

FARMERS & MERCHANTS BANCORP  
Form 10-K  
March 14, 2014

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

FORM 10-K

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

For the fiscal year ended December 31, 2013

OR

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

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

Commission File Number: 000-26099

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

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

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

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, \$0.01 Par Value Per Share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.  x

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

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

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

The aggregate market value of the Registrant's common stock held by non-affiliates on June 30, 2013 (based on the last reported trade on June 28, 2013) was \$311,161,000.

The number of shares of Common Stock outstanding as of February 28, 2014: 777,882

Documents Incorporated by Reference:

Portions of the definitive Proxy Statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A are incorporated by reference in Part III, Items 10 through 14.

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FARMERS & MERCHANTS BANCORP  
FORM 10-K

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Introduction – Forward Looking Statements

This Form 10-K contains various forward-looking statements, usually containing the words “estimate,” “project,” “expect,” “objective,” “goal,” or similar expressions and includes assumptions concerning Farmers & Merchants Bancorp’s (together with its subsidiaries, the “Company” or “we”) operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risks and uncertainties. In connection with the “safe-harbor” provisions of the Private Securities Litigation Reform Act of 1995, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (1) continuing economic sluggishness in the Central Valley of California; (2) significant changes in interest rates and prepayment speeds; (3) credit risks of lending and investment activities; (4) changes in federal and state banking laws or regulations; (5) competitive pressure in the banking industry; (6) changes in governmental fiscal or monetary policies; (7) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (8) other factors discussed in Item 1A. Risk Factors.

Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.

PART I

Item 1. Business

General Development of the Business

August 1, 1916, marked the first day of business for Farmers & Merchants Bank. The Bank was incorporated under the laws of the State of California and licensed as a state-chartered bank. Farmers & Merchants’ first venture out of Lodi occurred when the Galt office opened in 1948. Since then the Bank has opened full-service branches in Linden, Modesto, Sacramento, Elk Grove, Turlock, Hilmar, Stockton and Merced.

In addition to 21 full-service branches and 2 loan production offices, the Bank serves the needs of its customers through two stand-alone ATM’s located on the grounds of the Lodi Grape Festival and California State University-Stanislaus. In 2007, the Bank began offering certain products over the internet at [www.fmbonline.com](http://www.fmbonline.com).

During 2013 the Bank: (1) closed one of its four Modesto branches, consolidating those accounts into the Modesto Main office, which is in close proximity to the closed branch; (2) initiated efforts to establish loan production offices in Irvine, CA and Walnut Creek, CA; and (3) established equipment leasing operations under the Bank.

On March 10, 1999, the Company, pursuant to a reorganization, acquired all of the voting stock of Farmers & Merchants Bank of Central California (the “Bank”). The Company is a bank holding company incorporated in the State of Delaware and registered under the Bank Holding Company Act of 1956, as amended. The Company’s outstanding securities as of December 31, 2013, consisted of 777,882 shares of common stock, \$0.01 par value and no shares of preferred stock issued. The Bank is the Company’s principal asset.

The Bank’s two wholly owned subsidiaries are Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Farmers & Merchants Investment Corporation is currently dormant and Farmers/Merchants Corp. acts as trustee on deeds of trust originated by the Bank.

F & M Bancorp, Inc. was created in March 2002 to protect the name "F & M Bank." During 2002, the Company completed a fictitious name filing in California to begin using the streamlined name, "F & M Bank" as part of a larger effort to enhance the Company's image and build brand name recognition. Since 2002, the Company has converted all of its daily operating and image advertising to the "F & M Bank" name and the Company's logo, slogan and signage were redesigned to incorporate the trade name, "F & M Bank."

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During 2003, the Company formed a wholly owned Connecticut statutory business trust, FMCB Statutory Trust I, for the sole purpose of issuing trust-preferred securities. See Note 13 located in “Item 8. Financial Statements and Supplementary Data.”

During the 2<sup>nd</sup> quarter of 2013, the Bank entered the equipment leasing business. Equipment leasing is a form of asset-backed financing which typically preserves cash more optimally than other financial products by advancing 100% of the installed equipment cost and allowing for customized payment terms. Leases fall into one of two broad categories: (1) “finance leases”, where the lessee retains the tax benefits of ownership but obtains 100% financing on their equipment purchases; and (2) “true tax leases”, where the lessor places reliance on residual value and in so doing obtains the tax benefits of ownership.

The Company’s principal business is to serve as a holding company for the Bank and for other banking or banking related subsidiaries, which the Company may establish or acquire. As a legal entity separate and distinct from its subsidiary, the Company’s principal source of funds is, and will continue to be, dividends paid by and other funds from the Bank. Legal limitations are imposed on the amount of dividends that may be paid and loans that may be made by the Bank to the Company. See “Supervision and Regulation - Dividends and Other Transfer of Funds.”

The Bank’s deposit accounts are insured under the Federal Deposit Insurance Act up to applicable limits. See “Supervision and Regulation – Deposit Insurance.”

As a bank holding company, the Company is subject to regulation and examination by the Board of Governors of the Federal Reserve System (“FRB”). The Bank is a California state-chartered non-FRB member bank subject to the regulation and examination of the California Department of Business Oversight (“DBO”) and the Federal Deposit Insurance Corporation (“FDIC”).

### Service Area

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

At the present time the Company’s primary service area remains the mid Central Valley of California, including Sacramento, San Joaquin, Stanislaus and Merced counties, where we operate 21 full-service branches and two stand-alone ATM’s. This area encompasses:

Sacramento Metropolitan Statistical Area (“MSA”), with branches in Sacramento, Elk Grove and Galt. This MSA has a Population of 2.2 million and a Per Capita Income of approximately \$42,000. The MSA includes significant employment in the following sectors: state and local government; agriculture; and trade, transportation and utilities. Unemployment currently stands at 8.0%.

Stockton MSA, with branches in Lodi, Linden and Stockton. This MSA has a Population of 0.7 million and a Per Capita Income of approximately \$33,000. The MSA includes significant employment in the following sectors: state and local government; agriculture; trade, transportation, and utilities; and education and health services. Unemployment currently stands at 12.2%.

Modesto MSA, with branches in Modesto and Turlock. This MSA has a Population of 0.5 million and a Per Capita Income of approximately \$33,000. The MSA includes significant employment in the following sectors: agriculture;

trade, transportation and utilities; state and local government; and education and health services. Unemployment currently stands at 12.1%.

Merced MSA with branches in Hilmar and Merced. This MSA has a Population of 0.3 million and a Per Capita Income of approximately \$29,000. The MSA includes significant employment in the following sectors: agriculture; state and local government; and trade, transportation and utilities. Unemployment currently stands at 13.6%.

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All of the Company's Central Valley service areas are heavily influenced by the agricultural industry, however, with the exception of the State of California in the Sacramento MSA, no single employer represents a material concentration of jobs in any of our service areas.

See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview" and "Financial Condition – Loans & Leases" for additional discussion regarding the Company's market conditions.

Through its network of banking offices, the Company emphasizes personalized service along with a broad range of banking services to businesses and individuals located in the service areas of its offices. Although the Company focuses on marketing its services to small and medium sized businesses, a broad range of retail banking services are made available to the local consumer market.

The Company offers a wide range of deposit instruments. These include checking, savings, money market, time certificates of deposit, individual retirement accounts and online banking services for both business and personal accounts.

