

FARMERS & MERCHANTS BANCORP  
Form 10-Q  
November 07, 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 September 30, 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  x

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 October 31, 2014.

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FARMERS & MERCHANTS BANCORP

FORM 10-Q

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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 & MERCHANTS BANCORP  
Consolidated Balance Sheets

(in thousands except per share data)	Sept. 30, 2014 (Unaudited)	December 31, 2013	Sept. 30, 2013 (Unaudited)
<b>Assets</b>			
<b>Cash and Cash Equivalents:</b>			
Cash and Due from Banks	\$ 34,293	\$ 40,966	\$ 46,234
Interest Bearing Deposits with Banks	4,923	42,711	1,391
Total Cash and Cash Equivalents	39,216	83,677	47,625
<b>Investment Securities:</b>			
Available-for-Sale	336,526	404,639	421,765
Held-to-Maturity	69,441	68,505	70,961
Total Investment Securities	405,967	473,144	492,726
<b>Loans &amp; Leases</b>			
Loans & Leases	1,615,771	1,388,236	1,297,811
Less: Allowance for Credit Losses	34,267	34,274	34,111
Loans & Leases, Net	1,581,504	1,353,962	1,263,700
<b>Premises and Equipment, Net</b>			
Premises and Equipment, Net	24,927	22,887	21,814
Bank Owned Life Insurance	53,514	52,109	51,652
Interest Receivable and Other Assets	92,541	90,294	87,259
Total Assets	\$ 2,197,669	\$ 2,076,073	\$ 1,964,776
<b>Liabilities</b>			
<b>Deposits:</b>			
Demand	\$ 516,093	\$ 495,963	\$ 435,778
Interest Bearing Transaction	326,368	291,795	257,650
Savings and Money Market	614,137	589,511	561,277
Time	419,615	430,422	439,081
Total Deposits	1,876,213	1,807,691	1,693,786
Federal Home Loan Bank Advances	36,000	-	5,900
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	47,910	48,168	43,739
Total Liabilities	1,970,433	1,866,169	1,753,735
<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 September 30, 2014, December 31, 2013 and September 30, 2013, respectively	8	8	8
Additional Paid-In Capital	75,014	75,014	75,014
Retained Earnings	151,268	137,350	136,357

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Accumulated Other Comprehensive Income (Loss)	946	(2,468 )	(338 )
Total Shareholders' Equity	227,236	209,904	211,041
Total Liabilities and Shareholders' Equity	\$2,197,669	\$2,076,073	\$1,964,776

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		Nine Months	
	Ended September 30, 2014	2013	Ended September 30, 2014	2013
Interest Income				
Interest and Fees on Loans & Leases	\$18,166	\$16,679	\$51,178	\$48,030
Interest on Deposits with Banks	5	2	110	49
Interest on Investment Securities:				
Taxable	1,849	2,297	6,073	6,785
Exempt from Federal Tax	594	637	1,758	1,951
Total Interest Income	20,614	19,615	59,119	56,815
Interest Expense				
Deposits	621	632	1,819	1,943
Borrowed Funds	5	7	5	16
Subordinated Debentures	82	82	242	245
Total Interest Expense	708	721	2,066	2,204
Net Interest Income	19,906	18,894	57,053	54,611
Provision for Credit Losses	-	-	-	250
Net Interest Income After Provision for Credit Losses	19,906	18,894	57,053	54,361
Non-Interest Income				
Service Charges on Deposit Accounts	1,022	1,139	2,944	3,312
Net Gain (Loss) on Sale of Investment Securities	4	(1,137)	38	(248)
Increase in Cash Surrender Value of Life Insurance	477	473	1,405	1,399
Debit Card and ATM Fees	797	774	2,322	2,295
Net (Loss) Gain on Deferred Compensation Investments	(37)	875	1,493	2,279
Other	657	1,324	1,823	2,872
Total Non-Interest Income	2,920	3,448	10,025	11,909
Non-Interest Expense				
Salaries and Employee Benefits	9,336	8,244	26,710	25,184
Net (Loss) Gain on Deferred Compensation Investments	(37)	875	1,493	2,279
Occupancy	724	649	1,981	1,899
Equipment	714	705	2,117	2,078
FDIC Insurance	264	246	778	732
Other	1,541	1,466	4,137	5,074
Total Non-Interest Expense	12,542	12,185	37,216	37,246
Income Before Income Taxes	10,284	10,157	29,862	29,024
Provision for Income Taxes	3,852	3,805	11,044	10,856
Net Income	\$6,432	\$6,352	\$18,818	\$18,168
Basic Earnings Per Common Share	\$8.27	\$8.17	\$24.19	\$23.36

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

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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)	Three Months		Nine Months	
	Ended September		Ended September	
	30,	30,	30,	2013
	2014	2013	2014	2013
Net Income	6,432	\$6,352	\$18,818	\$18,168
Other Comprehensive Income (Loss)				
(Decrease) Increase in Net Unrealized (Losses) Gains on Available-for-Sale Securities	(1,752)	1,681	5,929	(12,907)
Reclassification Adjustment for Realized (Gains) Losses on Available-for-Sale Securities Included in Net Income	(4 )	1,137	(38 )	248
Deferred Tax Benefit (Expense)	738	(1,185)	(2,477 )	5,322
Change in Net Unrealized (Losses) Gains on Available-for-Sale Securities, Net of Tax	(1,018)	1,633	3,414	(7,337 )
Total Other Comprehensive (Loss) Income	(1,018)	1,633	3,414	(7,337 )
Comprehensive Income	\$5,414	\$7,985	\$22,232	\$10,831

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 Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Total Shareholders' Equity
Balance, January 1, 2013	777,882	\$ 8	\$ 75,014	\$ 123,012	\$ 6,999	\$ 205,033
Net Income		-	-	18,168	-	18,168
Cash Dividends Declared on Common Stock (\$6.20 per share)		-	-	(4,823 )	-	(4,823 )
Change in Net Unrealized Loss on Securities Available for Sale, Net of Tax		-	-	-	(7,337 )	(7,337 )
Balance, September 30, 2013	777,882	\$ 8	\$ 75,014	\$ 136,357	\$ (338 )	\$ 211,041
Balance, January 1, 2014	777,882	\$ 8	\$ 75,014	\$ 137,350	\$ (2,468 )	\$ 209,904
Net Income		-	-	18,818	-	18,818
Cash Dividends Declared on Common Stock (\$6.30 per share)		-	-	(4,900 )	-	(4,900 )
Change in Net Unrealized Loss on Securities Available for Sale, Net of Tax		-	-	-	3,414	3,414
Balance, September 30, 2014	777,882	\$ 8	\$ 75,014	\$ 151,268	\$ 946	\$ 227,236

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)

(in thousands)

	Nine Months Ended September 30,	
	2014	2013
Operating Activities:		
Net Income	\$ 18,818	\$ 18,168
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Credit Losses	-	250
Depreciation and Amortization	991	1,152
Net Amortization of Investment Security Premiums & Discounts	1,249	2,543
Net (Gain) Loss on Sale of Investment Securities	(38 )	248
Net Gain on Sale of Property & Equipment	(15 )	(705 )
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets	(5,984 )	(10,253 )
Net (Decrease) Increase in Interest Payable and Other Liabilities	(258 )	6,422
Net Cash Provided by Operating Activities	14,763	17,825
Investing Activities:		
Purchase of Investment Securities Available-for-Sale	(65,637 )	(221,100)
Proceeds from Sold, Matured or Called Securities Available-for-Sale	138,298	195,339
Purchase of Investment Securities Held-to-Maturity	(15,660 )	(355 )
Proceeds from Matured or Called Securities Held-to-Maturity	14,711	4,278
Net Loans & Leases Paid, Originated or Acquired	(227,739)	(51,649 )
Principal Collected on Loans & Leases Previously Charged Off	197	384
Additions to Premises and Equipment	(3,045 )	(187 )
Proceeds from Sale of Property & Equipment	29	827
Net Cash Used by Investing Activities	(158,846)	(72,463 )
Financing Activities:		
Net Increase (Decrease) in Deposits	68,522	(28,240 )
Net Changes in Other Borrowings	36,000	5,900
Cash Dividends	(4,900 )	(4,823 )
Net Cash Provided (Used) by Financing Activities	99,622	(27,163 )
Decrease in Cash and Cash Equivalents	(44,461 )	(81,801 )
Cash and Cash Equivalents at Beginning of Period	83,677	129,426
Cash and Cash Equivalents at End of Period	\$ 39,216	\$ 47,625
Supplementary Data		
Loans Transferred to Foreclosed Assets (ORE)	\$-	\$ 3,458
Cash Payments Made for Income Taxes	\$ 10,900	\$ 13,886
Interest Paid	\$ 2,103	\$ 2,346

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 and nine-month periods ended September 30, 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. 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 lease 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 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. Impaired loans & 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 borrower's (the term "borrower" is used herein to describe a customer who has entered into either a loan or lease transaction) financial difficulties grants a concession to the borrower 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 borrowers unless: (1) the existing loan or lease is brought current as to principal and interest payments; and (2) 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 that 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 assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only

when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, 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:

Commercial Real Estate – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. 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.

Real Estate Construction – Real estate construction loans, including land loans, are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. 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 – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. 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 – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related

real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Leases – Equipment leases are generally considered to possess a moderate inherent risk of loss. As Lessor, the company is subject to both the credit risk of the borrower 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.

