

FARMERS & MERCHANTS BANCORP INC

Form 10-Q

October 25, 2017

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**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 September 30, 2017**

**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 001-38084**

**FARMERS & MERCHANTS BANCORP, INC.**

**(Exact name of registrant as specified in its charter)**

<b>OHIO</b> (State or other jurisdiction of incorporation or organization)	<b>34-1469491</b> (IRS Employer Identification No.)
<b>307 North Defiance Street, Archbold, Ohio</b> (Address of principal executive offices)	<b>43502</b> (Zip Code)
<b>(419) 446-2501</b>	

**Registrant's telephone number, including area code**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or Section 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Common Stock, No Par Value	9,266,676
Class	Outstanding as of October 25, 2017



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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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

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## ITEM 1 FINANCIAL STATEMENTS

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

	Condensed Consolidated Balance Sheets (in thousands of dollars)	
	September 30, 2017 (Unaudited)	December 31, 2016
<b>Assets</b>		
Cash and due from banks	\$ 48,313	\$ 27,348
Federal funds sold	791	974
Total cash and cash equivalents	49,104	28,322
Interest-bearing time deposits	2,541	1,915
Securities - available-for-sale	192,811	218,527
Other securities, at cost	3,717	3,717
Loans held for sale	2,147	2,055
Loans, net	788,335	751,310
Premises and equipment	21,473	21,457
Goodwill	4,074	4,074
Mortgage servicing rights	2,264	2,192
Other real estate owned	615	774
Bank owned life insurance	14,446	14,376
Other assets	8,628	7,176
<b>Total Assets</b>	<b>\$ 1,090,155</b>	<b>\$ 1,055,895</b>
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest-bearing	\$ 189,963	\$ 186,390
Interest-bearing		
NOW accounts	294,911	230,446
Savings	224,911	226,537
Time	193,581	198,830
Total deposits	903,366	842,203
Federal Funds purchased and securities sold under agreements to repurchase	35,550	70,324
Federal Home Loan Bank (FHLB) advances	10,000	10,000
Dividend payable	1,193	1,053
Accrued expenses and other liabilities	7,157	6,738
Total liabilities	957,266	930,318

**Commitments and Contingencies****Stockholders Equity**

Common stock - No par value 20,000,000 shares authorized; issued and outstanding 10,400,000 shares 9/30/17 and 12/31/16 <sup>(1)</sup>	11,388	11,947
Treasury Stock - 1,133,324 shares 9/30/17, 1,158,250 shares 12/31/16 <sup>(1)</sup>	(12,126)	(12,267)
Retained earnings	134,320	127,869
Accumulated other comprehensive loss	(693)	(1,972)
<b>Total stockholders equity</b>	<b>132,889</b>	<b>125,577</b>
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 1,090,155</b>	<b>\$ 1,055,895</b>

<sup>(1)</sup> Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017  
See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2016, Condensed Consolidated Balance Sheet has been derived from the audited Consolidated Balance Sheet as of that date.

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## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

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

(Unaudited)

(in thousands of dollars, except per share data)

	Three Months Ended		Nine Months Ended	
	September 30, 2015	September 30, 2016	September 30, 2015	September 30, 2016
<b>Interest Income</b>				
Loans, including fees	\$ 9,547	\$ 8,629	\$ 27,367	\$ 24,997
Debt securities:				
U.S. Treasury and government agencies	605	559	1,870	1,734
Municipalities	290	344	905	1,093
Dividends	49	36	135	111
Federal funds sold	7	7	10	9
Other	37	15	93	37
<b>Total interest income</b>	<b>10,535</b>	<b>9,590</b>	<b>30,380</b>	<b>27,981</b>
<b>Interest Expense</b>				
Deposits	1,161	947	3,289	2,686
Federal funds purchased and securities sold under agreements to repurchase	135	115	366	346
Borrowed funds	37	37	110	110
<b>Total interest expense</b>	<b>1,333</b>	<b>1,099</b>	<b>3,765</b>	<b>3,142</b>
<b>Net Interest Income - Before Provision for Loan Losses</b>				
<b>Provision for Loan Losses</b>	<b>99</b>	<b>308</b>	<b>197</b>	<b>924</b>
<b>Net Interest Income After Provision For Loan Losses</b>				
<b>Noninterest Income</b>	<b>9,103</b>	<b>8,183</b>	<b>26,418</b>	<b>23,915</b>
Customer service fees	1,320	1,711	4,131	4,497
Other service charges and fees	1,134	941	3,214	2,850
Net gain on sale of loans	181	216	600	619
Net gain on sale of available for sale securities		47	47	503
<b>Total noninterest income</b>	<b>2,635</b>	<b>2,915</b>	<b>7,992</b>	<b>8,469</b>
<b>Noninterest Expense</b>				
Salaries and Wages	3,236	2,981	9,374	8,661
Employee benefits	943	849	2,648	2,426
Net occupancy expense	434	359	1,221	1,083



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Furniture and equipment	493	438	1,456	1,293
Data processing	300	360	919	1,132
Franchise taxes	226	219	676	658
Net (gain) loss on sale of other assets owned	13	(6)	27	39
FDIC Assessment	82	126	247	368
Mortgage servicing rights amortization	85	123	266	311
Other general and administrative	1,545	1,473	4,692	4,594
<b>Total other operating expenses</b>	<b>7,357</b>	<b>6,922</b>	<b>21,526</b>	<b>20,565</b>
<b>Income Before Income Taxes</b>	<b>4,381</b>	<b>4,176</b>	<b>12,884</b>	<b>11,819</b>
<b>Income Taxes</b>	<b>1,159</b>	<b>1,161</b>	<b>3,600</b>	<b>3,349</b>
<b>Net Income</b>	<b>3,222</b>	<b>3,015</b>	<b>9,284</b>	<b>8,470</b>
<b>Other Comprehensive Income (Loss)</b>				
<b>(Net of Tax):</b>				
Net unrealized gain (loss) on available for sale securities	(472)	58	1,984	2,652
Reclassification adjustment for gain on sale of available for sale securities		(47)	(47)	(503)
Net unrealized gain (loss) on available for sale securities	(472)	11	1,937	2,149
Tax expense (benefit)	(160)	4	659	731
Other comprehensive income (loss)	(312)	7	1,278	1,418
<b>Comprehensive Income</b>	<b>\$ 2,910</b>	<b>\$ 3,022</b>	<b>\$ 10,562</b>	<b>\$ 9,888</b>
<b>Earnings Per Share - Basic and Diluted <sup>(1)</sup></b>	<b>\$ 0.35</b>	<b>\$ 0.33</b>	<b>\$ 1.00</b>	<b>\$ 0.92</b>
<b>Dividends Declared <sup>(1)</sup></b>	<b>\$ 0.13</b>	<b>\$ 0.12</b>	<b>\$ 0.37</b>	<b>\$ 0.34</b>

<sup>(1)</sup> Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017

See Notes to Condensed Consolidated Unaudited Financial Statements

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## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	(in thousands of dollars)	
	Nine Months Ended	
	September 30, 2017	September 30, 2016
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 9,284	\$ 8,470
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,426	1,112
Amortization on available for sale securities, net	843	833
Amortization of servicing rights	266	311
Amortization of core deposit intangible	203	242
Compensation expense related to stock awards	346	297
Provision for loan loss	197	924
Gain on sale of loans held for sale	(600)	(619)
Originations of loans held for sale	(42,601)	(44,296)
Proceeds from sale of loans held for sale	44,574	44,119
Loss on sale of other assets owned	27	39
Gain on sales of securities available for sale	(47)	(503)
Change in other assets and other liabilities, net	(1,667)	(1,300)
Net cash provided by operating activities	12,251	9,629
<b>Cash Flows from Investing Activities</b>		
Activity in available-for-sale securities:		
Maturities, prepayments and calls	16,682	22,910
Sales	13,562	45,418
Purchases	(3,387)	(55,863)
Change in interest-bearing time deposits	(626)	(1,915)
Proceeds from sales of other assets owned	17	20
Additions to premises and equipment	(1,459)	(1,901)
Loan originations and principal collections, net	(39,195)	(52,996)
Net cash used in investing activities	(14,406)	(44,327)
<b>Cash Flows from Financing Activities</b>		
Net change in deposits	61,163	66,762
Net change in federal funds purchased and securities sold under agreements to repurchase	(34,774)	(19,328)
Purchase of Treasury Stock	(202)	(194)
Cash dividends paid on common stock	(3,250)	(3,062)

Net cash provided by financing activities	22,937	44,178
<b>Net Increase in Cash and Cash Equivalents</b>	<b>20,782</b>	<b>9,480</b>
<b>Cash and cash equivalents - Beginning of year</b>	<b>28,322</b>	<b>22,018</b>
<b>Cash and cash equivalents - End of period</b>	<b>\$ 49,104</b>	<b>\$ 31,498</b>
<b>Supplemental Information</b>		
Cash paid during the year for:		
Interest	\$ 3,735	\$ 3,098
Income taxes	\$ 3,802	\$ 3,810
Noncash investing activities:		
Transfer of loans to other real estate owned	\$	\$ 376

See Notes to Condensed Consolidated Unaudited Financial Statements.

**Table of Contents**ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS  
NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017. Operating results for the nine months ended September 30, 2017 are not necessarily indicative of the results that are expected for the year ended December 31, 2017. The condensed consolidated balance sheet of the Company as of December 31, 2016, has been derived from the audited consolidated balance sheet of the Company as of that date. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2016.

## NOTE 2 ASSET PURCHASES

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

An office was purchased on December 13, 2013 in Custar, Ohio. Core deposit intangible assets of \$1.17 million were recognized and are being amortized over its remaining economic useful life of the deposits of 7 years on a straight line basis.

The amortization expense for the year ended December 31, 2016 was \$323 thousand. Of the \$245 thousand to be expensed in 2017, \$203 thousand has been expensed for the nine months ended September 30, 2017.

	(In Thousands)		
	Hicksville	Custar	Total
2017	\$ 78	\$ 167	\$ 245
2018		167	167
2019		167	167
2020		161	161
	\$ 78	\$ 662	\$ 740

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

## NOTE 3 SECURITIES

The amortized cost and fair value of securities, with gross unrealized gains and losses at September 30, 2017 and December 31, 2016, follows:

	(In Thousands)			
	September 30, 2017			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 15,790	\$	\$ (114)	\$ 15,676
U.S. Government agencies	79,224		(1,064)	78,160
Mortgage-backed securities	42,409	142	(561)	41,990
State and local governments	56,438	779	(232)	56,985
<b>Total available-for-sale securities</b>	<b>\$ 193,861</b>	<b>\$ 921</b>	<b>\$ (1,971)</b>	<b>\$ 192,811</b>

	(In Thousands)			
	December 31, 2016			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
<b>Available-for-Sale:</b>				
U.S. Treasury	\$ 24,920	\$ 1	\$ (146)	\$ 24,775
U.S. Government agencies	84,266	3	(1,795)	82,474
Mortgage-backed securities	49,155	185	(879)	48,461
State and local governments	63,173	634	(990)	62,817
<b>Total available-for-sale securities</b>	<b>\$ 221,514</b>	<b>\$ 823</b>	<b>\$ (3,810)</b>	<b>\$ 218,527</b>

Investment securities will at times depreciate to an unrealized loss position. The Company utilizes the following criteria to assess whether impairment is other than temporary. No one item by itself will necessarily signal that a security should be recognized as an other than temporary impairment.

1. The fair value of the security has significantly declined from book value.
2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB by Standard and Poors.)

3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.
4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.
5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

If the impairment is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value, thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The amount of the write down shall be included in current earnings as a realized loss. The recovery in fair value, if any, shall be recognized in earnings when the security is sold. The table below is presented by category of security and length of time in a continuous loss position. The Company currently does not hold any securities with other than temporary impairment.

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

## NOTE 3 SECURITIES (Continued)

Information pertaining to securities with gross unrealized losses at September 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

	(In Thousands)			
	September 30, 2017			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	\$ (114)	\$ 15,676	\$	\$
U.S. Government agencies	(554)	62,910	(510)	15,251
Mortgage-backed securities	(288)	22,344	(273)	10,360
State and local governments	(130)	8,776	(102)	6,032
<b>Total available-for-sale securities</b>	<b>\$ (1,086)</b>	<b>\$ 109,706</b>	<b>\$ (885)</b>	<b>\$ 31,643</b>

	(In Thousands)			
	December 31, 2016			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	\$ (146)	\$ 15,745	\$	\$
U.S. Government agencies	(1,795)	77,471		
Mortgage-backed securities	(879)	36,474		
State and local governments	(983)	37,540	(7)	526
<b>Total available-for-sale securities</b>	<b>\$ (3,803)</b>	<b>\$ 167,230</b>	<b>\$ (7)</b>	<b>\$ 526</b>

Unrealized losses on securities have not been recognized into income because the issuers' bonds are of high credit quality, values have only been impacted by rate changes, and the Company has the intent and ability to hold the securities for the foreseeable future. Additionally, the decline in value is primarily due to changes in interest rates since the securities were purchased. The fair value is expected to recover as the bonds approach the maturity date.