The Company provides a broad complement of lending products, including commercial, real estate construction, agribusiness, consumer, credit card, real estate loans, and equipment leases. Commercial products include term loans, lines of credit and other working capital financing and letters of credit. Financing products for individuals include automobile financing, lines of credit, residential real estate, home improvement and home equity lines of credit.

The Company also offers a wide range of specialized services designed for the needs of its commercial accounts. These services include a credit card program for merchants, collection services, account reconciliation, investment sweep, on-line account access, and electronic funds transfers by way of domestic and international wire and automated clearinghouse.

The Company makes investment products available to customers, including mutual funds and annuities. These investment products are offered through a third party, which employs investment advisors to meet with and provide investment advice to the Company's customers.

### Employees

At December 31, 2013, the Company employed 299 full time equivalent employees. The Company believes that its employee relations are satisfactory.

### Competition

The banking and financial services industry in California generally, and in the Company's market areas specifically, is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the accelerating pace of consolidation among financial service providers. The Company competes with other major commercial banks, diversified financial institutions, credit unions, savings and loan associations, money market and other mutual funds, mortgage companies, and a variety of other non-banking financial services and advisory companies. Federal legislation encourages competition between different types of financial service providers and has fostered new entrants into the financial services market. It is anticipated that this trend will continue. Using the financial holding company structure, insurance companies and securities firms may compete more directly with banks and bank holding companies.

Many of our competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader range of financial services than the Company. In order to compete with other financial service providers, the Company relies upon personal contact by its officers, directors, employees, and stockholders, along

with various promotional activities and specialized services. In those instances where the Company is unable to accommodate a customer's needs, the Company may arrange for those services to be provided through its correspondents.

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### Government Policies

The Company's profitability, like most financial institutions, is primarily dependent on interest rate differentials. The difference between the interest rates paid by the Company on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by the Company on its interest-earning assets, such as loans & leases extended to its customers and securities held in its investment portfolio, comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors that are beyond the control of the Company and the Bank, such as inflation, recession and unemployment. The impact that changes in economic conditions might have on the Company and the Bank cannot be predicted.

The business of the Company is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the FRB. The FRB implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target federal funds and discount rates applicable to borrowings by depository institutions. The actions of the FRB in these areas influence the growth of bank loans & leases, investments, and deposits and also affect interest rates earned on interest-earning assets and paid on interest-bearing liabilities. The nature and impact on the Company of any future changes in monetary and fiscal policies cannot be predicted.

From time to time, legislative acts, as well as regulations, are enacted which have the effect of increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies, and other financial institutions and financial services providers are frequently made in the U.S. Congress, in the state legislatures, and before various regulatory agencies. This legislation may change banking statutes and the operating environment of the Company and its subsidiaries in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it, or any implemented regulations, would have on the financial condition or results of operations of the Company or any of its subsidiaries.

### Supervision and Regulation

#### General

Bank holding companies and banks are extensively regulated under both federal and state law. The regulation is intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of stockholders of the Company. Set forth below is a summary description of the material laws and regulations, which relate to the operations of the Company and the Bank. This description does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations.

#### The Company

The Company is a registered bank holding company and is subject to regulation under the Bank Holding Company Act of 1956 ("BHCA"), as amended. Accordingly, the Company's operations are subject to extensive regulation and examination by the FRB. The Company is required to file with the FRB quarterly and annual reports and such additional information as the FRB may require pursuant to the BHCA. The FRB conducts periodic examinations of the Company.

The FRB may require that the Company terminate an activity or terminate control of or liquidate or divest certain subsidiaries of affiliates when the FRB believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any of its banking subsidiaries. The FRB also has the

authority to regulate provisions of certain bank holding company debt. Under certain circumstances, the Company must file written notice and obtain approval from the FRB prior to purchasing or redeeming its equity securities.

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Under the BHCA and regulations adopted by the FRB, a bank holding company and its non-banking subsidiaries are prohibited from requiring certain tie-in arrangements in connection with an extension of credit, lease or sale of property, or furnishing of services. For example, with certain exceptions, a bank may not condition an extension of credit on a promise by its customer to obtain other services provided by it, its holding company or other subsidiaries, or on a promise by its customer not to obtain other services from a competitor. In addition, federal law imposes certain restrictions on transactions between Farmers & Merchants Bancorp and its subsidiaries. Further, the Company is required by the FRB to maintain certain levels of capital. See “Capital Standards.”

The Company is prohibited by the BHCA, except in certain statutorily prescribed instances, from acquiring direct or indirect ownership or control of more than 5% of the outstanding voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or furnishing services to its subsidiaries. However, the Company, subject to the prior notice and/or approval of the FRB, may engage in any, or acquire shares of companies engaged in, activities that are deemed by the FRB to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Under FRB regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, it is the FRB’s policy that in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. This support may be required at times when a bank holding company may not be able to provide such support. A bank holding company’s failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of the FRB’s regulations or both.

The Company is not a financial holding company for purposes of the FRB.

The Company is also a bank holding company within the meaning of the California Financial Code. As such, the Company and its subsidiaries are subject to examination by, and may be required to file reports with, the DBO.

The Company’s securities are registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). As such, the Company is subject to the reporting, proxy solicitation and other requirements and restrictions of the Exchange Act.

### The Bank

The Bank, as a California chartered non-FRB member bank, is subject to primary supervision, periodic examination and regulation by the DBO and the FDIC. If, as a result of an examination of the Bank, the FDIC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the Bank’s operations are unsatisfactory, or that the Bank or its management is violating or has violated any law or regulation, various remedies are available to the FDIC. Such remedies include the power to enjoin “unsafe or unsound” practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict the growth of the Bank, to assess civil monetary penalties, to remove officers and directors, and ultimately to terminate the Bank’s deposit insurance, which for a California chartered bank would result in a revocation of the Bank’s charter. The DBO has many of the same remedial powers.

Various requirements and restrictions under the laws of the State of California and the United States affect the operations of the Bank. State and federal statutes and regulations relate to many aspects of the Bank’s operations, including reserves against deposits, ownership of deposit accounts, interest rates payable on deposits, loans & leases, investments, mergers and acquisitions, borrowings, dividends, locations of branch offices, and capital requirements.

Further, the Bank is required to maintain certain levels of capital. See “Capital Standards.”

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#### The USA Patriot Act

Title III of the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”) includes numerous provisions for fighting international money laundering and blocking terrorism access to the U.S. financial system. The USA Patriot Act requires certain additional due diligence and record keeping practices, including, but not limited to, new customers, correspondent, and private banking accounts.

Part of the USA Patriot Act requires covered financial institutions to: (i) establish an anti-money laundering program; (ii) establish appropriate anti-money laundering policies, procedures and controls; (iii) appoint a Bank Secrecy Act officer responsible for day-to-day compliance; and (iv) conduct independent audits. The Patriot Act also expands penalties for violation of the anti-money laundering laws, including expanding the circumstances under which funds in a bank account may be forfeited. The Patriot Act also requires covered financial institutions to respond, under certain circumstances, to requests for information from federal banking agencies within 120 hours.