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Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the weakness in residential real estate values over the past five years. 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. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

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

At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's and Bank's regulators, including the Federal Reserve Bank (“FRB”), the California Department of Business Oversight (“DBO”) and the Federal Deposit Insurance Corporation (“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 Unaudited 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 September 30, 2014, December 31, 2013 or September 30, 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 Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
September 30, 2014				
Government Agency & Government-Sponsored Entities	\$ 13,220	\$ 141	\$-	\$ 13,361
Mortgage Backed Securities <sup>(1)</sup>	321,187	3,936	2,443	322,680
Other	485	-	-	485
Total	\$ 334,892	\$ 4,077	\$ 2,443	\$ 336,526

	Amortized Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
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 Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
September 30, 2013				
Government Agency & Government-Sponsored Entities	\$ 28,404	\$ 239	\$-	\$ 28,643
Mortgage Backed Securities <sup>(1)</sup>	342,963	4,928	5,814	342,077
Corporate Securities	49,696	250	185	49,761
Other	1,284	-	-	1,284
Total	\$ 422,347	\$ 5,417	\$ 5,999	\$ 421,765

<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		
September 30, 2014				
Obligations of States and Political Subdivisions	\$67,206	\$725	\$ 17	\$67,914
Other	2,235	-	-	2,235
Total	\$69,441	\$725	\$ 17	\$70,149

	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		
September 30, 2013				
Obligations of States and Political Subdivisions	\$67,717	\$965	\$ 741	\$67,941
Mortgage Backed Securities <sup>(1)</sup>	121	1	-	122
Other	3,123	-	-	3,123
Total	\$70,961	\$966	\$ 741	\$71,186

<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.

In June 2014, the Company sold \$375,000 of municipal bonds from a single issuer. The Company took this action under the provisions of ASC 320-10-25-6(a), which allow for the sale of HTM securities where there is "evidence of a significant deterioration in the issuer's creditworthiness." The resulting income statement impact was not material.

The amortized cost and estimated fair values of investment securities at September 30, 2014 by contractual maturity are shown in the following tables (in thousands):

	Available-for-Sale		Held-to-Maturity	
	Amortized	Fair/Book	Book	Fair
	Cost	Value	Value	Value
September 30, 2014				
Within one year	\$10,473	\$10,496	\$4,115	\$4,117
After one year through five years	3,232	3,350	17,518	17,814
After five years through ten years	-	-	13,440	13,589
After ten years	-	-	34,368	34,629
	13,705	13,846	69,441	70,149
Investment securities not due at a single maturity date:				
Mortgage-backed securities	321,187	322,680	-	-



Total	\$334,892	\$336,526	\$69,441	\$70,149
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Expected maturities of mortgage backed securities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

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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

September 30, 2014

Securities Available-for-Sale

Mortgage Backed Securities	\$62,825	\$ 240	\$64,968	\$ 2,203	127,793	\$ 2,443
Total	\$62,825	\$ 240	\$64,968	\$ 2,203	\$127,793	\$ 2,443

Securities Held-to-Maturity

Obligations of States and Political

Subdivisions	\$1,943	\$ 11	\$2,556	\$ 6	\$4,499	\$ 17
Total	\$1,943	\$ 11	\$2,556	\$ 6	\$4,499	\$ 17

December 31, 2013

Securities Available-for-Sale

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

September 30, 2013

Securities Available-for-Sale

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Mortgage Backed Securities	\$129,198	\$ 5,814	\$-	\$ -	\$129,198	\$ 5,814
Corporate Securities	19,881	185	-	-	19,881	185
Total	\$149,079	\$ 5,999	\$-	\$ -	\$149,079	\$ 5,999

Securities Held-to-Maturity

Obligations of States and Political

Subdivisions	\$9,411	\$ 741	\$-	\$ -	\$9,411	\$ 741
Total	\$9,411	\$ 741	\$-	\$ -	\$9,411	\$ 741

As of September 30, 2014, the Company held 280 investment securities of which 15 were in a loss position for less than twelve months. 12 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 September 30, 2014, December 31, 2013 and September 30, 2013.

Mortgage Backed Securities - The unrealized losses on the Company's investment in mortgage backed securities were \$2.4 million, \$7.6 million, and \$5.8 million at September 30, 2014, December 31, 2013, and September 30, 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 September 30, 2014, December 31, 2013 and September 30, 2013, respectively.

Obligations of States and Political Subdivisions - 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 have increased the overall risk associated with bank-qualified municipal bonds. As of September 30, 2014, over ninety-six 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 four 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. In June 2014, the Company sold \$375,000 of municipal bonds from a single issuer. The Company took this action under the provisions of ASC 320-10-25-6(a), which allow for the sale of HTM securities where there is “evidence of a significant deterioration in the issuer’s creditworthiness.” The resulting income statement impact was not material.

The unrealized losses on the Company’s investment in obligation of states and political subdivision were \$17,000, \$627,000, and \$741,000 at September 30, 2014, December 31, 2013 and September 30, 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 September 30, 2014, December 31, 2013 and September 30, 2013, respectively.

Corporate Securities – The Company did not hold any corporate securities at September 30, 2014. The unrealized losses on the Company’s investment in corporate securities at December 31, 2013, and September 30, 2013, were \$147,000, and \$185,000, respectively. 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 did not consider these investments to be other-than-temporarily impaired at December 31, 2013 and September 30, 2013, respectively.

Proceeds from sales and calls of securities were as follows:

	Three Months		Nine Months	
	Ended September		Ended September	
	30,		30,	
(in thousands)	2014	2013	2014	2013

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Proceeds	\$85,433	\$28,297	\$95,349	\$77,912
Gains	811	285	845	1,189
Losses	807	1,422	807	1,437

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## Pledged Securities

As of September 30, 2014, securities carried at \$360.0 million were pledged to secure public deposits, Federal Home Loan Bank (“FHLB”) borrowings, and other government agency deposits as required by law. This amount was \$334.8 million at December 31, 2013, and \$310.5 million at September 30, 2013.

## 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):

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
September 30, 2014											
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	\$30,577
Charge-Offs	-	-	-	(58 )	(70 )	-	-	(76 )	-	-	(204 )
Recoveries	12	-	-	-	54	3	83	45	-	-	297
Provision	2,608	370	1,026	92	(76 )	(6,426 )	2,135	76	1,206	(1,011)	1,395
Ending Balance- September 30, 2014	\$7,798	\$3,946	\$1,680	\$1,142	\$2,675	\$5,782	\$7,915	\$221	\$1,845	\$1,263	\$30,847
Third Quarter Allowance for Credit Losses:											
Beginning Balance- July 1, 2014	\$6,991	\$3,677	\$1,290	\$1,094	\$2,737	\$8,291	\$7,377	\$193	\$1,108	\$1,532	\$30,823
Charge-Offs	-	-	-	(25 )	(5 )	-	-	(31 )	-	-	(61 )
Recoveries	12	-	-	-	3	1	6	16	-	-	38
Provision	795	269	390	73	(60 )	(2,510 )	532	43	737	(269 )	1,395
Ending Balance- September 30, 2014	\$7,798	\$3,946	\$1,680	\$1,142	\$2,675	\$5,782	\$7,915	\$221	\$1,845	\$1,263	\$30,847
Ending Balance Individually Evaluated for Impairment	190	-	239	370	328	120	912	42	-	-	2,001
	7,608	3,946	1,441	772	2,347	5,662	7,003	179	1,845	1,263	30,847

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Ending Balance Collectively Evaluated for Impairment Loans & Leases:													
Ending Balance	\$473,505	\$364,161	\$104,463	\$168,310	\$33,283	\$237,521	\$192,804	\$4,816	\$36,908	\$-			\$1
Ending Balance Individually Evaluated for Impairment	20,175	-	4,419	1,847	1,658	518	4,877	42	-	-			3
Ending Balance Collectively Evaluated for Impairment	453,330	364,161	100,044	166,463	31,625	237,003	187,927	4,774	36,908	-			1

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	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Other
December 31, 2013											
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2013	\$6,464	\$2,877	\$986	\$1,219	\$3,235	\$10,437	\$7,963	\$182	\$-	\$854	\$34
Charge-Offs	(6 )	(575 )	-	(16 )	(91 )	(23 )	(60 )	(120 )	-	-	(8
Recoveries	-	-	-	-	115	42	312	54	-	-	52
Provision	(1,280 )	1,274	(332 )	(95 )	(492 )	1,749	(2,518 )	60	639	1,420	42
Ending Balance- December 31, 2013	\$5,178	\$3,576	\$654	\$1,108	\$2,767	\$12,205	\$5,697	\$176	\$639	\$2,274	\$34
Ending Balance Individually Evaluated for Impairment	-	-	-	414	209	122	820	51	-	-	1,0
Ending Balance Collectively Evaluated for Impairment	5,178	3,576	654	694	2,558	12,083	4,877	125	639	2,274	32
Loans & Leases:											
Ending Balance	\$407,514	\$328,264	\$41,092	\$151,292	\$35,477	\$256,414	\$150,398	\$5,052	\$12,733	\$-	\$1,3
Ending Balance Individually Evaluated for Impairment	22,176	-	4,500	2,072	1,045	522	5,250	51	-	-	35
Ending Balance Collectively Evaluated for Impairment	385,338	328,264	36,592	149,220	34,432	255,892	145,148	5,001	12,733	-	1,3
September 30, 2013											



