

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
July 31, 2013  
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# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period June 30, 2013

or

.. **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-14492

# FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

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**OHIO**  
(State or other jurisdiction of  
incorporation or organization)

**34-1469491**  
(IRS Employer  
Identification No.)

**307 North Defiance Street, Archbold, Ohio**  
(Address of principal executive offices)

**43502**  
(Zip Code)

**(419) 446-2501**

Registrant's telephone number, including area code

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or Section 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 (§ 232.405 of this chapter) 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 the definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Indicate the number of shares of each of the issuer's classes of common stock, as of the latest practicable date:

Common Stock, No Par Value  
Class

4,679,938  
Outstanding as of July 31, 2013

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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(1) Pursuant to Rule 406T of Regulation S-T, the interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.



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ITEM 1 FINANCIAL STATEMENTS  
FARMERS & MERCHANTS BANCORP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands of dollars)

**Farmers & Merchants Bancorp, Inc. and Subsidiary**

Condensed Consolidated Balance Sheets

(in thousands of dollars)

	June 30, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 15,054	\$ 25,620
Interest bearing deposits with banks	6,463	11,941
Federal Funds Sold	946	6,531
<b>Total cash and cash equivalents</b>	<b>22,463</b>	<b>44,092</b>
Securities - available for sale (Note 2)	354,474	355,905
Other Securities, at cost	4,216	4,365
Loans, net (Note 4)	495,777	496,178
Bank premises and equipment	18,287	17,599
Goodwill	4,074	4,074
Mortgage Servicing Rights	2,047	2,063
Other Real Estate Owned	1,754	2,310
Accrued interest and other assets	19,241	20,074
<b>Total Assets</b>	<b>\$ 922,333</b>	<b>\$ 946,660</b>
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest-bearing	\$ 95,442	\$ 103,966
Interest-bearing		
NOW accounts	201,843	196,971
Savings	195,888	192,808
Time	254,439	269,507
<b>Total deposits</b>	<b>747,612</b>	<b>763,252</b>
Federal funds purchased and securities sold under agreement to repurchase	54,728	51,312
FHLB Advances	7,100	11,600
Dividend payable	930	931
Accrued expenses and other liabilities	4,673	9,326
<b>Total liabilities</b>	<b>\$ 815,043</b>	<b>\$ 836,421</b>
<b>Stockholders Equity</b>		
Common stock - No par value - authorized 6,500,000 shares; issued & outstanding 5,200,000 shares	12,677	12,677
Treasury Stock - 515,902 shares 2013, 515,942 shares 2012	(10,677)	(10,588)

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Unearned Stock Awards - 30,210 shares 2013, 30,670 shares 2012	(572)	(584)
Retained earnings	105,434	102,641
Accumulated other comprehensive income	428	6,093
<b>Total stockholders' equity</b>	<b>107,290</b>	<b>110,239</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 922,333</b>	<b>\$ 946,660</b>

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2012 Balance Sheet has been derived from the audited financial statements of that date.

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FARMERS &amp; MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED STATEMENT OF INCOME &amp; COMPREHENSIVE INCOME

(Unaudited)

(in thousands of dollars, except per share data)

