FARMERS & MERCHANTS BANCORP
Form 10-Q
August 09, 2011

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

FORM 10-Q

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

For the quarterly period ended June 30, 2011
or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from ________ to ________

Commission File Number: 000-26099

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

Delaware (State or other jurisdiction of incorporation or organization)	94-3327828 (I.R.S. Employer Identification No.)
111 W. Pine Street, Lodi, California (Address of principal Executive offices)	95240 (Zip Code)

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

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o

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 o Accelerated filer x Non-accelerated filer o Smaller Reporting Company o

(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 July 31, 2011.

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FARMERS & MERCHANTS BANCORP

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PART I. - FINANCIAL INFORMATION

Item 1 - Financial Statements

FARMERS & MERCHANTS BANCORP
Consolidated Balance Sheets

(in thousands)	June 30, 2011	December 31, 2010	June 30, 2010
Assets	(Unaudited)		(Unaudited)
Cash and Cash Equivalents:			
Cash and Due From Banks	$48,604	$28,484	$32,525
Interest Bearing Deposits with Banks	8,100	32,176	1,781
Total Cash and Cash Equivalents	56,704	60,660	34,306
Investment Securities:			
Available-for-Sale	430,950	434,856	324,423
Held-to-Maturity	63,584	64,937	68,773
Total Investment Securities	494,534	499,793	393,196
Loans	1,191,801	1,176,002	1,188,840
Less: Allowance for Loan Losses	32,942	32,261	31,403
Loans, Net	1,158,859	1,143,741	1,157,437
Premises and Equipment, Net	24,620	24,214	24,437
Bank Owned Life Insurance	46,494	45,584	44,663
Interest Receivable and Other Assets	65,493	67,499	68,659
Total Assets	$1,846,704	$1,841,491	$1,722,698
Liabilities			
Deposits:			
Demand	$324,371	$343,482	$293,773
Interest Bearing Transaction	196,946	195,576	169,088
Savings and Money Market	494,716	453,531	422,930
Time	548,094	573,914	564,493
Total Deposits	1,564,127	1,566,503	1,450,284
Securities Sold Under Agreement to Repurchase	60,000	60,000	60,000
Federal Home Loan Bank Advances	561	591	4,821
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	30,602	30,846	26,535
Total Liabilities	1,665,600	1,668,250	1,551,950
Shareholders' Equity			
Common Stock	8	8	8
Additional Paid-In Capital	75,590	75,590	76,198
Retained Earnings	101,907	96,030	89,646
Accumulated Other Comprehensive Income	3,599	1,613	4,896
Total Shareholders' Equity	181,104	173,241	170,748
Total Liabilities & Shareholders' Equity	$1,846,704	$1,841,491	$1,722,698

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

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FARMERS & MERCHANTS BANCORP
Consolidated Statements of Income (Unaudited)

(in thousands except per share data)	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Interest Income				
Interest and Fees on Loans	$17,490	$18,057	$34,997	$36,138
Interest on Deposits with Banks	5	16	39	36
Interest on Investment Securities:				
Taxable	2,399	2,151	4,741	4,812
Tax-Exempt	641	695	1,289	1,407
Total Interest Income	20,535	20,919	41,066	42,393
Interest Expense				
Deposits	1,396	1,739	2,942	3,715
Borrowed Funds	545	545	1,083	1,084
Subordinated Debentures	82	82	163	162
Total Interest Expense	2,023	2,366	4,188	4,961
Net Interest Income	18,512	18,553	36,878	37,432
Provision for Loan Losses	3,925	5,120	4,450	9,235
Net Interest Income After Provision for Loan Losses	14,587	13,433	32,428	28,197
Non-Interest Income				
Service Charges on Deposit Accounts	1,365	1,688	2,740	3,284
Net Gain on Investment Securities	-	7	-	2,853
Increase in Cash Surrender Value of Life Insurance	459	454	910	904
Debit Card and ATM Fees	708	651	1,374	1,250
(Loss) Gain on Non-Qualified Deferred Compensation Plan Investments	(15)	(730)	390	(535)
Other	478	472	915	1,029
Total Non-Interest Income	2,995	2,542	6,329	8,785
Non-Interest Expense				
Salaries & Employee Benefits	7,463	7,062	14,705	14,336
(Loss) Gain on Non-Qualified Deferred Compensation Plan Investments	(15)	(730)	390	(535)
Occupancy	613	660	1,246	1,300
Equipment	711	658	1,425	1,259
ORE Holding Costs	367	91	892	495
FDIC Insurance	516	507	990	1,308
Other	1,578	1,598	3,021	3,036
Total Non-Interest Expense	11,233	9,846	22,669	21,199
Income Before Income Taxes	6,349	6,129	16,088	15,783
Provision for Income Taxes	2,194	2,122	5,807	5,726
Net Income	$4,155	$4,007	$10,281	$10,057
Earnings Per Share	$5.33	$5.13	$13.19	$12.88