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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	
Charge-Offs	(6 )	(575 )	-	(16 )	(23 )	(23 )	(4 )	(93 )	-	-	(7	
Recoveries	-	-	-	-	30	36	281	37	-	-	38	
Provision	(382 )	911	(48 )	(130 )	(492 )	(1,190 )	1,551	42	-	(12 )	25	
Ending												
Balance-												
September												
30, 2013	\$6,076	\$3,213	\$938	\$1,073	\$2,750	\$9,260	\$9,791	\$168	\$-	\$842	\$34	
Third Quarter												
Allowance												
for Credit												
Losses:												
Beginning												
Balance- July												
1, 2013	\$5,732	\$3,481	\$977	\$1,037	\$2,984	\$10,557	\$9,075	\$168	\$-	\$224	\$34	
Charge-Offs	(6 )	(175 )	-	-	(1 )	-	-	(29 )	-	-	(2	
Recoveries	-	-	-	-	10	16	45	16	-	-	87	
Provision	350	(93 )	(39 )	36	(243 )	(1,313 )	671	13	-	618	-	
Ending												
Balance-												
September												
30, 2013	\$6,076	\$3,213	\$938	\$1,073	\$2,750	\$9,260	\$9,791	\$168	\$-	\$842	\$34	
Ending												
Balance												
Individually												
Evaluated for												
Impairment	788	-	229	75	147	126	1,858	53	-	-	3,	
Ending												
Balance												
Collectively												
Evaluated for												
Impairment	5,288	3,213	709	998	2,603	9,134	7,933	115	-	842	30	
Loans &												
Leases:												
Ending												
Balance	\$401,626	\$311,401	\$27,099	\$143,577	\$37,160	\$221,569	\$145,793	\$5,063	\$4,523	\$-	\$1,	
Ending												
Balance												
Individually												
Evaluated for												
Impairment	22,467	849	4,527	1,962	1,125	738	2,192	53	-	-	33	
Ending	379,159	310,552	22,572	141,615	36,035	220,831	143,601	5,010	4,523	-	1,	
Balance												
Collectively												

Evaluated for  
Impairment

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The ending balance of loans individually evaluated for impairment includes restructured loans in the amount of \$26.6 million at September 30, 2014, \$28.4 million at December 31, 2013 and \$28.7 million at September 30, 2013, which are no longer disclosed or classified as TDR's.

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

September 30, 2014	Pass	Special Mention	Substandard	Total Loans & Leases
Loans & Leases:				
Commercial Real Estate	\$464,714	\$8,683	\$ 108	\$473,505
Agricultural Real Estate	364,161	-	-	364,161
Real Estate Construction	102,831	1,632	-	104,463
Residential 1st Mortgages	166,884	752	674	168,310
Home Equity Lines & Loans	32,309	88	886	33,283
Agricultural	236,760	695	66	237,521
Commercial	168,215	22,929	1,660	192,804
Consumer & Other	4,520	-	296	4,816
Leases	36,908	-	-	36,908
Total	\$1,577,302	\$34,779	\$ 3,690	\$1,615,771

December 31, 2013	Pass	Special Mention	Substandard	Total Loans & 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

September 30, 2013	Pass	Special Mention	Substandard	Total Loans
Loans & Leases:				
Commercial Real Estate	\$389,137	\$7,765	\$ 4,724	\$401,626
Agricultural Real Estate	307,736	2,497	1,168	311,401
Real Estate Construction	25,467	1,632	-	27,099
Residential 1st Mortgages	142,036	780	761	143,577
Home Equity Lines & Loans	36,090	-	1,070	37,160
Agricultural	220,504	464	601	221,569
Commercial	135,303	8,958	1,532	145,793
Consumer & Other	4,761	-	302	5,063
Leases	4,523	-	-	4,523
Total	\$1,265,557	\$22,096	\$ 10,158	\$1,297,811



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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 September 30, 2014, December 31, 2013, and September 30, 2013 rated doubtful or loss.

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

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
September 30, 2014							
Loans & Leases:							
Commercial Real Estate	\$-	\$-	\$ -	\$ -	\$-	\$473,505	\$473,505
Agricultural Real Estate	-	-	-	-	-	364,161	364,161
Real Estate Construction	-	-	-	-	-	104,463	104,463
Residential 1st Mortgages	-	-	-	283	283	168,027	168,310
Home Equity Lines & Loans	92	-	-	575	667	32,616	33,283
Agricultural	-	-	-	25	25	237,496	237,521
Commercial	-	-	-	1,600	1,600	191,204	192,804
Consumer & Other	12	-	-	14	26	4,790	4,816
Leases	-	-	-	-	-	36,908	36,908
Total	\$104	\$-	\$ -	\$ 2,497	\$2,601	\$1,613,170	\$1,615,771

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total 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	\$1,399	\$52	\$ -	\$ 2,596	\$4,047	\$1,384,189	\$1,388,236

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
September 30, 2013							
Loans & Leases:							
Commercial Real Estate	\$592	\$-	\$ -	\$ 176	\$768	\$400,858	\$401,626
Agricultural Real Estate	-	-	-	849	849	310,552	311,401
Real Estate Construction	-	-	-	-	-	27,099	27,099
Residential 1st Mortgages	-	-	-	455	455	143,122	143,577
Home Equity Lines & Loans	-	121	-	243	364	36,796	37,160
Agricultural	-	-	-	99	99	221,470	221,569

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Commercial	-	-	-	1,944	1,944	143,849	145,793
Consumer & Other	14	94	-	17	125	4,938	5,063
Leases	-	-	-	-	-	4,523	4,523
Total	\$606	\$215	\$ -	\$ 3,783	\$4,604	\$1,293,207	\$1,297,811

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

	Recorded Investment	Unpaid		Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
		Principal Balance	Related Allowance	Average Interest Recorded	Income Recognized	Average Interest Recorded	Income Recognized
September 30, 2014							
With no related allowance recorded:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$49	\$ -	\$82	\$ 4
Home Equity Lines & Loans	-	-	-	-	-	226	-
Agricultural	-	-	-	14	-	26	-
Commercial	-	-	-	1,575	-	2,740	54
	\$ -	\$ -	\$ -	\$1,638	\$ -	\$3,074	\$ 58
With an allowance recorded:							
Commercial Real Estate	\$ 94	\$ 94	\$ 2	\$47	\$ 2	\$16	\$ 2
Residential 1st Mortgages	658	771	131	550	1	522	3
Home Equity Lines & Loans	955	1,008	191	934	3	710	6
Agricultural	483	493	119	478	7	477	21
Commercial	4,744	4,801	908	3,179	27	2,144	27
Consumer & Other	43	47	43	44	1	47	2
	\$ 6,977	\$ 7,214	\$ 1,394	\$5,232	\$ 41	\$3,916	\$ 61
Total	\$ 6,977	\$ 7,214	\$ 1,394	\$6,870	\$ 41	\$6,990	\$ 119

	Recorded Investment	Unpaid		Average Interest Recorded	
		Principal Balance	Related Allowance	Investment	Income 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

Three Months Ended Sept. 30, 2013  
 Nine Months Ended Sept. 30, 2013

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September 30, 2013	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Interest Recorded Investment	Average Interest Recognized	Average Interest Recorded Investment	Average Interest Recognized
With no related allowance recorded:							
Commercial Real Estate	\$ 279	\$ 299	\$ -	\$1,626	\$ 2	\$953	\$ 6
Agricultural Real Estate	850	1,173	-	2,616	-	3,777	-
Residential 1st Mortgages	535	588	-	533	4	643	11
Home Equity Lines & Loans	287	306	-	331	3	379	5
Agricultural	99	121	-	278	-	1,239	-
Commercial	85	85	-	89	2	99	6
	\$ 2,135	\$ 2,572	\$ -	\$5,473	\$ 11	\$7,090	\$ 28
With an allowance recorded:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$4	\$ -	\$2	\$ -
Agricultural Real Estate	-	-	-	725	-	1,221	-
Residential 1st Mortgages	246	246	50	123	-	27	-
Home Equity Lines & Loans	243	290	132	243	-	195	-
Agricultural	488	488	122	766	8	1,562	24
Commercial	2,084	2,095	1,856	1,251	2	436	6
Consumer & Other	53	56	53	55	1	185	3
	\$ 3,114	\$ 3,175	\$ 2,213	\$3,167	\$ 11	\$3,628	\$ 33
Total	\$ 5,249	\$ 5,747	\$ 2,213	\$8,640	\$ 22	\$10,718	\$ 61



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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.

At September 30, 2014, the Company allocated \$1.3 million of specific reserves to \$6.4 million of troubled debt restructured loans, of which \$4.5 million were performing. The Company had no commitments at September 30, 2014 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the three and nine month periods ending September 30, 2014, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 5 years to 30 years. Modifications involving an extension of the maturity date were for periods ranging from 5 years to 30 years.

The following table presents loans by class, modified as troubled debt restructured loans & leases for the three and nine-month periods ended September 30, 2014 (in thousands):

Troubled Debt Restructurings	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014			
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Residential 1st Mortgages	1	\$ 248	\$ 222	4	\$ 565	\$ 528
Home Equity Lines & Loans	1	51	47	3	98	89
Agricultural	-	-	-	1	32	32
Total	2	\$ 299	\$ 269	8	\$ 695	\$ 649

The TDRs described above increased the allowance for credit losses by \$51,000 and \$50,000 and resulted in charge-offs of \$30,000 and \$46,000 for the three and nine-month period ending September 30, 2014.

During the three and nine-months ended September 30, 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):

Troubled Debt Restructurings	December 31, 2013		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
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 within the previous 12 months that subsequently defaulted during the twelve months ended December 31, 2013.

At September 30, 2013, the Company allocated \$364,000 of specific reserves to \$2.0 million of troubled debt restructured loans, of which \$1.5 million were performing. The Company had no commitments at September 30, 2013 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the three and nine month periods ending September 30, 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods of 5 years. Modifications involving an extension of the maturity date were for periods ranging from 6 months to 10 years.