**Farmers & Merchants Bancorp, Inc. and Subsidiary**

## Condensed Consolidated Statement of Income &amp; Comprehensive Income

(in thousands of dollars, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
<b>Interest Income</b>				
Loans, including fees	\$ 6,089	\$ 6,804	\$ 12,167	\$ 13,601
Debt securities:				
U.S. Treasury securities	64	92	125	173
Securities of U.S. Government Agencies	1,016	1,055	2,008	2,080
Municipalities	541	518	1,049	1,028
Dividends	45	46	94	95
Federal funds sold	4	4	11	11
Other	6	6	13	13
Total interest income	7,765	8,525	15,467	17,001
<b>Interest Expense</b>				
Deposits	1,079	1,470	2,206	2,909
Federal funds purchased and securities sold under agreements to repurchase	62	60	122	121
Borrowed funds	43	123	89	247
Total interest expense	1,184	1,653	2,417	3,277
<b>Net Interest Income</b> - Before provision for loan losses	6,581	6,872	13,050	13,724
<b>Provision for Loan Losses</b> (Note 4)	112	78	279	206
<b>Net Interest Income After Provision For Loan Losses</b>	6,469	6,794	12,771	13,518
<b>Noninterest Income</b>				
Customer service fees	1,256	1,245	2,617	2,569
Other service charges and fees	967	860	1,829	1,618
Net gain (loss) on sale of other assets owned	(110)	(210)	(126)	(277)
Net gain on sale of loans	322	622	802	783
Net gain on sale of securities	377		598	169
Total noninterest income	2,812	2,517	5,720	4,862
<b>Noninterest Expenses</b>				
Salaries and Wages	2,260	2,193	4,697	4,479
Pension and other employee benefits	610	744	1,454	1,572
Occupancy expense (net)	288	386	618	791
Furniture and equipment	358	349	707	701
Data processing	300	286	610	551
Franchise taxes	255	236	510	473
FDIC Assessment	141	89	260	219
Mortgage servicing rights amortization	120	178	257	372
Other general and administrative	1,438	1,292	2,783	2,450

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Total Noninterest Expense	5,770	5,753	11,896	11,608
<b>Income Before Federal Income Taxes</b>	<b>3,511</b>	<b>3,558</b>	<b>6,595</b>	<b>6,772</b>
<b>Federal Income Taxes</b>	<b>1,009</b>	<b>1,020</b>	<b>1,941</b>	<b>1,950</b>
<b>Net Income</b>	<b>\$ 2,502</b>	<b>\$ 2,538</b>	<b>\$ 4,654</b>	<b>\$ 4,822</b>
<b>Other Comprehensive Income (Net of Tax):</b>				
Unrealized gains (loss) on securities	\$ (4,916)	\$ 1,159	\$ (5,666)	\$ 6,764
<b>Comprehensive Income</b>	<b>\$ (2,414)</b>	<b>\$ 3,697</b>	<b>\$ (1,012)</b>	<b>\$ 11,586</b>
<b>Net Income Per Share</b>	<b>\$ 0.53</b>	<b>\$ 0.54</b>	<b>\$ 0.99</b>	<b>\$ 1.02</b>
<b>Weighted Average Shares Outstanding</b>	<b>4,679,971</b>	<b>4,695,151</b>	<b>4,681,805</b>	<b>4,704,674</b>
<b>Dividends Declared</b>	<b>\$ 0.20</b>	<b>\$ 0.19</b>	<b>\$ 0.40</b>	<b>\$ 0.38</b>

See Notes to Condensed Consolidated Unaudited Financial Statements



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FARMERS &amp; MERCHANTS BANCORP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands of dollars)

**Farmers & Merchants Bancorp, Inc. and Subsidiary****Condensed Consolidated Statements of Cash Flows****Six Months Ended**

	Six Months Ended	
	June 30, 2013	June 30, 2012
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 4,654	\$ 4,822
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	609	577
Accretion and amortization of securities	1,220	1,587
Amortization of servicing rights	257	372
Amortization of core deposit intangible	156	156
Stock Based Compensation	93	86
Provision for loan loss	279	206
Gain on sale of loans held for sale	(802)	(783)
Originations of loans held for sale	(43,331)	(69,946)
Proceeds from sale of loans held for sale	46,881	71,746
Loss on sale of other assets	126	277
Gain on sales of investment securities	(598)	(169)
Change in operating assets and other liabilities, net	(194)	4,728
Net cash provided by operating activities	9,350	13,659
<b>Cash Flows from Investing Activities</b>		
Activity in securities:		
Maturities, prepayments and calls	17,305	16,428
Securities	58,413	24,584
Purchases	(83,310)	(71,740)
Proceeds from sales of assets	3	2
Additions to premises and equipment	(1,300)	(477)
Loan originations and principal collections, net	(3,428)	5,786
Net cash used in investing activities	(12,317)	(25,417)
<b>Cash Flows from Financing Activities</b>		
Net increase (decrease) in deposits	(15,640)	10,769
Net change in short-term debt	3,416	2,034
Repayments of long-term debt	(4,500)	(34)
Purchase of Treasury Stock	(77)	(683)
Cash dividends paid on common stock	(1,861)	(1,780)
Net cash provided by (used in) financing activities	(18,662)	10,306
Decrease in Cash and Cash Equivalents	(21,629)	(1,452)
Cash and Cash Equivalents - Beginning of Year	44,092	43,143
Cash and Cash Equivalents - End of Period	\$ 22,463	\$ 41,691

