

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

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

FORM 10-Q

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

For the quarterly period ended March 31, 2014

or

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

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

Commission File Number: 000-26099

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

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

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

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

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

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

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Number of shares of common stock of the registrant: Par value \$0.01, authorized 7,500,000 shares; issued and outstanding 777,882 as of April 30, 2014.

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FARMERS & MERCHANTS BANCORP

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

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

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

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Balance Sheets

(in thousands)

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

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

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

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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Income (Unaudited)

(in thousands except per share data)

Three Months  
 Ended March 31,  
 2014      2013

## Interest Income

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

## Interest Expense

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

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

## Non-Interest Income

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

## Non-Interest Expense

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

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

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

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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)

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

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



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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands except share data)

|  | Common<br>Shares | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss), net | Total<br>Shareholders'<br>Equity |
|--|------------------|-----------------|----------------------------------|----------------------|--|----------------------------------|
| Balance, January 1, 2013   | 777,882          | \$ 8            | \$ 75,014                        | \$ 123,012           | \$ 6,999   | \$ 205,033                       |
| Net Income   |                  | -               | -                                | 6,251                | -  | 6,251                            |
| Change in Net Unrealized Gains on<br>Securities Available-for-Sale |                  | -               | -                                | -                    | (1,479)  | (1,479)                          |
| Balance, March 31, 2013  | 777,882          | \$ 8            | \$ 75,014                        | \$ 129,263           | \$ 5,520   | \$ 209,805                       |
| Balance, January 1, 2014   | 777,882          | \$ 8            | \$ 75,014                        | \$ 137,350           | \$ (2,468)   | \$ 209,904                       |
| Net Income   |                  | -               | -                                | 6,282                | -  | 6,282                            |
| Change in Net Unrealized Gains on<br>Securities Available-for-Sale |                  | -               | -                                | -                    | 1,765  | 1,765                            |
| Balance, March 31, 2014  | 777,882          | \$ 8            | \$ 75,014                        | \$ 143,632           | \$ (703)   | \$ 217,951                       |

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

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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Cash Flows (Unaudited)

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

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

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FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

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

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

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

**Basis of Presentation**

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

These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with U.S. GAAP have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. The results of operations for the three-month period ended March 31, 2014 may not necessarily be indicative of future operating results.

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

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

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



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### Cash and Cash Equivalents

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

### Investment Securities

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

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

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

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

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

### Loans & Leases

Loans & leases are reported at the principal amount outstanding net of unearned discounts and deferred loan & lease fees and costs. Interest income on loans & leases is accrued daily on the outstanding balances using the simple interest method. Loan & lease origination fees are deferred and recognized over the contractual life of the loan or lease as an adjustment to the yield. Loans & leases are placed on non-accrual status when the collection of principal or interest is in doubt or when they become past due for 90 days or more unless they are both well-secured and in the process of collection. For this purpose a loan or lease is considered well-secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or is guaranteed by a financially capable party. When a loan or lease is placed on non-accrual status, the accrued and unpaid interest receivable is reversed and charged against

current income; thereafter, interest income is recognized only as it is collected in cash. Additionally, cash would be applied to principal if all principal was not expected to be collected. Loans & leases placed on non-accrual status are returned to accrual status when the loans or leases are paid current as to principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan or lease.

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

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

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

## Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance-sheet date. The allowance is established through a provision for credit losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of three primary components, specific reserves related to impaired loans & leases, general reserves for inherent losses related to loans & leases that are not impaired and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

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

The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1<sup>st</sup> mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer and other; and (9) equipment leases. The allowance for credit losses attributable to each portfolio segment, which includes both individually evaluated impaired loans & leases and loans & leases that are collectively evaluated for impairment, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. A credit grade is established at inception for smaller balance loans & leases, such as consumer and residential real estate, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a

modification. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

### Premises and Equipment

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

### Other Real Estate

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

### Income Taxes

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

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

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

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

### Dividends and Basic Earnings Per Common Share

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

### Segment Reporting

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

### Derivative Instruments and Hedging Activities

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

From time to time, the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps, and collars. These instruments are purchased and/or sold to reduce the Company's exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments as of or for the period ended March 31, 2014, December 31, 2013 or March 31, 2013.

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## Comprehensive Income

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

## Loss Contingencies

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

## 2. Investment Securities

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

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

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

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

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

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

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

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

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

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

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

The amortized cost and estimated fair values of investment securities at March 31, 2013 by contractual maturity are shown in the following table (in thousands):

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

Investment securities not due at a single maturity date:

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



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

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

|  | Less Than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|--|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |

March 31, 2014

Securities Available-for-Sale

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

Securities Held-to-Maturity

Obligations of States and Political

|              |         |        |     |      |         |        |
|--------------|---------|--------|-----|------|---------|--------|
| Subdivisions | \$9,038 | \$ 257 | \$- | \$ - | \$9,038 | \$ 257 |
| Total        | \$9,038 | \$ 257 | \$- | \$ - | \$9,038 | \$ 257 |

|  | Less Than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|--|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |

December 31, 2013

Securities Available-for-Sale

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

Securities Held-to-Maturity

Obligations of States and Political

|              |         |        |     |      |         |        |
|--------------|---------|--------|-----|------|---------|--------|
| Subdivisions | \$9,518 | \$ 627 | \$- | \$ - | \$9,518 | \$ 627 |
| Total        | \$9,518 | \$ 627 | \$- | \$ - | \$9,518 | \$ 627 |

|  | Less Than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|--|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |

March 31, 2013

Securities Available-for-Sale

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

Securities Held-to-Maturity

Obligations of States and Political

|              |         |       |     |      |         |       |
|--------------|---------|-------|-----|------|---------|-------|
| Subdivisions | \$2,841 | \$ 22 | \$- | \$ - | \$2,841 | \$ 22 |
| Total        | \$2,841 | \$ 22 | \$- | \$ - | \$2,841 | \$ 22 |

As of March 31, 2014, the Company held 346 investment securities of which 47 were in a loss position for less than twelve months. 4 securities were in a loss position for twelve months or more. Management periodically evaluates each investment security for other-than-temporary impairment relying primarily on industry analyst reports and observations of market conditions and interest rate fluctuations. Management believes it will be able to collect all amounts due according to the contractual terms of the underlying investment securities.

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Securities of Government Agency and Government Sponsored Entities – There were no unrealized losses on the Company's investments in securities of government agency and government sponsored entities at March 31, 2014, December 31, 2013 and March 31, 2013.

Mortgage Backed Securities - The unrealized losses on the Company's investment in mortgage backed securities were \$5.4 million, \$7.6 million, and \$1.3 million at March 31, 2014, December 31, 2013, and March 31, 2013, respectively. The unrealized losses on the Company's investment in mortgage backed securities were caused by interest rate fluctuations. The contractual cash flows of these investments are guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2014, December 31, 2013 and March 31, 2013, respectively.

Obligations of States and Political Subdivisions - The financial problems experienced by certain municipalities over the past six years, along with the financial stresses exhibited by some of the large monoline bond insurers have increased the overall risk associated with bank-qualified municipal bonds. As of March 31, 2014, over ninety-three percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of the seven percent of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

The unrealized losses on the Company's investment in obligation of states and political subdivision were \$257,000, \$627,000, and \$22,000 at March 31, 2014, December 31, 2013 and March 31, 2013, respectively. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were primarily caused by interest rate fluctuations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2014, December 31, 2013 and March 31, 2013, respectively.

Corporate Securities - The unrealized losses on the Company's investment in corporate securities were \$63,000, \$147,000, and \$39,000 at March 31, 2014, December 31, 2013, and March 31, 2013. Changes in the prices of corporate securities are primarily influenced by: (1) changes in market interest rates; (2) changes in perceived credit risk in the general economy or in particular industries; (3) changes in the perceived credit risk of a particular company; and (4) day to day trading supply, demand and liquidity. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2014, December 31, 2013 and March 31, 2013, respectively.

Proceeds from sales and calls of securities were as follows:

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

**Pledged Securities**

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



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## 3. Loans &amp; Leases and Allowance for Credit Losses

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

| March 31,<br>2014                                    | Commercial<br>Real<br>Estate | Agricultural<br>Real<br>Estate | Real<br>Estate<br>Construction | Residential<br>1st<br>Mortgages | Home<br>Equity<br>Lines &<br>Loans | Agricultural | Commercial | Consumer<br>&<br>Other | Leases   | Unallocated | Total  |
|--|------------------------------|--------------------------------|--------------------------------|---------------------------------|------------------------------------|--------------|------------|------------------------|----------|-------------|--------|
| Year-To-Date Allowance for Credit Losses:            |                              |                                |                                |                                 |                                    |              |            |                        |          |             |        |
| Beginning Balance-                                   |                              |                                |                                |                                 |                                    |              |            |                        |          |             |        |
| January 1,<br>2014                                   | \$5,178                      | \$3,576                        | \$654                          | \$1,108                         | \$2,767                            | \$12,205     | \$5,697    | \$176                  | \$639    | \$2,274     | \$34,2 |
| Charge-Offs  | -                            | -                              | -                              | (3 )                            | -                                  | -            | -          | (27 )                  | -        | -           | (30    |
| Recoveries   | -                            | -                              | -                              | -                               | 12                                 | 1            | 5          | 15                     | -        | -           | 33     |
| Provision  | 1,248                        | (189 )                         | 423                            | (5 )                            | (131 )                             | (2,605 )     | 724        | 7                      | 282      | 246         | -      |
| Ending Balance-<br>March 31,<br>2014                 | \$6,426                      | \$3,387                        | \$1,077                        | \$1,100                         | \$2,648                            | \$9,601      | \$6,426    | \$171                  | \$921    | \$2,520     | \$34,2 |
| Ending Balance Individually Evaluated for Impairment | 245                          | -                              | 226                            | 340                             | 313                                | 118          | 814        | 48                     | -        | -           | 2,10   |
| Ending Balance Collectively Evaluated for Impairment | 6,181                        | 3,387                          | 851                            | 760                             | 2,335                              | 9,483        | 5,612      | 123                    | 921      | 2,520       | 32,1   |
| Loans:<br>Ending Balance                             | \$402,865                    | \$326,112                      | \$55,751                       | \$156,094                       | \$34,289                           | \$209,228    | \$155,802  | \$4,721                | \$18,168 | \$-         | \$1,36 |
| Ending Balance Individually Evaluated for Impairment | 22,046                       | -                              | 4,473                          | 1,701                           | 2,055                              | 587          | 5,100      | 48                     | -        | -           | 36,0   |
| Ending Balance Collectively Evaluated for Impairment | 380,819                      | 326,112                        | 51,278                         | 154,393                         | 32,234                             | 208,641      | 150,702    | 4,673                  | 18,168   | -           | 1,32   |

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| December 31, 2013  | Commercial Real Estate | Agricultural Real Estate | Real Estate Construction | Residential 1st Mortgages | Home Equity Lines & Loans | Agricultural | Commercial | Consumer & Other | Leases   | Unallocated | Total       |
|--|------------------------|--------------------------|--------------------------|---------------------------|---------------------------|--------------|------------|------------------|----------|-------------|-------------|
| Year-To-Date Allowance for Credit Losses:                            |                        |                          |                          |                           |                           |              |            |                  |          |             |             |
| Beginning Balance- January 1, 2013                                   | \$6,464                | \$2,877                  | \$986                    | \$1,219                   | \$3,235                   | \$10,437     | \$7,963    | \$182            | \$-      | \$854       | \$34,000    |
| Charge-Offs  | (6 )                   | (575 )                   | -                        | (16 )                     | (91 )                     | (23 )        | (60 )      | (120 )           | -        | -           | (89 )       |
| Recoveries   | -                      | -                        | -                        | -                         | 115                       | 42           | 312        | 54               | -        | -           | 523         |
| Provision  | (1,280 )               | 1,274                    | (332 )                   | (95 )                     | (492 )                    | 1,749        | (2,518 )   | 60               | 639      | 1,420       | 425         |
| Ending Balance- December 31, 2013                                    | \$5,178                | \$3,576                  | \$654                    | \$1,108                   | \$2,767                   | \$12,205     | \$5,697    | \$176            | \$639    | \$2,274     | \$34,000    |
| Ending Balance Individually Evaluated for Impairment                 | -                      | -                        | -                        | 414                       | 209                       | 122          | 820        | 51               | -        | -           | 1,600       |
| Ending Balance Collectively Evaluated for Impairment Loans & Leases: | 5,178                  | 3,576                    | 654                      | 694                       | 2,558                     | 12,083       | 4,877      | 125              | 639      | 2,274       | 32,400      |
| Ending Balance Individually Evaluated for Impairment                 | \$407,514              | \$328,264                | \$41,092                 | \$151,292                 | \$35,477                  | \$256,414    | \$150,398  | \$5,052          | \$12,733 | \$-         | \$1,300,000 |
| Ending Balance Collectively Evaluated for Impairment                 | 22,176                 | -                        | 4,500                    | 2,072                     | 1,045                     | 522          | 5,250      | 51               | -        | -           | 35,000      |
| Ending Balance Collectively Evaluated for Impairment                 | 385,338                | 328,264                  | 36,592                   | 149,220                   | 34,432                    | 255,892      | 145,148    | 5,001            | 12,733   | -           | 1,300,000   |