The following table presents loans by class, modified as troubled debt restructured loans & leases for the three and nine-month periods ended September 30, 2013 (in thousands):

Troubled Debt Restructurings	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Residential 1st Mortgages	-	\$ -	\$ -	4	\$ 306	\$ 290
Home Equity Lines & Loans	-	-	-	2	195	184
Commercial	-	-	-	2	292	292
Total	-	\$ -	\$ -	8	\$ 793	\$ 766

The TDRs described above increased the allowance for credit losses by \$0 and \$4,000 and resulted in charge-offs of \$0 and \$27,000 for the three and nine-month period ending September 30, 2013.

As of September 30, 2013, there was one commercial loan with an outstanding balance of \$277,000 that was previously modified as a troubled debt restructuring within the previous 12 months that subsequently defaulted during the nine months ended September 30, 2013. This defaulted loan did not increase the allowance for credit loss and did not result in any charge offs during the twelve-month period ending September 30, 2013.

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4. Fair Value Measurements

The Company follows the “Fair Value Measurement and Disclosures” topic, 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 “Receivables” topic. The fair value of impaired loans & leases is estimated using one of several methods, including collateral value when the loan & 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. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value or the appraised value contains a significant unobservable assumption, and there is no observable market price, the Company records the impaired loan or lease 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.

(in thousands)	Fair Value Total	Fair Value Measurements At September 30, 2014, Using Quoted Prices in		
		Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	\$13,361	\$13,361	\$ -	\$ -
Mortgage Backed Securities	322,680	39,566	283,114	-
Other	485	175	310	-
Total Assets Measured at Fair Value On a Recurring Basis	\$336,526	\$53,102	\$283,424	\$ -

(in thousands)	Fair Value Total	Fair Value Measurements At December 31, 2013, Using Quoted Prices in		
		Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (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	\$ -

(in thousands)	Fair Value Total	Fair Value Measurements At September 30, 2013, Using Quoted Prices in		
		Active Markets for Identical	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (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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		Assets (Level 1)			
Available-for-Sale Securities:					
Government Agency & Government-Sponsored Entities	\$28,643	\$23,587	\$ 5,056	\$	-
Mortgage Backed Securities	342,077	-	342,077		-
Corporate Securities	49,761	8,171	41,590		-
Other	1,284	974	310		-
Total Assets Measured at Fair Value On a Recurring Basis	\$421,765	\$32,732	\$ 389,033	\$	-

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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 three and nine-months ended September 30, 2014, there were no transfers in or out of level 1, 2, or 3. During the three and nine-months ended September 30, 2013, \$5.6 million were transferred out of level 3 available-for-sale investment securities into held-to-maturity investment securities. The following table presents changes in level 3 assets measured at fair value on a recurring basis.

	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2013
(in thousands)		
Balance at Beginning of Period	\$- \$5,612	\$- \$5,665
Total Realized and Unrealized Gains/(Losses) Included in Income	- -	- -
Total Unrealized Gains/(Losses) Included in Other Comprehensive Income	- -	- -
Purchase of Securities	- -	- -
Sales, Maturities, and Calls of Securities	- (31 )	- (84 )
Net Transfers out of Available for Sale Securities	- (5,581 )	- (5,581 )
Balance at End of Period	\$- \$-	\$- \$-

Available-for-sale investments securities categorized as Level 3 assets primarily consist of obligations of states and political subdivisions. These bonds were issued by local housing authorities and have no active market. These bonds are carried at historical cost, which approximates fair value, unless economic conditions for the municipality changes to a degree requiring a valuation adjustment. Due to the difficulty in valuing the senior housing authority bonds and the fact that the Company owns 100% of these bonds that were issued by a relationship banking customer, we transferred these bonds out of the available-for-sale category and into the held-to-maturity category as the Company intends to hold these bonds until maturity.

The following tables present information about the Company's impaired loans & leases and other real estate, 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 & leases are carried at fair value. Impaired loans & leases are only included in the following tables when their fair value is based upon an appraisal of the collateral, and if that appraisal results in a partial charge-off or the establishment of a specific reserve.

	Fair Value Measurements At September 30, 2014, Using Quoted Prices in Active Markets for Identifiable Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Fair Value Total		
Impaired Loans			
Commercial Real Estate	\$92	\$- \$ -	\$ 92
Residential 1st Mortgages	526	- -	526

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Home Equity Lines and Loans	763	-	-	763
Agricultural	363	-	-	363
Commercial	3,836	-	-	3,836
Total Impaired Loans	5,580	-	-	5,580
Other Real Estate				
Real Estate Construction	2,441	-	-	2,441
Agricultural Real Estate	858	-	-	858
Total Other Real Estate	3,299	-	-	3,299
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$8,879	\$-	\$-	\$ 8,879

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(in thousands)	Fair Value Total	Fair Value Measurements At December 31, 2013, Using Quoted Prices in Active Markets for Identifiable Other Assets		
		Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Significant Unobservable Inputs (Level 3)
Impaired Loans				
Residential 1st Mortgages	\$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

(in thousands)	Fair Value Total	Fair Value Measurements At September 30, 2013, Using Quoted Prices in Active Markets for Identifiable Other Assets		
		Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Significant Unobservable Inputs (Level 3)
Impaired Loans				
Residential 1st Mortgages	\$477	\$-	\$-	\$ 477
Home Equity Lines and Loans	293	-	-	293
Agricultural	366	-	-	366
Commercial	228	-	-	228
Total Impaired Loans	1,364	-	-	1,364
Other Real Estate				
Real Estate Construction	2,398	-	-	2,398
Agricultural Real Estate	1,268	-	-	1,268
Total Other Real Estate	3,666	-	-	3,666
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$5,030	\$-	\$-	\$ 5,030

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.

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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.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at September 30, 2014:

(in thousands)	Fair Value	Valuation Technique	Unobservable Inputs	Range, Weighted Avg.
<b>Impaired Loans</b>				
Commercial Real Estate	\$92	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% -1%, 1 %
Residential 1st Mortgages	\$526	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	11% -24%, 17 %
Home Equity Lines and Loans	\$763	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% - 14%, 11 %
Agricultural	\$343	Income Approach	Capitalization Rate	14% - 14%, 14 %
Agricultural	\$20	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% -1%, 1 %
Commercial	\$3,836	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% - 13%, 4 %
<b>Other Real Estate</b>				
Real Estate Construction	\$2,441	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	10% - 10%, 10 %
Agricultural Real Estate	\$858	Sales Comparison Approach	Adjustment for Difference 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:

September 30, 2014 (in thousands)	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices			Total Estimated Fair Value
		in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:					
Cash and Cash Equivalents	\$39,216	\$39,216	\$-	\$-	\$39,216
Investment Securities Available-for-Sale:					
Government Agency & Government-Sponsored Entities	13,361	13,361	-	-	13,361
Mortgage Backed Securities	322,680	39,566	283,114	-	322,680
Other	485	175	310	-	485
Total Investment Securities Available-for-Sale	336,526	53,102	283,424	-	336,526
Investment Securities Held-to-Maturity:					
Obligations of States and Political Subdivisions	67,206	-	54,375	13,539	67,914
Other	2,235	-	2,235	-	2,235
Total Investment Securities Held-to-Maturity	69,441	-	56,610	13,539	70,149
FHLB Stock	7,677	N/A	N/A	N/A	N/A
Loans & Leases, Net of Deferred Fees & Allowance:					
Commercial Real Estate	465,707	-	-	462,469	462,469
Agricultural Real Estate	360,215	-	-	360,976	360,976
Real Estate Construction	102,783	-	-	103,095	103,095
Residential 1st Mortgages	167,168	-	-	169,971	169,971
Home Equity Lines and Loans	30,608	-	-	32,601	32,601
Agricultural	231,739	-	-	230,572	230,572
Commercial	184,889	-	-	184,466	184,466
Consumer & Other	4,595	-	-	4,619	4,619
Leases	35,063			33,519	33,519

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Unallocated Allowance	(1,263 )	-	-	(1,263 )	(1,263 )
Total Loans & Leases, Net of Deferred Fees & Allowance	1,581,504	-	-	1,581,025	1,581,025
Accrued Interest Receivable	8,986	-	8,986	-	8,986
Liabilities:					
Deposits:					
Demand	516,093	516,093	-	-	516,093
Interest Bearing Transaction	326,368	326,368	-	-	326,368
Savings and Money Market	614,137	614,137	-	-	614,137
Time	419,615	-	419,663	-	419,663
Total Deposits	1,876,213	1,456,598	419,663	-	1,876,261
FHLB Advances	36,000	-	36,000	-	36,000
Subordinated Debentures	10,310	-	6,227	-	6,227
Accrued Interest Payable	314	-	314	-	314

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December 31, 2013 (in thousands)	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Total Estimated Fair Value
		Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
<b>Assets:</b>					
Cash and Cash Equivalents	\$83,677	\$83,677	\$ -	\$ -	\$83,677
<b>Investment Securities Available-for-Sale:</b>					
Government Agency & 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 Available-for-Sale	404,639	33,169	371,470	-	404,639
<b>Investment Securities Held-to-Maturity:</b>					
Obligations of States and Political 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 Held-to-Maturity	68,505	-	54,383	14,307	68,690
FHLB Stock	7,187	N/A	N/A	N/A	N/A
<b>Loans &amp; Leases, Net of Deferred Fees &amp; Allowance:</b>					
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 & Allowance	1,353,962	-	-	1,364,466	1,364,466
Accrued Interest Receivable	6,941	-	6,941	-	6,941
<b>Liabilities:</b>					
<b>Deposits:</b>					
Demand	495,963	495,963	-	-	495,963
Interest Bearing Transaction	291,795	291,795	-	-	291,795
Savings and Money Market	589,511	589,511	-	-	589,511
Time	430,422	-	430,752	-	430,752