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RECONCILIATION OF CASH AND CASH EQUIVALENTS:

Cash and cash due from banks	\$ 15,054	\$ 15,579
Interest bearing deposits with banks	6,463	14,049
Federal funds sold	946	12,063

Cash at end of period	\$ 22,463	\$ 41,691
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**Supplemental Information**

Cash paid during the year for:

Interest	\$ 2,528	\$ 3,295
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Income taxes	\$ 1,770	\$ 2,266
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Noncash investing activities:

Transfer of loans to other real estate owned	\$ 175	\$ 182
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See Notes to Condensed Consolidated Unaudited Financial Statements

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### NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

#### NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2013 are not necessarily indicative of the results that are expected for the year ended December 31, 2013. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2012.

#### NOTE 2 FAIR VALUE OF INSTRUMENTS FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair values of financial instruments are management's estimate of the values at which the instruments could be exchanged in a transaction between willing parties. These estimates are subjective and may vary significantly from amounts that would be realized in actual transactions. In addition, other significant assets are not considered financial assets including deferred tax assets, premises, equipment and intangibles. Further, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered in any of the estimates.

The following assumptions and methods were used in estimating the fair value for financial instruments.

##### Cash and Cash Equivalents

The carrying amounts reported in the balance sheet for cash, cash equivalents and federal funds sold approximate their fair values. Also included in this line item are the carrying amounts of interest-bearing deposits maturing within ninety days which approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

##### Securities

Fair values for securities, excluding Federal Home Loan Bank stock, are based on quoted market price, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

##### Other Securities

The carrying value of Federal Home Loan Bank stock, listed as other securities, approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

##### Loans

For those variable-rate loans that re-price frequently, and with no significant change in credit risk, fair values are based on carrying values. The fair values of the fixed rate and all other loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality.

##### Deposits - Interest Bearing, Non-interest Bearing and Time

The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed term money market accounts and certificates of deposit approximate their fair value at the reporting date. Fair value for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Short-Term Borrowings

The carrying value of short-term borrowings approximates fair values.

## FHLB Advances

Fair values of FHLB advances are estimated using discounted cash flow analysis based on the Company's current incremental borrowing rates for similar types or borrowing arrangements.

## Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

## Dividends Payable

The carrying amounts of dividends payable approximate their fair values and are generally paid within forty days of declaration.

## Off Balance Sheet Financial Instruments

Fair values for off-balance sheet, credit related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counter-parties' credit standing.

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of June 30, 2013 and December 31, 2012 are reflected below.

	Carrying Amount	Fair Value	(In Thousands) June 2013		
			Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 22,463	\$ 22,463	\$ 22,463	\$	\$
Securities - available for sale	354,474	354,474	25,479	316,571	12,424
Other Securities	4,216	4,216			4,216
Loans, net	495,777	504,731			504,731
Interest receivable	3,776	3,776			3,776
<b>Total Assets</b>	<b>\$ 880,706</b>	<b>\$ 889,660</b>	<b>\$ 47,942</b>	<b>\$ 316,571</b>	<b>\$ 525,147</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 397,731	\$ 399,483	\$	\$	\$ 399,483
Non-interest bearing Deposits	95,442	96,348		96,348	
Time Deposits	254,439	255,153			255,153
<b>Total Deposits</b>	<b>\$ 747,612</b>	<b>\$ 750,984</b>	<b>\$</b>	<b>\$ 96,348</b>	<b>\$ 654,636</b>
Short-term debt	54,728	54,728			54,728
Federal Home Loan Bank advances	7,100	8,489			8,489
Interest payable	270	270			270
Dividends payable	930	930		930	