#### Privacy Restrictions

The GLBA, in addition to the previous described changes in permissible, non-banking activities permitted to banks, bank holding companies, and financial holding companies, also requires financial institutions in the U.S. to provide certain privacy disclosures to customers and consumers, to comply with certain restrictions on the sharing and usage of personally identifiable information, and to implement and maintain commercially reasonable customer information safeguarding standards.

The Company believes that it complies with all provisions of the GLBA and all implementing regulations and the Bank has developed appropriate policies and procedures to meet its responsibilities in connection with the privacy provisions of GLBA.

#### Dividends and Other Transfer of Funds

Dividends from the Bank constitute the principal source of income to the Company. The Company is a legal entity separate and distinct from the Bank. The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends to the Company. Under such restrictions, the amount available for payment of dividends to the Company by the Bank totaled \$40.3 million at December 31, 2013. During 2013, the Bank paid \$10.5 million in dividends to the Company.

The FDIC and the DBO also have authority to prohibit the Bank from engaging in activities that, in their opinion, constitute unsafe or unsound practices in conducting its business. It is possible, depending upon the financial condition of the bank in question and other factors, that the FDIC or the DBO could assert that the payment of dividends or other payments might, under some circumstances, be an unsafe or unsound practice. Further, the FRB and the FDIC have established guidelines with respect to the maintenance of appropriate levels of capital by banks or bank holding companies under their jurisdiction. Compliance with the standards set forth in such guidelines and the restrictions that are or may be imposed under the prompt corrective action provisions of federal law could limit the amount of dividends that the Bank or the Company may pay. An insured depository institution is prohibited from paying management fees to any controlling persons or, with certain limited exceptions, making capital distributions if after such transaction the institution would be undercapitalized. The DBO may impose similar limitations on the Bank. See “Prompt Corrective Regulatory Action and Other Enforcement Mechanisms” and “Capital Standards” for a discussion of these additional restrictions on capital distributions.

#### Transactions with Affiliates

The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of the Company or other affiliates, the purchase of, or investments in stock or other securities thereof, the taking of such securities as collateral for loans & leases, and the purchase of assets of the Company or other affiliates. Such restrictions prevent the Company and other affiliates from borrowing from the Bank

unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by the Bank to or in the Company or to or in any other affiliates are limited, individually, to 10% of the Bank's capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20% of the Bank's capital and surplus (as defined by federal regulations).

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In addition, the Company and its operating subsidiaries generally may not purchase a low-quality asset from an affiliate, and other specified transactions between the Company or its operating subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

Also, the Company and its operating subsidiaries may engage in transactions with affiliates only on terms and under conditions that are substantially the same, or at least as favorable to the Company or its subsidiaries, as those prevailing at the time for comparable transactions with (or that in good faith would be offered to) non-affiliated companies.

California law also imposes certain restrictions with respect to transactions with affiliates. Additionally, limitations involving the transactions with affiliates may be imposed on the Bank under the prompt corrective action provisions of federal law. See "Prompt Corrective Action and Other Enforcement Mechanisms."

### Capital Standards

The FRB and the FDIC have established risk-based capital guidelines with respect to the maintenance of appropriate levels of capital by United States banking organizations. These guidelines are intended to provide a measure of capital that reflects the risk associated with a banking organization's operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit and recourse arrangements, which are recorded as off balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as commercial loans.

The federal banking agencies currently require a minimum ratio of qualifying total capital to risk-weighted assets of 8% and a minimum ratio of Tier 1 capital to risk-weighted assets of 4%. In addition to the risk-based guidelines, federal banking regulators require banking organizations to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets must be 4%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the regulators have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above minimum guidelines and ratios. For further information on the Company and the Bank's risk-based capital ratios see Note 14 located in "Item 8. Financial Statements and Supplementary Data."

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

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

### Prompt Corrective Action and Other Enforcement Mechanisms

The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective Federal regulatory agencies to implement systems for “prompt corrective action” for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management, and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An “undercapitalized” institution must develop a capital restoration plan. At December 31, 2013, the Bank exceeded all of the required ratios for classification as “well capitalized.” It should be noted; however, that the Bank’s capital category is determined solely for the purpose of applying the federal banking agencies’ prompt corrective action regulations and the capital category may not constitute an accurate representation of the Bank’s overall financial condition or prospects.

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An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions.

Banking agencies have also adopted regulations which mandate that regulators take into consideration: (i) concentrations of credit risk; (ii) interest rate risk (when the interest rate sensitivity of an institution's assets does not match the sensitivity of its liabilities or its off-balance-sheet position); and (iii) risks from non-traditional activities, as well as an institution's ability to manage those risks, when determining the adequacy of an institution's capital. That evaluation will be made as a part of the institution's regular safety and soundness examination. In addition, the banking agencies have amended their regulatory capital guidelines to incorporate a measure for market risk. In accordance with the amended guidelines, any company with significant trading activity must incorporate a measure for market risk in its regulatory capital calculations.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal banking agencies for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, any condition imposed in writing by the agency, or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders based upon a judicial determination that the agency would be harmed if such equitable relief was not granted. Additionally, a holding company's inability to serve as a source of strength to its subsidiary banking organizations could serve as an additional basis for a regulatory action against the holding company.

Federal banking regulators have also issued final guidance regarding commercial real estate ("CRE") lending. This guidance suggests that institutions that are potentially exposed to significant CRE concentration risk will be subject to increased regulatory scrutiny. Institutions that have experienced rapid growth in CRE lending, have notable exposure to a specific type of CRE lending, or are approaching or exceed certain supervisory criteria that measure an institution's CRE portfolio against its capital levels, may be subject to such increased regulatory scrutiny. The Company's CRE portfolio may be viewed as falling within one or more of the foregoing categories, and accordingly may become subject to increased regulatory scrutiny because of the CRE portfolio. Institutions that are determined by their regulator to have an undue concentration in CRE lending may be required to maintain levels of capital in excess of the statutory minimum requirements and/or be required to reduce their concentration in CRE loans. The FDIC has determined that the Company does not have any undue concentrations in CRE lending.

### Safety and Soundness Standards

The federal banking agencies have adopted guidelines designed to assist in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems, and internal audit systems; (ii) loan & lease documentation; (iii) credit underwriting; (iv) asset growth; (v) earnings; and (vi) compensation, fees, and benefits. In addition, the federal banking agencies have also adopted safety and soundness guidelines with respect to asset quality and earnings standards. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, any insured depository institution should: (i) conduct periodic asset quality reviews to identify problem assets; (ii) estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb estimated losses; (iii) compare problem asset totals to capital; (iv) take appropriate corrective action to resolve problem assets; (v) consider the size and potential risks of material asset concentrations; and (vi) provide periodic asset quality reports with adequate information for

management and the Board of Directors to assess the level of asset risk. These guidelines also set forth standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves.

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### Deposit Insurance

After the passage of the Dodd-Frank act, the deposits of the Bank are now insured by the FDIC up to \$250,000 per insured depositor.

The Federal Deposit Insurance Reform Act of 2005 provided the FDIC Board of Directors the authority to set the designated reserve ratio for the Deposit Insurance Fund (“DIF”) between 1.15% and 1.50%. The FDIC must adopt a restoration plan when the reserve ratio falls below 1.15% and begin paying dividends when the reserve ratio exceeds 1.35%.