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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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September 30, 2013 (in thousands)	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Total Estimated Fair Value
		Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
<b>Assets:</b>					
Cash and Cash Equivalents	\$47,625	\$47,625	\$ -	\$ -	\$47,625
<b>Investment Securities Available-for-Sale:</b>					
Government Agency & Government-Sponsored Entities	28,643	23,587	5,056	-	28,643
Mortgage Backed Securities	342,077	-	342,077	-	342,077
Corporate Securities	49,761	8,171	41,590	-	49,761
Other	1,284	974	310	-	1,284
Total Investment Securities Available-for-Sale	421,765	32,732	389,033	-	421,765
<b>Investment Securities Held-to-Maturity:</b>					
Obligations of States and Political Subdivisions	67,717	-	55,188	12,753	67,941
Mortgage Backed Securities	121	-	122	-	122
Other	3,123	-	3,123	-	3,123
Total Investment Securities Held-to-Maturity	70,961	-	58,433	12,753	71,186
FHLB Stock	7,187	N/A	N/A	N/A	N/A
<b>Loans &amp; Leases, Net of Deferred Fees &amp; Allowance:</b>					
Commercial Real Estate	395,550	-	-	399,792	399,792
Agricultural Real Estate	308,188	-	-	313,920	313,920
Real Estate Construction	26,161	-	-	26,437	26,437
Residential 1st Mortgages	142,504	-	-	145,778	145,778
Home Equity Lines and Loans	34,410	-	-	36,988	36,988
Agricultural	212,309	-	-	211,418	211,418
Commercial	136,002	-	-	137,033	137,033
Consumer & Other	4,895	-	-	4,945	4,945
Leases	4,523	-	-	4,523	4,523
Unallocated Allowance	(842 )	-	-	(842 )	(842 )
Total Loans & Leases, Net of Deferred Fees & Allowance	1,263,700	-	-	1,279,992	1,279,992
Accrued Interest Receivable	8,214	-	8,214	-	8,214
<b>Liabilities:</b>					
<b>Deposits:</b>					
Demand	435,778	435,778	-	-	435,778
Interest Bearing Transaction	257,650	257,650	-	-	257,650
Savings and Money Market	561,277	561,277	-	-	561,277
Time	439,081	-	439,485	-	439,485

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Total Deposits	1,693,786	1,254,705	439,485	-	1,694,190
FHLB Advances	5,900	-	5,900	-	5,900
Subordinated Debentures	10,310	-	5,665	-	5,665
Accrued Interest Payable	357	-	357	-	357

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Fair value estimates presented herein are based on pertinent information available to management as of September 30, 2014, December 31, 2013, and September 30, 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 Loan & Lease Fees & Allowance** - Fair values of loans & leases are estimated as follows: For variable rate loans & leases 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.

**FHLB Advances & Securities Sold Under Agreement to Repurchase** - The fair value of federal funds purchased and other short-term borrowings are approximated by the book value resulting in a Level 2 classification. The fair value for Federal Home Loan Bank advances is determined using discounted future cash flows 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. On May 19, 2014, the Board of Directors of Farmers & Merchants Bancorp

announced a mid-year cash dividend of \$6.30 per share, a 1.6% increase over the \$6.20 per share paid on July 1, 2013. The cash dividend was paid on July 1, 2014, to shareholders of record on June 9, 2014.

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Basic earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the basic earnings per share for the three and nine months ended September 30, 2014 and 2013.

(net income in thousands)	Three Months		Nine Months	
	Ended Sept. 30, 2014	2013	Ended Sept. 30, 2014	2013
Net Income	\$6,432	\$6,352	\$18,818	\$18,168
Weighted Average Number of Common Shares Outstanding	777,882	777,882	777,882	777,882
Basic Earnings Per Common Share	\$8.27	\$8.17	\$24.19	\$23.36

## 7. Recent Accounting Pronouncements

In May, 2014, the FASB has made available Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers: Topic 606. ASU 2014-09 affects any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g., insurance contracts or lease contracts). This ASU will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance. This ASU also supersedes some cost guidance included in Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts. In addition, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer (e.g., assets within the scope of Topic 360, Property, Plant, and Equipment, and intangible assets within the scope of Topic 350, Intangibles—Goodwill and Other) are amended to be consistent with the guidance on recognition and measurement (including the constraint on revenue) in this ASU. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. For a public entity, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not 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.

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 and nine months ended September 30, 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.

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### 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; (8) ongoing drought conditions in California and the resulting impact on the Company’s agricultural customers; and (9) 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.

During 2013: (1) the Company expanded its service area by establishing loan production offices (“LPO”) in Irvine, CA and Walnut Creek, CA; and (2) established equipment leasing as a new line of business. In March 2014, the Irvine LPO was converted to a full-service branch. The Company intends to convert the Walnut Creek LPO to a full-service branch in 4<sup>th</sup> quarter of 2014. Experienced lending and equipment leasing professionals have been hired to staff these offices. Both of these areas have strong local economies, and will help diversify some of the concentration risks that the Company now has in the Central Valley and the agricultural industry. The Irvine location is also 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. As a California, state-chartered, non-fed member bank, the Bank is subject to regulation and examination by the DBO and 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 and nine months ended September 30, 2014, Farmers & Merchants Bancorp reported net income of \$6,432,000 and \$18,818,000, basic earnings per common share of \$8.27 and \$24.19 and return on average assets of 1.19% and 1.18%, respectively. Return on average shareholders' equity was 11.45% and 11.42% for the three and nine months ended September 30, 2014.

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For the three and nine months ended September 30, 2013, Farmers & Merchants Bancorp reported net income of \$6,352,000 and \$18,168,000, basic earnings per common share of \$8.17 and \$23.36 and return on average assets of 1.28% and 1.23%, respectively. Return on average shareholders' equity was 12.38% and 11.67% for the three and nine months ended September 30, 2013.

The primary reasons for the Company's improved earnings performance in the first nine months of 2014 as compared to the same period last year were: (1) a \$2.4 million increase in net interest income; (2) a \$250,000 decrease in the provision for credit losses; and (3) a \$937,000 decrease in other non-interest expense mainly due to decreased legal fee expense and a decrease in operating losses. These positive impacts were partially offset by: (1) a \$1.0 million decrease in other non-interest income, primarily due to no gain on the sale of fixed assets and reduced swap fee income; (2) a \$368,000 decrease in service charges on deposit accounts; and (3) a \$1.5 million increase in salaries and employee benefits.

The following is a summary of the financial results for the nine-month period ended September 30, 2014 compared to September 30, 2013.

- Net income increased 3.6% to \$18.8 million from \$18.2 million.
- Basic Earnings per common share increased 3.6% to \$24.19 from \$23.36.
- Total assets increased 11.9% to \$2.2 billion.
- Total loans & leases increased 24.5% to \$1.6 billion.
- Total deposits increased 10.8% to \$1.9 billion.

## 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 and nine-month periods ended September 30, 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 & Merchants Bancorp  
 Quarterly Average Balances and Interest Rates  
 (Interest and Rates on a Taxable Equivalent Basis)  
 (in thousands)

	Three Months Ended Sept 30, 2014			Three Months Ended Sept 30, 2013		
Assets	Balance	Interest	Rate	Balance	Interest	Rate
Interest Bearing Deposits with Banks	\$7,921	\$5	0.25 %	\$2,625	\$2	0.30 %
Investment Securities:						
U.S. Agencies	17,193	47	1.09 %	27,569	62	0.90 %
Municipals - Non-Taxable	68,404	912	5.33 %	68,722	982	5.72 %
Mortgage Backed Securities	307,586	1,721	2.24 %	384,201	2,083	2.17 %
Other	30,870	80	1.04 %	53,636	152	1.13 %
Total Investment Securities	424,053	2,760	2.60 %	534,128	3,279	2.46 %
Loans & Leases:						
Real Estate	1,073,804	12,966	4.79 %	881,415	11,820	5.32 %
Home Equity Lines & Loans	33,716	462	5.44 %	37,501	538	5.69 %
Agricultural	232,929	2,338	3.98 %	214,833	2,354	4.35 %
Commercial	184,152	1,992	4.29 %	155,247	1,860	4.75 %
Consumer	4,742	65	5.44 %	5,101	73	5.68 %
Other	-	-	0.00 %	229	3	5.20 %
Leases	34,721	344	3.93 %	3,678.00	31.00	3.34 %
Total Loans & Leases	1,564,064	18,167	4.61 %	1,298,004	16,679	5.10 %
Total Earning Assets	1,996,038	\$20,932	4.16 %	1,834,757	\$19,960	4.32 %
Unrealized (Loss) Gain on Securities						
Available-for-Sale	2,975			(5,157 )		
Allowance for Credit Losses	(34,297 )			(34,239 )		
Cash and Due From Banks	31,758			32,580		
All Other Assets	167,975			158,526		
Total Assets	\$2,164,449			\$1,986,467		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits:						
Interest Bearing DDA	\$323,582	\$47	0.06 %	\$253,977	\$27	0.04 %
Savings and Money Market	626,248	277	0.18 %	580,391	251	0.17 %
Time Deposits	415,501	297	0.28 %	443,785	354	0.32 %
Total Interest Bearing Deposits	1,365,331	621	0.18 %	1,278,153	632	0.20 %
Federal Home Loan Bank Advances	13,139	5	0.15 %	24,254	7	0.11 %
Subordinated Debentures	10,310	82	3.16 %	10,310	82	3.16 %
Total Interest Bearing Liabilities	1,388,780	\$708	0.20 %	1,312,717	\$721	0.22 %
Interest Rate Spread			3.96 %			4.10 %
Demand Deposits (Non-Interest Bearing)	500,492			426,289		
All Other Liabilities	50,392			42,236		
Total Liabilities	1,939,664			1,781,242		
Shareholders' Equity	224,785			205,225		

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Total Liabilities & Shareholders' Equity	\$2,164,449		\$1,986,467	
Impact of Non-Interest Bearing Deposits and Other Liabilities		0.06%		0.06%
Net Interest Income and Margin on Total Earning Assets	20,224	4.02%	19,239	4.16%
Tax Equivalent Adjustment	(318 )		(345 )	
Net Interest Income	\$19,906	3.96%	\$18,894	4.09%

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 \$903,000 and \$801,000 for the quarters ended September 30, 2014 and 2013, respectively. Yields on securities available-for-sale are based on historical cost.

