	10,310	82	3.16	%	10,310	88	3.39	%
Total Interest Bearing Liabilities	1,296,579	\$1,968	0.60	%	1,257,996	\$2,395	0.76	%
Interest Rate Spread			4.30	%			4.44	%
Demand Deposits (Non-Interest Bearing)	339,927				303,363			
All Other Liabilities	33,790				38,340			
Total Liabilities	1,670,296				1,599,699			
Shareholders' Equity	184,038				172,715			
Total Liabilities & Shareholders' Equity	\$1,854,334				\$1,772,414			
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.15	%			0.17	%
Net Interest Income and Margin on Total Earning Assets	19,227		4.45	%	18,921		4.61	%
Tax Equivalent Adjustment	(334)				(348)			
Net Interest Income	\$18,893		4.37	%	\$18,573		4.53	%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$813,000 and \$269,000 for the quarters ended September 30, 2011 and 2010, respectively. Yields on securities available-for-sale are based on historical cost.

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Farmers & Merchants Bancorp

Year-to-Date Average Balances and Interest Rates

(Interest and Rates on a Taxable Equivalent Basis)

(in thousands)

Assets	Nine Months Ended Sept. 30, 2011				Nine Months Ended Sept. 30, 2010			
	Balance	Interest	Rate		Balance	Interest	Rate	
Interest Bearing Deposits with Banks	\$35,869	\$67	0.25	%	\$38,469	\$68	0.24	%
Investment Securities								
Available-for-Sale:								
U.S. Agencies	228,677	1,954	1.14	%	162,551	1,762	1.45	%
Municipals - Non-Taxable	6,042	340	7.50	%	6,937	395	7.59	%
Mortgage Backed Securities	196,816	4,959	3.36	%	151,470	4,819	4.24	%
Other	4,872	8	0.22	%	4,046	21	0.69	%
Total Investment Securities								
Available-for-Sale	436,407	7,261	2.22	%	325,004	6,997	2.87	%
Investment Securities								
Held-to-Maturity:								
Municipals - Non-Taxable	60,282	2,596	5.74	%	63,828	2,761	5.77	%
Mortgage Backed Securities	1,830	52	3.79	%	3,065	88	3.83	%
Other	2,268	16	0.94	%	1,989	38	2.55	%
Total Investment Securities								
Held-to-Maturity	64,380	2,664	5.52	%	68,882	2,887	5.59	%
Loans:								
Real Estate	719,701	33,929	6.30	%	717,662	33,981	6.33	%
Home Equity	55,992	2,433	5.81	%	64,006	2,814	5.88	%
Agricultural	217,753	9,151	5.62	%	213,746	9,597	6.00	%
Commercial	172,795	7,067	5.47	%	177,981	7,660	5.75	%
Consumer	7,509	356	6.34	%	9,478	418	5.90	%
Credit Card			0.00	%			0.00	%
Other	244	10	5.48	%	250	10	5.35	%
Total Loans	1,173,994	52,946	6.03	%	1,183,123	54,480	6.16	%
Total Earning Assets	1,710,650	\$62,937	4.92	%	1,615,478	\$64,432	5.33	%
Unrealized Gain (Loss) on Securities Available-for-Sale	4,346				7,746			
Allowance for Loan Losses	(32,556)				(32,205)			
Cash and Due From Banks	30,103				29,419			
All Other Assets	134,777				132,547			
Total Assets	\$1,847,320				\$1,752,985			
Liabilities & Shareholders' Equity								
Interest Bearing Deposits:								
Interest Bearing DDA	\$203,998	\$195	0.13	%	\$173,174	\$171	0.13	%

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Savings and Money Market	484,894	1,200	0.33	%	439,899	1,518	0.46	%
Time Deposits	551,216	2,884	0.70	%	572,966	3,783	0.88	%
Total Interest Bearing Deposits	1,240,108	4,279	0.46	%	1,186,039	5,472	0.62	%
Securities Sold Under								
Agreement to Repurchase	60,000	1,606	3.58	%	60,000	1,606	3.58	%
Other Borrowed Funds	2,246	26	1.55	%	1,432	28	2.61	%
Subordinated Debentures	10,310	245	3.18	%	10,310	250	3.24	%
Total Interest Bearing								
Liabilities	1,312,664	\$6,156	0.63	%	1,257,781	\$7,356	0.78	%
Interest Rate Spread			4.29	%			4.55	%
Demand Deposits (Non-Interest								
Bearing)	322,785				293,554			
All Other Liabilities	31,646				31,108			
Total Liabilities	1,667,095				1,582,443			
Shareholders' Equity	180,225				170,542			
Total Liabilities &								
Shareholders' Equity	\$1,847,320				\$1,752,985			
Impact of Non-Interest Bearing Deposits and								
Other Liabilities			0.15	%			0.17	%
Net Interest Income and Margin on Total								
Earning Assets	56,781		4.44	%	57,076		4.72	%
Tax Equivalent Adjustment	(1,010)				(1,071)			
Net Interest Income	\$55,771		4.36	%	\$56,005		4.64	%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$1,506,000 and \$714,000 for the nine months ended September 30, 2011 and 2010, respectively. Yields on securities available-for-sale are based on historical cost.

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Farmers & Merchants Bancorp
 Volume and Rate Analysis of Net Interest Revenue
 (Rates on a Taxable Equivalent Basis)
 (in thousands)

Interest Earning Assets	Three Months Ended			Nine Months Ended	
	Sept. 30, 2011 compared to Sept. 30, 2010			Sept. 30, 2011 compared to Sept. 30, 2010	
	Volume	Rate	Net Chg.	Volume	Rate