Below are the gross realized gains and losses for the three and nine months ended September 30.

	Three Months (In Thousands)		Nine Months (In Thousands)	
	2017	2016	2017	2016
Gross realized gains	\$	\$ 47	\$ 58	\$ 514
Gross realized losses			(11)	(11)
Net realized gains	\$	\$ 47	\$ 47	\$ 503
Tax expense related to net realized gains	\$	\$ 16	\$ 16	\$ 171

The net realized gains on sales and related tax expense is a reclassification out of accumulated other comprehensive income (loss). The net realized gain is included in net gain on sale of available-for-sale securities and the related tax expense is included in tax expense in the condensed consolidated statements of income and comprehensive income.



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

## NOTE 3 SECURITIES (Continued)

The amortized cost and fair value of debt securities at September 30, 2017, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(In Thousands)	
	Amortized Cost	Fair Value
One year or less	\$ 9,014	\$ 9,017
After one year through five years	88,228	88,088
After five years through ten years	50,404	49,979
After ten years	3,806	3,737
<b>Total</b>	<b>\$ 151,452</b>	<b>\$ 150,821</b>
Mortgage-backed securities	42,409	41,990
<b>Total</b>	<b>\$ 193,861</b>	<b>\$ 192,811</b>

Investments with a carrying value of \$84.5 million and \$129.4 million at September 30, 2017 and December 31, 2016, respectively, were pledged to secure public deposits and securities sold under repurchase agreements.

Other securities include Federal Home Loan Bank of Cincinnati and Farmer Mac stock as of September 30, 2017 and December 31, 2016.

## NOTE 4 LOANS

Loan balances as of September 30, 2017 and December 31, 2016:

	(In Thousands)	
Loans:	September 30, 2017	December 31, 2016
Consumer Real Estate	\$ 84,283	\$ 86,234
Agricultural Real Estate	63,603	62,375
Agricultural	87,095	84,563
Commercial Real Estate	394,481	377,481
Commercial and Industrial	124,078	109,256
Consumer	35,843	33,179
Industrial Development Bonds	6,555	5,732

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	795,938	758,820
Less: Net deferred loan fees and costs	(733)	(726)
	795,205	758,094
Less: Allowance for loan losses	(6,870)	(6,784)
Loans Net	\$ 788,335	\$ 751,310

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

## NOTE 4 LOANS (Continued)

The following is a contractual maturity schedule by major category of loans as of September 30, 2017:

	(In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	\$ 2,153	\$ 14,237	\$ 67,893
Agricultural Real Estate	401	5,495	57,707
Agricultural	51,979	25,915	9,201
Commercial Real Estate	10,875	120,924	262,682
Commercial and Industrial	68,139	34,860	21,079
Consumer	5,077	23,025	7,741
Industrial Development Bonds	831	85	5,639

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of September 30, 2017:

	(In Thousands)	
	Fixed Rate	Variable Rate
Consumer Real Estate	\$ 47,662	\$ 36,621
Agricultural Real Estate	46,557	17,046
Agricultural	35,708	51,387
Commercial Real Estate	266,316	128,165
Commercial and Industrial	58,560	65,518
Consumer	31,554	4,289
Industrial Development Bonds	6,555	

As of September 30, 2017 and December 31, 2016 one to four family residential mortgage loans amounting to \$17.7 and \$17.9 million, respectively, have been pledged as security for future loans and existing loans the Bank has received from the Federal Home Loan Bank.

Unless listed separately, Industrial Development Bonds are included in the Commercial and Industrial category for the remainder of the tables in this Note 4.

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

## NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment (in thousands) in past due loans by portfolio classification of loans as of September 30, 2017 and December 31, 2016, net of deferred loan fees and costs:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
September 30, 2017							
Consumer Real Estate	\$ 532	\$ 0	\$ 505	\$ 1,037	\$ 82,838	\$ 83,875	\$
Agricultural Real Estate	104		101	205	63,366	63,571	
Agricultural		2	124	126	87,113	87,239	
Commercial Real Estate			98	98	393,815	393,913	
Commercial and Industrial					130,720	130,720	
Consumer	37	8		45	35,842	35,887	
<b>Total</b>	<b>\$ 673</b>	<b>\$ 10</b>	<b>\$ 828</b>	<b>\$ 1,511</b>	<b>\$ 793,694</b>	<b>\$ 795,205</b>	<b>\$ 0</b>

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
December 31, 2016							
Consumer Real Estate	\$ 882	\$ 15	\$ 507	\$ 1,404	\$ 84,469	\$ 85,873	\$
Agricultural Real Estate	12		132	144	62,192	62,336	
Agricultural	101			101	84,591	84,692	
Commercial Real Estate	60			60	376,827	376,887	
Commercial and Industrial					115,093	115,093	
Consumer	29	6		35	33,178	33,213	
<b>Total</b>	<b>\$ 1,084</b>	<b>\$ 21</b>	<b>\$ 639</b>	<b>\$ 1,744</b>	<b>\$ 756,350</b>	<b>\$ 758,094</b>	<b>\$ 0</b>

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

## NOTE 4 LOANS (Continued)

The following table presents the recorded investment in nonaccrual loans by class of loans as of September 30, 2017 and December 31, 2016:

	(In Thousands)	
	September 30, 2017	December 31, 2016
Consumer Real Estate	\$ 1,176	\$ 1,091
Agricultural Real Estate	101	132
Agricultural	193	
Commercial Real Estate	98	
Commercial & Industrial	152	161
Consumer	9	
<b>Total</b>	<b>\$ 1,729</b>	<b>\$ 1,384</b>

Following are the characteristics and underwriting criteria for each major type of loan the Bank offers:

**Commercial Real Estate:** Construction, purchase, and refinance of business purpose real estate. Risks include potential construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower's ability to repay in orderly fashion, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

**Agricultural Real Estate:** Purchase of farm real estate or for permanent improvements to the farm real estate. Cash flow from the farm operation is the repayment source and is therefore subject to the financial success of the farm operation.

**Consumer Real Estate:** Purchase, refinance, or equity financing of one to four family owner occupied dwelling. Success in repayment is subject to borrower's income, debt level, character in fulfilling payment obligations, employment, and others.

**Commercial and Industrial:** Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of projections, financial leverage, economic trends, management ability and estimated capital expenditures during the fiscal year. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

**Agricultural:** Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re-finance of capital assets such as machinery and equipment and livestock. The production of crops and livestock

is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmer's ability to hedge their position by the use of the future contracts. The risk related to weather is often mitigated by requiring federal crop insurance.

Consumer: Funding for individual and family purposes. Success in repayment is subject to borrower's income, debt level, character in fulfilling payment obligations, employment, and others.

Industrial Development Bonds (IDB): Funds for public improvements in the Bank's service area. Repayment ability is based on the continuance of the taxation revenue as the source of repayment.

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

NOTE 4 LOANS (Continued)

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

The risk ratings are described as follows.

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

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

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

a.



At inception, the loan was secured with collateral possessing a loan value adequate to protect the Bank from loss;

- b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;
  - c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.
5. Four (4) Satisfactory / Monitored. A 4 (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.
  6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered potential, versus defined, impairments to the primary source of loan repayment and collateral.
  7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
    - a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
    - b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.

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

NOTE 4 LOANS (Continued)

- c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
  - d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
  - e. Unusual courses of action are needed to maintain a high probability of repayment.
  - f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.
  - g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.
  - h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.
  - i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.
  - j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.
8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:
- a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.
  - b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.

- c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.
9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.  
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by portfolio class, net of deferred fees and costs, based on the most recent analysis performed as of September 30, 2017 and December 31, 2016:

	(In Thousands)				
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
September 30, 2017					
1-2	\$ 3,973	\$ 5,316	\$ 1,639	\$ 10,166	\$
3	14,762	31,796	26,253	15,037	3,568
4	43,491	49,712	349,120	96,923	2,987
5	1,124	254	10,686	1,379	
6	221	161	6,215	547	
7				113	
8					
Total	\$ 63,571	\$ 87,239	\$ 393,913	\$ 124,165	\$ 6,555

	(In Thousands)				
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
December 31, 2016					
1-2	\$ 4,399	\$ 7,334	\$ 677	\$ 10,060	\$
3	16,660	31,397	27,858	14,064	2,640
4	39,808	44,560	333,523	83,100	3,092
5	1,209	1,234	8,321	1,379	
6	260	167	6,508	641	
7				117	
8					
Total	\$ 62,336	\$ 84,692	\$ 376,887	\$ 109,361	\$ 5,732

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

## NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, as was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of September 30, 2017 and December 31, 2016.

Grade	(In Thousands)	
	Consumer Real Estate September 30, 2017	Consumer Real Estate December 31, 2016
Pass	\$ 83,471	\$ 85,322
Special Mention (5)		25
Substandard (6)	320	368
Doubtful (7)	84	158
Total	\$ 83,875	\$ 85,873

	(In Thousands)			
	Consumer - Credit		Consumer - Other	
	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016
Performing	\$ 3,845	\$ 4,061	\$ 32,013	\$ 29,120
Nonperforming	1		28	32
Total	\$ 3,846	\$ 4,061	\$ 32,041	\$ 29,152

Information about impaired loans as of September 30, 2017, December 31, 2016 and September 30, 2016 are as follows:

	(In Thousands)		
	September 30, 2017	December 31, 2016	September 30, 2016
Impaired loans without a valuation allowance	\$ 1,294	\$ 1,141	\$ 515
Impaired loans with a valuation allowance	685	711	891

Total impaired loans	\$ 1,979	\$ 1,852	\$ 1,406
Valuation allowance related to impaired loans	\$ 123	\$ 135	\$ 125
Total non-accrual loans	\$ 1,729	\$ 1,384	\$ 1,132
Total loans past-due ninety days or more and still accruing	\$	\$	\$
Quarter ended average investment in impaired loans	\$ 1,804	\$ 1,684	\$ 1,499
Year to date average investment in impaired loans	\$ 1,793	\$ 1,802	\$ 1,843

No additional funds are committed to be advanced in connection with impaired loans.

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

## NOTE 4 LOANS (Continued)

The Bank had approximately \$540 thousand of its impaired loans classified as troubled debt restructured (TDR) as of September 30, 2017, \$557 thousand as of December 31, 2016 and \$562 thousand as of September 30, 2016. During the year to date 2017, there were no new loans considered TDR.

The following table represents three and nine months ended September 30, 2017.

Three Months September 30, 2017 (in thousands)	Number of Contracts Modified in the Last 3 Months	Pre-	Post-	Nine Months September 30, 2017 (in thousands)	Number of Contracts Modified in the Last 9 Months	Pre-	Post-
		Modification Recorded	Modification Recorded			Modification Recorded	Modification Recorded
Troubled Debt Restructurings		Investment	Investment	Troubled Debt Restructurings		Investment	Investment
None		\$	\$	None		\$	\$

The following table represents three and nine months ended September 30, 2016.

Three Months September 30, 2016 (in thousands)	Number of Contracts Modified in the Last 3 Months	Pre-	Post-	Nine Months September 30, 2016 (in thousands)	Number of Contracts Modified in the Last 9 Months	Pre-	Post-
		Modification Recorded	Modification Recorded			Modification Recorded	Modification Recorded
Troubled Debt Restructurings		Investment	Investment	Troubled Debt Restructurings		Investment	Investment
Consumer Real Estate		\$	\$	Consumer Real Estate	1	\$ 138	\$ 138

For the three and nine month period ended September 30, 2017 and 2016, there were no TDRs that subsequently defaulted after modification.

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

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



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

## NOTE 4 LOANS (Continued)

The following tables present loans individually evaluated for impairment by class of loans for three months ended September 30, 2017 and September 30, 2016.