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Farmers & Merchants Bancorp  
 Year-to-Date Average Balances and Interest Rates  
 (Interest and Rates on a Taxable Equivalent Basis)  
 (in thousands)

	Nine Months Ended Sept. 30, 2014			Nine Months Ended Sept. 30, 2013		
	Balance	Interest	Rate	Balance	Interest	Rate
Assets						
Interest Bearing Deposits with Banks	\$57,889	\$110	0.25 %	\$25,458	\$49	0.26 %
Investment Securities:						
U.S. Agencies	18,918	151	1.06 %	27,925	187	0.89 %
Municipals - Non-Taxable	65,425	2,698	5.50 %	70,009	2,988	5.69 %
Mortgage Backed Securities	320,742	5,536	2.30 %	387,623	6,152	2.12 %
Other	48,083	385	1.07 %	51,751	446	1.15 %
Total Investment Securities	453,168	8,770	2.58 %	537,308	9,773	2.43 %
Loans & Leases:						
Real Estate	997,216	36,459	4.89 %	858,166	34,098	5.31 %
Home Equity Lines & Loans	34,299	1,429	5.57 %	38,843	1,669	5.74 %
Agricultural	221,024	6,632	4.01 %	197,386	6,333	4.29 %
Commercial	168,332	5,720	4.54 %	150,310	5,648	5.02 %
Consumer	5,249	210	5.35 %	4,932	229	6.21 %
Other	23	1	5.81 %	231	10	5.79 %
Leases	22,957	728	4.24 %	1,702.00	43	3.38 %
Total Loans & Leases	1,449,100	51,179	4.72 %	1,251,570	48,030	5.13 %
Total Earning Assets	1,960,157	\$60,059	4.10 %	1,814,336	\$57,852	4.26 %
Unrealized Gain on Securities Available-for-Sale	501			4,609		
Allowance for Credit Losses	(34,280 )			(34,259 )		
Cash and Due From Banks	31,500			33,369		
All Other Assets	164,709			153,192		
Total Assets	\$2,122,587			\$1,971,247		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits:						
Interest Bearing DDA	\$306,693	\$120	0.05 %	\$253,595	\$83	0.04 %
Savings and Money Market	621,501	770	0.17 %	574,882	714	0.17 %
Time Deposits	421,274	929	0.29 %	448,355	1,146	0.34 %
Total Interest Bearing Deposits	1,349,468	1,819	0.18 %	1,276,832	1,943	0.20 %
Federal Home Loan Bank Advances	4,692	5	0.14 %	16,398	16	0.13 %
Subordinated Debentures	10,310	242	3.14 %	10,310	245	3.18 %
Total Interest Bearing Liabilities	1,364,470	\$2,066	0.20 %	1,303,540	\$2,204	0.23 %
Interest Rate Spread			3.89 %			4.04 %
Demand Deposits (Non-Interest Bearing)	488,677			420,204		
All Other Liabilities	49,772			40,014		
Total Liabilities	1,902,919			1,763,758		
Shareholders' Equity	219,668			207,489		
Total Liabilities & Shareholders' Equity	\$2,122,587			\$1,971,247		

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Impact of Non-Interest Bearing Deposits and Other Liabilities		0.06%		0.06%
Net Interest Income and Margin on Total Earning Assets	57,993	3.96%	55,648	4.10%
Tax Equivalent Adjustment	(940 )		(1,037 )	
Net Interest Income	\$57,053	3.89%	\$54,611	4.02%

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 \$2.8 million and \$2.7 million for the nine months ended September 30, 2014 and 2013, respectively. Yields on securities available-for-sale are based on historical cost.

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## Farmers &amp; Merchants Bancorp

## Volume and Rate Analysis of Net Interest Revenue

(in thousands)	Three Months Ended Sept. 30, 2014 compared to Sept. 30, 2013			Nine Months Ended Sept. 30, 2014 compared to Sept. 30, 2013		
	Volume	Rate	Net Chg.	Volume	Rate	Net Chg.
Interest Earning Assets						
Interest Bearing Deposits with Banks	\$3	\$-	\$3	\$62	\$(1	) \$61
Investment Securities:						
U.S. Agencies	(26 )	11	(15 )	(67 )	31	(36 )
Municipals - Non-Taxable	(5 )	(65 )	(70 )	(191 )	(99 )	(290 )
Mortgage Backed Securities	(427 )	65	(362 )	(1,123)	507	(616 )
Other	(60 )	(12 )	(72 )	(30 )	(31 )	(61 )
Total Investment Securities	(518 )	(1 )	(519 )	(1,411)	408	(1,003)
Loans & Leases:						
Real Estate	2,390	(1,244)	1,146	5,239	(2,878)	2,361
Home Equity Lines & Loans	(53 )	(23 )	(76 )	(190 )	(50 )	(240 )
Agricultural	189	(205 )	(16 )	728	(429 )	299
Commercial	322	(190 )	132	643	(571 )	72
Consumer	(5 )	(3 )	(8 )	14	(33 )	(19 )
Other	(3 )	-	(3 )	(9 )	-	(9 )
Leases	307	6	313	671	14	685
Total Loans & Leases	3,147	(1,659)	1,488	7,096	(3,947)	3,149
Total Earning Assets	2,632	(1,660)	972	5,747	(3,540)	2,207
Interest Bearing Liabilities						
Interest Bearing Deposits:						
Interest Bearing DDA	8	12	20	19	18	37
Savings and Money Market	21	5	26	58	(2 )	56
Time	(21 )	(36 )	(57 )	(66 )	(151 )	(217 )
Total Interest Bearing Deposits	8	(19 )	(11 )	11	(135 )	(124 )
Other Borrowed Funds	(4 )	2	(2 )	(12 )	1	(11 )
Subordinated Debentures	-	-	-	-	(3 )	(3 )
Total Interest Bearing Liabilities	4	(17 )	(13 )	(1 )	(137 )	(138 )
Total Change on a Tax Equivalent Basis	\$2,628	\$(1,643)	\$985	\$5,748	\$(3,403)	\$2,345

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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3rd Quarter 2014 vs. 3rd Quarter 2013

Net interest income for the third quarter of 2014 increased 5.4% or \$1.0 million to \$19.9 million. On a fully taxable equivalent basis, net interest income increased 5.1% and totaled \$20.2 million for the third quarter of 2014. As more fully discussed below, the increase in net interest income was due to: (1) an increase in earning assets; and (2) an increase in loans as a percentage of earning assets; that offset (3) a decrease in net interest margin.

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 September 30, 2014, the Company's net interest margin was 4.02% compared to 4.16% for the quarter ended September 30, 2013. This decrease in net interest margin was due to a decline in earning asset yields that exceeded a corresponding drop in funding costs.

Average loans & leases totaled \$1.6 billion for the quarter ended September 30, 2014; an increase of \$266.1 million compared to the average balance for the quarter ended September 30, 2013. Loans & leases increased from 70.7% of average earning assets at September 30, 2013 to 78.4% at September 30, 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 & lease portfolio declined to 4.61% for the quarter ended September 30, 2014, compared to 5.10% for the quarter ended September 30, 2013. See "Financial Condition – Loans and Leases" for a discussion of the Company's loan strategy in 2014. Overall, the positive impact on interest revenue from the increase in loan & lease balances resulted in interest revenue from loans & leases increasing 8.9% to \$18.2 million for quarter ended September 30, 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 & leases, the yield earned on investments is generally less than that of loans & leases. Average investment securities totaled \$424.1 million for the quarter ended September 30, 2014; a decrease of \$110.1 million compared to the average balance for the quarter ended September 30, 2013. Tax equivalent interest income on securities decreased \$519,000 to \$2.76 million for the quarter ended September 30, 2014, compared to \$3.27 million for the quarter ended September 30, 2013. The average investment portfolio yield, on a tax equivalent basis, for the quarter ended September 30, 2014, was 2.60% compared to 2.46% for the quarter ended September 30, 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. Average 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 September 30, 2014, was \$7.9 million, an increase of \$5.3 million compared to the average balance for the quarter ended September 30, 2013. Interest income on interest bearing deposits with banks for the quarter ended September 30, 2014, increased \$3,000 to \$5,000 from the quarter ended September 30, 2013.

Average interest-bearing liabilities increased \$76.1 million or 5.8% during the third quarter of 2014. Of that increase: (1) interest-bearing transaction deposits increased \$69.6 million; (2) savings and money market deposits increased \$45.9 million; (3) time deposits decreased \$28.3 million (see "Financial Condition – Deposits" for a discussion of trends in the Company's deposit base); (4) FHLB Advances decreased \$11.1 million (see "Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings"); and (5) subordinated debt remained unchanged (see "Financial Condition – Subordinated Debentures").