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Total Liabilities	\$ 810,640	\$ 815,401	\$	\$ 97,278	\$ 718,123
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FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands) December 2012				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 44,092	\$ 44,092	\$ 44,092	\$	\$
Securities - available for sale	355,905	355,905	10,568	328,929	16,408
Other Securities	4,365	4,365			4,365
Loans, net	496,178	502,125			502,125
Interest receivable	3,603	3,603			3,603
<b>Total Assets</b>	<b>\$ 904,143</b>	<b>\$ 910,090</b>	<b>\$ 54,660</b>	<b>\$ 328,929</b>	<b>\$ 526,501</b>
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 389,779	\$ 390,066	\$	\$	\$ 390,066
Non-interest bearing Deposits	103,966	104,529		104,529	
Time Deposits	269,507	272,591			272,591
<b>Total Deposits</b>	<b>\$ 763,252</b>	<b>\$ 767,186</b>	<b>\$</b>	<b>\$ 104,529</b>	<b>\$ 662,657</b>
Short-term debt	51,312	51,312			51,312
Federal Home Loan Bank advances	11,600	11,012			11,012
Interest payable	288	288			288
Dividends payable	931	931		931	
<b>Total Liabilities</b>	<b>\$ 827,383</b>	<b>\$ 830,729</b>	<b>\$</b>	<b>\$ 105,460</b>	<b>\$ 725,269</b>
<b>Fair Value Measurements</b>					

In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities in active markets that the Company has the ability to access.

Available-for-sale securities- When quoted prices are available in an active market, securities are valued using the quoted price and are classified as Level 1. The quoted prices are not adjusted.

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Available-for-sale securities classified as Level 2 are valued using the prices obtained from an independent pricing service. The prices are not adjusted. Securities of obligations of state and political subdivisions are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. Substantially all assumptions used by the independent pricing service are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the market place.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability. Local municipals have been purchased that the Bank evaluates based on the credit strength of the underlying project such as the hospital or retirement home. The fair value is determined by valuing similar credit payment streams at similar rates.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Company's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset.





**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Fair Value Measurement (Continued)

The following summarizes financial assets measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, segregated by level or the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured at Fair Value on a Recurring Basis			
(In Thousands)	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
June 30, 2013			
Assets-(Securities Available for Sale)			
U.S. Treasury	\$ 25,479	\$	\$
U.S. Government agency		210,915	
Mortgage-backed securities		45,338	
State and local governments		60,318	12,424
Total Securities Available for Sale	\$ 25,479	\$ 316,571	\$ 12,424
(In Thousands)	Quoted Prices in Active Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
December 31, 2012			
Assets-(Securities Available for Sale)			
U.S. Treasury	\$ 10,568	\$	\$
U.S. Government agency		220,200	
Mortgage-backed securities		53,006	
State and local governments		55,723	16,408
Total Securities Available for Sale	\$ 10,568	\$ 328,929	\$ 16,408

Most of the Company's available for sale securities, including any bonds issued by local municipalities, have CUSIP numbers or have similar characteristics of those in the municipal markets, making them marketable and comparable as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At June 30, 2013 and December 31, 2012, such assets consist primarily of impaired loans. Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)

At June 30, 2013 and December 31, 2012, impaired loans categorized as Level 3 were \$4.5 and \$4.6 million, respectively. The specific allocation for impaired loans was \$771 and \$865 thousand as of June 30, 2013 and December 31, 2012, respectively, which are accounted for in the allowance for loan losses (see Note 4).