	(In Thousands)					
	Recorded	Unpaid Principal	Related Allowance	QTD Average Recorded	QTD Interest Income	QTD Interest Income Recognized Cash Basis
Three Months Ended September 30, 2017	Investment	Balance	Allowance	Investment	Recognized	Basis
With no related allowance recorded:						
Consumer Real Estate	\$ 928	\$ 928	\$	\$ 926	\$ 8	\$ 5
Agricultural Real Estate	205	205		136		
Agricultural	161	161		54		
Commercial Real Estate						
Commercial and Industrial						
Consumer						
With a specific allowance recorded:						
Consumer Real Estate	84	84	25	85		
Agricultural Real Estate						
Agricultural						
Commercial Real Estate	488	488	67	489	5	
Commercial and Industrial	113	113	31	114		
Consumer						
Totals:						
Consumer Real Estate	\$ 1,012	\$ 1,012	\$ 25	\$ 1,011	\$ 8	\$ 5
Agricultural Real Estate	\$ 205	\$ 205	\$	\$ 136	\$	\$
Agricultural	\$ 161	\$ 161	\$	\$ 54	\$	\$
Commercial Real Estate	\$ 488	\$ 488	\$ 67	\$ 489	\$ 5	\$
Commercial and Industrial	\$ 113	\$ 113	\$ 31	\$ 114	\$	\$
Consumer	\$	\$	\$	\$	\$	\$



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

## NOTE 4 LOANS (Continued)

	(In Thousands)					
	Recorded	Unpaid Principal	Related Allowance	QTD Average Recorded Investment	QTD Interest Income Recognized	QTD Interest Income Recognized Cash Basis
Three Months Ended September 30, 2016	Investment	Balance	Allowance	Investment	Recognized	Basis
With no related allowance recorded:						
Consumer Real Estate	\$ 383	\$ 383	\$	\$ 51	\$	\$
Agricultural Real Estate	132	132		132		
Agricultural						
Commercial Real Estate				345	4	4
Commercial and Industrial				446	6	
Consumer						
With a specific allowance recorded:						
Consumer Real Estate	329	329	35	377	4	1
Agricultural Real Estate						
Agricultural						
Commercial Real Estate	444	444	68	30		
Commercial and Industrial	118	118	22	118		
Consumer						
Totals:						
Consumer Real Estate	\$ 712	\$ 712	\$ 35	\$ 428	\$ 4	\$ 1
Agricultural Real Estate	\$ 132	\$ 132	\$	\$ 132	\$	\$
Agricultural	\$	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 444	\$ 444	\$ 68	\$ 375	\$ 4	\$ 4
Commercial and Industrial	\$ 118	\$ 118	\$ 22	\$ 564	\$ 6	\$
Consumer	\$	\$	\$	\$	\$	\$

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

## NOTE 4 LOANS (Continued)

The following tables present loans individually evaluated for impairment by class of loans for nine months ended September 30, 2017 and September 30, 2016.

	(In Thousands)					
	Recorded	Unpaid Principal	Related Allowance	YTD Average Recorded	YTD Interest Income	YTD Interest Income Recognized Cash Basis
Nine Months Ended September 30, 2017	Investment	Balance	Allowance	Investment	Recognized	
With no related allowance recorded:						
Consumer Real Estate	\$ 928	\$ 928	\$	\$ 959	\$ 25	\$ 17
Agricultural Real Estate	205	205		119		
Agricultural	161	161		18		
Commercial Real Estate						
Commercial and Industrial						
Consumer						
With a specific allowance recorded:						
Consumer Real Estate	84	84	25	89		
Agricultural Real Estate						
Agricultural						
Commercial Real Estate	488	488	67	493	17	2
Commercial and Industrial	113	113	31	115		
Consumer						
Totals:						
Consumer Real Estate	\$ 1,012	\$ 1,012	\$ 25	\$ 1,048	\$ 25	\$ 17
Agricultural Real Estate	\$ 205	\$ 205	\$	\$ 119	\$	\$
Agricultural	\$ 161	\$ 161	\$	\$ 18	\$	\$
Commercial Real Estate	\$ 488	\$ 488	\$ 67	\$ 493	\$ 17	\$ 2
Commercial and Industrial	\$ 113	\$ 113	\$ 31	\$ 115	\$	\$
Consumer	\$	\$	\$	\$	\$	\$



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

## NOTE 4 LOANS (Continued)

	(In Thousands)					
	Recorded	Unpaid Principal	Related Allowance	YTD Average Recorded Investment	YTD Interest Income Recognized	YTD Interest Income Recognized Cash Basis
Nine Months Ended September 30, 2016	Investment	Balance	Allowance	Investment	Recognized	Basis
With no related allowance recorded:						
Consumer Real Estate	\$ 383	\$ 383	\$	\$ 78	\$ 1	\$ 1
Agricultural Real Estate	132	132		152	1	
Agricultural						
Commercial Real Estate				367	17	16
Commercial and Industrial				450	18	
Consumer						
With a specific allowance recorded:						
Consumer Real Estate	329	329	35	387	11	7
Agricultural Real Estate				13		
Agricultural						
Commercial Real Estate	444	444	68	254		
Commercial and Industrial	118	118	22	142		
Consumer						
Totals:						
Consumer Real Estate	\$ 712	\$ 712	\$ 35	\$ 465	\$ 12	\$ 8
Agricultural Real Estate	\$ 132	\$ 132	\$	\$ 165	\$ 1	\$
Agricultural	\$	\$	\$	\$	\$	\$
Commercial Real Estate	\$ 444	\$ 444	\$ 68	\$ 621	\$ 17	\$ 16
Commercial and Industrial	\$ 118	\$ 118	\$ 22	\$ 592	\$ 18	\$
Consumer	\$	\$	\$	\$	\$	\$

As of September 30, 2017, the Company had \$25 thousand of foreclosed residential real estate property obtained by physical possession and \$59 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions. As of September 30, 2016, the Company had \$808 thousand of foreclosed residential real estate property obtained by physical possession and \$211 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings were in process according to local jurisdictions.



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

## NOTE 4 LOANS (Continued)

The Allowance for Loan and Lease Losses (ALLL) has a direct impact on the provision expense. An increase in the ALLL is funded through recoveries and provision expense. The following tables summarize the activities in the allowance for credit losses.

	(In Thousands)	
	Nine Months Ended September 30, 2017	Twelve Months Ended December 31, 2016
<b>Allowance for Loan &amp; Lease Losses</b>		
Balance at beginning of year	\$ 6,784	\$ 6,057
Provision for loan loss	197	1,121
Loans charged off	(208)	(550)
Recoveries	97	156
Allowance for Loan & Lease Losses	\$ 6,870	\$ 6,784
<b>Allowance for Unfunded Loan Commitments &amp; Letters of Credit</b>	 \$ 228	 \$ 217
Total Allowance for Credit Losses	\$ 7,098	\$ 7,001

The Company segregates its ALLL into two reserves: The ALLL and the Allowance for Unfunded Loan Commitments and Letters of Credit (AULC). When combined, these reserves constitute the total Allowance for Credit Losses (ACL).

The AULC is reported within other liabilities on the balance sheet while the ALLL is netted within the loans, net asset line. The ACL presented above represents the full amount of reserves available to absorb possible credit losses.

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

## NOTE 4 LOANS (Continued)

The following table breaks down the activity within ACL for each loan portfolio classification and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs.

Additional analysis, presented in thousands, related to the allowance for credit losses for three months ended September 30, 2017 and September 30, 2016 is as follows:

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of CrediUnallocated	Total	
<b>Three Months Ended September 30, 2017</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 250	\$ 253	\$ 596	\$ 3,076	\$ 1,352	\$ 407	\$ 219	\$ 924	\$ 7,077
Charge Offs				(19)		(92)			(111)
Recoveries				4	2	18			24
Provision (Credit)	26	(5)	17	56	38	90		(123)	99
Other Non-interest expense related to unfunded							9		9
Ending Balance	\$ 276	\$ 248	\$ 613	\$ 3,117	\$ 1,392	\$ 423	\$ 228	\$ 801	\$ 7,098
Ending balance: individually evaluated for impairment	\$ 25	\$	\$	\$ 67	\$ 31	\$	\$	\$	\$ 123
Ending balance: collectively evaluated for	\$ 251	\$ 248	\$ 613	\$ 3,050	\$ 1,361	\$ 423	\$ 228	\$ 801	\$ 6,975

impairment

Ending balance: loans acquired with deteriorated credit quality	\$	\$	\$	\$	\$	\$	\$	\$	\$
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**FINANCING  
RECEIVABLES:**

Ending balance	\$ 83,875	\$ 63,571	\$ 87,239	\$ 393,913	\$ 130,720	\$ 35,887	\$	\$	\$ 795,205
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Ending balance: individually evaluated for impairment	\$ 1,012	\$ 205	\$ 161	\$ 488	\$ 113	\$	\$	\$	\$ 1,979
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Ending balance: collectively evaluated for impairment	\$ 82,863	\$ 63,366	\$ 87,078	\$ 393,425	\$ 130,607	\$ 35,887	\$	\$	\$ 793,226
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Ending balance: loans acquired with deteriorated credit quality	\$ 194	\$	\$	\$	\$	\$	\$	\$	\$ 194
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Three Months Ended September 30, 2016</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 413	\$ 229	\$ 591	\$ 2,717	\$ 1,215	\$ 365	\$ 219	\$ 963	\$ 6,712
Charge Offs	(42)		(3)	(90)		(83)			(218)
Recoveries	1		4	2	3	19			29
Provision (Credit)	(86)	5	(12)	376	(23)	59		(11)	308
Other Non-interest expense related to unfunded							8		8
Ending Balance	\$ 286	\$ 234	\$ 580	\$ 3,005	\$ 1,195	\$ 360	\$ 227	\$ 952	\$ 6,839
Ending balance: individually evaluated for impairment	\$ 35	\$	\$	\$ 68	\$ 22	\$	\$	\$	\$ 125
Ending balance: collectively evaluated for impairment	\$ 251	\$ 234	\$ 580	\$ 2,937	\$ 1,173	\$ 360	\$ 227	\$ 952	\$ 6,714
Ending balance: loans acquired with deteriorated credit quality	\$ 1	\$	\$	\$	\$	\$	\$	\$	\$ 1

**FINANCING  
RECEIVABLES:**

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Ending balance	\$ 85,977	\$ 59,458	\$ 79,332	\$ 369,721	\$ 111,953	\$ 30,616	\$	\$	\$ 737,057
Ending balance: individually evaluated for impairment	\$ 712	\$ 132	\$	\$ 444	\$ 118	\$	\$	\$	\$ 1,406
Ending balance: collectively evaluated for impairment	\$ 85,265	\$ 59,326	\$ 79,332	\$ 369,277	\$ 111,835	\$ 30,616	\$	\$	\$ 735,651
Ending balance: loans acquired with deteriorated credit quality	\$ 265	\$	\$	\$	\$	\$	\$	\$	\$ 265

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

## NOTE 4 LOANS (Continued)

Additional analysis, presented in thousands, related to the allowance for credit losses for nine months ended September 30, 2017 and September 30, 2016 is as follows:

	Consumer Real Estate	Agricultural Real Estate	Agricultural Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Nine Months Ended September 30, 2017</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 316	\$ 241	\$ 616	\$ 3,250	\$ 1,318	\$ 394	\$ 217	\$ 649	\$ 7,001
Charge Offs				(19)		(189)			(208)
Recoveries	13		2	11	8	63			97
Provision (Credit)	(53)	7	(5)	(125)	66	155		152	197
Other Non-interest expense related to unfunded							11		11
Ending Balance	\$ 276	\$ 248	\$ 613	\$ 3,117	\$ 1,392	\$ 423	\$ 228	\$ 801	\$ 7,098
Ending balance: individually evaluated for impairment	\$ 25	\$	\$	\$ 67	\$ 31	\$	\$	\$	\$ 123
Ending balance: collectively evaluated for impairment	\$ 251	\$ 248	\$ 613	\$ 3,050	\$ 1,361	\$ 423	\$ 228	\$ 801	\$ 6,975
Ending balance: loans acquired with	\$	\$	\$	\$	\$	\$	\$	\$	\$

deteriorated credit  
quality

**FINANCING  
RECEIVABLES:**

Ending balance	\$ 83,875	\$ 63,571	\$ 87,239	\$ 393,913	\$ 130,720	\$ 35,887	\$	\$	\$ 795,205
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Ending balance:

individually  
evaluated for  
impairment

\$ 1,012	\$ 205	\$ 161	\$ 488	\$ 113	\$	\$	\$	\$ 1,979
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Ending balance:

collectively  
evaluated for  
impairment

\$ 82,863	\$ 63,366	\$ 87,078	\$ 393,425	\$ 130,607	\$ 35,887	\$	\$	\$ 793,226
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Ending balance:

loans acquired with  
deteriorated credit  
quality

\$ 194	\$	\$	\$	\$	\$	\$	\$	\$ 194
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
<b>Nine Months Ended September 30, 2016</b>									
<b>ALLOWANCE FOR CREDIT LOSSES:</b>									
Beginning balance	\$ 338	\$ 211	\$ 582	\$ 2,516	\$ 1,229	\$ 337	\$ 208	\$ 844	\$ 6,265
Charge Offs	(106)		(21)	(93)	(20)	(236)			(476)
Recoveries	23		9	7	8	60			107
Provision (Credit)	31	23	10	575	(22)	199		108	924
Other Non-interest expense related to unfunded							19		19
Ending Balance	\$ 286	\$ 234	\$ 580	\$ 3,005	\$ 1,195	\$ 360	\$ 227	\$ 952	\$ 6,839
Ending balance: individually evaluated for impairment	\$ 35	\$	\$	\$ 68	\$ 22	\$	\$	\$	\$ 125
Ending balance: collectively evaluated for impairment	\$ 251	\$ 234	\$ 580	\$ 2,937	\$ 1,173	\$ 360	\$ 227	\$ 952	\$ 6,714
Ending balance: loans acquired with deteriorated credit quality	\$ 1	\$	\$	\$	\$	\$	\$	\$	1