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 June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Net Income	$4,155	$4,007	$10,281	$10,057
Other Comprehensive Income -				
Unrealized Gains on Securities:				
Unrealized holding gains arising during the period, net of income tax benefit of $1,961 and $1,043 for the quarters ended June 30, 2011 and 2010, respectively, and of $1,441 and $1,302 for the six months ended June 30, 2011 and 2010, respectively.	2,702	1,437	1,986	1,795
Less: Reclassification adjustment for realized gains included in net income, net of related income tax effects of $0 and $(3) for the quarters ended June 30, 2011 and 2010, respectively, and of $0 and $(1,200) for the six months ended June 30, 2011 and 2010, respectively.	-	(4)	-	(1,653)
Total Other Comprehensive Income	2,702	1,433	1,986	142
Comprehensive Income	$6,857	$5,440	$12,267	$10,199

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		-	-	10,057	-	10,057
Cash Dividends Declared on Common Stock ($5.35 per share)		-	-	(4,178)	-	(4,178)
Change in Net Unrealized Gain on Securities Available for Sale		-	-	-	142	142
Balance, June 30, 2010	780,944	$8	$76,198	$89,646	$ 4,896	$ 170,748
Balance, January 1, 2011	779,424	$8	$75,590	$96,030	$ 1,613	$ 173,241
Net Income		-	-	10,281	-	10,281
Cash Dividends Declared on Common Stock ($5.65 per share)		-	-	(4,404)	-	(4,404)
Change in Net Unrealized Gain on Securities Available for Sale		-	-	-	1,986	1,986
Balance, June 30, 2011	779,424	$8	$75,590	$101,907	$ 3,599	$ 181,104

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

FARMERS & MERCHANTS BANCORP
Consolidated Statements of Cash Flows (Unaudited)
(in thousands)

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Operating Activities		
Net Income	$10,281	$10,057
Adjustments to Reconcile Net Income to Net		
Cash Provided by Operating Activities:		
Provision for Loan Losses	4,450	9,235
Depreciation and Amortization	896	954
Net Accretion of Investment Security Discounts & Premium	373	(291)
Net Gain on Investment Securities	-	(2,853)
Net Gain on Sale of Property & Equipment	(5)	(19)
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets	(341)	(10,000)
Net Decrease in Interest Payable and Other Liabilities	(244)	(1,169)
Net Cash Provided by Operating Activities	15,410	5,914
Investing Activities		
Purchase of Investment Securities Available-for-Sale	(67,514)	(135,949)
Proceeds from Sold, Matured, or Called Securities Available-for-sale	74,485	180,467
Purchase of Investment Securities Held-to-Maturity	(720)	-
Proceeds from Matured or Called Securities Held-to-Maturity	2,058	840
Net Loans Paid, Originated or Acquired	(19,627)	16,113
Principal Collected on Loans Previously Charged Off	59	120
Additions to Premises and Equipment	(1,317)	(506)
Proceeds from Disposition of Property & Equipment	20	21
Net Cash (Used in) Provided by Investing Activities	(12,556)	61,106
Financing Activities		
Net Decrease in Deposits	(2,376)	(47,840)
Net Change in Other Borrowings	(30)	(15,328)
Cash Dividends	(4,404)	(4,178)
Net Cash Used in Financing Activities	(6,810)	(67,346)
Decrease in Cash and Cash Equivalents	(3,956)	(326)
Cash and Cash Equivalents at Beginning of Period	60,660	34,632
Cash and Cash Equivalents at End of Period	$56,704	$34,306

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

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 six-month period ended June 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 by the period 2007 through 2010. 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 June 30, 2011, December 31, 2010 and June 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 and cash flow hedges.