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| March 31,<br>2013                                    | Commercial<br>Real Estate | Agricultural<br>Real Estate | Real Estate<br>Construction | Residential<br>1st<br>Mortgages | Home<br>Equity<br>Lines &<br>Loans | Agricultural | Commercial | Consumer<br>&<br>Other | Leases | Unallocated | Total       |
|--|---------------------------|-----------------------------|-----------------------------|---------------------------------|------------------------------------|--------------|------------|------------------------|--------|-------------|-------------|
| Year-To-Date Allowance for Credit Losses:            |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| Beginning Balance-                                   |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| January 1,<br>2013                                   | \$6,464                   | \$2,877                     | \$986                       | \$1,219                         | \$3,235                            | \$10,437     | \$7,963    | \$182                  | \$-    | \$854       | \$34,217    |
| Charge-Offs  | -                         | -                           | -                           | (16 )                           | (1 )                               | -            | -          | (18 )                  | -      | -           | (35 )       |
| Recoveries   | -                         | -                           | -                           | -                               | 2                                  | 13           | 47         | 11                     | -      | -           | 73          |
| Provision  | 207                       | 918                         | (17 )                       | 57                              | (27 )                              | (1,038 )     | (44 )      | (12 )                  | -      | (44 )       | -           |
| Ending Balance-                                      |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| March 31,<br>2013                                    | \$6,671                   | \$3,795                     | \$969                       | \$1,260                         | \$3,209                            | \$9,412      | \$7,966    | \$163                  | \$-    | \$810       | \$34,255    |
| Ending Balance Individually Evaluated for Impairment |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| Ending Balance                                       | 1,191                     | 263                         | 232                         | 29                              | 186                                | 1,028        | 214        | 58                     | -      | -           | 3,201       |
| Ending Balance Collectively Evaluated for Impairment |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| Ending Balance                                       | 5,480                     | 3,532                       | 737                         | 1,231                           | 3,023                              | 8,384        | 7,752      | 105                    | -      | 810         | 31,054      |
| Ending Balance Individually Evaluated for Impairment |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| Ending Balance                                       | \$360,893                 | \$318,823                   | \$32,681                    | \$145,419                       | \$40,141                           | \$181,725    | \$142,115  | \$4,898                | \$-    | \$-         | \$1,226,695 |
| Ending Balance Collectively Evaluated for Impairment |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| Ending Balance                                       | 22,719                    | 5,335                       | 4,577                       | 1,950                           | 1,007                              | 3,961        | 578        | 58                     | -      | -           | 40,185      |
| Ending Balance Collectively Evaluated for Impairment |                           |                             |                             |                                 |                                    |              |            |                        |        |             |             |
| Ending Balance                                       | 338,174                   | 313,488                     | 28,104                      | 143,469                         | 39,134                             | 177,764      | 141,537    | 4,840                  | -      | -           | 1,186,510   |

The ending balance of loans individually evaluated for impairment includes restructured loans in the amount of \$28.9 million at March 31, 2014, \$28.4 million at December 31, 2013 and \$29.3 million at March 31, 2013, which are no longer disclosed or classified as TDR's.





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The following tables show the loan & lease portfolio allocated by management's internal risk ratings at the dates indicated (in thousands):

| March 31, 2014            | Pass        | Special<br>Mention | Substandard | Total<br>Loans<br>& Leases |
|---------------------------|-------------|--------------------|-------------|----------------------------|
| Loans & Leases:           |             |                    |             |                            |
| Commercial Real Estate    | \$389,366   | \$13,126           | \$373       | \$402,865                  |
| Agricultural Real Estate  | 326,112     | -                  | -           | 326,112                    |
| Real Estate Construction  | 54,120      | 1,631              | -           | 55,751                     |
| Residential 1st Mortgages | 154,743     | 767                | 584         | 156,094                    |
| Home Equity Lines & Loans | 33,196      | -                  | 1,093       | 34,289                     |
| Agricultural              | 208,308     | 843                | 77          | 209,228                    |
| Commercial                | 137,125     | 16,928             | 1,749       | 155,802                    |
| Consumer & Other          | 4,529       | -                  | 192         | 4,721                      |
| Leases                    | 18,168      |                    |             | 18,168                     |
| Total                     | \$1,325,667 | \$33,295           | \$4,068     | \$1,363,030                |

| December 31, 2013         | Pass        | Special<br>Mention | Substandard | Total<br>Loans<br>& Leases |
|---------------------------|-------------|--------------------|-------------|----------------------------|
| Loans & Leases:           |             |                    |             |                            |
| Commercial Real Estate    | \$398,488   | \$7,979            | \$1,047     | \$407,514                  |
| Agricultural Real Estate  | 325,926     | 2,338              | -           | 328,264                    |
| Real Estate Construction  | 39,460      | 1,632              | -           | 41,092                     |
| Residential 1st Mortgages | 149,798     | 774                | 720         | 151,292                    |
| Home Equity Lines & Loans | 34,821      | -                  | 656         | 35,477                     |
| Agricultural              | 255,443     | 889                | 82          | 256,414                    |
| Commercial                | 132,008     | 15,426             | 2,964       | 150,398                    |
| Consumer & Other          | 4,763       | -                  | 289         | 5,052                      |
| Leases                    | 12,733      | -                  | -           | 12,733                     |
| Total                     | \$1,353,440 | \$29,038           | \$5,758     | \$1,388,236                |

| March 31, 2013            | Pass        | Special<br>Mention | Substandard | Total<br>Loans |
|---------------------------|-------------|--------------------|-------------|----------------|
| Loans:                    |             |                    |             |                |
| Commercial Real Estate    | \$336,525   | \$15,273           | \$9,095     | \$360,893      |
| Agricultural Real Estate  | 308,475     | 3,799              | 6,549       | 318,823        |
| Real Estate Construction  | 26,472      | 6,209              | -           | 32,681         |
| Residential 1st Mortgages | 142,951     | 1,376              | 1,092       | 145,419        |
| Home Equity Lines & Loans | 38,870      | -                  | 1,271       | 40,141         |
| Agricultural              | 177,245     | 980                | 3,500       | 181,725        |
| Commercial                | 135,375     | 6,289              | 451         | 142,115        |
| Consumer & Other          | 4,644       | -                  | 254         | 4,898          |
| Total                     | \$1,170,557 | \$33,926           | \$22,212    | \$1,226,695    |

See "Note 1. Significant Accounting Policies - Allowance for Credit Losses" for a description of the internal risk ratings used by the Company. There were no loans or leases outstanding at March 31, 2014, December 31, 2013, and March 31, 2013, rated doubtful or loss.



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The following tables show an aging analysis of the loan & lease portfolio by the time past due at the dates indicated (in thousands):

|                           | 30-89<br>Days<br>Past<br>Due | 90 Days<br>and<br>Still<br>Accruing | Nonaccrual | Total<br>Past<br>Due | Current     | Total<br>Loans |
|---------------------------|------------------------------|-------------------------------------|------------|----------------------|-------------|----------------|
| March 31, 2014            |                              |                                     |            |                      |             |                |
| Loans & Leases:           |                              |                                     |            |                      |             |                |
| Commercial Real Estate    | \$ -                         | \$ -                                | \$ -       | \$-                  | \$402,865   | \$402,865      |
| Agricultural Real Estate  | -                            | -                                   | -          | -                    | 326,112     | 326,112        |
| Real Estate Construction  | -                            | -                                   | -          | -                    | 55,751      | 55,751         |
| Residential 1st Mortgages | -                            | -                                   | 316        | 316                  | 155,778     | 156,094        |
| Home Equity Lines & Loans | 30                           | -                                   | 969        | 999                  | 33,290      | 34,289         |
| Agricultural              | 25                           | -                                   | 32         | 57                   | 209,171     | 209,228        |
| Commercial                | -                            | -                                   | 1,801      | 1,801                | 154,001     | 155,802        |
| Consumer & Other          | 5                            | -                                   | 15         | 20                   | 4,701       | 4,721          |
| Leases                    | -                            | -                                   | -          | -                    | 18,168      | 18,168         |
| Total                     | \$ 60                        | \$ -                                | \$ 3,133   | \$3,193              | \$1,359,837 | \$1,363,030    |

|                           | 30-89<br>Days<br>Past<br>Due | 90 Days<br>and<br>Still<br>Accruing | Nonaccrual | Total<br>Past<br>Due | Current     | Total<br>Loans |
|---------------------------|------------------------------|-------------------------------------|------------|----------------------|-------------|----------------|
| December 31, 2013         |                              |                                     |            |                      |             |                |
| Loans & Leases:           |                              |                                     |            |                      |             |                |
| Commercial Real Estate    | \$773                        | \$ -                                | \$ -       | \$773                | \$406,741   | \$407,514      |
| Agricultural Real Estate  | 607                          | -                                   | -          | 607                  | 327,657     | 328,264        |
| Real Estate Construction  | -                            | -                                   | -          | -                    | 41,092      | 41,092         |
| Residential 1st Mortgages | -                            | -                                   | 324        | 324                  | 150,968     | 151,292        |
| Home Equity Lines & Loans | 52                           | -                                   | 406        | 458                  | 35,019      | 35,477         |
| Agricultural              | -                            | -                                   | 35         | 35                   | 256,379     | 256,414        |
| Commercial                | -                            | -                                   | 1,815      | 1,815                | 148,583     | 150,398        |
| Consumer & Other          | 19                           | -                                   | 16         | 35                   | 5,017       | 5,052          |
| Leases                    | -                            | -                                   | -          | -                    | 12,733      | 12,733         |
| Total                     | \$1,451                      | \$ -                                | \$ 2,596   | \$4,047              | \$1,384,189 | \$1,388,236    |

|                           | 30-89<br>Days<br>Past<br>Due | 90 Days<br>and<br>Still<br>Accruing | Nonaccrual | Total<br>Past<br>Due | Current     | Total<br>Loans |
|---------------------------|------------------------------|-------------------------------------|------------|----------------------|-------------|----------------|
| March 31, 2013            |                              |                                     |            |                      |             |                |
| Loans:                    |                              |                                     |            |                      |             |                |
| Commercial Real Estate    | \$364                        | \$ -                                | \$ -       | \$364                | \$360,529   | \$360,893      |
| Agricultural Real Estate  | 893                          | -                                   | 5,335      | 6,228                | 312,595     | 318,823        |
| Real Estate Construction  | -                            | -                                   | -          | -                    | 32,681      | 32,681         |
| Residential 1st Mortgages | -                            | -                                   | 405        | 405                  | 145,014     | 145,419        |
| Home Equity Lines & Loans | 275                          | -                                   | 195        | 470                  | 39,671      | 40,141         |
| Agricultural              | -                            | -                                   | 3,237      | 3,237                | 178,488     | 181,725        |
| Commercial                | -                            | -                                   | 287        | 287                  | 141,828     | 142,115        |
| Consumer & Other          | 178                          | -                                   | 19         | 197                  | 4,701       | 4,898          |
| Total                     | \$1,710                      | \$ -                                | \$ 9,478   | \$11,188             | \$1,215,507 | \$1,226,695    |



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The following tables show information related to impaired loans & leases for the periods indicated (in thousands):

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| March 31, 2014                      |                        |                                |                      |                                   |                                  |
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$ 98                  | \$ 98                          | \$ -                 | \$ 100                            | \$ 2                             |
| Home Equity Lines & Loans           | 677                    | 686                            | -                    | 339                               | -                                |
| Agricultural                        | 32                     | 41                             | -                    | 34                                | -                                |
| Commercial                          | 3,331                  | 3,389                          | -                    | 3,403                             | 27                               |
|                                     | \$ 4,138               | \$ 4,214                       | \$ -                 | \$ 3,876                          | \$ 29                            |
| With an allowance recorded:         |                        |                                |                      |                                   |                                  |
| Residential 1st Mortgages           | \$ 411                 | \$ 443                         | \$ 82                | \$ 590                            | \$ 1                             |
| Home Equity Lines & Loans           | 394                    | 414                            | 120                  | 542                               | -                                |
| Agricultural                        | 473                    | 473                            | 118                  | 481                               | 7                                |
| Commercial                          | 1,627                  | 1,657                          | 814                  | 1,634                             | -                                |
| Consumer & Other                    | 48                     | 51                             | 48                   | 49                                | 1                                |
|                                     | \$ 2,953               | \$ 3,038                       | \$ 1,182             | \$ 3,296                          | \$ 9                             |
| Total                               | \$ 7,091               | \$ 7,252                       | \$ 1,182             | \$ 7,172                          | \$ 38                            |