**FINANCING  
RECEIVABLES:**

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Ending balance	\$ 85,977	\$ 59,458	\$ 79,332	\$ 369,721	\$ 111,953	\$ 30,616	\$	\$	\$ 737,057
Ending balance: individually evaluated for impairment	\$ 712	\$ 132	\$	\$ 444	\$ 118	\$	\$	\$	\$ 1,406
Ending balance: collectively evaluated for impairment	\$ 85,265	\$ 59,326	\$ 79,332	\$ 369,277	\$ 111,835	\$ 30,616	\$	\$	\$ 735,651
Ending balance: loans acquired with deteriorated credit quality	\$ 265	\$	\$	\$	\$	\$	\$	\$	\$ 265



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## ITEM 1 NOTES TO CONDESED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 EARNINGS PER SHARE

Basic earnings per share are calculated using the two-class method. The two-class method is an earnings allocation formula under which earnings per share is calculated from common stock and participating securities according to dividends declared and participation rights in undistributed earnings. Under this method, all earnings distributed and undistributed, are allocated to participating securities and common shares based on their respective rights to receive dividends. Unvested share-based payment awards that contain non-forfeitable rights to dividends are considered participating securities (i.e. unvested restricted stock), not subject to performance based measures. Basic earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding. Application of the two-class method for participating securities results a more dilutive basic earnings per share as the participating securities are allocated the same amount of income as if they are outstanding for purposes of basic earnings per share. There is no additional potential dilution in calculating diluted earnings per share, therefore basic and diluted earnings per share are the same amounts. Other than the restricted stock plan, the Company has no other stock based compensation plans.

	In Thousands			
	Three Months Ended		Year to Date Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Earnings per share				
Net income	\$ 3,222	\$ 3,015	\$ 9,284	\$ 8,470
Less: distributed earnings allocated to participating securities	(12)	(10)	(33)	(27)
Less: undistributed earnings allocated to participating securities	(19)	(16)	(54)	(45)
Net earnings available to common shareholders	\$ 3,191	\$ 2,989	\$ 9,197	\$ 8,398
Weighted average common shares outstanding including participating securities <sup>(1)</sup>	9,252,919	9,225,532	9,245,514	9,218,376
Less: average unvested restricted shares <sup>(1)</sup>	(88,596)	(80,422)	(87,074)	(77,866)
Weighted average common shares outstanding <sup>(1)</sup>	9,164,323	9,145,110	9,158,440	9,140,510
Basic earnings and diluted per share <sup>(1)</sup>	\$ 0.35	\$ 0.33	\$ 1.00	\$ 0.92

<sup>(1)</sup> Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017

## NOTE 6 FAIR VALUE OF INSTRUMENTS

## FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

Cash and Cash Equivalents

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

Interest Bearing Time Deposits

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Securities Available-for-sale

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

Other Securities

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

Loans Held for Sale

The carrying amount approximates fair value due to insignificant amount of time between origination and date of sale.

Loans, net

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

Deposits

The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed term money market accounts and

certificates of deposit approximate their fair value at the reporting date. Fair value for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

#### Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

The carrying value of federal funds purchased and securities sold under agreements to repurchase approximates fair values.

#### Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Off Balance Sheet Financial Instruments

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

## FHLB Advances

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

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of September 30, 2017 and December 31, 2016 are reflected below.

	(In Thousands)				
	September 30, 2017				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 49,104	\$ 49,104	\$ 49,104	\$	\$
Interest-bearing time deposits	2,541	2,541		2,541	
Securities - available-for-sale	192,811	192,811	15,676	175,693	1,442
Other Securities	3,717	3,717			3,717
Loans held for sale	2,147	2,147			2,147
Loans, net	788,335	790,893			790,893
Interest receivable	5,106	5,106			5,106
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 519,822	\$ 519,865	\$	\$	\$ 519,865
Non-interest bearing Deposits	189,963	189,963		189,963	
Time Deposits	193,581	194,342			194,342
<b>Total Deposits</b>	<b>\$ 903,366</b>	<b>\$ 904,170</b>	<b>\$</b>	<b>\$ 189,963</b>	<b>\$ 714,207</b>
<b>Federal Funds Purchased and Securities Sold Under Agreement to Repurchase</b>					
Federal Home Loan Bank advances	\$ 35,550	\$ 35,550	\$	\$	\$ 35,550
Interest payable	10,000	10,041			10,041
	285	285			285

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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands)				
	December 31, 2016				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$ 28,322	\$ 28,322	\$ 28,322	\$	\$
Interest-bearing time deposits	1,915	1,918		1,918	
Securities - available-for-sale	218,527	218,527	24,775	192,334	1,418
Other Securities	3,717	3,717			3,717
Loans held for sale	2,055	2,055			2,055
Loans, net	751,310	753,357			753,357
Interest receivable	3,880	3,880			3,880
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$ 456,983	\$ 456,983	\$	\$	\$ 456,983
Non-interest bearing Deposits	186,390	186,390		186,390	
Time Deposits	198,830	199,658			199,658
<b>Total Deposits</b>	<b>\$ 842,203</b>	<b>\$ 843,031</b>	<b>\$</b>	<b>\$ 186,390</b>	<b>\$ 656,641</b>
<b>Federal Funds Purchased and Securities Sold Under</b>					
Agreement to Repurchase	\$ 70,324	\$ 70,324	\$	\$	\$ 70,324
Federal Home Loan Bank advances	10,000	10,041			10,041
Interest payable	256	256			256
<b>Fair Value Measurements</b>					

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

Available-for-sale securities, when quoted prices are available in an active market, securities are valued using the quoted price and are classified as Level 1.

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

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

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability. The Bank holds some local municipals that the Bank evaluates based on the credit strength of the underlying project. The fair value is determined by valuing similar credit payment streams at similar rates.



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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

The following summarizes financial assets measured at fair value on a recurring basis as of September 30, 2017 and December 31, 2016, segregated by level or the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured at Fair Value on a Recurring Basis (In Thousands)			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
September 30, 2017			
Assets - (Securities Available-for-Sale)			
U.S. Treasury	\$ 15,676	\$	\$
U.S. Government agencies		78,160	
Mortgage-backed securities		41,990	
State and local governments		55,543	1,442
Total Securities Available-for-Sale	\$ 15,676	\$ 175,693	\$ 1,442
December 31, 2016			
Assets - (Securities Available-for-Sale)			
U.S. Treasury	\$ 24,775	\$	\$
U.S. Government agencies		82,474	
Mortgage-backed securities		48,461	
State and local governments		61,399	1,418
Total Securities Available-for-Sale	\$ 24,775	\$ 192,334	\$ 1,418



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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table represents the changes in the Level 3 fair-value category of which unobservable inputs are relied upon as of September 30, 2017 and September 30, 2016.

	(In Thousands)		
	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	State and Local Governments Tax-Exempt	State and Local Governments Taxable	State and Local Governments Total
Balance at January 1, 2017	\$	\$ 1,418	\$ 1,418
Change in Market Value		24	24
Payments & Maturities			
Balance at September 30, 2017	\$	\$ 1,442	\$ 1,442

	(In Thousands)		
	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	State and Local Governments Tax-Exempt	State and Local Governments Taxable	State and Local Governments Total
Balance at January 1, 2016	\$ 5,904	\$ 1,448	\$ 7,352
Change in Market Value		93	93
Payments & Maturities	(5,904)		(5,904)
Balance at September 30, 2016	\$	\$ 1,541	\$ 1,541

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

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At September 30, 2017 and December 31, 2016, such assets consist primarily of collateral dependent impaired loans. Collateral dependent impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)



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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

At September 30, 2017 and December 31, 2016, fair value of collateral dependent impaired loans categorized as Level 3 was \$562 and \$576 thousand, respectively. The specific allocation for impaired loans was \$123 and \$135 thousand as of September 30, 2017 and December 31, 2016, respectively, which are accounted for in the allowance for loan losses (see Note 4).

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

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements:

	Fair Value at September 30, 2017 (In Thousands)	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
State and local government	\$ 1,442	Discounted Cash Flow	Credit strength of underlying project or entity / Discount rate	0-5%(3.59%)
Collateral dependent Impaired Loans	562	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%(18.00%)
Other real estate owned - residential		Appraisals	Discount to reflect current market	0-20%(0.0%)
Other real estate owned - commercial	266	Appraisals	Discount to reflect current market	0-20%(5.15%)
	Fair Value at December 31, 2016 (In Thousands)	Valuation Technique	Unobservable Inputs	Range (Weighted Average)

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State and local government	\$ 1,418	Discounted Cash Flow	Credit strength of underlying project or entity / Discount rate	0-5%(3.92%)
Collateral dependent Impaired Loans	576	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%(18.92%)
Other real estate owned - residential	144	Appraisals	Discount to reflect current market	0-20%(0.51%)
Other real estate owned - commercial		Appraisals	Discount to reflect current market	0-20%(0.0%)

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

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents impaired loans and other real estate owned as recorded at fair value on September 30, 2017 and December 31, 2016:

	Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2017 (In Thousands)			
	Balance at September 30, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent impaired loans	\$ 562	\$	\$	\$ 562
Other real estate owned - residential				
Other real estate owned - commercial	266			266
Total fair value				\$ 828

	Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2016 (In Thousands)			
	Balance at December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent impaired loans	\$ 576	\$	\$	\$ 576
Other real estate owned - residential	144			144
Other real estate owned - commercial				
Total fair value				\$ 720

## NOTE 7 FEDERAL FUNDS PURCHASED AND SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

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The Company did not have any Federal Funds Purchased as of September 30, 2017 and had \$17 million as of December 31, 2016. During the same time periods the company also had \$35.5 million and \$53.3 million in securities sold under agreement to repurchase.

	September 30, 2017				Total
	Remaining Overnight & Continuous	Contratual Maturity Up to 30 days	of the Agreements 30-90 days	Greater Than 90 days	
Federal funds purchased	\$	\$	\$	\$	\$
Repurchase Agreements; US Treasury & agency securities	\$ 14,737	\$	\$	\$ 20,813	\$ 35,550
	\$ 14,737	\$	\$	\$ 20,813	\$ 35,550

	December 31, 2016				Total
	Remaining Overnight & Continuous	Contratual Maturity Up to 30 days	of the Agreements 30-90 days	Greater Than 90 days	
Federal funds purchased	\$ 17,000	\$	\$	\$	\$ 17,000
Repurchase Agreements; US Treasury & agency securities	\$ 32,814	\$	\$	\$ 20,510	\$ 53,324
	\$ 49,814	\$	\$	\$ 20,510	\$ 70,324



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

## NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS

In January 2016, the Financial Accounting Standards Board (FASB) issued ASU No. 2016-01 *Financial Instruments Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company is assessing the impact of ASU 2016-01 on its accounting and disclosures.

In February 2016, the FASB issued ASU No. 2016-02 *Leases (Topic 842)*. ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its accounting and disclosures and currently has very limited exposure to the rule.

In June 2016, FASB issued 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses

on available-for-sale debt securities and purchased financial assets with credit deterioration

The ASU is effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently gathering information, reviewing possible vendors and has formed a committee to formulate the methodology to be used. Most importantly, the Company is gathering as much data as possible to enable review scenarios and determine which calculations will produce the most reliable results. . At this time an additional external advisor has not been contracted with though the Bank has been reviewing the use of external software.

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

## NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS (Continued)

In November 2016, the FASB issued ASU No. 2016-18 *Statement of Cash Flows (Topic 230) Restricted Cash*. ASU-2016-18 provides amendments to cash flow statement classification and presentation to explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and should be applied using a retrospective transition method to each period presented. Early adoption is permitted including adoption in an interim period. The Company has assessed ASU 2016-18 and does not expect a material impact on its accounting and disclosures as it currently does not have what would be considered Restricted cash at this time.