Through the later part of 2008 and into 2009, the number of bank failures began to rise significantly. This placed considerable strain on the DIF. As a result, on September 29, 2009 the FDIC adopted an Amended Restoration Plan to allow the DIF to return to a ratio of 1.15% within eight years. The FDIC also adopted risk-based assessment rates beginning in January of 2011. On November 12, 2009, the FDIC also adopted a final rule amending the assessment regulations to require insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012, on December 30, 2009, except for those institutions where the FDIC grants an exemption. The prepaid assessment was collected December 30, 2009, and resulted in a prepayment by the Bank of \$7,258,000. Since December 2009, the Company has expensed \$4,362,000 of this prepaid assessment. The FDIC prepaid assessment program ended March 29, 2013, and resulted in a \$2,896,000 refund of unused assessment credits to the Bank on July 1, 2013.

Under the Dodd-Frank Act, the minimum designated reserve ratio of the DIF increased from 1.15% to 1.35% of estimated insured deposits. Additionally, the Dodd-Frank Act revised the assessment base against which an insured depository institution’s deposit insurance premiums paid to the DIF will be calculated. On February 7, 2011, the FDIC approved a final rule, as mandated by Dodd-Frank, changing the deposit insurance assessment system from one that is based on total domestic deposits to one that is based on average consolidated total assets minus average tangible equity. The new rule took effect for the quarter beginning April 1, 2011.

The Bank’s FDIC premiums were \$981,000 in 2013 compared to \$968,000 in 2012. Future increases in insurance premiums could have adverse effects on the operating expenses and results of operations of the Company. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC or the Bank’s primary regulator. Management of the Company is not aware of any practice, condition or violation that might lead to termination of the Company’s deposit insurance.

### Community Reinvestment Act (“CRA”) and Fair Lending

The Bank is subject to certain fair lending requirements involving lending, investing, and other CRA activities. CRA requires each insured depository institution to identify the communities served by the institution’s offices and to identify the types of credit and investments the institution is prepared to extend within such communities including low and moderate-income neighborhoods. It also requires the institution’s regulators to assess the institution’s performance in meeting the credit needs of its community and to take such assessment into consideration in reviewing applications for mergers, acquisitions, relocation of existing branches, opening of new branches, and other transactions. A bank may be subject to substantial penalties and corrective measures for a violation of certain fair lending laws.

A bank’s compliance with the Community Reinvestment Act is assessed using an evaluation system, which bases CRA ratings on an institution’s lending, service and investment performance. An unsatisfactory rating may be the basis for denying a merger application. The Bank’s latest CRA examination was completed by the Federal Deposit Insurance

Corporation in July 2010 and the Bank received an overall Satisfactory rating in complying with its CRA obligations.

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### The Sarbanes-Oxley Act of 2002(Sarbanes-Oxley Act)

This legislation addresses certain accounting oversight and corporate governance matters, including but not limited to:

- required executive certification of financial presentations;
- increased requirements for board audit committees and their members;
- enhanced disclosure of controls and procedures and internal control over financial reporting;
- enhanced controls over, and reporting of, insider trading; and
- increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

As a public reporting company, the Company is subject to the requirements of this legislation and related rules and regulations issued by the Securities and Exchange Commission (the “SEC”). Compliance with the Sarbanes-Oxley Act did not have a material impact upon its business. However, other non-interest expense items, including professional expenses and other costs related to compliance with the reporting requirements of the securities laws have significantly increased and can be expected to continue to increase.

### Consumer Protection Regulations

The Company’s lending activities are subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act, Equal Credit Opportunity Act, the Fair Housing Act, and the Truth-in-Lending Act. Deposit operations are also subject to laws and regulations that protect consumer rights including Funds Availability, Truth in Savings, and Electronic Funds Transfers. Additional rules govern check writing ability on certain interest earning accounts and prescribe procedures for complying with administrative subpoenas of financial records. Additionally, a provision of the Federal Reserve Regulation E has been changed effective July 1, 2010 that puts restrictions on institutions assessing overdraft fees on consumer’s accounts relating to debit card usage or other forms of transfers.

### The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)

On July 21, 2010, President Obama signed into law the sweeping financial regulatory reform, Dodd-Frank Act, that implements significant changes to the regulation of the financial services industry, including provisions that, among other things:

- Centralize responsibility for consumer financial protection by creating a new agency within the Federal Reserve Board, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and thrifts.
- Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to bank holding companies.
- Require the FDIC to seek to make its capital requirements for banks countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction.
- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital.
- Implement corporate governance revisions, including executive compensation and proxy access by stockholders.

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Make permanent the \$250,000 limit for federal deposit insurance and increase the cash limit of Securities Investor Protection Corporation protection from \$100,000 to \$250,000, and provide unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts at all insured depository institutions.

Repeal the federal prohibitions on the payment of interest on demand deposits effective July 21, 2011, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Many aspects of the Dodd-Frank Act are subject to rulemaking by various regulatory agencies and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers or the financial industry more generally. The elimination of the prohibition on the payment of interest on demand deposits could materially increase our interest expense, depending on our competitors' responses.

### Future Legislation and Regulatory Initiatives

Various legislative and regulatory initiatives are from time to time introduced in Congress and state legislatures, as well as regulatory agencies. Future legislation regarding financial institutions may change banking statutes and the operating environment of the Company and the Bank in substantial and unpredictable ways, and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance depending upon whether any of this potential legislation will be enacted, and if enacted, the effect that it or any implementing regulations, would have on the financial condition or results of operations of the Company or the Bank. The nature and extent of future legislative and regulatory changes affecting financial institutions is unpredictable at this time. The Company cannot determine the ultimate effect that such potential legislation, if enacted, would have upon its financial condition or operations.

### Available Information

Company reports filed with the SEC including the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and ownership reports filed by directors, executive officers and principal stockholders can be accessed through the Company's web site at <http://www.fmbonline.com>. The link to the SEC is on the About Us page.

### Item 1A. Risk Factors

An investment in our common stock is subject to risks inherent in our business. The material risks and uncertainties that management believes may affect our business are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this 10-K Report. The risks and uncertainties described below are not the only ones facing our business. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This 10-K Report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

### Risks Associated With Our Business

Continuing Difficult Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses - While the national economy and the economy of other portions of California have experienced improvements over the past twelve to eighteen months, the Central Valley of California, the Company's primary market area, continues to experience sluggish economic conditions. This is reflected in: (1) continuing public



sector financial stress, both at the local and statewide level (See “Item 1. Business – Service Area” - the State of California, a large employer in one of the Company’s market territories continues to experience budget problems that have yet to be fully solved and the City of Stockton has recently declared bankruptcy); and (2) continuing high levels of unemployment and home prices that have only slightly improved and remain well below peak levels.

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Our retail and commercial banking operations are concentrated primarily in Sacramento, San Joaquin, Stanislaus and Merced Counties. See “Item 1. Business – Service Area.” As a result of this geographic concentration, our results of operations depend largely upon economic conditions in these areas. Whereas much of this area appears to have stabilized, real estate values remain well below peak prices and unemployment remains well above most other areas in the state and country. As a result, risk still remains from the possibility that losses will be sustained if a significant number of our borrowers, guarantors and related parties fail to perform in accordance with the terms of their loans or leases. We have adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for credit losses, that management believes are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan & lease performance and diversifying our credit portfolio. These policies and procedures; however, may not prevent unexpected losses that could materially adversely affect our results of operations in general and the market value of our stock. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2014 and Beyond.”