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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):

June 30, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair/Book Value
Securities of U.S. Government Agencies	$217,724	$496	$384	$217,836
Obligations of States and Political Subdivisions	5,620	-	-	5,620
Mortgage Backed Securities	194,051	6,782	684	200,149
Other	7,345	-	-	7,345
Total	$424,740	$7,278	$1,068	$430,950

December 31, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair/Book Value
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

June 30, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair/Book Value
Securities of U.S. Government Agencies	$166,332	$585	$-	$166,917
Obligations of States and Political Subdivisions	6,443	-	-	6,443
Mortgage Backed Securities	136,677	7,864	-	144,541
FHLB Stock	6,212	-	-	6,212
Total	$315,974	$8,449	$-	$324,423

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

June 30, 2011	Book Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Obligations of States and Political Subdivisions	$59,648	$1,964	$7	$61,605
Mortgage Backed Securities	1,673	72	-	1,745
Other	2,263	-	-	2,263
Total	$63,584	$2,036	$7	$65,613

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

June 30, 2010	Book Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Obligations of States and Political Subdivisions	$63,897	$1,525	$39	$65,383

Mortgage Backed Securities	2,887	135	-	3,022
Other	1,989	-	-	1,989
Total	$68,773	$1,660	$39	$70,394

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

Securities Available-for-Sale June 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	$10,220	$201,574	$6,042	$-	$217,836
Obligations of States and Political Subdivisions	-	-	-	5,620	5,620
Mortgage Backed Securities	-	-	74,936	125,213	200,149
Other	7,345	-	-	-	7,345
Total	$17,565	$201,574	$80,978	$130,833	$430,950

Securities Held-to-Maturity June 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	$50	$7,143	$42,108	$10,347	$59,648
Mortgage Backed Securities	-	1,673	-	-	1,673
Other	-	-	7	2,256	2,263
Total	$50	$8,816	$42,115	$12,603	$63,584

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.

	Less Than 12 Months		12 Months or More		Total	
June 30, 2011	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities of U.S. Government Agencies	$86,806	$384	$-	$-	$86,806	$384
Obligations of States and Political Subdivisions	1,494	7	-	-	1,494	7
Mortgage Backed Securities	49,976	684	-	-	49,976	684
Total	$138,276	$1,075	$-	$-	$138,276	$1,075

	Less Than 12 Months		12 Months or More		Total	
December 31, 2010	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

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	
June 30, 2010	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Obligations of States and Political Subdivisions	$2,542	$39	$-	$-	$2,542	$39
Total	$2,542	$39	$-	$-	$2,542	$39

As of June 30, 2011, the Company held 225 investment securities of which 25 were 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.

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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 June 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 June 30, 2011.

Obligations of States and Political Subdivisions
The increasing financial problems being experienced by certain municipalities, along with the financial stresses exhibited by some of the large monoline bond insurers, has increased the overall risk associated with bank-qualified municipal bonds. As of June 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 June 30, 2011.

Pledged Securities
As of June 30, 2011, securities carried at $384.7 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 June 30, 2011 and December 31, 2010 by portfolio segment and by impairment methodology (in thousands):