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Other real estate is reported at either the lower of the fair value of the real estate minus the estimated costs to sell the asset or the cost of the asset. The determination of fair value of the real estate relies primarily on appraisals from third parties. If the fair value of the real estate, minus the estimated costs to sell the asset, is less than the asset's cost, the deficiency is recognized as a valuation allowance against the asset through a charge to expense. The valuation allowance is therefore increased or decreased, through charges or credits to expense, for changes in the asset's fair value or estimated selling costs.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents impaired loans and other real estate owned as recorded at fair value on June 30, 2013 and December 31, 2012:

(\$ in Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2013				Change in fair value for Six-month period ended June 30, 2013
	Balance at June 30, 2013	Markets for Identical sets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Impaired loans	\$ 4,521	\$	\$	\$ 4,521	\$ (3)
Other real estate owned residential mortgages	\$ 609	\$	\$	\$ 609	\$ (16)
Other real estate owned commercial	\$ 1,145	\$	\$	\$ 1,145	\$ (64)
					\$ (83)

(\$ in Thousands)	Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2012				Change in fair value for twelve-month period ended Dec. 31, 2012
	Balance at December 31, 2012	Markets for Identical sets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Impaired loans	\$ 4,591	\$	\$	\$ 4,591	\$ (76)
Other real estate owned residential mortgages	\$ 783	\$	\$	\$ 783	\$ (62)
Other real estate owned commercial	\$ 1,526	\$	\$	\$ 1,526	\$ (214)
					\$ (352)

The Company also has other assets, which under certain conditions, are subject to measurement at fair value. These assets include loans held for sale, bank owned life insurance, and mortgage servicing rights. The Company estimated the fair values of these assets utilizing Level 3 inputs, including, the discounted present value of expected future cash flows. At June 30, 2013 and December 31, 2012, the Company estimates that there is no impairment of these assets, with the exception of mortgage servicing rights. Mortgage servicing rights recognized impairment in one stratum with a charge of \$16 thousand in 2012 to expense. The impairment however was eliminated, as of June 30, 2013. Therefore, no impairment charge to other expense was required to adjust these assets to their estimated fair values.

## NOTE 3 ASSET PURCHASES

In connection with a December 31, 2007 Knisely acquisition, the Company recognized a core deposit intangible asset of \$1.1 million, which is being amortized on a straight line basis over 7 years, which represents the estimated remaining economic useful life of the deposits.

The Company also recognized core deposit intangible assets of \$1.09 million with the purchase of the Hicksville office on July 9, 2010. These are being amortized over an estimated remaining economic useful life of the deposits of 7 years on a straight line basis.

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The amortization expense for the year ended December 31, 2012 was \$312 thousand. Of the \$312 thousand to be expensed in 2013, \$156 thousand has been expensed as of June 30, 2013.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 3 ASSET PURCHASES (Continued)

	(In Thousands)		
	Knisley	Hicksville	Total
2013	\$ 157	\$ 155	\$ 312
2014	157	155	312
2015		155	155
2016		155	155
2017		79	79
Thereafter			
	\$ 314	\$ 699	\$ 1,013

NOTE 4 LOANS

The Company had \$565.7 thousand in loans held for sale as of June 30, 2013 as compared to \$2.5 million in loans held for sale on December 31, 2012. Due to lack of materiality, these loans are included in the Consumer Real Estate loans below.

Loan balances as of June 30, 2013 and December 31, 2012:

	(In Thousands)	
Loans:	June 30, 2013	December 31, 2012
Commercial real estate	\$ 215,246	\$ 199,999
Agricultural real estate	35,746	40,143
Consumer real estate	77,948	80,287
Commercial and industrial	93,978	101,624
Agricultural	55,331	57,770
Consumer	19,881	20,413
Industrial Development Bonds	3,102	1,299
	501,232	501,535
Less: Net deferred loan fees and costs	(158)	(133)
	501,074	501,402
Less: Allowance for loan losses	(5,297)	(5,224)
Loans - Net	\$ 495,777	\$ 496,178