Additionally, despite the stability of our earnings over the last several years, economic uncertainties may continue for the foreseeable future and the full extent of the repercussions on our local economies in general and our business in particular are not fully known at this time. Such events may have a negative effect on: (i) our ability to service our existing customers and attract new customers; (ii) the ability of our borrowers to operate their business as successfully as in the past; (iii) the financial security and net worth of our customers; and (iv) the ability of our customers to repay their loans or leases with us in accordance with the terms thereof.

**Nonperforming Assets Take Significant Time To Resolve And Adversely Affect Our Company’s Results Of Operations And Financial Condition -** Nonperforming assets adversely affect our net income in various ways. Until economic and market conditions improve in our local markets, we expect to continue to incur losses relating to non-performing loans & leases. We do not record interest income on non-accrual loans & leases or other real estate owned, thereby adversely affecting our income and increasing our loan & lease administration costs. When we take collateral in foreclosures and similar proceedings, we are required to mark the related loan to the then fair market value of the collateral, which may result in a loss. While we have reduced our problem assets through workouts, restructurings and otherwise, decreases in the value of these assets, or the underlying collateral, or in these borrowers’ performance or financial conditions, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management, which can be detrimental to the performance of other responsibilities. There can be no assurance that we will not experience further increases in nonperforming loans & leases in the future.

**Our Allowance For Credit Losses May Not Be Adequate To Cover Actual Losses -** A significant source of risk arises from the possibility that losses could be sustained because borrowers, guarantors, and related parties may fail to perform in accordance with the terms of their loans & leases. The underwriting and credit monitoring policies and procedures that we have adopted to address this risk may not prevent unexpected losses that could have a material adverse effect on our business, financial condition, results of operations and cash flows. Unexpected losses may arise from a wide variety of specific or systemic factors, many of which are beyond our ability to predict, influence, or control.

Like all financial institutions, we maintain an allowance for credit losses to provide for loan & lease defaults and non-performance. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Provision and Allowance for Credit Losses.” The allowance is funded from a provision for credit losses, which is a charge to our income statement. Our allowance for credit losses may not be adequate to cover actual loan & lease losses, and future provisions for credit losses could materially and adversely affect our business, financial condition, results of operations and cash flows. The allowance for credit losses reflects our estimate of the probable losses in our loan & lease portfolio at the relevant balance sheet date. Our allowance for credit losses is based on prior experience, as well as an evaluation of the known risks in the current portfolio, composition and growth of the loan &

lease portfolio and other economic factors. The determination of an appropriate level of credit loss allowance is an inherently difficult process and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, that may be beyond our control and these losses may exceed current estimates.

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The process we use to estimate losses inherent in our credit exposure requires difficult, subjective and complex judgments, including forecasts of economic conditions and how these economic conditions might impair the ability of our borrowers to repay their loans and lessees to make their lease payments. The level of uncertainty concerning current economic conditions may adversely affect the accuracy of our estimates, which may, in turn, impact the reliability of the allowance for credit losses.

While we believe that our allowance for credit losses is adequate to cover current losses, we cannot assure you that we will not increase the allowance for credit losses further or that regulators will not require us to increase this allowance. Either of these occurrences could materially adversely affect our business, financial condition, results of operations and cash flows.

**We Are Dependent On Real Estate And Further Downturns In The Real Estate Market Could Hurt Our Business -** Although our regulators have determined that we do not have significant CRE concentration risk, a significant portion of our loan portfolio is dependent on real estate. See “Item 1. Business – Supervision and Regulation - Prompt Corrective Action and Other Enforcement Mechanisms.” At December 31, 2013, real estate served as the principal source of collateral with respect to approximately 73% of our loan outstandings and 19% of loans outstanding were secured by production agricultural properties. Continuing stresses in current economic conditions in our local markets or rising interest rates could have an adverse effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing loans and the value of real estate owned by us, as well as our financial condition and results of operations in general and the market value of our common stock.

Acts of nature, including earthquakes, floods and fires, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also negatively impact our financial condition.

**Our Real Estate Lending Also Exposes Us To The Risk Of Environmental Liabilities -** In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third persons for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be materially and adversely affected.

**Our Business Is Subject To Interest Rate Risk And Changes In Interest Rates May Adversely Affect Our Performance And Financial Condition -** Our earnings are impacted by changing interest rates. Changes in interest rates impact the demand for new loans & leases, the credit profile of our borrowers, the rates received on loans & leases and securities and rates paid on deposits and borrowings. The difference between the rates received on loans & leases and securities and the rates paid on deposits and borrowings is known as the net interest margin. Like many financial institutions, our net interest margin has been declining. We expect that continued low interest rates and aggressive competitor pricing strategies will continue to push net interest margin lower in 2014.

Although we believe our current level of interest rate sensitivity is reasonable, significant fluctuations in interest rates and increasing competition may have an adverse effect on our business, financial condition and results of operations. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Net Interest Income/Net Interest Margin” and “Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk.”

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Continuing low levels of market interest rates could adversely affect our earnings. The FRB regulates the supply of money and credit in the United States. Its policies determine, in large part, the cost of funds for lending and investing and the yield earned on those loans, leases and investments, which impact the Company's net interest margin. Beginning in September 2007 the FRB implemented a series of rate reductions in response to the current state of the national economy and housing market as well as the volatility of financial markets. Rates have remained low ever since, and show no signs of significantly increasing in the near future. When interest rates decline, borrowers tend to refinance higher-rate, fixed-rate loans at lower rates, and prepaying their existing loans. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our CRE and commercial loans, which carry interest rates that, in general, adjust in accordance with changes in the prime rate, will adjust to lower rates. We are also significantly affected by the level of loan & lease demand available in our market. The inability to make sufficient loans & leases directly affects the interest income we earn. Lower loan & lease demand will generally result in lower interest income realized as we place funds in lower yielding investments. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2014 and Beyond."

**Our Accounting Estimates and Risk Management Processes Rely On Analytical and Forecasting Models -** The processes we use to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on our financial condition and results of operations, depends upon the use of analytical and forecasting models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use to measure the fair value of financial instruments are inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Any such failure in our analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

**Failure To Successfully Execute Our Strategy Could Adversely Affect Our Performance -** Our financial performance and profitability depends on our ability to execute our corporate growth strategy. Continued growth however, may present operating and other problems that could adversely affect our business, financial condition and results of operations. Accordingly, there can be no assurance that we will be able to execute our growth strategy or maintain the level of profitability that we have recently experienced. Factors that may adversely affect our ability to attain our long-term financial performance goals include those stated elsewhere in this section, as well as the:

- inability to maintain or increase net interest margin;
- inability to control non-interest expense, including, but not limited to, rising employee and healthcare costs and the costs of regulatory compliance;
- inability to maintain or increase non-interest income; and
- continuing ability to expand through de novo branching or otherwise.