June 30, 2011	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity	Agricultural	Commercial	Consumer & Other	Unallocated	Total
Year-To-Date Allowance for Credit Losses:										
Beginning Balance- January 1, 2011	$7,631	$1,539	$2,160	$1,164	$3,724	$6,733	$9,084	$216	$10	$32,261
Charge-Offs	(13)	-	-	(340)	(462)	(2,750)	(176)	(87)	-	(3,828)
Recoveries	-	-	-	4	7	15	9	24	-	59
Provision	(1,892)	1,274	202	370	181	2,286	1,877	99	53	4,450
Ending Balance- June 30, 2011	$5,726	$2,813	$2,362	$1,198	$3,450	$6,284	$10,794	$252	$63	$32,942
Second Quarter Allowance for Credit Losses:										
Beginning Balance- April 1, 2011	$5,830	$2,471	$2,707	$1,088	$3,645	$7,284	$9,012	$191	$103	$32,331
Charge-Offs	(13)	-	-	(36)	(363)	(2,750)	(140)	(52)	-	(3,354)
Recoveries	-	-	-	4	5	15	4	12	-	40
Provision	(91)	342	(345)	142	163	1,735	1,918	101	(40)	3,925
Ending Balance- June 30, 2011	$5,726	$2,813	$2,362	$1,198	$3,450	$6,284	$10,794	$252	$63	$32,942
Ending Balance Individually Evaluated for Impairment	500	400	-	-	40	350	65	34	-	1,389
Ending Balance Collectively Evaluated for	5,226	2,413	2,362	1,198	3,410	5,934	10,729	218	63	31,553

Impairment										
Loans:										
Ending Balance	$316,914	$275,581	$28,071	$104,647	$54,531	$225,870	$178,729	$7,458	$-	$1,191,801
Ending Balance Individually Evaluated for Impairment	3,289	3,321	-	441	320	4,077	332	37	-	11,817
Ending Balance Collectively Evaluated for Impairment	313,625	272,260	28,071	104,206	54,211	221,793	178,397	7,421	-	1,179,984

December 31, 2010	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity	Agricultural	Commercial	Consumer & 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
Ending Balance Collectively Evaluated for Impairment	294,164	252,778	31,293	101,750	58,958	230,400	164,986	8,712	-	1,143,041

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

June 30, 2011	Pass	Special Mention	Substandard	Total Loans
Loans:				
Commercial Real Estate	$ 276,531	$ 16,372	$ 24,011	$ 316,914
Agricultural Real Estate	248,063	20,188	7,330	275,581
Real Estate Construction	19,855	3,217	4,999	28,071
Residential 1st Mortgages	101,436	2,350	861	104,647
Home Equity	53,928	-	603	54,531
Agricultural	198,109	20,271	7,490	225,870
Commercial	170,421	6,427	1,881	178,729
Consumer & Other	6,872	-	586	7,458
Total	$ 1,075,215	$ 68,825	$ 47,761	$ 1,191,801

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 June 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 June 30, 2011 and December 31, 2010 (in thousands):

June 30, 2011	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Loans:						
Commercial Real Estate	$163	$ -	$243	$406	$316,508	$316,914
Agricultural Real Estate	435	-	3,321	3,756	271,825	275,581
Real Estate Construction	-	-	-	-	28,071	28,071
Residential 1st Mortgages	570	-	358	928	103,720	104,648
Home Equity	358	-	246	604	53,927	54,531
Agricultural	299	-	3,437	3,736	222,134	225,870
Commercial	950	-	332	1,282	177,447	178,729
Consumer & Other	74	-	37	111	7,346	7,457
Total	$2,849	$ -	$7,974	$10,823	$1,180,978	$1,191,801

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 periods ended June 30, 2011 and December 31, 2010 (in thousands):

June 30, 2011	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial Real Estate	$244	$264	$-	$272	$-
Agricultural Real Estate	2,499	2,499	-	1,737	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	443	579	-	624	1
Home Equity	246	246	-	251	-
Agricultural	146	146	-	97	-
Commercial	190	191	-	203	-
Consumer & Other	-	-	-	11	-
	$3,768	$3,925	$-	$3,195	$1
With an allowance recorded:					
Commercial Real Estate	$3,048	$3,046	$500	$1,537	$2
Agricultural Real Estate	826	822	400	826	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	-	-	-	-	-
Home Equity	74	83	40	141	1
Agricultural	3,931	6,245	350	2,331	9
Commercial	141	141	65	104	-
Consumer & Other	38	63	34	38	-
	$8,058	$10,400	$1,389	$4,977	$12
Total	$11,826	$14,325	$1,389	$8,172	$13

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				