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| December 31, 2013                   |                        |                                |                      |                                   |                                  |
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$ 102                 | \$ 101                         | \$ -                 | \$ 865                            | \$ 8                             |
| Agricultural Real Estate            | -                      | -                              | -                    | 2,185                             | -                                |
| Residential 1st Mortgages           | -                      | -                              | -                    | 450                               | 11                               |
| Home Equity Lines and Loans         | -                      | -                              | -                    | 228                               | 5                                |
| Agricultural                        | 35                     | 43                             | -                    | 586                               | -                                |
| Commercial                          | 3,474                  | 3,532                          | -                    | 939                               | 13                               |
|                                     | \$ 3,611               | \$ 3,676                       | \$ -                 | \$ 5,253                          | \$ 37                            |
| With an allowance recorded:         |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$ -                   | \$ -                           | \$ -                 | \$ 2                              | \$ -                             |
| Agricultural Real Estate            | -                      | -                              | -                    | 823                               | -                                |
| Residential 1st Mortgages           | 769                    | 826                            | 154                  | 254                               | 6                                |
| Home Equity Lines and Loans         | 689                    | 821                            | 138                  | 332                               | 3                                |
| Agricultural                        | 488                    | 488                            | 122                  | 1,002                             | 31                               |
| Commercial                          | 1,641                  | 1,657                          | 820                  | 1,072                             | 6                                |
| Consumer & Other                    | 50                     | 53                             | 50                   | 126                               | 3                                |
|                                     | \$ 3,637               | \$ 3,845                       | \$ 1,284             | \$ 3,611                          | \$ 49                            |
| Total                               | \$ 7,248               | \$ 7,521                       | \$ 1,284             | \$ 8,864                          | \$ 86                            |

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| March 31, 2013                      |                        |                                |                      |                                   |                                  |
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial Real Estate              | \$ 107                 | \$ 110                         | \$ -                 | \$ 198                            | \$ 2                             |
| Agricultural Real Estate            | 3,508                  | 3,500                          | -                    | 4,473                             | -                                |
| Residential 1st Mortgages           | 736                    | 782                            | -                    | 697                               | 3                                |
| Home Equity Lines & Loans           | 249                    | 268                            | -                    | 521                               | 1                                |

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|                             |           |           |          |           |       |
|-----------------------------|-----------|-----------|----------|-----------|-------|
| Agricultural                | 1,753     | 1,783     | -        | 1,843     | -     |
| Commercial                  | 103       | 110       | -        | 105       | 2     |
|                             | \$ 6,456  | \$ 6,553  | \$ -     | \$ 7,837  | \$ 8  |
| With an allowance recorded: |           |           |          |           |       |
| Commercial Real Estate      | \$ -      | \$ -      | \$ -     | \$ -      | \$ -  |
| Residential 1st Mortgages   | -         | -         | -        | -         | -     |
| Home Equity Lines & Loans   | 153       | 196       | 153      | 174       | -     |
| Agricultural                | 1,988     | 2,004     | 1,022    | 1,997     | 8     |
| Commercial                  | 143       | 144       | 210      | 144       | 2     |
| Consumer & Other            | 345       | 354       | 58       | 203       | 1     |
|                             | \$ 4,470  | \$ 4,532  | \$ 1,706 | \$ 3,439  | \$ 11 |
| Total                       | \$ 10,926 | \$ 11,085 | \$ 1,706 | \$ 11,276 | \$ 19 |

Total recorded investment shown in the prior tables will not equal the total ending balance of loans & leases individually evaluated for impairment on the allocation of allowance tables. This is because the calculation of recorded investment takes into account charge-offs, net unamortized loan & lease fees & costs, unamortized premium or discount, and accrued interest. This table also excludes impaired loans that were previously modified in a troubled debt restructuring, are currently performing and are no longer disclosed or classified as TDR's.

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At March 31, 2014, the Company allocated \$1.1 million of specific reserves to \$6.3 million of troubled debt restructured loans & leases, of which \$4.0 million were performing. The Company had no commitments at March 31, 2014 to lend additional amounts to customers with outstanding loans or leases that are classified as troubled debt restructurings.

During the three-month period ending March 31, 2014, the terms of certain loans & leases were modified as troubled debt restructurings. The modification of the terms of such loans & leases can include one or a combination of the following: a reduction of the stated interest rate; 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.

There were no modifications involving a reduction of the stated interest rates. Modifications involving an extension of the maturity date were for periods ranging from 5 years to 30 years.

The following table presents loans or leases by class modified as troubled debt restructured loans or leases during the three-month period ended March 31, 2014 (in thousands):

|                              | March 31, 2014  |  |
|------------------------------|---|--|
|                              | Pre-Modification<br>Number<br>of Outstanding<br>Loans<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Troubled Debt Restructurings |   |  |
| Residential 1st Mortgages    | 2 \$ 247  | \$ 245   |
| Agricultural                 | 1 32  | 32   |
| Total                        | 3 \$ 279  | \$ 277   |

The TDRs described above had no impact on the allowance for credit losses but resulted in charge-offs of \$2,000 for the three-month period ending March 31, 2014.

During the three-months ended March 31, 2014, there were no payment defaults on loans or leases modified as troubled debt restructurings within twelve months following the modification. The Company considers a loan or lease to be in payment default once it is greater than 90 days contractually past due under the modified terms.

At December 31, 2013, the Company allocated \$1.2 million of specific reserves to \$6.8 million of troubled debt restructured loans or leases, of which \$4.6 million were performing. The Company had no commitments at December 31, 2013, to lend additional amounts to customers with outstanding loans or leases that are classified as troubled debt restructurings.

During the twelve-month period ending December 31, 2013, the terms of certain loans or leases 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; 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 were for periods of 5 years. Modifications involving an extension of the maturity date were for periods ranging from 6 months to 10 years.

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The following table presents loans or leases by class modified as troubled debt restructured loans during the twelve-month period ended December 31, 2013 (in thousands):

|                              | December 31, 2013   |  |
|------------------------------|---|--|
|                              | Pre-Modification<br>Number<br>of Outstanding<br>Loans<br>Recorded | Post-Modification<br>Outstanding<br>Investment<br>Recorded |
| Troubled Debt Restructurings |   |  |
| Residential 1st Mortgages    | 4 \$ 306  | \$ 290   |
| Home Equity Lines and Loans  | 4 414   | 387  |
| Commercial                   | 4 5,016   | 5,016  |
| Total                        | 12 \$ 5,736   | \$ 5,693   |

The TDRs described above did not increase the allowance for credit losses but did result in charge-offs of \$43,000 during the year ended December 31, 2013.

During the twelve-month period ended December 31, 2013, there was one commercial loan with an outstanding balance of \$174,000 that was previously modified as a troubled debt restructuring with the previous 12 months that subsequently defaulted during the twelve months ended December 31, 2013.

At March 31, 2013, the Company allocated \$444,000 of specific reserves to \$2.1 million of troubled debt restructured loans or leases, of which \$1.4 million were performing. The Company had no commitments at March 31, 2013 to lend additional amounts to customers with outstanding loans or leases that are classified as troubled debt restructurings.

During the three-month period ending March 31, 2013, the terms of certain loans or leases were modified as troubled debt restructurings. The modification of the terms of such loans or leases included one or a combination of the following: a reduction of the stated interest rate; 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 were for periods of 5 years. Modifications involving an extension of the maturity date were for periods ranging from 16 months to 10 years.

The following table presents loans by class modified as troubled debt restructured loans or leases during the three-month period ended March 31, 2013 (in thousands):

|                              | March 31, 2013  |  |
|------------------------------|---|--|
|                              | Pre-Modification<br>Number<br>of Outstanding<br>Loans<br>Recorded | Post-Modification<br>Outstanding<br>Investment<br>Recorded |
| Troubled Debt Restructurings |   |  |
| Residential 1st Mortgages    | 4 \$ 306  | \$ 290   |
| Home Equity Lines & Loans    | 1 16  | 15   |
| Commercial                   | 2 292   | 292  |
| Total                        | 7 \$ 614  | \$ 597   |

The TDRs described above increased the allowance for credit losses by \$61,000 and resulted in charge-offs of \$17,000 for the three-month period ending March 31, 2013.

During the twelve months ended March 31, 2013, there were no loans or leases modified as troubled debt restructurings for which there was a payment default within twelve months following the modification.





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4. 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 U.S. GAAP 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 1, 2 and 3 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond’s terms and conditions, among other things.

The Company does not record all loans & leases at fair value on a recurring basis. However, from time to time, a loan or lease is considered impaired and an allowance for credit losses is established. Once a loan or lease is identified as individually impaired, management measures impairment in accordance with the “Receivable” topic of the FASB ASC. The fair value of impaired loans or leases is estimated using one of several methods, including collateral value when the loan or lease is collateral dependent, market value of similar debt, enterprise value, and discounted cash flows. Those impaired loans & leases not requiring an allowance represent loans & leases for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans & leases. Impaired loans & leases 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 or lease as nonrecurring Level 2. Otherwise, the Company records the impaired loan & leases as nonrecurring Level 3.

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.

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

|  |               | Fair Value Measurements<br>At March 31, 2014, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for |            |           | Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
|--|---------------|---|------------|-----------|-------------------------------|---------------------------------------|
| (in thousands)   | Fair<br>Value | Identical<br>Assets<br>(Level<br>1)   | (Level 2)  | (Level 3) |                               |                                       |
| Available-for-Sale Securities:                           |               |   |            |           |                               |                                       |
| Government Agency & Government-Sponsored Entities        | \$18,426      | \$13,399  | \$ 5,027   | \$ -      |                               |                                       |
| Mortgage Backed Securities                               | 329,730       | -   | 329,730    | -         |                               |                                       |
| Corporate Securities                                     | 49,352        | 7,966   | 41,386     | -         |                               |                                       |
| Other  | 2,235         | 1,925   | 310        | -         |                               |                                       |
| Total Assets Measured at Fair Value On a Recurring Basis | \$399,743     | \$23,290  | \$ 376,453 | \$ -      |                               |                                       |

|  |               | Fair Value Measurements<br>At December 31, 2013, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for |            |           | Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
|--|---------------|--|------------|-----------|-------------------------------|---------------------------------------|
| (in thousands)   | Fair<br>Value | Identical<br>Assets<br>(Level<br>1)  | (Level 2)  | (Level 3) |                               |                                       |
| Available-for-Sale Securities:                           |               |  |            |           |                               |                                       |
| Government Agency & Government-Sponsored Entities        | \$28,436      | \$23,394   | \$ 5,042   | \$ -      |                               |                                       |
| Mortgage Backed Securities                               | 324,929       | -  | 324,929    | -         |                               |                                       |
| Corporate Securities                                     | 49,380        | 8,191  | 41,189     | -         |                               |                                       |
| Other  | 1,894         | 1,584  | 310        | -         |                               |                                       |
| Total Assets Measured at Fair Value On a Recurring Basis | \$404,639     | \$33,169   | \$ 371,470 | \$ -      |                               |                                       |

|  |               | Fair Value Measurements<br>At March 31, 2013, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for |            |           | Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
|--|---------------|---|------------|-----------|-------------------------------|---------------------------------------|
| (in thousands)   | Fair<br>Value | Identical<br>Assets<br>(Level<br>1)   | (Level 2)  | (Level 3) |                               |                                       |
| Available-for-Sale Securities:                           |               |   |            |           |                               |                                       |
| Government Agency & Government-Sponsored Entities        | \$28,436      | \$23,394  | \$ 5,042   | \$ -      |                               |                                       |
| Mortgage Backed Securities                               | 324,929       | -   | 324,929    | -         |                               |                                       |
| Corporate Securities                                     | 49,380        | 8,191   | 41,189     | -         |                               |                                       |
| Other  | 1,894         | 1,584   | 310        | -         |                               |                                       |
| Total Assets Measured at Fair Value On a Recurring Basis | \$404,639     | \$33,169  | \$ 371,470 | \$ -      |                               |                                       |

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| (in thousands)   | Total     | Identical<br>Assets<br>(Level<br>1) | (Level 2)  | (Level 3) |
|--|-----------|-------------------------------------|------------|-----------|
| Available-for-Sale Securities:                           |           |                                     |            |           |
| Government Agency & Government-Sponsored Entities        | \$26,692  | \$21,612                            | \$ 5,080   | \$ -      |
| Obligations of States and Political Subdivisions         | 5,643     | -                                   | -          | 5,643     |
| Mortgage Backed Securities                               | 432,285   | -                                   | 432,285    | -         |
| Corporate Securities                                     | 50,128    | 9,373                               | 40,755     | -         |
| Other  | 825       | 515                                 | 310        | -         |
| Total Assets Measured at Fair Value On a Recurring Basis | \$515,573 | \$31,500                            | \$ 478,430 | \$ 5,643  |

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Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the quarters ended March 31, 2014 and 2013, there were no transfers in or out of level 1, 2, or 3.