In January 2017, the FASB issued ASU No. 2017-01 *Business Combinations (Topic 805) Clarifying the Definition of a Business*. ASU 2017-01 provides amendments to clarify the definition of a business and affect all companies and other reporting organizations that must determine whether they have acquired or sold a business. The amendments are intended to help companies and other organizations evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and adoption is permitted under certain circumstances. The company has assessed ASU 2017-01 and does not expect it to have a material impact on its accounting and disclosures.

In January 2017, the FASB issued ASU No. 2017-04 *Intangibles Goodwill and other (Topic 350) Simplifying the Test for Goodwill Impairment*. These amendments eliminate Step 2 from the goodwill impairment test. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The guidance is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment test performed on testing dates after January 1, 2017. ASU 2017-04 should be adopted on a prospective basis. The Company does not expect ASU 2017-04 to have a material impact on its accounting disclosures, as goodwill testing has been completed annually without any impairment concerns.

In March 2017, the FASB issued Accounting Standards Update (ASU) No. 2017-08 *Receivables Nonrefundable Fees and Other Cost (Subtopic 310-20), Premium Amortization on Purchased Callable Debit Securities*. These amendments shorten the amortization period for certain callable debit securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company does have exposure and is assessing the impact of ASU 2017-08 and may choose early adoption. Overall, the Company does not expect it to have a material impact on its accounting.

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-09 *Compensation - Stock Compensation (Topic 718), Scope of Modification Accounting*. These amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. The amendments should be applied on a prospective basis to an award modified on or after the adoption date. The Company adopted ASU 2016-09 on January 1, 2017. ASU 2016-09 also requires that companies make an accounting policy election regarding forfeitures, to either estimate the number of awards that are expected to vest or account for them when they occur. The impact of this change and that of the remaining provisions of ASU 2016-09 did not have a significant impact on our financial statements.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**OVERVIEW**

The Company continued to obtain greater visibility with the investment community throughout the third quarter of 2017. On July 26, 2017, the Company rang the opening bell at the NASDAQ ceremony in New York City. The Company is listed under the symbol, FMAO. Being listed on the NASDAQ Capital Market and included in the Russell 3000 Index have caused the liquidity of the stock to improve as measured by the increased average daily volume and may have contributed to a higher market value than before these events took place. The stock price rose to an unprecedented \$87.00 per share or \$43.50 per share adjusted for the stock split. With the increased market value, the associated expense of the 2017 restricted stock awards will be higher than past years. On August 18, 2017, the Company's Board of Director's authorized a two-for-one stock split payable on September 20, 2017 for shareholders of record on September 5, 2017. The Company believes these steps will help with positioning for future strategic opportunities while benefiting shareholders with greater liquidity and enhanced ease of trading.

The Company continued to emphasize the importance of loan growth to overall profitability for the current year. Third quarter loan growth performance for 2017 was not as strong as the previous third quarter 2016. It did represent a continuation of 2016's milestone year. The increases in rate by the Federal Reserve which began in December 2016 provided the stimulus for the prime lending rate to be increased by similar amounts. Many of the Bank's variable loans have now had spread adjustments raising the base rates equivalent to their floors or above. This has resulted in improved asset yield and when coupled with loan growth has increased interest income.

After having a wet planting season throughout the Company's market area, the weather changed to an erratic rainfall pattern. As we enter the harvest season, crop production will likely be quite variable area to area. The Bank is not overly concerned as our clients remain well capitalized and we have only seen slight decreases in land values.

Unemployment rates remain low throughout the market area and competition for employees is high. Originations of residential mortgage loans slowed for the third quarter 2017 as compared to third quarter 2016.

Commercial activity remains similar to slightly better than a year ago. Businesses continue to look for additional labor to meet production requirements. The Company continues to see loan growth on the commercial side as clients continue to look for new opportunities as well as referring potential clients to the Company.

Loan growth drove the improvement in net interest income as compared to last year. Net income after taxes ended the third quarter 2017 6.9% above third quarter 2016. The 11.2% increase in net interest income after provision for loan losses was offset by a 9.6% decrease in noninterest income and a 6.3% increase in noninterest expenses which netted a 6.1% increase in earnings per share for the 2017 third quarter as compared to 2016's third quarter.

**NATURE OF ACTIVITIES**

Farmers & Merchants Bancorp, Inc. (the Company) is a financial holding company incorporated under the laws of Ohio in 1985. Our subsidiaries are, The Farmers & Merchants State Bank (the Bank), a community bank operating in Northwest Ohio since 1897 and Farmers & Merchants Risk Management, Inc., a captive insurance company formed in December 2014 and is located in Nevada. We report our financial condition and net income on a consolidated basis and we have only one segment.

Our executive offices are located at 307 North Defiance Street, Archbold, Ohio 43502, and our telephone number is (419) 446-2501. The Bank operates twenty-five full service banking offices throughout Northwest Ohio and Northeast

Indiana.

The Bank opened an additional office during April of 2016 in Fort Wayne, Indiana and the office is located within the corporation limits of Hometown, with a Fort Wayne address. The Bank has continued its expansion strategy and the new office is expected to provide new growth opportunities.

The Bank opened its twenty-fourth location in Bowling Green, Ohio in the fourth quarter 2016. It is the second leased office and was renovated to meet the Bank's needs before opening.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

**NATURE OF ACTIVITIES (Continued)**

The Farmers & Merchants State Bank engages in general commercial banking and savings business including commercial, agricultural and residential mortgage, consumer and credit card lending activities. The largest segment of the lending business relates to commercial, both real estate and non-real estate. The type of commercial business ranges from small business to multi-million dollar companies. The loans are a reflection of business located within the Bank's market area. Because the Bank's offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such items as farm land, farm equipment, livestock and operating loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for the purchase of autos, trucks, recreational vehicles, motorcycles, and other consumer goods.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition, Automated Teller Machines (ATMs) are provided at most branch locations along with other independent locations such as major employers and hospitals in the market area. The Bank has custodial services for Individual Retirement Accounts (IRAs) and Health Savings Accounts (HSAs). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and Automated Clearing House (ACH) file transmittal. In addition, the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Mobile banking was added in 2012 and has been widely accepted and used by consumers. Over the past couple of years, the Bank has updated its consumer offerings with Secure and Pure checking in 2014 and with KASASA Cash Back in 2015. During the second quarter 2017, new business checking products were announced and existing business accounts were converted to one of three new products, Business Essential, Edge or Elite. The new products provided customers with new options to bundle services and for the Bank to utilize the full relationship to determine pricing. This was the next step of implementation for the Bank's earn to free strategic initiative. Upgrades to our digital products and services continue to occur in both retail and business lines.

The Bank has established underwriting policies and procedures which facilitate operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank's practice has been to not promote innovative, unproven credit products which may not be in the best interest of the Bank or its customers. The Bank does offer a hybrid mortgage loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank's adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer

Mac and Small Business Lending programs. The Bank also normally retains the servicing rights on these partially or 100% sold loans. In order for the customer to participate in these programs they must meet the requirements established by those agencies. In addition, the Bank does sell some of its longer term fixed rate agricultural mortgages into the secondary market with the aid of a broker.

The Bank does not have a program to fund sub-prime loans. Sub-prime loans are characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers.

All loan requests are reviewed as to credit worthiness and are subject to the Bank's underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on collateral types as set forth in the Bank's Loan Policy. In addition, credit scores of principal borrowers are reviewed and an approved exception from an additional officer is required should a credit score not meet the Bank's Loan Policy guidelines.



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ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

NATURE OF ACTIVITIES (Continued)

Consumer Loans:

Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect.

Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage periods for wage or death.

Boats, campers, motorcycles, RV's and Motor Coaches range from 80%-90% based on age of vehicle.

1st or 2nd mortgages on 1-4 family homes range from 75%-90% with in-house first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV.

Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

Commercial/Agriculture/Real Estate:

Maximum LTVs range from 70%-80% depending on type.

Accounts Receivable: Up to 80% LTV less retainages and greater than 90 days.

Inventory:

Agriculture:

Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%.

Commercial:

Maximum LTV of 50% on raw and finished goods.

Floor plan:

- o New/used vehicles to 100% of wholesale.
- o New/Used recreational vehicles and manufactured homes to 80% of wholesale.

Equipment:

New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value.

Restaurant equipment up to 35% of market value.

Heavy trucks, titled trailers up to NTE 75% LTV and aircraft up to 75% of appraised value.

F&M Investment Services, the brokerage department of the Bank, opened for business in April, 1999. Securities are offered through Raymond James Financial Services, Inc.

In December of 2014, the Company became a financial holding company within the meaning of the Bank Holding Company Act of 1956 as amended (the Act), in order to provide the flexibility to take advantage of the expanded powers available to a financial holding company under the Act. Our subsidiary bank is in turn regulated and examined by the Ohio Division of Financial Institutions and the Federal Deposit Insurance Corporation. The activities of our bank subsidiary are also subject to other federal and state laws and regulations. The Company also formed a captive insurance company (the captive) in December 2014 which is located in Nevada and regulated by the State of Nevada Division of Insurance.

The Bank's primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Lucas, Williams, Wood and in the Indiana counties of Allen, DeKalb and Steuben. In our banking activities, we compete directly with other commercial banks, credit unions, farm credit services, and savings and loan institutions in each of our operating localities. In a number of our locations, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of the services provided.

At September 30, 2017, we had 272 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be good.

## **REGULATORY DEVELOPMENTS**

The Bank remains attentive to the current regulatory environment in light of the risk-based approach regulatory agencies use to conduct examinations. The degree of regulatory changes and the complexity of the recent new rules, which lack clarity or guidance on various provisions, and have resulted in uncertainties regarding liability, pose an increased overall risk of noncompliance. Various significant mortgage rules require ongoing monitoring by means of testing, validation of results, additional training, and further research or consultation to assist with ensuring compliance.



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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

**REGULATORY DEVELOPMENTS (Continued)**

The Bank is subject to numerous laws, rules, regulations and guidance which include, but are not limited to, the following significant matters: deposit insurance coverage; equal credit opportunity; fair lending; community reinvestment; anti-money laundering; suspicious activity reporting; identity theft identification and prevention; protections for military members and their dependents; flood disaster protection; integrated mortgage disclosures; mortgage servicing rights; legal lending limits; electronic fund transfers; consumer privacy; and unfair and deceptive acts and practices. Extensive training and training resources are necessary to develop and maintain expertise on the various regulatory matters.

New Military Lending Act (MLA) requirements have been implemented. The MLA is intended to protect active duty military service members and their dependents from potentially abusive lending practices. These new requirements resulted in expanded coverage of more types of loans. Safe harbor methods to identify covered borrowers who are military service members or their dependents are utilized. Coverage of credit card accounts becomes effective on October 3, 2017.

The Company has implemented Basel III capital rules which began to be phased in for the Company on January 1, 2015. These rules may impact the ability of some financial institutions to pay dividends, though the Company believes itself to be able to maintain its strong capital position and not be limited in that regard.

With regard to all regulatory matters, the Bank remains committed in making good faith efforts to comply with technical requirements of the laws, rules, regulations, and guidance from both federal and state agencies which govern its activities.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the financial services industry in which it operates. At times the application of these principles requires management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements and accompanying notes.

These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event. These policies, along with the disclosures presented in the notes to the condensed consolidated financial statements and in the management discussion and analysis of the financial condition and results of operations, provide information on how significant assets and liabilities are valued and how those values are determined for the financial statements. Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions,

estimates, and judgments underlying those amounts, management has identified the determination of the ALLL, the valuation of its Mortgage Servicing Rights and the valuation of real estate acquired through or in lieu of; loan foreclosures ( OREO Property ) as the accounting areas that require the most subjective or complex judgments, and as such could be the most subject to revision as new information becomes available.

OREO Property held for sale and is initially recorded at fair value at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell.

Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and a write-down is recorded by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell.

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ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

CRITICAL ACCOUNTING POLICIES AND ESTIMATES (Continued)

The net income from operations of foreclosed real estate held for sale is reported either in non-interest income or non-interest expense depending upon whether the property is in a gain or loss position overall. At September 30, 2017 OREO property holdings were \$615 thousand. OREO totaled \$774 thousand and \$1.4 million as of December 31, 2016 and September 30, 2016 respectively.