**Our Financial Results Can Be Impacted By The Cyclicity and Seasonality Of Our Agricultural Business And The Risks Related Thereto -** The Company has provided financing to agricultural customers in the Central Valley throughout its history. We recognize the cyclical nature of the industry, often caused by fluctuating commodity prices and changing climatic conditions, and manage these risks accordingly. The Company remains committed to providing credit to agricultural customers and will always have a material exposure to this industry. Although the Company's loan portfolio is believed to be well diversified, at various times during 2013 approximately 41% of the Company's loan balances were outstanding to agricultural borrowers. Commitments are well diversified across various commodities, including dairy, grapes, walnuts, almonds, cherries, apples, pears, walnuts, and various row crops. Additionally, many individual borrowers are themselves diversified across commodity types, reducing their exposure,

and therefore the Company's, to cyclical downturns in any one commodity. The state of California experienced drought conditions during much of 2013. Importantly, most of the Company's agricultural customers have access to their own ground water supplies and, therefore, are not as dependent on the delivery of surface water as growers in other parts of California. Although Management does not expect current conditions to have a material impact on credit quality during 2014, the lack of rain will have some adverse impact on our agricultural customers' operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels reach critical stage.

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The Company's service areas can also be significantly impacted by the seasonal operations of the agricultural industry. As a result, the Company's financial results can be influenced by the banking needs of its agricultural customers (e.g., generally speaking during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and the planting of crops. Correspondingly, deposit balances are replenished and loans repaid in late fall and winter as crops are harvested and sold).

**We Face Strong Competition From Financial Service Companies And Other Companies That Offer Banking Services That Could Adversely Impact Our Business** - The financial services business in our market areas is highly competitive. It is becoming increasingly competitive due to changes in regulation, technological advances, and the accelerating pace of consolidation among financial services providers. We face competition both in attracting deposits and in making loans & leases. We compete for loans & leases principally through the interest rates and loan & lease fees we charge and the efficiency and quality of services we provide. Increasing levels of competition in the banking and financial services business may reduce our market share, decrease loan & lease demand, cause the prices we charge for our services to fall, or decrease our net interest margin by forcing us to offer lower lending interest rates and pay higher deposit interest rates. Therefore, our results may differ in future periods depending upon the nature or level of competition.

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

Many of our competitors offer products and services that we do not offer, and many have substantially greater resources, such as greater capital resources and more access to longer term, lower cost funding sources. Many also have greater name recognition and market presence that benefit them in attracting business. In addition, larger competitors may be able to price loans & lease and deposits more aggressively than we do. Our larger competitors generally have easier access to capital, and often on better terms. Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured state-chartered banks, national banks and federal savings institutions. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services. Other competitors are subject to similar regulation but have the advantages of larger established customer bases, higher lending limits, extensive branch networks, numerous automated teller machines, greater advertising and marketing budgets or other factors. Some of our competitors have other advantages, such as tax exemption in the case of credit unions, and lesser regulation in the case of mortgage companies and specialty finance companies.

**Deposit Insurance Assessments Could Increase At Any Time, Which Will Adversely Affect Profits** - FDIC deposit insurance expense for the years 2013, 2012, and 2011 was \$981,000, \$968,000, and \$1.5 million, respectively. During 2011, the FDIC changed its methodology for calculating deposit premiums, See "Item 1. Business – Supervision and Regulation – Deposit Insurance." While FDIC deposit insurance assessments in 2012 and 2013 were well below those in 2011, they remain well above the pre-recession level of \$144,000 the Company paid in 2007. Any increases could have adverse effects on the operating expenses and results of operations of the Company.

**We May Not Be Able To Attract And Retain Skilled People** - Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most of our activities can be intense and we may not be able to hire people or to retain them. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Our Internal Operations Are Subject To A Number Of Risks - We are subject to certain operations risks, including, but not limited to, information system failures and errors, customer or employee fraud and catastrophic failures resulting from terrorist acts or natural disasters. We maintain a system of internal controls to mitigate against such occurrences and maintain insurance coverage for such risks that are insurable, but should such an event occur that is not prevented or detected by our internal controls, uninsured or in excess of applicable insurance limits, it could have a significant adverse impact on our business, financial condition or results of operations.

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We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan & leases and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

Natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans and lessees to make lease payments, impair the value of collateral securing loans & leases, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Operations in several of our markets could be disrupted by both the evacuation of large portions of the population as well as damage and or lack of access to our banking and operation facilities. While we have not experienced such an occurrence to date, other natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

**We Depend On Cash Dividends From Our Subsidiary Bank To Meet Our Cash Obligations -** As a holding company, dividends from our subsidiary bank provide a substantial portion of our cash flow used to service the interest payments on our Trust Preferred Securities and our other obligations, including cash dividends. See “Item 5. Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.” Various statutory provisions restrict the amount of dividends our subsidiary bank can pay to us without regulatory approval.

## Risks Associated With Our Industry

**We Are Subject To Government Regulation That Could Limit Or Restrict Our Activities, Which In Turn Could Adversely Impact Our Financial Performance -** The financial services industry is regulated extensively and we are subject to examination, supervision and comprehensive regulations by various regulatory agencies. Federal and state regulations are designed primarily to protect the deposit insurance funds and consumers, and not to benefit our stockholders. These regulations can sometimes impose significant limitations on our operations and increase our cost of doing business.

Further, federal monetary policy, particularly as implemented by the FRB, significantly affects economic conditions for us.

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Proposals to change the laws and regulations governing the operations and taxation of, and federal insurance premiums paid by, banks and other financial institutions and companies that control such institutions are frequently raised in the U.S. Congress, the California legislature and before bank regulatory authorities. The likelihood of any major changes in the future and the impact such changes, including the Dodd-Frank Act, might have on us or the Bank are impossible to determine. Similarly, proposals to change the accounting treatment applicable to banks and other depository institutions are frequently raised by the SEC, the federal banking agencies, the IRS and other appropriate authorities. The likelihood and impact of any additional future changes in law or regulation and the impact such changes might have on us or the Bank are impossible to determine at this time.

### Risks Associated With Our Stock

**Our Stock Trades Less Frequently Than Others** - The Company's common stock is not widely held or listed on any exchange. However, trades may be reported on the OTC Bulletin Board under the symbol "FMCB." Management is aware that there are private transactions in the Company's common stock. However, the limited trading market for the Company's common stock may make it difficult for stockholders to dispose of their shares.

**Our Stock Price Is Affected By A Variety Of Factors** - Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly in response to a variety of factors discussed in this section, including, among other things:

- actual or anticipated variations in quarterly results of operations;
- operating and stock price performance of other companies that investors deem comparable to our Company;
- news reports relating to trends, concerns and other issues in the financial services industry;
- available investment liquidity in our market area since our stock is not listed on any exchange; and
- perceptions in the marketplace regarding our Company and/or its competitors.

**Our Common Stock Is Not An Insured Deposit** - Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this "Risk Factors" section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire our common stock, you may lose some or all of your investment.

### Item 1B. Unresolved Staff Comments

The Company has no unresolved comments received from staff at the SEC.

### Item 2. Properties

Farmers & Merchants Bancorp along with its subsidiaries are headquartered in Lodi, California. Executive offices are located at 111 W. Pine Street. Banking services are provided in twenty-one branch locations in the Company's service area. Of the twenty-one branches, fifteen are owned and six are leased. Both of the loan production offices are leased. The expiration of these leases occurs between the years 2014 and 2018. See Note 19 located in "Item 8. Financial Statements and Supplementary Data."

### Item 3. Legal Proceedings

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

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

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## Item 4. Mine Safety Disclosures

Not Applicable

## PART II

## Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades may be reported on the OTC Bulletin Board under the symbol "FMCB." Additionally, management is aware that there are private transactions in the Company's common stock.