The following is a maturity schedule by major category of loans as of June 30, 2013:

	Maturities (In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years

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Commercial Real Estate	\$ 36,770	\$ 103,283	\$ 75,193
Agricultural Real Estate	2,609	9,126	24,011
Consumer Real Estate	11,501	13,082	53,365
Commercial/Industrial	61,597	27,005	5,376
Agricultural	32,792	19,349	3,190
Consumer	5,210	12,573	1,940
Industrial Development Bonds	2,220	490	392

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of June 30, 2013. Variable rate loans whose current rates are equal to their floor or ceiling are classified as fixed in this table.

	(In Thousands)	
	Fixed Rate	Variable Rate
Commercial Real Estate	\$ 127,488	\$ 87,758
Agricultural Real Estate	\$ 25,836	\$ 9,910
Consumer Real Estate	\$ 64,041	\$ 13,907
Commercial/Industrial	\$ 73,134	\$ 20,844
Agricultural	\$ 50,697	\$ 4,634
Consumer	\$ 16,415	\$ 3,308
Industrial Development Bonds	\$ 3,102	\$

As of June 30, 2013 and December 31, 2012 one to four family residential mortgage loans amounting to \$26.8 and \$26.8 million, respectively, have been pledged as security for loans the Bank has received from the Federal Home Loan Bank.

The percentage of delinquent loans has trended downward since the beginning of January 2010 from a high of 2.85% of total loans to a low of .64% as of March 31, 2012. As of June 30, 2013, past dues were 1.07%. These percentages do not include nonaccrual loans which are not past due (nonaccruals are not considered past due if current). This level of delinquency is due in part to an adherence to sound underwriting practices over the course of time, an improvement in the financial status of companies to which the Bank extends credit, continued financial stability in the agricultural loan portfolio, and the writing down of uncollectable credits in a timely manner.

Industrial Development Bonds are included in the commercial and industrial category for the remainder of the tables in this Note 4.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment in past due loans by portfolio segment of loans as of June 30, 2013 and December 31, 2012, net of deferred fees:

June 30, 2013	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Residential	\$ 453	\$ 249	\$ 319	\$ 1,021	\$ 76,927	\$ 77,948	\$
Ag Real Estate	104		88	192	35,554	35,746	
Ag					55,331	55,331	
Commercial Real Estate	501		1,035	1,536	213,710	215,246	
Commercial and Industrial	65		2,552	2,617	94,463	97,080	
Consumer	13	7		20	19,703	19,723	
<b>Total</b>	<b>\$ 1,136</b>	<b>\$ 256</b>	<b>\$ 3,994</b>	<b>\$ 5,386</b>	<b>\$ 495,688</b>	<b>\$ 501,074</b>	<b>\$</b>

December 31, 2012	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Residential	\$ 575	\$	\$ 648	\$ 1,223	\$ 79,064	\$ 80,287	\$
Ag Real Estate					40,143	40,143	
Ag	11			11	57,759	57,770	
Commercial Real Estate			877	877	199,122	199,999	
Commercial and Industrial	78		2,567	2,645	100,278	102,923	
Consumer	65	7		72	20,208	20,280	1
<b>Total</b>	<b>\$ 729</b>	<b>\$ 7</b>	<b>\$ 4,092</b>	<b>\$ 4,828</b>	<b>\$ 496,574</b>	<b>\$ 501,402</b>	<b>\$ 1</b>



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table presents the recorded investment in nonaccrual loans by class of loans as of June 30, 2013 and December 31, 2012:

	(In Thousands)	
	June 30 2013	December 31 2012
Consumer Real Estate	\$ 551	\$ 964
Agricultural Real Estate	88	
Agriculture		
Commercial Real Estate	1,035	877
Commercial and Industrial	2,935	2,987
Consumer		
<b>Total</b>	<b>\$ 4,609</b>	<b>\$ 4,828</b>

The Bank uses a nine tier risk rating system to grade its loans. The grade of a loan may change during the life of the loan.