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Total interest expense on interest bearing deposits was \$621,000 for the third quarter of 2014 as compared to \$632,000 for the third quarter of 2013. The average rate paid on interest-bearing deposits was 0.18% for the third quarter of 2014 compared to 0.20% for the third quarter of 2013. The Company anticipates that future declines in deposit rates, if any, will continue to be modest.

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### Nine Months Ending September 30, 2014 vs. Nine Months Ending September 30, 2013

During the first nine months of 2014, net interest income increased 4.5% to \$57.1 million, compared to \$54.6 million at September 30, 2013. On a fully taxable equivalent basis, net interest income increased 4.2% and totaled \$58.0 million at September 30, 2014, compared to \$55.6 million at September 30, 2013. The increase in net interest income was primarily due to growth in average earning assets that offset a decrease in net interest margin.

For the nine months ended September 30, 2014, the Company's net interest margin was 3.96% compared to 4.10% for the same period in 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.

The average balance of loans & leases increased by \$197.5 million for the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. The yield on the loan & lease portfolio decreased 41 basis points to 4.72% for the nine months ended September 30, 2014 compared to 5.13% for the nine months ended September 30, 2013. This increase in loan & lease balances, offset somewhat by a decrease in yields resulted in interest income from loans & leases increasing 6.6% or \$3.1 million for the first nine months of 2014.

Average investment securities were \$453.2 million for the nine months ended September 30, 2014 compared to \$537.3 million for the same period in 2013. The average yield (Tax Equivalent) for the nine months ended September 30, 2014 was 2.58% compared to 2.43% for the nine months ended September 30, 2013. This decrease in balances, offset somewhat by an increase in yields, resulted in a decrease in interest income of \$1.0 million or 10.3%, for the nine months ended September 30, 2014.

Average 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 nine months ended September 30, 2014, was \$57.9 million, an increase of \$32.4 million compared to the average balance for the nine-months ended September 30, 2013. Interest income on interest bearing deposits with banks for the nine months ended September 30, 2014, increased \$61,000 to \$110,000 compared to the nine months ended September 30, 2013.

Average interest-bearing liabilities increased \$60.9 million or 4.7% during the nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013. Of that increase: (1) interest-bearing deposits increased \$72.6million; (2) FHLB advances decreased \$11.7 million; and (3) subordinated debentures remained unchanged.

The \$72.6 million increase in average interest-bearing deposits was primarily in interest bearing transaction and savings and money market deposits, which grew \$99.7 million since September 30, 2014, while time deposits decreased by \$27.1 million. Total interest expense on deposits was \$1.8 million for the first nine months of 2014 as compared to \$1.9 million for the first nine months of 2013. The average rate paid on interest-bearing deposits was 0.18% in the first nine months of 2014 and 0.20% in the first nine months of 2013.

### 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 (the term "borrower" is used herein to describe a customer who has entered into either a loan or lease transaction), 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 3. 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.

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### 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's or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's 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 borrower's financial difficulties grants a concession to the borrower 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 that 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 & 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 assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, 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 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 are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. 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.

Real Estate Construction – Real estate construction loans, including land loans, are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. 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 – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. 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 – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related

real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Leases – Equipment leases are generally considered to possess a moderate inherent risk of loss. As Lessor, the company is subject to both the credit risk of the borrower 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.



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Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the weakness in residential real estate values over the past five years. 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. 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.

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 September 30, 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 has experienced drought conditions during much of 2013 and 2014. 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.

The Company made no provision for credit loss during the first nine months of 2014 compared to \$250,000 for the first nine months of 2013. Net charge-offs for the nine months ended September 30, 2014 were \$7,000 compared to net charge-offs of \$356,000 for the same period in 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.

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After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of September 30, 2014, was adequate.

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Balance at Beginning of Period	\$34,290	\$34,235	\$34,274	\$34,217
Charge-Offs	(61 )	(211 )	(204 )	(740 )
Recoveries	38	87	197	384
Provision	-	-	-	250
Balance at End of Period	\$34,267	\$34,111	\$34,267	\$34,111

The table below breaks out year-to-date and current quarter activity by portfolio segment (in thousands):

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgage	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
September 30, 2014											
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	-	-	-	(58 )	(70 )	-	-	(76 )	-	-	(204 )
Recoveries	12	-	-	-	54	3	83	45	-	-	197
Provision	2,608	370	1,026	92	(76 )	(6,426 )	2,135	76	1,206	(1,011 )	-
Ending Balance- September 30, 2014	\$7,798	\$3,946	\$1,680	\$1,142	\$2,675	\$5,782	\$7,915	\$221	\$1,845	\$1,263	\$34,267
Third Quarter Allowance for Credit Losses:											
Beginning Balance- July 1, 2014	\$6,991	\$3,677	\$1,290	\$1,094	\$2,737	\$8,291	\$7,377	\$193	\$1,108	\$1,532	\$34,290
Charge-Offs	-	-	-	(25 )	(5 )	-	-	(31 )	-	-	(61 )
Recoveries	12	-	-	-	3	1	6	16	-	-	38
Provision	795	269	390	73	(60 )	(2,510 )	532	43	737	(269 )	-
Ending Balance- September 30, 2014	\$7,798	\$3,946	\$1,680	\$1,142	\$2,675	\$5,782	\$7,915	\$221	\$1,845	\$1,263	\$34,267

The Allowance for Credit Losses as of September 30, 2014 remained nearly unchanged from December 31, 2013. However, the allowance allocated to the following categories of loans did change materially during the first nine months of 2014:

Commercial Real Estate, Real Estate Construction and Commercial allowance balances increased from December 31, 2013, primarily as a result of increased loan balances.

Agricultural allowance balances decreased \$6.4 million, primarily as a result of decreased loan balances.

Leasing allowance balances increased \$1.2 million, primarily as a result of increased lease 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.

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3rd Quarter 2014 vs. 3rd Quarter 2013

Non-interest income decreased \$528,000 or 15.3% for the three months ended September 30, 2014, compared to the same period of 2013. This decrease was primarily due to: (1) a \$117,000 decrease in service charges on deposits accounts, primarily NSF/OD fees; (2) a \$912,000 decrease in the gain on deferred compensation investments; and (3) \$667,000 decrease in other non-interest income, primarily related to a non-recurring gain on the sale of a Company office building that took place in 2013. Partially offsetting these decreases was a \$1.1 million increase in net gain on sale of investment securities.

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.

Nine Months Ending September 30, 2014 vs. Nine Months Ending September 30, 2013

Non-interest income decreased \$1.9 million or 15.8% for the nine months ended September 30, 2014, compared to the same period of 2013. This decrease was primarily due to: (1) a \$368,000 decrease in service charges on deposit accounts, primarily NSF/OD fees; (2) a \$786,000 decrease in the gain on deferred compensation investments; and (3) \$1.0 million decrease in other non-interest income, primarily related to a non-recurring gain on the sale of a Company office building that took place in 2013 and decreased SWAP referral fees. Partially offsetting these decreases was a \$268,000 increase in net gain on sale of investment securities.

Non-Interest Expense

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

3rd Quarter 2014 vs. 3rd Quarter 2013

Overall, non-interest expense increased \$357,000 or 2.9% for the three months ended September 30, 2014, compared to the same period in 2013. This increase was primarily due to: (1) a \$1.1 million increase in salaries and employee benefits and a \$75,000 increase in occupancy, both increases primarily related to new staff and facilities added for the Walnut Creek and Irvine offices; (2) bank-wide raises; and (3) increased medical insurance costs. These increases were partially offset by a \$912,000 decrease in net gain on deferred compensation investments.

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.

Nine Months Ending September 30, 2014 vs. Nine Months Ending September 30, 2013

Non-interest expense decreased \$30,000 or 0.1% for the nine months ended September 30, 2014, compared to the same period of 2013. This decrease was primarily due to: (1) a \$786,000 decrease in net gain on deferred compensation investments; and (2) a \$937,000 decrease in other non-interest expense primarily due to a \$646,000 decrease in legal expense and a \$250,000 decrease in operating losses. These decreases were partially offset by: (1) a \$1.5 million increase in salaries and employee benefits and an \$82,000 increase in occupancy, both increases primarily related to new staff and facilities added for the Walnut Creek and Irvine offices; (2) bank-wide raises, and (3) increased medical insurance costs.

Income Taxes

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The provision for income taxes increased 1.2% to \$3.9 million for the third quarter of 2014. The Company's effective tax rate for the third quarter of 2014 and 2013 was 37.5%.

The provision for income taxes increased 1.7% to \$11.0 million for the first nine months of 2014. The Company's effective tax rate for the first nine months of 2014 was 37.0% compared to 37.4% for the same period in 2013.

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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 interest income exclusion; 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 loans & lease 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 September 30, 2014, as compared to December 31, 2013 and to September 30, 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. This portfolio of corporate securities was sold during the 3<sup>rd</sup> quarter of 2014 in order to fund the Company's increase in loan balances.

The Company's investment portfolio at September 30, 2014 was \$405.9 million compared to \$473.1 million at the end of 2013, a decrease of \$67.2 million or 14.2%. At September 30, 2013, the investment portfolio totaled \$492.7 million. 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.

The Company's total investment portfolio currently represents 18.5% of the Company's total assets as compared to 22.8% at December 31, 2013, and 25.1% at September 30, 2013.