The ALLL and ACL represents management's estimate of probable credit losses inherent in the Bank's loan portfolio, unfunded loan commitments, and letters of credit at the report date. The ALLL methodology is regularly reviewed for its appropriateness and is approved annually by the Board of Directors. This written methodology is consistent with Generally Accepted Accounting Principles which provides for a consistently applied analysis.

The Bank's methodology provides an estimate of the probable credit losses either by calculating a specific loss per credit or by applying a composite of historical factors over a relevant period of time with current internal and external factors which may affect credit collectability. Such factors which may influence estimated losses are the conditions of the local and national economy, local unemployment trends, and abilities of lending staff, valuation trends of fixed assets, and trends in credit delinquency, classified credits, and credit losses.

Inherent in most estimates is imprecision. The Bank's ALLL provides a margin for imprecision with an unallocated portion. Bank regulatory agencies and external auditors periodically review the Bank's methodology and adequacy of the ALLL. Any required changes in the ALLL or loan charge-offs by these agencies or auditors may have a material effect on the ALLL.

The Bank is also required to estimate the value of its mortgage servicing rights. The Bank's mortgage servicing rights relating to fixed rate single-family mortgage loans that is has sold without recourse but services for others for a fee represent an asset on the Bank's balance sheet. The valuation is completed by an independent third party.

The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced.

The Bank's mortgage servicing rights relating to loans serviced for others represent an asset. This asset is initially capitalized and included in other assets on the Company's consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights using the level yield method. The amortization thereof is recorded in non-interest expense. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Bank. The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Bank's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Bank of the mortgage servicing rights, the Bank receives a valuation of its mortgage servicing rights from an independent third party. The

independent third party's valuation of the mortgage servicing rights is based on relevant characteristics of the Bank's loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as current national market interest rate levels, market forecasts and other economic conditions. For purposes of determining impairment, the mortgage servicing assets are stratified into like groups based on loan type, term, new versus seasoned and interest rate. Management, with the advice from its third party valuation firm, reviewed the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter's analysis related to the mortgage servicing asset. In addition, based upon the independent third party's valuation of the Bank's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Bank. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Bank's net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on market conditions. The accuracy of these estimates and assumptions by management and its third party valuation specialist can be directly tied back to the fact that management has only been required to record minor valuation allowances through its income statement over time based upon the valuation of each stratum of servicing rights.

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****CRITICAL ACCOUNTING POLICIES AND ESTIMATES (Continued)**

For more information regarding the estimates and calculations used to establish the ALLL and the value of Mortgage Servicing Rights, please see Note 1 to the consolidated financial statements provided herewith.

**MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES**

The Company plans to continue in its growth mode in 2017 led by loan growth from within our newer markets. The Bank is focused on funding the loan growth with the least expensive source. Growing deposits will also be a focus especially in our newer business checking product lines. These products bundle services and enable customers to choose their desired levels services and offer pricing based on a full relationship and not on just the single account. The Bank was able to grow deposits in the last quarter of 2016 and continued to do so through the first nine months of 2017. The Bank also decreased the level of pledged securities by offering the Insured Cash Sweep, ICS product accessed through the Promontory network of financial institutions. This has provided more availability for sales of securities by the Bank if warranted to fund loan growth.

Liquidity in terms of cash and cash equivalents ended almost \$20.8 million higher as of September 30, 2017 than it was at yearend December 31, 2016. A decrease in securities held along with increased deposits funded the \$37.0 million increase in net loans since yearend 2016. The largest loan growth occurred in commercial real estate and commercial and industrial portfolios. Agricultural, agricultural real estate and consumer portfolios also experienced increases. The largest decline was in consumer real estate which was due to sales into the secondary market outpacing new originations.

In comparing to the same prior year period, the September 30, 2017 (net of deferred fees and cost) loan balances of \$795.2 million accounted for a \$58.1 million or 7.9% increase when compared to 2016's \$737.1 million. The year over year improvement was made up of a 17.1% increase in commercial and industrial loans, a 6.5% increase in commercial real estate loans, a 17.2% increase in consumer loans and lastly a combined increase in agricultural related loans (comprised of a 6.9% increase in agricultural real estate loans and 10.0% increase in non-real estate agricultural loans). Consumer real estate loans decreased by 2.4% while Industrial Development Bonds (IDBs) increased 11.3%. The Company credits the growth to a strong team of lenders focused on providing customers valuable localized services and thereby increasing our market share.

The chart below shows the breakdown of the loan portfolio by category as of September 30 for the last three years, net of deferred fees and costs.

	(In Thousands)		
	September-17	September-16	September-15
	Amount	Amount	Amount
Consumer Real Estate	\$ 83,875	\$ 85,977	\$ 87,217
Agricultural Real Estate	63,571	59,458	54,950



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Agricultural	87,239	79,332	73,310
Commercial Real Estate	393,913	369,721	301,342
Commercial and Industrial	124,165	106,061	84,465
Consumer	35,887	30,616	26,458
Industrial Development Bonds	6,555	5,892	6,649
Total Loans, net	\$ 795,205	\$ 737,057	\$ 634,391

While the security portfolio has been utilized to fund loan growth for the last three years, additional sources have been cultivated during 2016 and 2017. The security portfolio decreased \$25.7 million in the first nine months 2017 from yearend 2016. The amount of pledged investment securities decreased significantly by \$44.9 million as compared to yearend and \$108.9 million as compared to September 30, 2016. This was accomplished by utilizing Promontory's Insured Cash Sweep, ICS, product to protect Ohio public fund depositors and commercial sweep customers with FDIC coverage rather than pledge securities. This in turn improves liquidity with the additional option of selling unpledged investment securities if needed to fund loan growth or other initiatives. As of September 30, 2017, pledged investment securities totaled \$84.5 million. The current portfolio is in a net unrealized loss position of \$1.1 million.

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES (Continued)**

With the exception of stock, which is shown as other securities, all of the Company's security portfolio is categorized as available for sale and as such is recorded at fair value.

Management feels confident that liquidity needs for future growth can be met through additional maturities and/or sales from the security portfolio, increased deposits and additional borrowings. For short term needs, the Bank has \$114.8 million of unsecured borrowing capacity through its correspondent banks.

Overall total assets grew 3.2% since yearend 2016 and 4.4% since September 30, 2016. The largest growth was in cash and cash equivalents followed by the loan portfolios.

Deposits accounted for the largest growth within liabilities, up 7.3% or \$61.2 million since yearend and 7.8% or \$65.3 million over September 30, 2016 balances. Core deposits continue to drive the increase which provided the greatest benefit for both lower cost of funds and the opportunity to generate additional noninterest income. Compared to previous year and last quarter, a movement of funds from securities sold under agreement to repurchase into interest bearing NOW accounts occurred due to utilization of the ICS product previously mentioned. This growth aided the increased liquidity position and funded the loan growth for the periods along with usage of purchased Federal Funds for daily borrowings.

Shareholders' equity increased by \$7.3 million as of the third quarter of 2017 compared to yearend 2016, as earnings exceeded dividend declarations. Accumulated other comprehensive loss decreased in loss position \$1.3 million which encompassed the shift of \$47 thousand from unrealized gain to realized gain with the sale of securities since yearend 2016. Dividends paid for the quarter increased from the previous quarter and dividends declared also increased 4.0%. Compared to September 30, 2016, shareholders' equity increased 4.7% or \$5.9 million. Record profits during 2016 were offset by a change in accumulated other comprehensive income related to the available for sale securities portfolio from a gain of \$1.6 million to a loss position of \$693 thousand as of September 30, 2016 and 2017, respectively. Profits are also higher in 2017 than 2016 by \$814 thousand.

Basel III regulatory capital requirements became effective in 2016. The Bank and Company include a capital conservation buffer as a part of the transition provision. For calendar year 2016, the applicable required capital conservation buffer percentage of 0.625% was the base above which institutions avoid limitations on distributions and certain discretionary bonus payments. For the calendar 2017, the applicable required capital conservation buffer percentage is 1.25%. The total buffer requirement will increase to 2.5% for calendar year 2019. As of September 30, 2017, the Company and the Bank are both positioned well above the 2019 requirement.

The Company continues to be well-capitalized in accordance with Federal regulatory capital requirements as the capital ratios below show:

Tier I Leverage Ratio	12.02%
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Risk Based Capital Tier I	14.71%
Total Risk Based Capital	15.51%
Stockholders Equity/Total Assets	12.19%
Capital Conservation Buffer	7.51%

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****MATERIAL CHANGES IN RESULTS OF OPERATIONS****Comparison of Results of Interest Earnings and Expenses for three month periods ended September 30, 2017, 2016 and June 30, 2017.**

When comparing third quarter 2017 to third quarter 2016, average loan balances grew \$53.5 million. This represented a strong 7.3% increase in a one year time period. Interest income on loan balances also experienced an increase of \$918 thousand as compared to the same quarter ended September 30, 2016.

In terms of comparison to second quarter 2017, loan interest income was \$427 thousand higher in third quarter 2017. The three months of third quarter 2017 had more days at 92 than second quarter had with 91.

The higher levels of loan interest income helped to offset the loss of interest income from the available-for-sale securities portfolio, which decreased in average balances, whether comparing to last quarter or the previous year. The decreased balances were expected as available for sale securities were used as a source of funds for loan growth. The income associated with the security portfolio decreased by \$23 thousand in comparison to second quarter 2017 and increased \$5 thousand in comparison to the same third quarter 2016. The benefit of the increase in interest income from loans was well above the loss of interest income from the smaller security portfolio.

Overall, interest income for the quarter comparisons was higher for third quarter 2017 by 9.9% or \$945 thousand as to third quarter 2016 and higher by 4.1% or \$411 thousand as to second quarter 2017.

In terms of annualized yield, for the quarter ended September 30, 2017, it was 4.24% which compares to last quarter's 4.11% and a year ago third quarter ended September 30, 2016 of 4.03%. The following chart demonstrates the value of increased loan balances in the balance sheet mix, even if offset by lower balances in the securities portfolio. The yields on tax-exempt securities and the portion of the tax-exempt IDB loans included in loans have been tax adjusted based on a 34% tax rate in the charts to follow.

Interest Earning Assets:	(In Thousands)		Yield/Rate	
	Average Balance	Interest/Dividends	September 30, 2017	September 30, 2016
Loans	\$ 790,397	\$ 9,547	4.83%	4.69%
Taxable Investment Securities	146,731	690	1.88%	1.57%
Tax-exempt Investment Securities	51,668	254	2.98%	3.33%
Fed Funds Sold & Interest Bearing Deposits	17,504	44	1.01%	0.64%
<b>Total Interest Earning Assets</b>	<b>\$ 1,006,300</b>	<b>\$ 10,535</b>	<b>4.24%</b>	<b>4.03%</b>

**Change in Quarter to Date September 30, 2017 Interest Income Compared to September 30, 2016 (In Thousands)**

Interest Earning Assets:	Change	Due to Volume	Due to Rate
Loans	\$ 918	\$ 646	\$ 272
Taxable Investment Securities	44	(82)	126
Tax-exempt Investment Securities	(39)	(13)	(26)
Fed Funds Sold & Interest Bearing Deposits	22	9	13
<b>Total Interest Earning Assets</b>	<b>\$ 945</b>	<b>\$ 560</b>	<b>\$ 385</b>

Offsetting some of the increase in interest income for the quarter was the increase in cost of funds in 2017. Third quarter 2017 was higher by \$234 thousand than third quarter 2016. Since 2016, average interest-bearing deposit balances have increased \$39.3 million and resulted in \$214 thousand more in interest expense for the most recent quarter. Additionally, interest expense on Fed Funds Purchased, Securities Sold Under Agreement to Repurchase and FHLB borrowings increased \$20 thousand in the third quarter 2017 over the same time frame in 2016.

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

	(In Thousands)		Yield/Rate	
	Average	Interest/	September 30,	September 30,
Interest Bearing Liabilities:	Balance	Dividends	2017	2016
Savings Deposits	\$ 513,595	\$ 609	0.47%	0.38%
Other Time Deposits	185,113	552	1.19%	1.01%
Other Borrowed Money	10,000	37	1.48%	1.48%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	35,859	135	1.51%	0.74%
Total Interest Bearing Liabilities	\$ 744,567	\$ 1,333	0.72%	0.60%

**Change in Quarter to Date September 30, 2017 Interest Expense Compared to September 30, 2016 (In Thousands)**

Interest Bearing Liabilities:	Change	Due	Due to
		to	Rate
		Volume	
Savings Deposits	\$ 176	\$ 68	\$ 108
Other Time Deposits	38	(54)	92
Other Borrowed Money			
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	20	(98)	118
Total Interest Bearing Liabilities	\$ 234	\$ (84)	\$ 318

Overall, net interest spread for the third quarter 2017 is higher than last year and up from last quarter. As the chart below illustrates, higher yields on interest and dividend income did offset the higher interest expense in the most recent quarter when comparing to the same period a year ago or to the previous quarter. Interest expense for the quarter as compared to last quarter increased by \$80 thousand, some of which can be attributed to a higher number of days in the current quarter compared to the last quarter.