The following table summarizes the actual high, low, and close sale prices for the Company's common stock since the first quarter of 2012. These figures are based on activity posted on the OTC Bulletin Board and on private transactions between individual stockholders that are reported to the Company.

| Calendar Quarter    | High  | Low   | Close | Cash Dividends Declared (Per Share) |
|---------------------|-------|-------|-------|-------------------------------------|
| 2013 Fourth quarter | \$417 | \$405 | \$417 | \$ 6.30                             |
| Third quarter       | 420   | 400   | 415   | -                                   |
| Second quarter      | 500   | 384   | 400   | 6.20                                |
| First quarter       | 470   | 375   | 470   | -                                   |

| Calendar Quarter    | High  | Low   | Close | Cash Dividends Declared (Per Share) |
|---------------------|-------|-------|-------|-------------------------------------|
| 2012 Fourth quarter | \$405 | \$355 | \$405 | \$ 6.20                             |
| Third quarter       | 375   | 355   | 375   | -                                   |
| Second quarter      | 400   | 350   | 375   | 5.90                                |
| First quarter       | 400   | 342   | 350   | -                                   |

As of January 31, 2014, there were approximately 1,463 stockholders of record of the Company's common stock.

The Company and, before the Company was formed, the Bank, have paid cash dividends for the past 79 consecutive years. There are limitations under Delaware corporate law as to the amounts of cash dividends that may be paid by the Company. Additionally, if we decided to defer interest on our subordinated debentures, we would be prohibited from paying cash dividends on the Company's common stock. The Company is dependent on cash dividends paid by the Bank to fund its cash dividend payments to its stockholders. There are regulatory limitations on cash dividends that may be paid by the Bank under state and federal laws. See "Item 1. Business – Supervision and Regulation."

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

increasing the funds available for the Company's common stock repurchase program to \$20 million over the three-year period ending September 30, 2015.

Repurchases under the program will continue to be made on the open market or through private transactions. The repurchase program also requires that no purchases may be made if the Bank would not remain "well-capitalized" after the repurchase.

There were no shares repurchased by the Company during 2013. The approximate dollar value of shares that may yet be purchased under the program is \$20 million.

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On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Registrar and Transfer Company, as Rights Agent, and the Company declared a dividend of a right to acquire one preferred share purchase right (a “Right”) for each outstanding share of the Company’s common stock, \$0.01 par value per share, to stockholders of record at the close of business on August 15, 2008. Generally, the Rights are only triggered and become exercisable if a person or group (the “Acquiring Person”) acquires beneficial ownership of 10 percent or more of the Company’s common stock or announces a tender offer for 10 percent or more of the Company’s common stock.

The Rights Plan is similar to plans adopted by many other publicly traded companies. The effect of the Rights Plan is to discourage any potential acquirer from triggering the Rights without first convincing Farmers & Merchants Bancorp’s Board of Directors that the proposed acquisition is fair to, and in the best interest of, all of the stockholders of the Company. The provisions of the Plan will substantially dilute the equity and voting interest of any potential acquirer unless the Board of Directors approves of the proposed acquisition. Each Right, if and when exercisable, will entitle the registered holder to purchase from the Company one one-hundredth of a share of Series A Junior Participating Preferred Stock, no par value, at a purchase price of \$1,200 for each one one-hundredth of a share, subject to adjustment. Each holder of a Right (except for the Acquiring Person, whose Rights will be null and void upon such event) shall thereafter have the right to receive, upon exercise, that number of Common Shares of the Company having a market value of two times the exercise price of the Right. At any time before a person becomes an Acquiring Person, the Rights can be redeemed, in whole, but not in part, by Farmers and Merchants Bancorp’s Board of Directors at a price of \$0.001 per Right. The Rights Plan will expire on August 5, 2018.

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Performance Graphs

The following graph compares the Company's cumulative total stockholder return on common stock from December 31, 2008 to December 31, 2013 to that of: (i) the Morningstar Banks Index - Regional (US) Industry Group; and (ii) the cumulative total return of the New York Stock Exchange market index. The graph assumes an initial investment of \$100 on December 31, 2008 and reinvestment of dividends. The stock price performance set forth in the following graph is not necessarily indicative of future price performance. The Company's stock price data is based on activity posted on the OTC Bulletin Board and on private transactions between individual stockholders that are reported to the Company. This data was furnished by Zacks SEC Compliance Services Group.

This graph shall not be deemed filed or incorporated by reference into any filing under the Securities Act of 1933.

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## Item 6. Selected Financial Data

Farmers & Merchants Bancorp  
Five Year Financial Summary of Operations

(in thousands except per share data)

|  |             |             |             |             |             |   |
|--|-------------|-------------|-------------|-------------|-------------|---|
| Summary of Income:                                       | 2013        | 2012        | 2011        | 2010        | 2009        |   |
| Total Interest Income                                    | \$76,531    | \$78,491    | \$82,354    | \$84,461    | \$91,314    |   |
| Total Interest Expense                                   | 2,891       | 5,140       | 7,974       | 9,685       | 16,331      |   |
| Net Interest Income                                      | 73,640      | 73,351      | 74,380      | 74,776      | 74,983      |   |
| Provision for Credit Losses                              | 425         | 1,850       | 6,775       | 14,735      | 15,420      |   |
| Net Interest Income After Provision for<br>Credit Losses | 73,215      | 71,501      | 67,605      | 60,041      | 59,563      |   |
| Total Non-Interest Income                                | 15,937      | 14,110      | 12,274      | 17,185      | 18,194      |   |
| Total Non-Interest Expense                               | 50,870      | 48,277      | 45,028      | 43,939      | 46,429      |   |
| Income Before Income Taxes                               | 38,282      | 37,334      | 34,851      | 33,287      | 31,328      |   |
| Provision for Income Taxes                               | 14,221      | 13,985      | 12,642      | 12,169      | 11,315      |   |
| Net Income   | \$24,061    | \$23,349    | \$22,209    | \$21,118    | \$20,013    |   |
| Balance Sheet Data:                                      |             |             |             |             |             |   |
| Total Assets   | \$2,076,073 | \$1,974,686 | \$1,919,684 | \$1,841,491 | \$1,781,014 |   |
| Loans & Leases   | 1,388,236   | 1,246,902   | 1,163,078   | 1,176,002   | 1,212,718   |   |
| Allowance for Credit Losses                              | 34,274      | 34,217      | 33,017      | 32,261      | 29,813      |   |
| Investment Securities                                    | 473,144     | 486,383     | 542,912     | 493,581     | 435,166     |   |
| Deposits   | 1,807,691   | 1,722,026   | 1,626,197   | 1,566,503   | 1,498,124   |   |
| Federal Home Loan Bank Advances                          | -           | -           | 530         | 591         | 20,149      |   |
| Shareholders' Equity                                     | 209,904     | 205,033     | 189,346     | 173,241     | 164,727     |   |
| Selected Ratios:   |             |             |             |             |             |   |
| Return on Average Assets                                 | 1.21        | % 1.22      | % 1.19      | % 1.19      | % 1.15      | % |
| Return on Average Equity                                 | 11.54       | % 11.62     | % 12.10     | % 12.25     | % 12.33     | % |
| Dividend Payout Ratio                                    | 40.41       | % 40.34     | % 41.24     | % 41.93     | % 42.95     | % |
| Average Loans & Leases to Average<br>Deposits            | 74.28       | % 72.02     | % 74.48     | % 79.03     | % 80.12     | % |
| Average Equity to Average Assets                         | 10.52       | % 10.45     | % 9.85      | % 9.74      | % 9.34      | % |
| Period-end Shareholders' Equity to Total<br>Assets       | 10.11       | % 10.38     | % 9.86      | % 9.41      | % 9.25      | % |
| Basic Per Share Data:                                    |             |             |             |             |             |   |
| Net Income <sup>(1)</sup>                                | \$30.93     | \$29.99     | \$28.49     | \$27.05     | \$25.57     |   |
| Cash Dividends Per Share                                 | \$12.50     | \$12.10     | \$11.75     | \$11.35     | \$11.00     |   |