As of September 30, 2014 the Company held \$67.2 million of municipal investments, of which \$53.7 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. 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. As of September 30, 2014 ninety-six 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 all municipal investments with particular attention paid to the approximately four percent (\$2.4 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. In June 2014, the Company sold \$375,000 of municipal bonds from a single issuer. The Company took this action under the provisions of ASC 320-10-25-6(a), which allow for the sale of HTM securities where there is "evidence of a significant deterioration in the issuer's creditworthiness."

See Note 2 located in “Item I. Financial Statements.”

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Interest bearing deposits with banks consist 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 \$4.9 million at September 30, 2014, \$42.7 million at December 31, 2013 and \$1.4 million at September 30, 2013.

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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 September 30, 2014, December 31, 2013 and September 30, 2012, 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.

**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.





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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.

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 & 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 or lease 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 September 30, 2014 totaled \$1.6 billion, an increase of \$318.0 million or 24.5% over September 30, 2013 and \$227.5 million or 16.4% over December 31, 2013. This increase has occurred despite the continuing sluggish economic conditions in the Central Valley of California and is a result of: (1) the Company's intensified business development efforts directed toward credit-qualified borrowers; (2) entry into the equipment leasing business; and (3) expansion of our service area into Walnut Creek and Irvine. No assurances can be made that this growth in the loan & lease portfolio will continue.

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

Loan & Lease Portfolio (in thousands)	September 30, 2014		December 31, 2013		September 30, 2013	
	\$	%	\$	%	\$	%
Commercial Real Estate	\$477,726	30.6 %	\$411,037	29.5 %	\$404,740	30.6 %
Agricultural Real Estate	364,161	24.1 %	328,264	23.6 %	311,401	24.1 %
Real Estate Construction	104,463	2.5 %	41,092	3.0 %	27,099	2.5 %
Residential 1st Mortgages	168,310	10.5 %	151,292	10.9 %	143,577	10.5 %
Home Equity Lines & Loans	33,283	2.9 %	35,477	2.5 %	37,160	2.9 %
Agricultural	237,521	16.5 %	256,414	18.4 %	221,569	16.5 %
Commercial	192,804	12.3 %	150,398	10.8 %	145,793	12.3 %
Consumer & Other	4,816	0.4 %	5,052	0.4 %	5,063	0.4 %
Leases	36,908	0.2 %	12,733	0.9 %	4,523	0.2 %
Total Gross Loans & Leases	1,619,992	100.0 %	1,391,759	100.0 %	1,300,925	100.0 %
Less: Unearned Income	4,221		3,523		3,114	
Subtotal	1,615,771		1,388,236		1,297,811	
Less: Allowance for Credit Losses	34,267		34,274		34,111	
Net Loans & Leases	\$1,581,504		\$1,353,962		\$1,263,700	

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 & lease 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,” and these loans & leases receive increased management attention. As of September 30, 2014, classified loans & leases totaled \$3.7 million compared to \$5.8 million at December 31, 2013 and \$10.2 million at September 30, 2013.

Classified loans & leases with higher levels of credit risk can be further designated as “impaired.” 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 or 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 or 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. Non-accrual loans & leases totaled \$2.5 million as of September 30, 2014. At December 31, 2013 and September 30, 2013, non-accrual loans & leases totaled \$2.6 million and \$3.8 million, respectively.

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.

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As of September 30, 2014, restructured loans & leases on accrual totaled \$4.5 million as compared to \$4.6 million at December 31, 2013. Restructured loans & leases on accrual at September 30, 2013, were \$1.5 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 property 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

(in thousands)	September 30, 2014	Dec. 31, 2013	September 30, 2013
Non-Performing Loans & Leases	\$ 2,497	\$2,596	\$ 3,783
Other Real Estate	3,299	4,611	3,666
Total Non-Performing Assets	\$ 5,796	\$7,207	\$ 7,449
Non-Performing Loans & Leases as a % of Total Loans & Leases	0.15	%	0.19
Restructured Loans & Leases (Performing)	\$ 4,476	\$4,649	\$ 1,463

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 \$990,000, \$983,000, and \$1.9 million have been established for non-performing loans & leases at September 30, 2014, December 31, 2013 and September 30, 2013, respectively.

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 \$75,000 for the nine months ended September 30, 2014, \$52,000 for the year ended December 31, 2013, and \$80,000 for the nine months ended September 30, 2013.

The Company reported \$3.3 million of ORE at September 30, 2014, \$4.6 million at December 31, 2013 and \$3.7 million at September 30, 2013. These values are net of a reserve for ORE valuation allowance in the amount of \$3.7 million at September 30, 2014, \$4.1 million at December 31, 2013 and \$3.7 million at September 30, 2013.

Except for those classified and non-performing loans & leases discussed above, the Company's management is not aware of any loans & leases as of September 30, 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 or lease repayment terms, 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.

The state of California has experienced drought conditions during much of 2013 and 2014. 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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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 (loans, leases and investments) 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 September 30, 2014 have increased \$182.4 million or 10.8% compared to September 30, 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 which has built 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 10.8% since September 30, 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 have increased \$149.0 million or 21.5% since September 30, 2013.
- Savings and money market accounts have increased \$52.9 million or 9.4% since September 30, 2013.
- Time deposit accounts have decreased \$19.5 million or 4.4% since September 30, 2013.

The Company's deposit balances at September 30, 2014 have increased \$68.5 million or 3.8% compared to December 31, 2013. Demand and interest-bearing transaction accounts increased 6.9% or \$54.7 million, savings and money market accounts increased \$24.6 million or 4.2% and time deposit accounts decreased by \$10.8 million or 2.5%. Deposit trends in the first nine months of the year can be impacted by the seasonal needs of our agricultural customers.

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. FHLB advances were \$36.0 million at September 30, 2014. There were no FHLB Advances at December 31, 2013 and there were \$5.9 million at September 30, 2013. There were no amounts outstanding on the Company’s line of credit with the FRB as of September 30, 2014.

As of September 30, 2014 the Company had additional borrowing capacity of \$374.0 million with the Federal Home Loan Bank and \$321.3 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.

At September 30, 2014, December 31, 2013, and September 30, 2013, the Company had no securities sold under agreement to repurchase





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### Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities (“TPS”). See Note 13 located in “Item 8. Financial Statements and Supplementary Data” of the Company’s 2013 Annual Report on Form 10-K. Although this amount is reflected as subordinated debt on the Company’s balance sheet, under current regulatory guidelines, our TPS will continue to qualify as regulatory capital (See “Basel III Regulatory Capital Rules”). 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 September 30, 2014, 3.09% at December 31, 2013 and 3.10% at September 30, 2013. The average rate paid for these securities for the nine months of 2014 was 3.14% compared to 3.18% for the first nine months 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 \$227.2 million at September 30, 2014, \$209.9 million at December 31, 2013, and \$211.0 million at September 30, 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.

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 September 30, 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.

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(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 September 30, 2014						
Total Capital to Risk Weighted Assets	\$260,660	13.44%	\$155,169	8.0 %	N/A	N/A
Tier 1 Capital to Risk Weighted Assets	\$236,290	12.18%	\$77,584	4.0 %	N/A	N/A
Tier 1 Capital to Average Assets	\$236,290	10.92%	\$86,542	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 September 30, 2014						
Total Capital to Risk Weighted Assets	\$260,591	13.44%	\$155,157	8.0 %	\$193,946	10.0 %
Tier 1 Capital to Risk Weighted Assets	\$236,222	12.18%	\$77,579	4.0 %	\$116,368	6.0 %
Tier 1 Capital to Average Assets	\$236,222	10.92%	\$86,509	4.0 %	\$108,136	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 TPS. On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of 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 TPS 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 TPS 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.

There were no stock repurchases during the third quarter of 2014 or 2013. The remaining dollar value of shares that may yet be purchased under the Company’s Common Stock Repurchase Plan is approximately \$20 million.

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 Computershare Trust Company, N.A. 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

Both the FRB and FDIC have approved final rules that 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.

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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.

(in thousands)	September 30, 2014	December 31, 2013	September 30, 2013
Commitments to Extend Credit	\$ 543,595	\$ 445,294	\$ 473,475
Letters of Credit	7,470	7,393	7,434
Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our Borrowing Customers and Third Parties	263	-	-

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 September 30, 2014, December 31, 2013, and September 30, 2013. We do not anticipate any material losses as a result of these transactions.

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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 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's or lease's effective interest rate, the fair value of the loan's 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.

Central to the first phase of the analysis of the loan & lease portfolio is the risk rating system. The originating credit officer assigns each borrower an initial risk rating, which is based primarily on a thorough analysis of that 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.

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The second phase is conducted by segmenting the loan & lease portfolio by risk rating and into groups of loans & leases 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 service 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 September 30, 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.

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.



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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 September 30, 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 1.04% if rates increase by 200 basis points and a decrease in net interest income of 0.19% 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 September 30, 2014 the Company has additional borrowing capacity of \$374.4 million with the Federal Home Loan Bank and \$321.6 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.

At September 30, 2014, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities available-for-sale of approximately \$68.7 million, which represents 3.17% 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.

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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 third 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.

The common stock of Farmers & Merchants Bancorp is not widely held nor listed on any exchange. However, trades may be reported on the Over-The-Counter 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”

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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: November 7, 2014 /s/ Kent A. Steinwert

Kent A. Steinwert  
Chairman, President  
& Chief Executive Officer  
(Principal Executive Officer)

Date: November 7, 2014 /s/ Stephen W. Haley

Stephen W. Haley  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial & Accounting Officer)

Index to Exhibits

Exhibit  
No.      Description

<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