Second quarter 2017 recorded an asset yield of 4.11% for the quarter with cost of funds at 0.68%. Net interest spread and margin for second quarter 2017 were lower at 3.43% and 3.61% respectively as compared to current quarter shown below.

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	6/30/2017	6/30/2016	6/30/2015
Interest/Dividend income/yield	4.24%	4.03%	4.11%
Interest Expense / yield	0.72%	0.60%	0.68%
Net Interest Spread	3.52%	3.43%	3.43%
Net Interest Margin	3.71%	3.57%	3.61%

Net interest income was up \$711 thousand for the third quarter 2017 over the same time frame in 2016 due to the increase in loan interest income and partially offset by higher interest expense, as previously mentioned. There has also been a \$331 thousand increase in net interest income over second quarter 2017. As the new loans added in 2016 and 2017 generate more income, management expects the benefits of the Company's strategy of repositioning the balance sheet to continue to widen this margin as measured in dollars.

The discussion will now be separated into two distinct quarter discussions – third quarter comparisons and the two most recent quarter comparisons.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

**MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

**Comparison of Noninterest Results of Operations Third Quarter 2017 to Third Quarter 2016**

**Provision Expense**

The ALLL has a direct impact on the provision expense. The increase in the ALLL is funded through recoveries and provision expense. The following tables both deal with the allowance for credit losses. The first table breaks down the activity within ALLL for each loan portfolio class and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table discloses how much of the

ALLL is attributed to each class of the loan portfolio, as well as the percent that each particular class of the loan portfolio represents to the entire loan portfolio in the aggregate. The consumer and consumer real estate loan portfolio accounted for the largest component of charge-offs and recoveries for third quarter of 2017 and 2016. As was mentioned in previous discussion, the commercial real estate portfolio is currently creating a large impact on the ALLL due to the loan growth.

Total provision for loan losses was \$209 thousand lower for the third quarter 2017 as compared to the same quarter 2016. Management continues to monitor asset quality, making adjustments to the provision as necessary. Loan charge-offs were \$107 thousand higher in third quarter 2016 than the same quarter 2017, recoveries were higher by \$5 thousand. Combined net charge-offs were \$102 thousand lower in third quarter 2017 than same time period 2016. Past due loans increased \$553 thousand from September 30, 2017 as compared to September 30, 2016. The majority of the change is attributed to the increase of past due balances in the consumer real estate, agricultural, and agricultural real estate portfolios while the commercial real estate portfolio decreased.

The following table breaks down the activity within the ALLL for each loan portfolio class and shows the contribution provided by both recoveries and the provision, along with the reduction of the allowance caused by charge-offs. The time period covered is for three months ended September 30, 2017, 2016, and 2015.

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## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

	In Thousands		
	Three Months Ended	Three Months Ended	Three Months Ended
	September-17	September-16	September-15
Loans, net	\$ 795,205	\$ 737,057	\$ 634,391
Daily average of outstanding loans	\$ 790,397	\$ 736,924	\$ 627,677
Allowance for Loan Losses-Jul 1	\$ 6,858	\$ 6,493	\$ 5,927
Loans Charged off:			
Consumer Real Estate		42	
Agriculture Real Estate			
Agricultural		3	
Commercial Real Estate	19	90	25
Commercial and Industrial			79
Consumer	92	83	73
	111	218	177
Loan Recoveries:			
Consumer Real Estate		1	12
Agriculture Real Estate			
Agricultural		4	61
Commercial Real Estate	4	2	1
Commercial and Industrial	2	3	66
Consumer	18	19	32
	24	29	172
Net Charge Offs	87	189	5
Provision for loan loss	99	308	243
Acquisition provision for loan loss			
Allowance for Loan & Lease Losses - Sept 30	6,870	6,612	6,165
Allowance for Unfunded Loan Commitments & Letters of Credit - Sept 30	228	227	196
Total Allowance for Credit Losses - Sept 30	\$ 7,098	\$ 6,839	\$ 6,361

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Ratio of net charge-offs to average Loans outstanding	0.01%	0.03%	0.00%
Ratio of the Allowance for Loan Loss to Nonperforming Loans*	397.35%	584.18%	266.69%

\*Nonperforming loans are defined as all loans on nonaccrual, plus any loans past 90 days not on nonaccrual.

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

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

Loans classified as nonaccrual were higher as of September 30, 2017 at \$1.7 million compared to \$1.1 million as of September 30, 2016.

In determining the allocation for impaired loans the Bank applies the appraised market value of the collateral securing the asset, reduced by applying a discount for estimated costs of collateral liquidation. In some instances where the discounted market value is less than the loan amount, a specific impairment allocation is assigned, which may be reduced or eliminated by the write down of the credit's active principal outstanding balance.

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

The following table presents the balances for allowance of loan losses by loan type for nine months ended September 30, 2017 and September 30, 2016.

	(In Thousands) September-2017		(In Thousands) September-2016	
	Amount	% of Loan Category	Amount	% of Loan Category
<b>Balance at End of Period Applicable To:</b>				
Consumer Real Estate	\$ 276	10.64	\$ 286	11.77
Agricultural Real Estate	248	8.24	234	8.15
Agricultural	613	10.57	580	10.74
Commercial Real Estate	3,117	49.72	3,006	50.03
Commercial and Industrial	1,392	16.36	1,195	15.16
Consumer	423	4.47	360	4.15
Unallocated	801	0.00	951	0.00
<b>Allowance for Loan &amp; Lease Losses</b>	<b>6,870</b>		<b>6,612</b>	
Off Balance Sheet Commitments	228		227	
<b>Total Allowance for Credit Losses</b>	<b>\$ 7,098</b>		<b>\$ 6,839</b>	

Noninterest Income

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Noninterest income was down \$280 thousand for the third quarter 2017 over the same time frame in 2016. The Company has seen a decrease in its mortgage production volume and as a result the gain on the sale of these loans was \$35 thousand lower for the third quarter 2017 over the same period in 2016. Loan originations on loans held for sale for the third quarter 2017 were \$12.4 million with proceeds from sale at \$12.9 million for 2017 which was less than 2016's third quarter activity of \$16.8 million in originations and \$16.9 million in sales. The net result of the activity was 2017 had \$35 thousand less revenue on gain of sale on the quarter. The Company was able to better take advantage of market fluctuations in its available-for-sale portfolio and sales on securities in third quarter 2016 than third quarter 2017. The gain was \$47 thousand lower in the most recent quarter than the same quarter prior year. The next largest fluctuation in noninterest income was in the combined service fee lines, which was \$198 thousand higher than the same quarter last year.

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights. The capitalization runs through non-interest income while the amortization thereof is included in non-interest expense. For the third quarter of 2017, mortgage servicing rights caused a net \$34 thousand in income, in comparison to a breakeven for the third quarter of 2016. The higher capitalized additions for 2017 are attributed to a higher mortgage servicing rights value being applied to originations of 1-4 families in 2017 as compared to 2016. For loans of 15 years and less, the value was .927% in the third quarter 2017 versus .821% in third quarter 2016. For loans over 15 years, the value was 1.137% versus 1.029% for the same periods respectively. The carrying value is well below the market value of \$3.1 million which indicates any large expense to fund the valuation allowance to be unlikely in 2017.

	(In Thousands)	
	September 30, 2017	September 30, 2016
Beginning Balance, January 1	\$ 2,192	\$ 2,056
Capitalized Additions	338	398
Amortization	(266)	(311)
Ending Balance, September 30	2,264	2,143
Valuation Allowance		
Mortgage Servicing Rights, net September 30	\$ 2,264	\$ 2,143

**Noninterest Expense**

For the third quarter 2017, noninterest expenses were \$435 thousand higher than for the same quarter in 2016. Salaries, wages, and employee benefits increased \$349 thousand, with the addition of the Hometown and Bowling Green offices, and normal merit increases. Data processing charges decreased \$60 thousand for third quarter 2017 compared to the third quarter 2016. Two reasons for the improvement was the negotiation of an extended contract with our core processor and 2016 had the additional cost of upgrading Bank customer debit cards to incorporate EMV chip card technology. Both already better align with our future strategies while controlling costs. General and administrative expenses were up \$72 thousand compared to third quarter 2016 with no one item noteworthy.

Results overall, net income in the third quarter of 2017 was up \$207 thousand as compared to the same quarter last year. The Company has done an exceptional job of growing loans while keeping past dues low. The Company remains strong, stable, and well capitalized and has the capacity to continue to cover the increased costs of expansion and doing business in a less than robust economy.

**Comparison of Noninterest Results of Operations Third Quarter 2017 to Second Quarter 2017**

### Provision Expense

Total provision for loan losses was \$74 thousand higher for third quarter 2017 than for second quarter 2017. Loan growth continued in the third quarter, in addition to strong asset quality. The strong asset quality and low net charge-offs offset any need for additional provision above the \$99 thousand that was expensed. Since the second quarter 2017, past due loans have increased by \$454 thousand. Though, net charge-offs were higher at \$87 thousand for third quarter 2017 compared to second quarter 2017 s \$17 thousand.

### Noninterest Income

Noninterest income for the third quarter 2017 was lower than the second quarter by \$138 thousand. The decrease is attributed to lower total service fees and charges of \$85 thousand along with a decrease in net gain on sale of loans and net gain on sale of available for sale securities of \$37 thousand and \$16 thousand respectively.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

**MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

**Noninterest Expense**

For the third quarter 2017, noninterest expenses were \$259 thousand higher than in second quarter 2017. Mortgage servicing rights amortization was \$12 thousand lower than last quarter. Salaries and wages increased by \$99 thousand from the previous quarter. Employee benefits increased by \$160 thousand over the previous quarter due to increased medical claims.

Net occupancy expenses increased from the previous quarter by \$60 thousand. The increase is primarily attributed to the decrease in brokerage commission of \$49 thousand over second quarter 2017.

General and administrative was down by \$42 thousand over second quarter; however, the Company has seen increased cost resulting from Bancorp stock activity.

**Net Income**

Overall, net income for the third quarter of 2017 was lower by \$1 thousand as compared to the second quarter of 2017. The Company has done an exceptional job of growing loans while keeping past dues low. The growth in loans has spurred the large increase in net interest income that has flowed through to the bottom line. The opening of the new offices may create a slight drag in the short run; however, the Company remains focused on the long term.

The Company continues to look for new opportunities to generate and protect revenue and provide additional channels through which to serve our customers and maintain our high level of customer satisfaction.

**Comparison of Results of Operation for year to date ended September 30, 2017 and 2016**

**Interest Income**

Higher loan balances created the improvement in the interest income for the nine months ended September 30, 2017 as compared to the nine months ended September 30, 2016. Interest income rose 8.6% or \$2.4 million while interest income from loans accounted for the majority of the increase. Offsetting the improvement from loans was a decrease in securities income of \$28 thousand. The change in the balance sheet mix along with the loan growth caused the asset yield to improve by 12 basis points to 4.12% for the year to date 2017 compared to the same year to date 2016's 4.0%.

With each quarter of 2017, the loan growth contributes to the continued improvement in asset yield. The growth factor contribution is shown in the charts which follow. Improvement in loan interest income far outweighs the loss of investment income.

The average interest earning asset base was \$49.0 million higher in third quarter 2017 than for third quarter 2016, an increase of approximately 5.2%.





**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

The yields on tax-exempt securities and the portion of the tax-exempt IDB loans included in loans have been tax adjusted based on a 34% tax rate in the charts to follow.

	(In Thousands)		Yield/Rate	
	Average	Interest/	September 30,	September 30,
	Balance	Dividends	2017	2016
Interest Earning Assets:				
Loans	\$ 776,828	\$ 27,367	4.71%	4.66%
Taxable Investment Securities	155,546	2,117	1.81%	1.59%
Tax-exempt Investment Securities	52,659	793	3.04%	3.42%
Fed Funds Sold & Interest Bearing Deposits	13,946	103	0.98%	0.61%
<b>Total Interest Earning Assets</b>	<b>\$ 998,979</b>	<b>\$ 30,380</b>	<b>4.12%</b>	<b>4.00%</b>

**Change in Year to Date September 30, 2017 Interest Income Compared to September 30, 2016 (In Thousands)**

Interest Earning Assets:	Change	Due to Volume	Due to Rate
Loans	\$ 2,370	\$ 2,121	\$ 249
Taxable Investment Securities	118	(165)	283
Tax-exempt Investment Securities	(146)	(64)	(82)
Fed Funds Sold & Interest Bearing Deposits	57	29	28
<b>Total Interest Earning Assets</b>	<b>\$ 2,399</b>	<b>\$ 1,921</b>	<b>\$ 478</b>

**Interest Expense**

Interest expense was also higher for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. At \$3.8 million, third quarter 2017 was up \$623 thousand as compared to same time period 2016 or 19.8%.