The risk ratings are described as follows.

1. Zero (0) Unclassified. Any loan which has not been assigned a classification.
2. One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of Risk Management Association ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank's loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.
3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50, and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.
4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans that are meeting the terms of repayment.

Loans may be graded 3 when there is no recent information on which to base a current risk evaluation and the following conditions apply:

At inception, the loan was properly underwritten and did not possess an unwarranted level of credit risk:

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- a. At inception, the loan was secured with collateral possessing a loan value adequate to protect the Bank from loss;
  - b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;
  - c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.
5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.

6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential, versus defined, impairments to the primary source of loan repayment and collateral.
7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
  - a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
  - b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.
  - c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
  - d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
  - e. Unusual courses of action are needed to maintain a high probability of repayment.
  - f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.
  - g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.
  - h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.
  - i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.
  - j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:
- a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.
  - b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.
  - c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.
9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by class based on the most recent analysis performed as of June 30, 2013 and December 31, 2012:

(in Thousands)	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>June 30, 2013</b>					
1-2	\$ 3,258	\$ 5,014	\$ 2,573	\$ 605	\$
3	12,953	21,695	53,936	23,894	2,758
4	18,625	28,588	147,286	63,047	344
5	786	34	5,283	2,245	
6	36		6,168	1,517	
7	88			2,670	
8					
<b>Total</b>	<b>\$ 35,746</b>	<b>\$ 55,331</b>	<b>\$ 215,246</b>	<b>\$ 93,978</b>	<b>\$ 3,102</b>

	Agriculture Real Estate	Agriculture	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
<b>December 31, 2012</b>					
1-2	\$ 2,719	\$ 5,022	\$ 4,046	\$ 750	\$ 97
3	15,111	23,525	42,467	21,750	859
4	21,481	29,188	137,537	71,228	343
5	794	35	8,984	3,385	
6	38		6,295	2,202	
7			670	2,309	
8					
<b>Total</b>	<b>\$ 40,143</b>	<b>\$ 57,770</b>	<b>\$ 199,999</b>	<b>\$ 101,624</b>	<b>\$ 1,299</b>

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of June 30, 2013 and December 31, 2012.

	(In Thousands)	
	Consumer Real Estate	Consumer Real Estate
	June 30 2013	December 31 2012
Grade		
Pass	\$ 77,531	\$ 79,766
Special Mention (5)		
Substandard (6)	393	110
Doubtful (7)	24	411
Total	\$ 77,948	\$ 80,287

	(In Thousands)			
	Consumer - Credit		Consumer - Other	
	June 30 2013	December 31 2012	June 30 2013	December 31 2012
Performing	\$ 3,498	\$ 3,470	\$ 16,225	\$ 16,775
Nonperforming		3		32
Total	\$ 3,498	\$ 3,473	\$ 16,225	\$ 16,807

Information about impaired loans as of June 30, 2013, December 31, 2012 and June 30, 2012 are as follows:

	(In Thousands)		
	June 30, 2013	December 31, 2012	June 30, 2012
Impaired loans without a valuation allowance	\$ 1,703	\$ 730	\$ 806
Impaired loans with a valuation allowance	2,818	3,861	3,548
Total impaired loans	\$ 4,521	\$ 4,591	\$ 4,354
Valuation allowance related to impaired loans	\$ 771	\$ 865	\$ 557
Total non-accrual loans	\$ 4,609	\$ 4,828	\$ 4,893
Total loans past-due ninety days or more and still accruing	\$	\$ 1	\$
Three months ended average investment in impaired loans	\$ 4,363	\$ 4,468	\$ 2,772

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Six months ended average investment in impaired loans	\$	4,342	\$	4,508	\$	2,363
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No additional funds are committed to be advanced in connection with impaired loans.

The Bank had approximately \$2.9 million of its impaired loans classified as troubled debt restructured as of June 30, 2013, \$627.3 thousand as of December 31, 2012 and \$207 thousand as of June 30, 2012.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

The following table represents three months and six months ended June 30, 2013.