The following tables present information about the Company's other real estate and impaired loans or leases, classes of assets or liabilities that the Company carries at fair value on a non-recurring basis, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the periods indicated. Not all impaired loans or leases are carried at fair value. Impaired loans or leases are only included in the following tables when their fair value is based upon a current appraisal of the collateral, and if that appraisal results in a partial charge-off or the establishment of a specific reserve.

|  | Fair Value Measurements<br>At March 31, 2014, Using |   |   |   |
|--|---|---|---|---|
|  | Fair Value  | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identifiable<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level<br>3) |
| (in thousands)   | Total   |   |   |   |
| Impaired Loans   |   |   |   |   |
| Residential 1st Mortgage                                     | \$329   | \$-   | \$-   | \$ 329  |
| Home Equity Lines and Loans                                  | 273   | -   | -   | 273   |
| Agricultural   | 354   | -   | -   | 354   |
| Commercial   | 814   | -   | -   | 814   |
| Total Impaired Loans   | 1,770   | -   | -   | 1,770   |
| Other Real Estate  |   |   |   |   |
| Real Estate Construction                                     | 2,441   | -   | -   | 2,441   |
| Agricultural Real Estate                                     | 853   | -   | -   | 853   |
| Total Other Real Estate                                      | 3,294   | -   | -   | 3,294   |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$5,064   | \$-   | \$-   | \$ 5,064  |

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|  | Fair Value Measurements<br>At December 31, 2013, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Other<br>Identifiable<br>Inputs<br>(Level<br>1) (Level 2) (Level 3) |                                   |  |  |
|--|--|-----------------------------------|--|--|
|  | Fair Value   | Observable<br>Inputs<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands)   | Total  |                                   |  |  |
| Impaired Loans   |  |                                   |  |  |
| Residential 1st Mortgage                                     | \$614  | \$-                               | \$-  | \$ 614   |
| Home Equity Lines and Loans                                  | 551  | -                                 | -  | 551  |
| Agricultural   | 366  | -                                 | -  | 366  |
| Commercial   | 820  | -                                 | -  | 820  |
| Total Impaired Loans   | 2,351  | -                                 | -  | 2,351  |
| Other Real Estate  |  |                                   |  |  |
| Real Estate Construction                                     | 2,399  | -                                 | -  | 2,399  |
| Agricultural Real Estate                                     | 2,212  | -                                 | -  | 2,212  |
| Total Other Real Estate                                      | 4,611  | -                                 | -  | 4,611  |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$6,962  | \$-                               | \$-  | \$ 6,962   |

|  | Fair Value Measurements<br>At March 31, 2013, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Other<br>Identifiable<br>Inputs<br>(Level<br>1) (Level 2) (Level 3) |                                   |  |  |
|--|---|-----------------------------------|--|--|
|  | Fair Value  | Observable<br>Inputs<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands)   | Total   |                                   |  |  |
| Impaired Loans   |   |                                   |  |  |
| Agricultural Real Estate                                     | \$1,572   | \$-                               | \$-  | \$ 1,572   |
| Residential 1st Mortgage                                     | 289   | -                                 | -  | 289  |
| Home Equity Lines and Loans                                  | 15  | -                                 | -  | 15   |
| Agricultural   | 965   | -                                 | -  | 965  |
| Commercial   | 220   | -                                 | -  | 220  |
| Total Impaired Loans   | 3,061   | -                                 | -  | 3,061  |
| Other Real Estate  |   |                                   |  |  |
| Real Estate Construction                                     | 2,553   | -                                 | -  | 2,553  |
| Agricultural Real Estate                                     | 1,910   | -                                 | -  | 1,910  |
| Agricultural   | 280   | -                                 | -  | 280  |
| Total Other Real Estate                                      | 4,743   | -                                 | -  | 4,743  |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$7,804   | \$-                               | \$-  | \$ 7,804   |

The Company's property appraisals are primarily based on the sales comparison approach and the income approach methodologies, which consider recent sales of comparable properties, including their income generating characteristics, and then make adjustments to reflect the general assumptions that a market participant would make when analyzing the property for purchase. These adjustments may increase or decrease an appraised value and can vary significantly depending on the location, physical characteristics and income producing potential of each property. Additionally, the quality and volume of market information available at the time of the appraisal can vary from period to period and cause significant changes to the nature and magnitude of comparable sale adjustments. Given these variations, comparable sale adjustments are generally not a reliable indicator for how fair value will increase or decrease from period to period. Under certain circumstances, management discounts are applied based on specific characteristics of an individual property.

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The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at March 31, 2014:

| (in thousands)              | Fair Value | Valuation Technique                        | Unobservable Inputs      | Range, Weighted Avg. |
|-----------------------------|------------|--|--------------------------|----------------------|
| Impaired Loans              |            |  |                          |                      |
|                             |            | Sales Comparison Adjustment for Difference |                          |                      |
| Residential 1st Mortgage    | \$329      | Approach                                   | Between Comparable Sales | 10% -19%, 14 %       |
|                             |            | Sales Comparison Adjustment for Difference |                          |                      |
| Home Equity Lines and Loans | \$273      | Approach                                   | Between Comparable Sales | 2% - 15%, 7 %        |
| Agricultural                | \$354      | Income Approach                            | Capitalization Rate      | 14% - 14%, 14 %      |
|                             |            | Sales Comparison Adjustment for Difference |                          |                      |
| Commercial                  | \$814      | Approach                                   | Between Comparable Sales | 13% - 13%, 13 %      |
| Other Real Estate           |            |  |                          |                      |
|                             |            | Sales Comparison Adjustment for Difference |                          |                      |
| Real Estate Construction    | \$2,441    | Approach                                   | Between Comparable Sales | 10% - 10%, 10 %      |
|                             |            | Sales Comparison Adjustment for Difference |                          |                      |
| Agricultural Real Estate    | \$853      | Approach                                   | Between Comparable Sales | 10% - 10%, 10 %      |

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## 5. Fair Value of Financial Instruments

U.S. GAAP requires 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 tables summarize the book value and estimated fair value of financial instruments for the periods indicated:

|   | Carrying Amount | Fair Value of Financial Instruments Using                      |                                   |   |      | Total Estimated Fair Value |
|---|-----------------|--|-----------------------------------|---|------|----------------------------|
|   |                 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |      |                            |
| March 31, 2014<br>(in thousands)                  |                 |  |                                   |   |      |                            |
| Assets:   |                 |  |                                   |   |      |                            |
| Cash and Cash Equivalents                         | \$ 173,727      | \$ 173,727   | \$ -                              | \$ -                                      |      | \$ 173,727                 |
| Investment Securities Available-for-Sale:         |                 |  |                                   |   |      |                            |
| Government Agency & Government-Sponsored Entities | 18,426          | 13,399   | 5,027                             | -   |      | 18,426                     |
| Mortgage Backed Securities                        | 329,730         |  | 329,730                           | -   |      | 329,730                    |
| Corporate Securities                              | 49,352          | 7,966  | 41,386                            | -   |      | 49,352                     |
| Other   | 2,235           | 1,925  | 310                               | -   |      | 2,235                      |
| Total Investment Securities Available-for-Sale    | 399,743         | 23,290   | 376,453                           | -   |      | 399,743                    |
| Investment Securities Held-to-Maturity:           |                 |  |                                   |   |      |                            |
| Obligations of States and Political Subdivisions  | 62,890          | -  | 49,348                            | 13,996                                    |      | 63,344                     |
| Mortgage Backed Securities                        | 4               | -  | 4                                 | -   |      | 4                          |
| Other   | 2,761           | -  | 2,761                             | -   |      | 2,761                      |
| Total Investment Securities Held-to-Maturity      | 65,655          | -  | 52,113                            | 13,996                                    |      | 66,109                     |
| FHLB Stock  | 7,187           | N/   | A N/                              | A N/                                      | A N/ | A N/                       |
| Loans & Leases, Net of Deferred Fees & Allowance: |                 |  |                                   |   |      |                            |
| Commercial Real Estate                            | 396,439         | -  | -                                 | 397,090                                   |      | 397,090                    |
| Agricultural Real Estate                          | 322,725         | -  | -                                 | 326,210                                   |      | 326,210                    |
| Real Estate Construction                          | 54,674          | -  | -                                 | 55,040                                    |      | 55,040                     |
| Residential 1st Mortgages                         | 154,994         | -  | -                                 | 157,714                                   |      | 157,714                    |
| Home Equity Lines and Loans                       | 31,641          | -  | -                                 | 33,994                                    |      | 33,994                     |

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|   |           |           |         |           |           |
|---|-----------|-----------|---------|-----------|-----------|
| Agricultural  | 199,627   | -         | -       | 198,836   | 198,836   |
| Commercial  | 149,376   | -         | -       | 149,450   | 149,450   |
| Consumer & Other  | 4,550     | -         | -       | 4,599     | 4,599     |
| Leases  | 17,247    | -         | -       | 17,080    | 17,080    |
| Unallocated Allowance                                     | (2,520 )  | -         | -       | (2,520 )  | (2,520 )  |
| Total Loans & Leases, Net of Deferred Fees<br>& Allowance | 1,328,753 | -         | -       | 1,337,493 | 1,337,493 |
| Accrued Interest Receivable                               | 6,732     | -         | 6,732   | -         | 6,732     |
| Liabilities:  |           |           |         |           |           |
| Deposits:   |           |           |         |           |           |
| Demand  | 489,786   | 489,786   | -       | -         | 489,786   |
| Interest Bearing Transaction                              | 287,174   | 287,174   | -       | -         | 287,174   |
| Savings and Money Market                                  | 639,370   | 639,370   | -       | -         | 639,370   |
| Time  | 424,284   | -         | 424,568 | -         | 424,568   |
| Total Deposits  | 1,840,614 | 1,416,330 | 424,568 | -         | 1,840,898 |
| Subordinated Debentures                                   | 10,310    | -         | 6,220   | -         | 6,220     |
| Accrued Interest Payable                                  | 345       | -         | 345     | -         | 345       |

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| December 31, 2013<br>(in thousands)                       | Carrying<br>Amount | Fair Value of Financial Instruments Using<br>Quoted<br>Prices<br>in Active<br>Markets<br>for |  |  |           | Total<br>Estimated<br>Fair Value |
|---|--------------------|--|--|--|-----------|----------------------------------|
|   |                    | Identical<br>Assets<br>(Level 1)   | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |           |                                  |
| Assets:   |                    |  |  |  |           |                                  |
| Cash and Cash Equivalents                                 | \$83,677           | \$83,677   | \$ -                                       | \$ -   | \$83,677  |                                  |
| Investment Securities Available-for-Sale:                 |                    |  |  |  |           |                                  |
| Government Agency &<br>Government-Sponsored Entities      | 28,436             | 23,394   | 5,042                                      | -  | 28,436    |                                  |
| Mortgage Backed Securities                                | 324,929            | -  | 324,929                                    | -  | 324,929   |                                  |
| Corporate Securities                                      | 49,380             | 8,191  | 41,189                                     | -  | 49,380    |                                  |
| Other   | 1,894              | 1,584  | 310  | -  | 1,894     |                                  |
| Total Investment Securities<br>Available-for-Sale         | 404,639            | 33,169   | 371,470                                    | -  | 404,639   |                                  |
| Investment Securities Held-to-Maturity:                   |                    |  |  |  |           |                                  |
| Obligations of States and Political<br>Subdivisions       | 65,685             | -  | 51,563                                     | 14,307   | 65,870    |                                  |
| Mortgage Backed Securities                                | 45                 | -  | 45   | -  | 45        |                                  |
| Other   | 2,775              | -  | 2,775                                      | -  | 2,775     |                                  |
| Total Investment Securities<br>Held-to-Maturity           | 68,505             | -  | 54,383                                     | 14,307   | 68,690    |                                  |
| FHLB Stock  | 7,187              | N/   | A N/                                       | A N/   | A N/      | A                                |
| Loans & Leases, Net of Deferred Fees &<br>Allowance:      |                    |  |  |  |           |                                  |
| Commercial Real Estate                                    | 402,336            | -  | -  | 403,790  | 403,790   |                                  |
| Agricultural Real Estate                                  | 324,688            | -  | -  | 328,704  | 328,704   |                                  |
| Real Estate Construction                                  | 40,438             | -  | -  | 40,800   | 40,800    |                                  |
| Residential 1st Mortgages                                 | 150,184            | -  | -  | 153,352  | 153,352   |                                  |
| Home Equity Lines and Loans                               | 32,710             | -  | -  | 35,250   | 35,250    |                                  |
| Agricultural  | 244,209            | -  | -  | 242,950  | 242,950   |                                  |
| Commercial  | 144,701            | -  | -  | 145,131  | 145,131   |                                  |
| Consumer & Other  | 4,876              | -  | -  | 4,912  | 4,912     |                                  |
| Leases  | 12,094             | -  | -  | 11,851   | 11,851    |                                  |
| Unallocated Allowance                                     | (2,274 )           | -  | -  | (2,274 )   | (2,274 )  |                                  |
| Total Loans & Leases, Net of Deferred Fees<br>& Allowance | 1,353,962          | -  | -  | 1,364,466  | 1,364,466 |                                  |
| Accrued Interest Receivable                               | 6,941              | -  | 6,941                                      | -  | 6,941     |                                  |
| Liabilities:  |                    |  |  |  |           |                                  |
| Deposits:   |                    |  |  |  |           |                                  |
| Demand  | 495,963            | 495,963  | -  | -  | 495,963   |                                  |
| Interest Bearing Transaction                              | 291,795            | 291,795  | -  | -  | 291,795   |                                  |

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|                          |           |           |         |   |           |
|--------------------------|-----------|-----------|---------|---|-----------|
| Savings and Money Market | 589,511   | 589,511   | -       | - | 589,511   |
| Time                     | 430,422   | -         | 430,752 | - | 430,752   |
| Total Deposits           | 1,807,691 | 1,377,269 | 430,752 | - | 1,808,021 |
| Subordinated Debentures  | 10,310    | -         | 6,224   | - | 6,224     |
| Accrued Interest Payable | 352       | -         | 352     | - | 352       |