The average balance of interest-bearing liabilities was higher by \$29.3 million in 2017 than third quarter 2016. Interest bearing deposits increased \$62.7 million while Fed Funds sold and securities sold under agreement to repurchase decreased by \$33.4 million. The higher balance coupled with the slight variation of the balance sheet mix, resulted in a 9 basis points increase in the cost of funds at 0.68% for the year to date 2017 as compared to the same year to date

2016 s 0.59%.

The Federal Funds and prime rate increases of 25 basis points in December 2015, December 2016, March and June 2017 has only had a marginal effect on the Bank s pricing methodologies. Loans with variable rates and floors have had the rates begin to increase over the floors with the 100 basis points increase in prime rate over the last 21 months. This should be evident in the third quarter chart relating to the change report due to volume and rate. On the liability side, the slow pace of the rate increases has placed more pressure on the short term funds. Competition for public funds had caused those short term deposits to price higher. This is evidenced in the change chart as the increase cost is driven more by rate than volume.

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)****MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

	(In Thousands)		Yield/Rate	
	Year to Date Ended September 30, 2017		September 30, 2017	September 30, 2016
Interest Bearing Liabilities:	Average Balance	Interest/ Dividends		
Savings Deposits	\$ 507,327	\$ 1,674	0.44%	0.39%
Other Time Deposits	188,064	1,615	1.15%	0.97%
Other Borrowed Money	10,000	110	1.47%	1.47%
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	32,859	366	1.49%	0.70%
<b>Total Interest Bearing Liabilities</b>	<b>\$ 738,250</b>	<b>\$ 3,765</b>	<b>0.68%</b>	<b>0.59%</b>

**Change in Year to Date September 30, 2017 Interest Expense Compared to September 30, 2016 (In Thousands)**

Interest Bearing Liabilities:	Change	Due to Volume	Due to Rate
Savings Deposits	\$ 382	\$ 222	\$ 160
Other Time Deposits	221	(39)	260
Other Borrowed Money			
Fed Funds Purchased & Securities Sold under Agreement to Repurch.	20	(372)	392
<b>Total Interest Bearing Liabilities</b>	<b>\$ 623</b>	<b>\$ (189)</b>	<b>\$ 812</b>

**Net Interest Income**

Overall, net interest spread figures through the third quarter 2017 are up from 2016 by 3 basis points and up 6 basis points from 2015. Net interest margin through the third quarter of 2017 is higher than the same period 2016 and 2015. As the chart below illustrates, both higher yields on interest and dividend income, were offset by higher interest expense resulting in total net interest margin up 5 basis points since the year to date 2016 and over the year to date 2015 by 8 basis points.

	9/30/2017	9/30/2016	9/30/2015
Interest/Dividend income/yield	4.12%	4.00%	3.92%
Interest Expense / yield	0.68%	0.59%	0.54%

Net Interest Spread	3.44%	3.41%	3.38%
Net Interest Margin	3.61%	3.56%	3.52%

Net interest income was up \$1.8 million through third quarter 2017 over the same time frame in 2016 due to the increase in loan income even with higher interest expense, as previously mentioned. New loans added in 2016 and 2017 will continue to generate more income; the benefits of the Company's strategy of repositioning the balance sheet will continue to grow.

**Comparison of Noninterest Results of Operations Year to Date September 30, 2017 to Year to Date September 30, 2016.**

Provision Expense

Total provision for loan losses was \$727 thousand lower for nine months 2017 than for the first nine months 2016. While loan growth continued in the third quarter, strong asset quality continued also. The strong asset quality and lower net charge-offs offset any need for additional provision above the \$197 thousand that was expensed. In comparing past due balances of loans 30+ days, September 30, 2017 balances were \$553 thousand higher than September 30, 2016 balances. Net charge-offs were lower at \$111 thousand for third quarter 2017 compared to third quarter 2016's \$369 thousand.

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## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

	(In Thousands)		
	Nine Months Ended September-17	Nine Months Ended September-16	Nine Months Ended September-15
Loans, net	\$ 795,205	\$ 737,057	\$ 634,391
Daily average of outstanding loans	\$ 776,828	\$ 716,731	\$ 618,552
Allowance for Loan & Lease Losses - January 1	\$ 6,784	\$ 6,057	\$ 5,905
Loans Charged off:			
Consumer Real Estate		106	
Agricultural Real Estate			
Agricultural		21	
Commercial Real Estate	19	93	111
Commercial and Industrial		20	468
Consumer	189	236	219
	208	476	798
Loan Recoveries			
Consumer Real Estate	13	23	39
Agricultural Real Estate			
Agricultural	2	9	64
Commercial Real Estate	11	7	203
Commercial and Industrial	8	8	88
Consumer	63	60	124
	97	107	518
Net Charge Offs	111	369	280
Provision for loan loss	197	924	540
Allowance for Loan & Lease Losses - Sept 30	\$ 6,870	\$ 6,612	\$ 6,165
Allowance for Unfunded Loan Commitments & Letters of Credit - Sept 30	228	227	196
Total Allowance for Credit Losses - Sept 30	\$ 7,098	\$ 6,839	\$ 6,361

Ratio of net charge-offs to average Loans outstanding	0.01%	0.05%	0.05%
Ratio of Allowance for Loan Loss to Nonperforming Loans	397.35%	584.18%	266.69%

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

**MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)**

**Noninterest Income**

Noninterest income for the first nine months 2017 was below the first nine months of 2016 by \$477 thousand. The increased number of business days in 2016 as compared to 2017, provided more opportunity to transact business and generate noninterest income. Gain on available for sale securities by decreased by \$456 thousand over the prior year.

**Noninterest Expense**

Through the third quarter 2017, noninterest expenses were \$961 thousand higher than through the third quarter 2016. The effect of an increase of \$713 thousand in salaries and wages was combined with an increase of \$222 thousand in employee benefits. Two offices were added in 2016 whose expenses only partially impacted 2016, but which fully impacted 2017 expenses related to salaries, wages and employee benefits. Higher profit levels are driving higher incentive accruals for 2017. The other portion of 2017's increase in employee benefits was derived from higher costs related to medical claims for the period.

Data processing fees were \$213 thousand lower than last year due to a seven year contract extension signed in the third quarter of 2016. It has helped reduce the expense while adding new products and services to better align with our customers' expectations in the coming years. We have already added additional products in 2017, mainly focused on mobile services and business deposit accounts.

The next largest decrease for 2017 was in the FDIC assessment. This line item on the income statement was down by \$121 thousand over third quarter 2016. Improved FDIC funding and asset quality of the Bank aided to keep this expense below 2016 levels.

**Net Income**

Overall, net income through the third quarter of 2017 was up \$814 thousand as compared to the third quarter of 2016. The Company continues to grow loans while keeping past dues low. The growth in loans has spurred the increase in net interest income that has flowed through to the bottom line. The asset quality has kept loan provision down as the allowance for loan loss remains adequate for the level of credit risk. The opening of the new offices has hampered earnings in the short term; however, the Company remains focused on the long term.

The Company continues to look for new opportunities to generate and protect revenue and provide additional channels through which to serve our customers and maintain our high level of customer satisfaction.

**FORWARD LOOKING STATEMENTS**

Statements contained in this portion of the Company's report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as intend, believe, expect, anticipate, should, planned, estimated, and potential. Such

forward-looking statements are based on current expectations, but actual results may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.



**Table of Contents****ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of our interest rate risk arises from the instruments, positions and transactions entered into for purposes other than trading such as loans, available for sale securities, interest bearing deposits, short term borrowings and long term borrowings. Interest rate risk occurs when interest bearing assets and liabilities re-price at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates.

Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.

The shocks presented below assume an immediate change of rate in the percentages and directions shown covering a twelve month period:

Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total (\$000)	% Change to Flat Rate
2.90%	-4.56%	Rising	3.00%	30,651	-0.85%
2.92%	-3.96%	Rising	2.00%	30,460	-1.47%
2.99%	-1.65%	Rising	1.00%	30,704	-0.69%
3.04%	0.00%	Flat	0.00%	30,915	0.00%
3.35%	10.03%	Falling	-1.00%	32,987	6.70%
3.22%	5.82%	Falling	-2.00%	31,892	3.16%
3.06%	0.75%	Falling	-3.00%	30,617	-0.97%

The net interest margin represents the forecasted twelve month margin. The Company also reviews shocks with a 4.0% fluctuation with a delayed time frame of 10 months and over a 24 month time frame. It also shows the effect rate changes will have on both the margin and net interest income. The goal of the Company is to lengthen the term of some of the Bank's fixed rate liabilities or sources of funds to decrease the exposure to a rising rate environment. Of course, customer desires also impact the Bank's ability to attract longer term deposits. Currently, the majority of customers look for terms of twelve months and under while the Bank would prefer 24 months and longer. Some movement into the longer term time deposits has occurred. Over the past five year period, the Bank has experienced a decrease in the time balances of our deposit portfolio, and therefore, a loss of term funding.

The shock chart currently shows a slight tightening in net interest margin over the next twelve months in an increasing rate environment with no tightening in a falling rate environment. With the Federal Reserve having raised its rates, the Company has room for widening should rates fall. Cost of funds are below 0.75% so at even the lowest shock of 100 basis points, the Bank cannot take full advantage and reprice funds to match the level of shock. Since the average

duration of the majority of the assets is outside the 12 month shock period, the rising rate environment only shows minor improvement. The majority of the newer loans added to the commercial real estate portfolio begin with an initial fixed rate period of three to five years whose variable adjustment is outside of the current shock time frame. The Bank enhanced its use of the software model during 2012 by including decay rates and key rate ties on certain deposit accounts and continues to review and modify those rates as changes are within risk exposure guidelines at all levels. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

Overall, what the chart shows is that the Company must concentrate on increasing loan spreads on variable loans and extend the duration on cost of funds where possible. Changes in portfolio and/or balance sheet composition are needed for the margin to improve regardless of any rate shock.

**Table of Contents****ITEM 4 CONTROLS AND PROCEDURES**

As of September 30, 2017, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2017. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

**PART II OTHER INFORMATION****ITEM 1 LEGAL PROCEEDINGS**

None

**ITEM 1A RISK FACTORS**

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2016.

**ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Treasury stock repurchased the quarter ended September 30, 2017 <sup>(1)</sup>.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	(d) Maximum Number of Shares that may yet be purchased under the Plans or Programs
7/1/2017 to 7/31/2017				400,000
8/1/2017 to 8/31/2017	6,484 <sup>(2)</sup>	28.28 <sup>(2)</sup>		400,000
9/1/2017 to 9/30/2017				400,000
<b>Total</b>	<b>6,484</b>	<b>28.28</b>		<b>400,000</b>

- (1) From time to time, the Company purchases shares in the market pursuant to a stock repurchase program publicly announced on January 20, 2017. On that date, the Board of Directors authorized the repurchase of 200,000 common shares between January 20, 2017 and December 31, 2017. The number of shares authorized to repurchase has been adjusted to reflect a two-for-one split on September 20, 2017.
  
- (2) Shares which were repurchased for taxes on vested stock awards are outside of this program.

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PART II OTHER INFORMATION (Continued)

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable

ITEM 5 OTHER INFORMATION

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ITEM 6 EXHIBITS

3.1	<u>Amended Articles of Incorporation of the Registrant</u>
3.2	<u>Amended and Restated Code of Regulations of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on July 26, 2017)</u>
31.1	<u>Rule 13-a-14(a) Certification - CEO</u>
31.2	<u>Rule 13-a-14(a) Certification - CFO</u>
32.1	<u>Section 1350 Certification - CEO</u>
32.2	<u>Section 1350 Certification - CFO</u>
101.INS	XBRL Instance Document (1)
101.SCH	XBRL Taxonomy Extension Schem Document (1)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (1)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (1)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (1)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (1)

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SIGNATURES

**SIGNATURES**

Pursuant to the requirements 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, Inc.,

Date: October 25, 2017

By: /s/ Paul S. Siebenmorgen  
Paul S. Siebenmorgen  
President and CEO

Date: October 25, 2017

By: /s/ Barbara J. Britenriker  
Barbara J. Britenriker  
Exec. Vice-President and CFO