Three Months June 30, 2013	Number of Contracts Modified in the Last 3 Months	Modification Outstanding Recorded Investment	Modification Outstanding Recorded Investment	Six Months June 30, 2013	Number of Contracts Modified in the Last 3 Months	Modification Outstanding Recorded Investment	Modification Outstanding Recorded Investment
Troubled Debt Restructurings				Troubled Debt Restructurings			
Commercial Real Estate		\$	\$	Commercial Real Estate		\$	\$
Ag Real Estate		\$	\$	Ag Real Estate		\$	\$
Commercial and Industrial	3	\$ 2,251	\$ 2,251	Commercial and Industrial	4	\$ 2,294	\$ 2,332

Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 3 Months	Recorded Investment	Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 3 Months	Recorded Investment
Commercial Real Estate		\$	Commercial Real Estate		\$
Ag Real Estate		\$	Ag Real Estate		\$
Commercial and Industrial		\$	Commercial and Industrial		\$

The following table represents three months and six months ended June 30, 2012.

Three Months June 30, 2012	Number of Contracts Modified in the Last 6 Months	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Six Months June 30, 2012	Number of Contracts Modified in the Last 6 Months	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Troubled Debt Restructurings				Troubled Debt Restructurings			
Commercial Real Estate	1	\$ 1,937	\$ 1,937	Commercial Real Estate	1	\$ 1,937	\$ 1,937
Ag Real Estate		\$	\$	Ag Real Estate		\$	\$
Commercial and Industrial		\$	\$	Commercial and Industrial		\$	\$

Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 6 Months	Recorded Investment	Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts Modified in the Last 6 Months	Recorded Investment
Commercial Real Estate		\$	Commercial Real Estate		\$
Ag Real Estate		\$	Ag Real Estate		\$
Commercial and Industrial		\$	Commercial and Industrial		\$



**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

For the majority of the Bank's impaired loans, the Bank will apply the observable market price methodology. However, the Bank may also utilize a measurement incorporating the present value of expected future cash flows discounted at the loan's effective rate of interest. To determine observable market price, collateral asset values securing an impaired loan are periodically evaluated. Maximum time for re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the collateral value used.

The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off, whether a partial or full loan balance. A charge-off in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency. Commercial and agricultural credits are charged down at 120 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy, unsecured debt is charged off. Additional charge-off may be realized as further unsecured positions are recognized.

The following table presents loans individually evaluated for impairment by class of loans for three months ended June 30, 2013.

Three Months Ended June 30, 2013 (in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer real estate	\$ 359	\$ 431	\$	\$ 202	\$
Agriculture real estate					
Agriculture					
Commercial real estate	1,035	1,459		1,038	
Commercial and industrial	309	309		309	
Consumer		3			
With a specific allowance recorded:					
Consumer real estate	111	111	38	111	
Agriculture real estate	88	88	15	111	
Agriculture					
Commercial real estate				15	
Commercial and industrial	2,619	2,619	718	2,659	
Consumer					
Totals:					
Consumer real estate	\$ 470	\$ 542	\$ 38	\$ 313	\$
Agriculture real estate	\$ 88	\$ 88	\$ 15	\$ 111	\$
Agriculture	\$	\$	\$	\$	\$
Commercial real estate	\$ 1,035	\$ 1,459	\$	\$ 1,053	\$
Commercial and industrial	\$ 2,928	\$ 2,928	\$ 718	\$ 2,968	\$
Consumer	\$	\$ 3	\$	\$	\$



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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)  
NOTE 4 LOANS (Continued)

Three Months Ended June 30, 2012

(in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance recorded:</b>					
Consumer real estate	\$ 340	\$ 355	\$	\$ 213	\$
Agriculture real estate					
Agriculture					
Commercial real estate	207	384		207	
Commercial and industrial	364	364		122	
Consumer		10			
<b>With a specific allowance recorded:</b>					
Consumer real estate	398	425	139	400	