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| March 31, 2013<br>(in thousands)  | Carrying<br>Amount | Fair Value of Financial Instruments Using<br>Quoted<br>Prices<br>in Active<br>Markets<br>for |  |  |           | Total<br>Estimated<br>Fair Value |
|---|--------------------|--|--|--|-----------|----------------------------------|
|   |                    | Identical<br>Assets<br>(Level 1)   | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |           |                                  |
| Assets:   |                    |  |  |  |           |                                  |
| Cash and Cash Equivalents   | \$43,533           | \$43,533   | \$ -                                       | \$ -   | \$43,533  |                                  |
| Investment Securities Available-for-Sale:   |                    |  |  |  |           |                                  |
| Government Agency &<br>Government-Sponsored Entities<br>Obligations of States and Political<br>Subdivisions | 26,692             | 21,612   | 5,080                                      | -  | 26,692    |                                  |
| Mortgage Backed Securities  | 5,643              | -  | -  | 5,643  | 5,643     |                                  |
| Corporate Securities  | 432,285            | -  | 432,285                                    | -  | 432,285   |                                  |
| Other   | 50,128             | 9,373  | 40,755                                     | -  | 50,128    |                                  |
| Total Investment Securities<br>Available-for-Sale   | 825                | 515  | 310  | -  | 825       |                                  |
| Investment Securities Held-to-Maturity:   |                    |  |  |  |           |                                  |
| Obligations of States and Political<br>Subdivisions   | 65,165             | -  | 59,757                                     | 7,282  | 67,039    |                                  |
| Mortgage Backed Securities  | 341                | -  | 349  | -  | 349       |                                  |
| Other   | 2,202              | -  | 2,202                                      | -  | 2,202     |                                  |
| Total Investment Securities<br>Held-to-Maturity   | 67,708             | -  | 62,308                                     | 7,282  | 69,590    |                                  |
| FHLB Stock  | 7,368              | N/   | A  | N/   | A         | N/                               |
| Loans, Net of Deferred Loan Fees &<br>Allowance:  |                    |  |  |  |           |                                  |
| Commercial Real Estate  | 354,222            | -  | -  | 358,684  | 358,684   |                                  |
| Agricultural Real Estate  | 315,028            | -  | -  | 321,212  | 321,212   |                                  |
| Real Estate Construction  | 31,712             | -  | -  | 32,070   | 32,070    |                                  |
| Residential 1st Mortgages   | 144,159            | -  | -  | 149,062  | 149,062   |                                  |
| Home Equity Lines and Loans   | 36,932             | -  | -  | 39,477   | 39,477    |                                  |
| Agricultural  | 172,313            | -  | -  | 171,562  | 171,562   |                                  |
| Commercial  | 134,149            | -  | -  | 133,299  | 133,299   |                                  |
| Consumer & Other  | 4,735              | -  | -  | 4,769  | 4,769     |                                  |
| Unallocated Allowance   | (810 )             | -  | -  | (810 )   | (810 )    |                                  |
| Total Loans, Net of Deferred Loan Fees &<br>Allowance   | 1,192,440          | -  | -  | 1,209,325  | 1,209,325 |                                  |
| Accrued Interest Receivable   | 6,661              | -  | 6,661                                      | -  | 6,661     |                                  |
| Liabilities:  |                    |  |  |  |           |                                  |
| Deposits:   |                    |  |  |  |           |                                  |
| Demand  | 417,341            | 417,341  | -  | -  | 417,341   |                                  |

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|                              |           |           |         |   |           |
|------------------------------|-----------|-----------|---------|---|-----------|
| Interest Bearing Transaction | 257,171   | 257,171   | -       | - | 257,171   |
| Savings and Money Market     | 590,323   | 590,323   | -       | - | 590,323   |
| Time                         | 450,331   | -         | 451,084 | - | 451,084   |
| Total Deposits               | 1,715,166 | 1,264,835 | 451,084 | - | 1,715,919 |
| Subordinated Debentures      | 10,310    | -         | 5,758   | - | 5,758     |
| Accrued Interest Payable     | 427       | -         | 427     | - | 427       |

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Fair value estimates presented herein are based on pertinent information available to management as of March 31, 2014, December 31, 2013, and March 31, 2013. 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 purpose of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above. 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. All cash and cash equivalents are classified as Level 1.

**Investment Securities** - Fair values for investment securities 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. Based on the available market information the classification level could be 1, 2, or 3.

**Federal Home Loan Bank Stock** - It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

**Loans & Leases, Net of Deferred Fees & Allowance** - Fair values of loans & leases are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans & leases are estimated using discounted cash flow analyses, using interest rates currently being offered for loans & leases with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans & leases are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans & leases do not necessarily represent an exit price.

**Deposit Liabilities** - The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. Fair values for fixed-maturity certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

**Subordinated Debentures** - The fair values of the Company's Subordinated Debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

**Accrued Interest Receivable and Payable** - The carrying amount of accrued interest receivable and payable approximates their fair value resulting in a Level 2 classification.

### 6. Dividends and Basic Earnings Per Common 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. No cash dividends were declared during the first quarter of 2014 or 2013.

Basic earnings per common 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 basic earnings per common share for the three months ended March 31, 2014 and 2013.



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| (net income in thousands)                   | 2014    | 2013    |
|---|---------|---------|
| Net Income                                  | \$6,282 | \$6,251 |
| Average Number of Common Shares Outstanding | 777,882 | 777,882 |
| Basic Earnings Per Common Share Amount      | \$8.08  | \$8.04  |

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7. Recent Accounting Pronouncements

In January, 2014, the FASB issued Accounting Standards Update (ASU) 2014-04 - Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. This Update clarifies when an in-substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The objective of the amendments in this Update is to reduce diversity in practice. An in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company does not anticipate that the adoption of this ASU will have a material impact on the Company's financial position, results of operation, cash flows, or disclosure.

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 months ended March 31, 2014. This analysis should be read in conjunction with our 2013 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) continuing economic sluggishness in the Central Valley of California; (2) significant changes in interest rates and prepayment speeds; (3) credit risks of lending and investment activities; (4) changes in federal and state banking laws or regulations; (5) competitive pressure in the banking industry; (6) changes in governmental fiscal or monetary policies; (7) 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 (8) other factors discussed in Item 1A. Risk Factors located in the Company's 2013 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 its primary service area, the mid Central Valley of California, through twenty-one full-service

branches 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.

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During 2013, the Company initiated efforts to broaden its geographic footprint by establishing loan production offices (“LPO”) in Irvine, CA and Walnut Creek, CA. Both LPO’s were opened in January 2014, and in March 2014 the Irvine LPO was converted to a full-service branch. Experienced lending and equipment leasing professionals have been hired to staff these offices. The Company intends to convert the Walnut Creek LPO to a full-service branch in the near future. Both of these areas have strong local economies, and will help diversify some of the concentration risks that the Company now has to the Central Valley and the agricultural industry. The Irvine location will also be the headquarters for the Company’s equipment leasing activities.

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 Business Oversight (“DBO”) and the Federal Deposit Insurance Corporation (“FDIC”).

### Overview

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

For the three months ended March 31, 2014, Farmers & Merchants Bancorp reported net income of \$6,282,000, earnings per share of \$8.08 and return on average assets of 1.20%. Return on average shareholders’ equity was 11.70% for the three months ended March 31, 2014.

For the three months ended March 31, 2013, Farmers & Merchants Bancorp reported net income of \$6,251,000, earnings per share of \$8.04 and return on average assets of 1.28%. Return on average shareholders’ equity was 12.04% for the three months ended March 31, 2013.

The primary reasons for the Company’s improved earnings performance in the first quarter of 2014 as compared to the same period last year were: (1) an \$876,000 increase in net interest income; and (2) a \$171,000 decrease in the provision for income taxes. These positive impacts were partially offset by an \$898,000 decrease in non-interest income attributable to reduced securities gains and deposit service charges.

The following is a summary of the financial results for the three-month period ended March 31, 2014 compared to March 31, 2013.

- Net income increased 0.5% to \$6,282,000 from \$6,251,000.
- Earnings per share increased 0.5% to \$8.08 from \$8.04.
- Total assets increased 7.9% to \$2.13 billion.
- Total loans & leases increased 11.1% to \$1.36 billion.
- Total deposits increased 7.3% to \$1.84 billion.

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Results of Operations

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 month periods ended March 31, 2014 and 2013.

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 & leases and other interest earning assets exceed the interest paid on interest bearing sources of funds. For the purpose of analysis, the interest earned on tax-exempt investments and municipal loans is adjusted to an amount comparable to interest subject to normal income taxes. This adjustment is referred to as "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 &amp; Merchants Bancorp

Year-to-Date Average Balances and Interest Rates

(Interest and Rates on a Taxable Equivalent Basis)

(in thousands)

|   | Three Months Ended March 31,<br>2014 |          |                          |   | Three Months Ended March 31,<br>2013 |          |                          |   |
|---|--------------------------------------|----------|--------------------------|---|--------------------------------------|----------|--------------------------|---|
|   | Balance                              | Interest | Annualized<br>Yield/Rate |   | Balance                              | Interest | Annualized<br>Yield/Rate |   |
| Assets  |                                      |          |                          |   |                                      |          |                          |   |
| Interest Bearing Deposits With Banks                              | \$102,142                            | \$64     | 0.25                     | % | \$70,206                             | \$44     | 0.25                     | % |
| Investment Securities   |                                      |          |                          |   |                                      |          |                          |   |
| Government Agency &<br>Government-Sponsored Entities              | 21,369                               | 55       | 1.03                     | % | 29,835                               | 71       | 0.95                     | % |
| Obligations of States and Political<br>Subdivisions - Non-Taxable | 64,329                               | 916      | 5.70                     | % | 71,114                               | 1,011    | 5.69                     | % |
| Mortgage Backed Securities  | 324,507                              | 1,907    | 2.35                     | % | 366,810                              | 1,891    | 2.06                     | % |
| Other   | 53,964                               | 153      | 1.13                     | % | 48,637                               | 144      | 1.18                     | % |
| Total Investment Securities                                       | 464,169                              | 3,031    | 2.61                     | % | 516,396                              | 3,117    | 2.41                     | % |
| Loans & Leases  |                                      |          |                          |   |                                      |          |                          |   |
| Real Estate   | 935,838                              | 11,519   | 4.99                     | % | 840,253                              | 11,154   | 5.38                     | % |
| Home Equity Line & Loans  | 34,829                               | 475      | 5.53                     | % | 40,556                               | 455      | 4.55                     | % |
| Agricultural  | 214,141                              | 2,141    | 4.05                     | % | 187,871                              | 1,969    | 4.25                     | % |
| Commercial  | 159,021                              | 1,884    | 4.80                     | % | 144,532                              | 1,777    | 4.99                     | % |
| Consumer  | 6,258                                | 71       | 4.60                     | % | 4,733                                | 87       | 7.45                     | % |
| Other   | 70                                   | 1        | 5.79                     | % | 232                                  | 3        | 5.24                     | % |
| Leases  | 14,867                               | 180      | 4.91                     | % | -                                    | -        | 0.00                     | % |
| Total Loans & Leases  | 1,365,024                            | 16,271   | 4.83                     | % | 1,218,177                            | 15,445   | 5.14                     | % |
| Total Earning Assets  | 1,931,335                            | \$19,366 | 4.07                     | % | 1,804,779                            | \$18,606 | 4.18                     | % |
| Unrealized Gain (Loss) on Securities                              |                                      |          |                          |   |                                      |          |                          |   |
| Available-for-Sale  | (1,975 )                             |          |                          |   | 10,623                               |          |                          |   |
| Allowance for Credit Losses                                       | (34,270 )                            |          |                          |   | (34,253 )                            |          |                          |   |
| Cash and Due From Banks   | 32,604                               |          |                          |   | 33,086                               |          |                          |   |
| All Other Assets  | 161,930                              |          |                          |   | 146,547                              |          |                          |   |
| Total Assets  | \$2,089,624                          |          |                          |   | \$1,960,782                          |          |                          |   |
| Liabilities & Shareholders' Equity                                |                                      |          |                          |   |                                      |          |                          |   |
| Interest Bearing Deposits   |                                      |          |                          |   |                                      |          |                          |   |
| Transaction   | \$290,018                            | \$33     | 0.05                     | % | \$253,157                            | \$29     | 0.05                     | % |
| Savings and Money Market  | 619,852                              | 240      | 0.16                     | % | 577,270                              | 244      | 0.17                     | % |
| Time Deposits   | 426,462                              | 327      | 0.31                     | % | 455,171                              | 410      | 0.37                     | % |
| Total Interest Bearing Deposits                                   | 1,336,332                            | 600      | 0.18                     | % | 1,285,598                            | 683      | 0.22                     | % |
| Federal Home Loan Bank Advances                                   | 5                                    | -        | 0.00                     | % | 87                                   | -        | 0.00                     | % |
| Subordinated Debentures   | 10,310                               | 80       | 3.10                     | % | 10,310                               | 81       | 3.19                     | % |
| Total Interest Bearing Liabilities                                | 1,346,647                            | \$680    | 0.20                     | % | 1,295,995                            | \$764    | 0.24                     | % |
| Interest Rate Spread  |                                      |          | 3.86                     | % |                                      |          | 3.94                     | % |
| Demand Deposits (Non-Interest Bearing)                            | 482,603                              |          |                          |   | 421,845                              |          |                          |   |
| All Other Liabilities   | 45,600                               |          |                          |   | 35,220                               |          |                          |   |
| Total Liabilities   | 1,874,850                            |          |                          |   | 1,753,060                            |          |                          |   |

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|   |             |          |      |             |          |      |
|---|-------------|----------|------|-------------|----------|------|
| Shareholders' Equity  | 214,774     |          |      | 207,722     |          |      |
| Total Liabilities & Shareholders' Equity                      | \$2,089,624 |          |      | \$1,960,782 |          |      |
| Impact of Non-Interest Bearing Deposits and Other Liabilities |             | 0.06     | %    |             | 0.07     | %    |
| Net Interest Income and Margin on Total Earning Assets        |             | 18,686   | 3.92 | %           | 17,842   | 4.01 |
| Tax Equivalent Adjustment                                     |             | (319 )   |      |             | (351 )   |      |
| Net Interest Income   |             | \$18,367 | 3.86 | %           | \$17,491 | 3.93 |

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 \$956,000 and \$774,000 for the quarters ended March 31, 2014 and 2013, respectively. Yields on securities available-for-sale are based on historical cost.

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Volume and Rate Analysis of Net Interest Revenue  
(Interest and Rates on a Taxable Equivalent Basis)

| (in thousands)   | Three Months Ended<br>Mar. 31, 2014<br>compared to Mar. 31,<br>2013 |         |             |
|--|---|---------|-------------|
|  | Volume  | Rate    | Net<br>Chg. |
|  | \$20  | \$-     | \$20        |
| <b>Interest Earning Assets</b>                                 |   |         |             |
| Interest Bearing Deposits With Banks                           |   |         |             |
| Investment Securities  |   |         |             |
| Government Agency & Government-Sponsored Entities              | (22 )   | 6       | (16 )       |
| Obligations of States and Political Subdivisions - Non-Taxable | (97 )   | 2       | (95 )       |
| Mortgage Backed Securities                                     | (232 )  | 248     | 16          |
| Other  | 15  | (6 )    | 9           |
| Total Investment Securities                                    | (336 )  | 250     | (86 )       |
| <b>Loans &amp; Leases</b>                                      |   |         |             |
| Real Estate  | 1,226   | (861)   | 365         |
| Home Equity Line & Loans                                       | (70 )   | 90      | 20          |
| Agricultural   | 268   | (96 )   | 172         |
| Commercial   | 175   | (68 )   | 107         |
| Consumer   | 24  | (40 )   | (16 )       |
| Other  | (2 )  | -       | (2 )        |
| Leases   | 180   | -       | 180         |
| Total Loans & Leases   | 1,801   | (975)   | 826         |
| Total Earning Assets   | 1,485   | (725)   | 760         |
| <b>Interest Bearing Liabilities</b>                            |   |         |             |
| Interest Bearing Deposits                                      |   |         |             |
| Transaction  | 4   | -       | 4           |
| Savings and Money Market                                       | 18  | (22 )   | (4 )        |
| Time Deposits  | (25 )   | (58 )   | (83 )       |
| Total Interest Bearing Deposits                                | (3 )  | (80 )   | (83 )       |
| Other Borrowed Funds   | -   | -       | -           |
| Subordinated Debentures  | -   | (1 )    | (1 )        |
| Total Interest Bearing Liabilities                             | (3 )  | (81 )   | (84 )       |
| Total Change   | \$1,488   | \$(644) | \$844       |

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



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Net interest income increased \$876,000 or 5.0% to \$18.4 million during the first quarter of 2014 compared to \$17.5 million for the first quarter of 2013. On a fully tax equivalent basis, net interest income increased 4.7% and totaled \$18.7 million at March 31, 2014, compared to \$17.8 million at March 31, 2013. As more fully discussed below, the increase in net interest income was primarily due to a \$126.6 million increase in average earning assets.

Net interest income on a taxable equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For the quarter ended March 31, 2014, the Company's net interest margin was 3.92% compared to 4.01% for the quarter ended March 31, 2013. This decrease in net interest margin was due primarily to a decline in earning asset yields that exceeded a corresponding drop in funding costs.

Average loans & leases totaled \$1.4 billion for the quarter ended March 31, 2014; an increase of \$146.8 million compared to the average balance for the quarter ended March 31, 2013. Loans & leases increased from 67.5% of average earning assets at March 31, 2013 to 70.7% at March 31, 2014. As a result of the continuing impact of the sustained low rate environment since late 2008, the annualized yield on the Company's loan portfolio declined to 4.83% for the quarter ended March 31, 2014, compared to 5.14% for the quarter ended March 31, 2013. Overall, the positive impact on interest revenue from the increase in loan & lease balances was only partially offset by the negative impact of a decline in yields resulting in interest revenue from loans & leases increasing 5.4% to \$16.3 million for quarter ended March 31, 2014. The Company has been experiencing aggressive competitor pricing for loans & leases to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan & lease yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Since the risk factor for investments is typically lower than that of loans or leases, the yield earned on investments is generally less than that of loans & leases. Average investment securities totaled \$464.2 million for the quarter ended March 31, 2014; a decrease of \$52.2 million compared to the average balance for the quarter ended March 31, 2013. Tax equivalent interest income on securities decreased \$86,000 to \$3.0 million for the quarter ended March 31, 2014, compared to \$3.1 million for the quarter ended March 31, 2013. The average investment portfolio yield, on a tax equivalent (TE) basis, was 2.61% for the quarter ended March 31, 2014, compared to 2.41% for the quarter ended March 31, 2013. This increase in yield occurred primarily as a result of the Company's sale of \$28.2 million of lower yielding Mortgage Backed Securities in September 2013. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2014. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statement of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Interest bearing deposits with banks consisted of FRB deposits. Deposits with the FRB earn interest at the Fed Funds rate, which has been 0.25% since December 2008. Average interest bearing deposits with banks for the quarter ended March 31, 2014, was \$102.1 million, a decrease of \$31.9 million compared to the average balance for the quarter ended March 31, 2013. Interest income on interest bearing deposits with banks for the quarter ended March 31, 2014, increased \$20,000 to \$64,000 compared to the quarter ended March 31, 2013.

Average interest-bearing liabilities increased \$50.7 million or 3.9% during the first quarter of 2014. Of that increase: (1) interest-bearing transaction deposits increased \$36.9 million; (2) savings and money market deposits increased \$42.6 million; (3) time deposits decreased \$28.7 million; (4) Federal Home Loan Bank ("FHLB") Advances decreased \$82,000 (see "Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings"); and (5) subordinated debt remained unchanged (see "Financial Condition – Subordinated Debentures").

Total interest expense on interest bearing deposits was \$600,000 for the first quarter of 2014 as compared to \$683,000 million for the first quarter of 2013. The average rate paid on interest-bearing deposits was 0.18% for the first quarter

of 2014 compared to 0.22% for the first quarter of 2013. The Company anticipates that this decline in deposit rates, if any, will be much more modest through the remainder of 2014.

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### Provision and Allowance for Credit Losses

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

### Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance-sheet date. The allowance is established through a provision for credit losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of three primary components, specific reserves related to impaired loans & leases, general reserves for inherent losses related to loans & leases that are not impaired and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

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

A restructuring of a loan or lease constitutes a troubled debt restructuring ("TDR") under ASC 310-40, 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 or leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment.

The determination of the general reserve for loans or leases that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, 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 & lease portfolio, and probable losses inherent in the portfolio taken as a whole.



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The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1<sup>st</sup> mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer & other; and (9) equipment leases. See “Financial Condition – Loans & Leases” for examples of loans & leases made by the Company. The allowance for credit losses attributable to each portfolio segment, which includes both impaired loans & leases and loans & leases 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 & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. A credit grade is established at inception for smaller balance loans, such as consumer and residential real estate, and then updated only when the loan becomes contractually delinquent or when the borrower requests a modification. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan & lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

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

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

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

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

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

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

**Commercial Real Estate** – Commercial real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of

commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

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

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

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

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

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

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

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

### Provision for Credit Losses

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

The Central Valley of California was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy appears to have stabilized throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country. While, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of March 31, 2014, compare very favorably to our peers at the present time, carefully managing credit risk remains a key focus of the Company.

The state of California experienced drought conditions during much of 2013. Importantly, most of the Company's agricultural customers have access to their own ground water supplies and, therefore, are not as dependent on the

delivery of surface water as growers in other parts of California. Although Management does not expect current conditions to have a material impact on credit quality during 2014, the lack of rain will have some adverse impact on our agricultural customers' operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels reach critical stage.

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The Company made no provision for credit losses during the first quarters of 2014 or 2013. Net recoveries during the first quarter of 2014 were \$3,000 compared to net recoveries of \$38,000 in the first quarter of 2013. See “Overview – Looking Forward: 2014 and Beyond”, “Critical Accounting Policies and Estimates – Allowance for Credit Losses” and “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk” located in the Company’s 2013 Annual Report on Form 10-K.

After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of March 31, 2014, was adequate.

|  | Three Months Ended March 31, |          |
|--|------------------------------|----------|
|  | 2014                         | 2013     |
| Allowance for Credit Losses (in thousands)           |                              |          |
| Balance at Beginning of Period                       | \$34,274                     | \$34,217 |
| Loans or Leases Charged Off                          | (30 )                        | (35 )    |
| Recoveries of Loans or Leases Previously Charged Off | 33                           | 73       |
| Provision Charged to Expense                         | -                            | -        |
| Balance at End of Period                             | \$34,277                     | \$34,255 |

The table below breaks out current quarter activity by portfolio segment (in thousands):

|  | Commercial Real Estate | Agricultural Real Estate | Real Estate Construction | Home Residential Mortgages |         | Home Equity Lines of Credit | Agricultural Commercial | Consumer & Other |       | Unallocated | Total    |
|--|------------------------|--------------------------|--------------------------|----------------------------|---------|-----------------------------|-------------------------|------------------|-------|-------------|----------|
|  |                        |                          |                          | 1st                        | 2nd     |                             |                         | Leases           | Other |             |          |
| Year-To-Date Allowance for Credit Losses: Beginning Balance- January 1, 2014 | \$5,178                | \$3,576                  | \$654                    | \$1,108                    | \$2,767 | \$12,205                    | \$5,697                 | \$176            | \$639 | \$2,274     | \$34,274 |
| Charge-Offs  | -                      | -                        | -                        | (3 )                       | -       | -                           | -                       | (27 )            | -     | -           | (30 )    |
| Recoveries   | -                      | -                        | -                        | -                          | 12      | 1                           | 5                       | 15               | -     | -           | 33       |
| Provision  | 1,248                  | (189 )                   | 423                      | (5 )                       | (131 )  | (2,605 )                    | 724                     | 7                | 282   | 246         | -        |
| Ending Balance- March 31, 2014   | \$6,426                | \$3,387                  | \$1,077                  | \$1,100                    | \$2,648 | \$9,601                     | \$6,426                 | \$171            | \$921 | \$2,520     | \$34,277 |

The Allowance for Credit Losses at March 31, 2014 remained nearly unchanged from December 31, 2013. However, the allowance allocated to the following categories of loans did change materially during the quarter:

Commercial Real Estate allowance balances increased \$1.2 million, primarily as a result of increased balances of loans risk rated special mention.

Agricultural allowance balances decreased \$2.6 million, primarily as a result of decreased loan balances.

See “Management’s Discussion and Analysis - Financial Condition – Classified Loans & Leases and Non-Performing Assets” for further discussion regarding these loan categories.

See “Note 3. Allowance for Credit Losses” for additional details regarding the provision and allowance for credit losses.

#### Non-Interest Income

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

Overall, non-interest income decreased \$2.3 million or 42.5% for the three months ended March 31, 2014, compared to the same period of 2013. This decrease was primarily due to: (1) a \$166,000 decrease in service charges on deposit accounts related to the Company’s overdraft privilege service; (2) a \$732,000 decrease in net gain on sale of investment securities; (3) a \$1.2 million decrease in the net gain on deferred compensation investments; and (4) a \$209,000 decrease in swap referral fee income.

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

### Non-Interest Expense

Non-interest expense for the Company includes expenses for: (1) salaries and employee benefits; (2) net gain on deferred compensation investment; (3) occupancy; (4) equipment; (5) ORE holding costs; (6) supplies; (7) legal fees; (8) professional services; (9) data processing; (10) marketing; (11) deposit insurance; and (12) other miscellaneous expenses.

Overall, non-interest expense decreased \$1.3 million or 10.2% for the three months ended March 31, 2014, compared to the same period in 2013. This decrease was primarily comprised of: (1) a \$1.2 million decrease in the net gain on deferred compensation investments; and (2) a \$150,000 decrease in legal fee expense. These decreases were partially offset by a \$192,000 increase in salaries and employee benefits primarily related to: (1) new staff added for the LPO's in Walnut Creek and Irvine; (2) bank-wide raises; and (3) increased medical insurance premiums.

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

### Income Taxes

The provision for income taxes decreased 4.5% to \$3.6 million for the first quarter of 2014 compared to the first quarter of 2013. The effective tax rate for the first quarter of 2014 was 36.5% compared to 37.7% for the first quarter of 2013. The Company's effective tax rate fluctuates from quarter to quarter due primarily to changes in the mix of taxable and tax-exempt earning sources. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance; California enterprise zone hiring tax credit; and tax-exempt interest income on municipal securities and loans.

Current tax law causes the Company's current taxes payable to approximate or exceed the current provision for taxes on the income statement. Three provisions have had a significant effect on the Company's current income tax liability: (1) the restrictions on the deductibility of credit losses; (2) deductibility of retirement and other long-term employee benefits only when paid; and (3) the statutory deferral of deductibility of California franchise taxes on the Company's federal return.

### Financial Condition

This section discusses material changes in the Company's balance sheet at March 31, 2014, as compared to December 31, 2013 and to March 31, 2013. As previously discussed (see "Overview") the Company's financial condition can be influenced by the seasonal banking needs of its agricultural customers.

### Investment Securities and Federal Funds Sold

The investment portfolio provides the Company with an income alternative to loans & leases. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2013, the Company began to selectively add investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities.



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The Company's investment portfolio at March 31, 2014 was \$465.4 million compared to \$473.1 million at the end of 2013, a decrease of \$7.7 million or 1.6%. At March 31, 2013, the investment portfolio totaled \$583.3 million. The mix of the investment portfolio has changed over the past three to five years. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company has invested most of its available funds in either shorter term government agency & government-sponsored entity securities and shorter term (10, 15, and 20 year) mortgage-backed securities. Beginning in late May 2013 rates on 10-year treasuries began to increase from under 2% to a peak of just below 3% in early September 2013, then dropped to around 2.65% at September 30, 2013, and over the past six months have settled into a trading range of 2.60% – 2.90%. As a result of these overall increases in rates, the market value of the Company's security portfolio has declined. . In late September 2013, the Company took advantage of the pull back in rates to sell \$28.2 million of 20-year mortgage-backed securities for a loss of \$1.1 million.

The Company's total investment portfolio currently represents 21.9% of the Company's total assets as compared to 22.8% at December 31, 2013, and 29.6% at March 31, 2013.

As of March 31, 2014 the Company held \$62.9 million of municipal investments, of which \$48.9 million were bank-qualified municipal bonds, all classified as held-to-maturity. The financial problems experienced by certain municipalities over the past five years, along with the financial stresses exhibited by some of the large monoline bond insurers, has increased the overall risk associated with bank-qualified municipal bonds. This situation caused the Company not to purchase any municipal bonds between late 2006 and year-end 2011. However, during the first quarter of 2012 the Company began investing in bank-qualified municipals that were rated AA or better. As of March 31, 2014 ninety-three percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." Additionally, in order to comply with Section 939A of the Dodd-Frank Act, the Company performs its own credit analysis on new purchases of municipal bonds and corporate securities. The Company monitors the status of the approximately seven percent (\$3.6 million) of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Interest bearing deposits with banks consisted of FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. Interest bearing deposits with banks totaled \$134.7 million at March 31, 2014, \$42.7 million at December 31, 2013 and \$12.8 million at March 31, 2013.

The Company classifies its investments as held-to-maturity, trading, or available-for-sale. Securities are classified as held-to-maturity and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of March 31, 2014, December 31, 2013 and March 31, 2013, there were no securities in the trading portfolio. Securities classified as available-for-sale include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes.

### Loans & Leases

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

Commercial and Agricultural Real Estate - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties within our market area. Commercial mortgage

term loans can be made if the property is either income producing or scheduled to become income producing based upon acceptable pre-leasing, and the income will be the Bank's primary source of repayment for the loan. Loans are made both on owner occupied and investor properties; generally do not exceed 15 years (and may have pricing adjustments on a shorter timeframe); have debt service coverage ratios of 1.00 or better with a target of greater than 1.20; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

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

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

Home Equity Lines and Loans - These are loans made to individuals for home improvements and other personal needs. Generally, amounts do not exceed \$250,000; Combined Loan To Value (CLTV) does not exceed 80%; FICO scores are at or above 670; Total Debt Ratios do not exceed 43%; and in some situations the Company is in a 1<sup>st</sup> lien position.

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

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

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

Leases –These are leases to businesses or individuals, for the purpose of financing the acquisition of equipment. They can be either “finance leases” where the lessee retains the tax benefits of ownership but obtains 100% financing on their equipment purchases; or “true tax leases” where the Company, as lessor, places reliance on equipment residual value and in doing so obtains the tax benefits of ownership. Leases typically have a maturity of three to ten years, and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.





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Each loan or lease type involves risks specific to the: (1) borrower; (2) collateral; and (3) loan & lease structure. See “Results of Operations - Provision and Allowance for Credit Losses” for a more detailed discussion of risks by loan & lease type. The Company’s current underwriting policies and standards are designed to mitigate the risks involved in each loan & lease type. The Company’s policies require that loans & leases are approved only to those borrowers exhibiting a clear source of repayment and the ability to service existing and proposed debt. The Company’s underwriting procedures for all loan & lease types require careful consideration of the borrower, the borrower’s financial condition, the borrower’s management capability, the borrower’s industry, and the economic environment affecting the loan or lease.

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

In order to be responsive to borrower needs, the Company prices loans & leases: (1) on both a fixed rate and adjustable rate basis; (2) over different terms; and (3) based upon different rate indices; as long as these structures are consistent with the Company’s interest rate risk management policies and procedures (see Item 3. Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk).

The Company's loan & lease portfolio at March 31, 2014 totaled \$1.36 billion, an increase of \$136.3 million or 11.1% over March 31, 2013. This increase has occurred despite what has been a difficult economic environment combined with a very competitive pricing environment, and is a result of the Company’s intensified business development efforts directed toward credit-qualified borrowers. No assurances can be made that this growth in the loan & lease portfolio will continue until the economy in the Central Valley of California improves.

Loans & leases at March 31, 2014 decreased \$25.2 million from December 31, 2013, primarily as a result of the normal seasonal paydowns of loans made to the Company’s agricultural customers.

The following table sets forth the distribution of the loan & lease portfolio by type and percent as of the periods indicated.

| Loan & Lease Portfolio<br>(in thousands) | March 31, 2014 |        | December 31, 2013 |        | March 31, 2013 |        |
|--|----------------|--------|-------------------|--------|----------------|--------|
|  | \$             | %      | \$                | %      | \$             | %      |
| Commercial Real Estate                   | \$406,495      | 29.8 % | \$411,037         | 29.5 % | \$363,384      | 29.5 % |
| Agricultural Real Estate                 | 326,112        | 23.9 % | 328,264           | 23.6 % | 318,823        | 25.9 % |
| Real Estate Construction                 | 55,751         | 4.1 %  | 41,092            | 3.0 %  | 32,681         | 2.7 %  |
| Residential 1st Mortgages                | 156,094        | 11.4 % | 151,292           | 10.9 % | 145,419        | 11.8 % |
| Home Equity Lines and Loans              | 34,289         | 2.5 %  | 35,477            | 2.5 %  | 40,141         | 3.3 %  |
| Agricultural                             | 209,228        | 15.3 % | 256,414           | 18.4 % | 181,725        | 14.8 % |
| Commercial                               | 155,802        | 11.4 % | 150,398           | 10.8 % | 142,115        | 11.6 % |
| Consumer & Other                         | 4,721          | 0.3 %  | 5,052             | 0.4 %  | 4,898          | 0.4 %  |
| Leases                                   | 18,168         | 1.3 %  | 12,733            | 0.9 %  | -              | 0.0 %  |
| Total Gross Loans & Leases               | 1,366,660      | 100.0% | 1,391,759         | 100.0% | 1,229,186      | 100.0% |
| Less: Unearned Income                    | 3,630          |        | 3,523             |        | 2,491          |        |
| Subtotal                                 | 1,363,030      |        | 1,388,236         |        | 1,226,695      |        |
| Less: Allowance for Credit Losses        | 34,277         |        | 34,274            |        | 34,255         |        |
| Net Loans & Leases                       | \$1,328,753    |        | \$1,353,962       |        | \$1,192,440    |        |

Classified Loans & Leases and Non-Performing Assets

All loans & leases are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See “Results of Operations - Provision and Allowance for Credit Losses” for more detail on risk grades. The Company

utilizes the services of a third-party independent loan review firm to perform evaluations of individual loans & leases and review the credit risk grades the Company places on loans & leases. Loans & leases that are judged to exhibit a higher risk profile are referred to as “classified loans & leases,” and these loans & leases receive increased management attention. As of March 31, 2014, classified loans totaled \$4.1 million compared to \$5.8 million at December 31, 2013 and \$22.2 million at March 31, 2013.

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

**Non-Accrual Loans & leases** - Accrual of interest on loans & leases is generally discontinued when a loan or lease becomes contractually past due by 90 days or more with respect to interest or principal. When loans & leases are 90 days past due, but in management's judgment are well secured and in the process of collection, they may not be classified as non-accrual. When a loan or lease is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans & leases is then recognized only to the extent that cash is received and where the future collection of principal is probable. As of March 31, 2014 non-accrual loans & leases totaled \$3.1 million. At December 31, 2013 and March 31, 2013, non-accrual loans totaled \$2.6 million and \$9.5 million, respectively. The decrease in non-accrual loans & leases was primarily a result of workouts with problem credit related to the dairy industry.

**Restructured Loans & Leases** - A restructuring of a loan or lease constitutes a troubled debt restructuring (“TDR”) under ASC 310-40, 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 or leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR loans, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment.

As of March 31, 2014, restructured loans & leases on accrual totaled \$4.0 million as compared to \$4.6 million at December 31, 2013. Restructured loans on accrual at March 31, 2013 were \$1.4 million.

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

The following table sets forth the amount of the Company's non-performing loans & leases (defined as non-accrual loans & leases plus accruing loans & leases past due 90 days or more) and ORE as of the dates indicated.

Non-Performing Assets

|  | March<br>31,<br>2014 | Dec.<br>31,<br>2013 | March<br>31,<br>2013 |
|--|----------------------|---------------------|----------------------|
| (in thousands)   |                      |                     |                      |
| Non-Performing Loans & Leases                                | \$3,133              | \$2,596             | \$9,478              |
| Other Real Estate  | 3,294                | 4,611               | 4,743                |
| Total Non-Performing Assets                                  | \$6,427              | \$7,207             | \$14,221             |
| Non-Performing Loans & Leases as a % of Total Loans & Leases | 0.23 %               | 0.19 %              | 0.77 %               |
| Restructured Loans & Leases (Performing)                     | \$3,956              | \$4,649             | \$1,427              |

Although management believes that non-performing loans & leases are generally well-secured and that potential losses are provided for in the Company's allowance for credit losses, there can be no assurance that future deterioration in economic conditions and/or collateral values will not result in future credit losses. Specific reserves of \$1.0 million, \$983,000, and \$1.3 million have been established for non-performing loans & leases at March 31, 2014, December 31, 2013 and March 31, 2013, respectively.

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Foregone interest income on non-accrual loans & leases which would have been recognized during the period, if all such loans & leases had been current in accordance with their original terms, totaled \$13,000 for the three months ended March 31, 2014, \$30,500 for the year ended December 31, 2013, and \$219,000 for the three months ended March 31, 2013.

The Company reported \$3.3 million of ORE at March 31, 2014, \$4.6 million at December 31, 2013, and \$4.7 million at March 31, 2013. The March 31, 2014 value is net of a \$3.7 million reserve for ORE valuation allowance. The December 31, 2013 and March 31, 2013 values are both net of a \$4.1 million reserve for ORE valuation allowance.

Except for those classified and non-performing loans & leases discussed above, the Company's management is not aware of any loans or leases as of March 31, 2014, for which known financial problems of the borrower would cause serious doubts as to the ability of these borrowers to materially comply with their present loan repayment terms or lease payments, or any known events that would result in the loan or lease being designated as non-performing at some future date. However, the Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy appears to have stabilized throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country. See "Part I, Item 1A. Risk Factors" in the Company's 2013 Annual Report on Form 10-K.

### Deposits

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

The Company's deposit balances at March 31, 2014 have increased \$125.4 million or 7.3% compared to March 31, 2013. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) the Federal government's decision to permanently increase FDIC deposit insurance limits from \$100,000 to \$250,000 per depositor; and (2) the Company's strong financial results and position and F&M Bank's reputation as one of the most safe and sound banks in its market territory. The Company expects that, at some point, deposit customers may begin to diversify how they invest their money (e.g., move funds back into the stock market or other investments) and this could impact future deposit growth.

Although total deposits have increased 7.3% since March 31, 2013, the Company's focus has been on increasing low cost transaction and savings accounts, which have grown at a much faster pace:

- Demand and interest-bearing transaction accounts increased \$102.4 million or 15.2% since March 31, 2013.
- Savings and money market accounts have increased \$49.0 million or 8.3% since March 31, 2013.

Time deposit accounts have decreased \$26.0 million or 5.8% since March 31, 2013. This decline was the continuing result of an explicit pricing strategy adopted by the Company beginning in 2009 based upon the recognition that market CD rates were greater than the yields that the Company could obtain reinvesting these funds in short-term government agency & government-sponsored entity securities or overnight Fed Funds. Beginning in 2009, management carefully reviewed time deposit customers and reduced our deposit rates to customers that did not also have transaction, money market, and/or savings balances with us (i.e., depositors who were not "relationship customers"). Given the Company's strong deposit growth in transaction, savings and money market accounts, this time deposit decline has not presented any liquidity issues and it has significantly enhanced the Company's net interest margin and earnings.

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The Company's deposit balances at March 31, 2014 have increased \$32.9 million or 1.8% compared to December 31, 2013. Savings and money market deposits increased 8.5% or \$49.8 million while demand and interest-bearing transaction accounts decreased by \$10.8 million or 1.4% and time deposit accounts decreased by \$6.1 million or 1.4%. Deposit trends in the first half of the year can be impacted by the seasonal needs of our agricultural customers.

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

Lines of credit with the Federal Reserve Bank and the Federal Home Loan Bank are other key sources of funds to support earning assets See “Item 3. Quantitative and Qualitative Disclosures About Market Risk and Liquidity Risk.” These sources of funds are also used to manage the Company’s interest rate risk exposure, and as opportunities arise, to borrow and invest the proceeds at a positive spread through the investment portfolio. There were no FHLB Advances at March 31, 2014, December 31, 2013, and March 31, 2013. There were no amounts outstanding on the Company’s line of credit with the FRB as of March 31, 2014.

As of March 31, 2014 the Company has additional borrowing capacity of \$366.2 million with the Federal Home Loan Bank and \$356.7 million with the Federal Reserve Bank. Any borrowings under these lines would be collateralized with loans that have been accepted for pledging at the FHLB and FRB.

#### Securities Sold Under Agreement to Repurchase

Securities Sold Under Agreement to Repurchase are used as secured borrowing alternatives to FHLB Advances or FRB Borrowings.

In 2008, the Bank entered into medium term repurchase agreements with Citigroup totaling \$60 million. In 2012, the repurchase agreements with Citigroup were terminated resulting in an early termination fee totaling \$1.7 million. The Bank had determined that it was appropriate to replace these relatively “high-cost” borrowings with short-term FHLB advances at substantially lower rates.

At March 31, 2014, December 31, 2013 and March 31, 2013, the Company had no securities sold under agreement to repurchase.

#### Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities. See Note 13 located in “Item 8. Financial Statements and Supplementary Data.” Although this amount is reflected as subordinated debt on the Company’s balance sheet, under current regulatory guidelines, our trust preferred securities will continue to qualify as regulatory capital (See “Basel III Regulatory Capital Rules” for a discussion of the potential impact of proposed regulatory guidelines on this qualification). These securities accrue interest at a variable rate based upon 3-month LIBOR plus 2.85%. Interest rates reset quarterly and were 3.08% as of March 31, 2014, 3.9% at December 31, 2013 and 3.13% at March 31, 2013. The average rate paid for these securities for the first quarter of 2014 was 3.10% compared to 3.19% for the first quarter of 2013. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company’s common stock.

#### Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders’ Equity totaled \$218.0 million at March 31, 2014, \$209.9 million at December 31, 2013, and \$209.8 million at March 31, 2013.

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





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Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios set forth in the table below of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all terms as defined in the regulations). Management believes, as of March 31, 2014, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

In its most recent notification from the FDIC the Bank was categorized as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” the Bank must maintain minimum Total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the institution’s categories.

| (in thousands)                         | Actual     |         | Regulatory Capital Requirements |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|------------|---------|---------------------------------|-------|--|--------|
|  | Amount     | Ratio   | Amount                          | Ratio | Amount   | Ratio  |
| The Company:                           |            |         |                                 |       |  |        |
| As of March 31, 2014                   |            |         |                                 |       |  |        |
| Total Capital to Risk Weighted Assets  | \$ 250,461 | 14.46 % | \$ 138,560                      | 8.0 % | N/A  | N/A    |
| Tier 1 Capital to Risk Weighted Assets | \$ 228,653 | 13.20 % | \$ 69,280                       | 4.0 % | N/A  | N/A    |
| Tier 1 Capital to Average Assets       | \$ 228,653 | 10.93 % | \$ 83,667                       | 4.0 % | N/A  | N/A    |
|  |            |         |                                 |       |  |        |
| (in thousands)                         | Actual     |         | Regulatory Capital Requirements |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|  | Amount     | Ratio   | Amount                          | Ratio | Amount   | Ratio  |
| The Bank:                              |            |         |                                 |       |  |        |
| As of March 31, 2014                   |            |         |                                 |       |  |        |
| Total Capital to Risk Weighted Assets  | \$ 250,398 | 14.46 % | \$ 138,533                      | 8.0 % | \$ 173,167   | 10.0 % |
| Tier 1 Capital to Risk Weighted Assets | \$ 228,595 | 13.20 % | \$ 69,267                       | 4.0 % | \$ 103,900   | 6.0 %  |
| Tier 1 Capital to Average Assets       | \$ 228,595 | 10.93 % | \$ 83,633                       | 4.0 % | \$ 104,542   | 5.0 %  |

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

The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company’s financial statements, but rather the subordinated debentures are shown as a liability.

In 1998, the Board approved the Company’s first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on September 11, 2012, the Board of Directors approved

increasing the funds available for the Company's common stock repurchase program to \$20 million over the three-year period ending September 30, 2015. See "Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" of the Company's 2013 Annual Report on Form 10-K for additional information.

During 2013 and first quarter of 2014, the Company did not repurchase any shares under the Stock Repurchase Program. During 2012, the Company repurchased 1,542 shares under the Stock Repurchase Program at an average per share price of \$373. The remaining dollar value of shares that may yet be purchased under the Company's Stock Repurchase Program is approximately \$20 million.

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On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Registrar and Transfer Company as Rights Agent. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2013 Annual Report on Form 10-K for further explanation.

Basel III Regulatory Capital Rules

On July 2, 2013, the FRB approved final rules and the FDIC subsequently adopted interim final rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. These rules would implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

The final rules include new minimum risk-based capital and leverage ratios, which would be phased in over time. The new minimum capital level requirements applicable to the Company and the Bank under the final rules will be: (i) a common equity Tier 1 capital ratio of 4.5% of risk weighted assets (“RWA”); (ii) a Tier 1 capital ratio of 6% of RWA; (iii) a total capital ratio of 8% of RWA; and (iv) a Tier 1 leverage ratio of 4% of total assets. The final rules also establish a “capital conservation buffer” of 2.5% above each of the new regulatory minimum capital ratios, which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0% of RWA; (ii) a Tier 1 capital ratio of 8.5% of RWA, and (iii) a total capital ratio of 10.5% of RWA. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount.

The final rules also implement other revisions to the current capital rules but, in general, those revisions are not as onerous as originally thought when the proposed rules were issued in June 2012. For instance, the Company’s subordinated debentures will continue to qualify for Tier 1 under the rules. The Company believes that it is currently in compliance with all of these new capital requirements (as fully phased-in) and that they will not result in any restrictions on the Company’s business activity.

Critical Accounting Policies and Estimates

This “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” is based upon the Company’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing the Company’s financial statements management makes estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. These judgments govern areas such as the allowance for credit losses, the fair value of financial instruments and accounting for income taxes.

For a full discussion of the Company’s critical accounting policies and estimates see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” in the Company’s 2013 Annual Report on Form 10-K.

Off Balance Sheet Commitments

In the normal course of business the Company enters into financial instruments with off balance sheet risks in order to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit, letters of credit and other types of financial guarantees. The Company had the following off balance sheet commitments as of the dates indicated.

|  | March<br>31, 2014 | December<br>31, 2013 | March<br>31, 2013 |
|--|-------------------|----------------------|-------------------|
| (in thousands)   |                   |                      |                   |
| Commitments to Extend Credit   | \$508,578         | \$445,294            | \$348,165         |
| Letters of Credit  | 7,509             | 7,393                | 6,932             |
| Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our Borrowing Customers and Third Parties | -                 | -                    | 1,833             |



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

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. Most standby letters of credit are issued for 18 months or less. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Additionally, the Company maintains a reserve for off balance sheet commitments which totaled \$142,000 at March 31, 2014, December 31, 2013, and March 31, 2013. We do not anticipate any material losses as a result of these transactions.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### Risk Management

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

### Credit Risk

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

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

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

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

Part 1- includes a detailed analysis of the loan & lease portfolio in two phases. The first phase is conducted in accordance with the "Receivables" topic of the FASB ASC. Individual loans & leases are reviewed to identify them for impairment. A loan or lease is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan or lease. Impairment is measured as either the expected future cash flows discounted at each loan or lease's effective interest rate, the fair value of the loan or lease's collateral if the loan or lease

is collateral dependent, or an observable market price of the loan or lease, if one exists. Upon measuring the impairment, the Company will ensure an appropriate level of allowance is present or established.

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

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

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

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

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

Part 3 - An unallocated allowance often occurs due to the imprecision in estimating and allocating allowance balances associated with macro factors such as: (1) the continuing sluggish economic conditions in the Central Valley; and (2) the long term impact of drought conditions currently being experienced in California.

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

Management believes, that based upon the preceding methodology, and using information currently available, the allowance for credit losses at March 31, 2014 was adequate. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans & leases, or net loan & lease charge-offs that would require

increases in the provision for credit losses and thereby adversely affect the results of operations.

#### Interest Rate Risk

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

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

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

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

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

The simulation model estimates the impact of changing interest rates on interest income from all interest-earning assets and the interest expense paid on all interest-bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 100 basis point downward shift in interest rates. A shift in rates over a 12-month period is assumed. Results that exceed policy limits, if any, are analyzed for risk tolerance and reported to the Board with appropriate recommendations. At March 31, 2014, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was an increase in net interest income of 0.36% if rates increase by 200 basis points and a decrease in net interest income of 0.31% if rates decline 100 basis points. Comparatively, at December 31, 2013, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was an increase in net interest income of 0.83% if rates increase by 200 basis points and a decrease in net interest income of 0.31% if rates decline 100 basis points.

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

### Liquidity Risk

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

The Company's principal operating sources of liquidity include (see "Item 8. Financial Statements and Supplementary Data – Consolidated Statements of Cash Flows" of the Company's 2013 Annual Report on Form 10-K) cash and cash equivalents, cash provided by operating activities, principal payments on loans & leases, proceeds from the maturity or sale of investments, and growth in deposits. To supplement these operating sources of funds the Company maintains Federal Funds credit lines of \$71.0 million and repurchase lines of \$100.0 million with major banks. As of March 31, 2014 the Company has additional borrowing capacity of \$366.9 million with the Federal Home Loan Bank and \$356.96 million with the Federal Reserve Bank. Borrowings under these lines are collateralized with loans or securities that have been accepted for pledging at the FHLB and FRB.

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At March 31, 2014, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities available-for-sale of approximately \$289 million, which represents 13.787% of total assets.

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures designed to ensure that information is recorded and reported in all filings of financial reports. Such information is reported to the Company's management, including its Chief Executive Officer and its Chief Financial Officer to allow timely and accurate disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e). In designing these controls and procedures, management recognizes that they can only provide reasonable assurance of achieving the desired control objectives. Management also evaluated the cost-benefit relationship of possible controls and procedures.

As of the end of the period covered by this report, the Company carried out an evaluation of the effectiveness of Company's disclosure controls and procedures under the supervision and with the participation of the Chief Executive Officer, the Chief Financial Officer and other senior management of the Company. The evaluation was based, in part, upon reports and affidavits provided by a number of executives. Based on the foregoing, the Company's Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

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

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

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

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

ITEM 1A. Risk Factors

See "Item 1A. Risk Factors" in the Company's 2013 Annual Report to Shareholders on Form 10-K. In management's opinion, there have been no material changes in risk factors since the filing of the 2013 Form 10-K.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

There were no shares repurchased by Farmers & Merchants Bancorp during the first quarter of 2014. The remaining dollar value of shares that may yet be purchased under the Company's Stock Repurchase Plan is approximately \$20.0 million.

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The common stock of Farmers & Merchants Bancorp is not widely held nor listed on any exchange. However, trades may be reported on the OTC Bulletin Board under the symbol "FMCB." Additionally, management is aware that there are private transactions in the Company's common stock.

ITEM 3. Defaults Upon Senior Securities

Not applicable

ITEM 4. Mine Safety Disclosures

Not applicable

ITEM 5. Other Information

None

ITEM 6. Exhibits

See "Index to Exhibits"

SIGNATURES

Pursuant to the requirement of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FARMERS & MERCHANTS BANCORP

Date: May 9, 2014 /s/ Kent A. Steinwert  
Kent A. Steinwert  
Chairman, President  
& Chief Executive Officer  
(Principal Executive Officer)

Date: May 9, 2014 /s/ Stephen W. Haley  
Stephen W. Haley  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial & Accounting Officer)

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Index to Exhibits

| <u>Exhibit</u><br><u>No.</u> | <u>Description</u>  |
|------------------------------|---|
| <u>31(a)</u>                 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| <u>31(b)</u>                 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| <u>32</u>                    | Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS                      | XBRL Instance Document  |
| 101.SCH                      | XBRL Schema Document  |
| 101.CAL                      | XBRL Calculation Linkbase Document  |
| 101.LAB                      | XBRL Label Linkbase Document  |
| 101.PRE                      | XBRL Presentation Linkbase Document   |
| 101.DEF                      | XBRL Definition Linkbase Document   |