<sup>(1)</sup> Based on the weighted average number of shares outstanding of 777,882, 778,648, 779,424, 780,619, and 782,754 for the years ended December 31, 2013, 2012, 2011, 2010, and 2009, respectively.



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## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

## Overview

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

## The Five-Year Period: 2009 through 2013

Through much of 2007 the economy in our primary service area was strong, the stock market rising and individuals and businesses doing well. Then in October 2007 the financial markets started what would become a major adjustment and an economic recession began, the impact of which is still being felt today in the Central Valley of California. The Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy appears to have stabilized throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country.

Despite this difficult economic environment, in management's opinion, the Company's operating performance over the past five years has been exceptionally strong.

(in thousands, except per share data)

| Financial Performance Indicator                              | 2013        | 2012        | 2011        | 2010        | 2009        |
|--|-------------|-------------|-------------|-------------|-------------|
| Net Income   | \$24,061    | \$23,349    | \$22,209    | \$21,118    | \$20,013    |
| Total Assets   | \$2,076,073 | \$1,974,686 | \$1,919,684 | \$1,841,491 | \$1,781,014 |
| Total Loans & Leases   | \$1,388,236 | \$1,246,902 | \$1,163,078 | \$1,176,002 | \$1,212,718 |
| Total Deposits   | \$1,807,691 | \$1,722,026 | \$1,626,197 | \$1,566,503 | \$1,498,124 |
| Total Shareholders' Equity                                   | \$209,904   | \$205,033   | \$189,346   | \$173,241   | \$164,727   |
| Total Consolidated Risk-Based Capital Ratio                  | 13.99       | % 14.96     | % 14.86     | % 13.82     | % 12.48     |
| Non-Performing Loans & Leases as a % of Total Loans & Leases | 0.19        | % 0.74      | % 0.36      | % 0.45      | % 0.76      |
| Substandard Loans & Leases as a % of Total Loans & Leases    | 0.41        | % 1.72      | % 3.67      | % 3.40      | % 5.17      |
| Net Charge-Offs to Average Loans & Leases                    | 0.03        | % 0.05      | % 0.51      | % 1.04      | % 0.48      |
| Credit Loss Allowance as a % of Total Loans & Leases         | 2.46        | % 2.74      | % 2.83      | % 2.74      | % 2.45      |
| Return on Average Assets                                     | 1.21        | % 1.22      | % 1.19      | % 1.19      | % 1.15      |
| Return on Average Equity                                     | 11.54       | % 11.62     | % 12.10     | % 12.25     | % 12.33     |
| Basic Earnings Per Common Share                              | \$30.93     | \$29.99     | \$28.49     | \$27.05     | \$25.57     |
| Cash Dividends Per Share                                     | \$12.50     | \$12.10     | \$11.75     | \$11.35     | \$11.00     |
| Cash Dividends Declared                                      | \$9,723     | \$9,418     | \$9,158     | \$8,855     | \$8,596     |

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|   |       |       |       |       |       |
|---|-------|-------|-------|-------|-------|
| # Shares Repurchased During Year          | -     | 1,542 | -     | 1,520 | 6,016 |
| Average Share Price of Repurchased Shares | \$-   | \$373 | \$-   | \$400 | \$387 |
| High Stock Price – Fourth Quarter         | \$417 | \$405 | \$400 | \$425 | \$425 |
| Low Stock Price – Fourth Quarter          | \$405 | \$355 | \$345 | \$400 | \$325 |
| Closing Stock Price – Fourth Quarter      | \$417 | \$405 | \$400 | \$415 | \$380 |

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Although the Company was not entirely immune to the pressures that a struggling economy brought to bear, management also believes that the Company's performance compared very favorably to its peer banks during the five-year period ending December 31, 2013:

- Net income totaled \$110.8 million and never dropped below \$20.0 million in any single year.
- Return on Average Assets never dropped below 1.15% in any single year.
- Total assets increased 23.3% to \$2.1 billion.
- Total loans & leases increased 17.9% to \$1.4 billion.
- Total deposits increased 26.2% to \$1.8 billion.

More recently:

In 2013, the Company earned \$24.1 million for a return on average assets of 1.21%, and our return on average assets averaged 1.19% over the five-year period. Importantly, these strong results were generated at the same time the Company increased its credit loss allowance by \$14.2 million, to \$34.3 million or 2.46% of total loans & leases.

In 2013, the Company increased its cash dividend per share by 3.3% over 2012 levels, and our strong financial performance allowed us to increase dividends every year during this five-year period.

The Company's total risk based capital ratio was --13.99% at December 31, 2013, and the Bank achieved the highest regulatory classification of "well capitalized" in each of the five years. See "Financial Condition – Capital."

Despite continuing sluggish economic conditions in the Company's local markets, the Company's asset quality remains very strong compared to peer banks at the present time, when measured by: (1) net charge-offs of 0.03% of average loans & leases during this five-year period; and (2) substandard loans & leases totaling 0.41% of total loans & leases at December 31, 2013. See "Results of Operations – Provision and Allowance for Credit Losses" and "Financial Condition – Classified Loans & leases and Non-Performing Assets."

As a result of this strong earnings performance, capital position, and asset quality, stockholders have benefited from the fact that cash dividends per share have increased 17.4% since 2008, and totaled \$58.70 per share over the five-year period. The 2013 dividend of \$12.50 per share represents a 3% yield based upon the December 31, 2013 ending stock price of \$417 per share.

Looking Forward: 2014 and Beyond

In management's opinion, the following key issues will influence the financial results of the Company in 2014 and future years:

The Company's earnings are heavily dependent on its net interest margin, which is sensitive to such factors as: (1) market interest rates; (2) the mix of our earning assets and interest-bearing liabilities; and (3) competitor pricing strategies.

During the third quarter of 2007, the FRB began dropping short-term market rates. Market rates remain low, and the FRB continues to imply that they expect them to remain that way well past 2014.

- Deposit growth has outstripped loan growth over the past five years, and the Company's loan-to-deposit ratio has dropped since 2008. This results in a higher percentage of our earning assets being placed into lower yielding

investment securities, interest-bearing deposits with banks, and Federal Funds Sold. Although loan growth picked-up in 2013, this growth occurred despite what continues to be a difficult economic environment in the Central Valley combined with a very competitive pricing environment, and is a result of the Company's intensified business development efforts directed toward credit-qualified borrowers. No assurances can be given that this growth in the loan & lease portfolio will continue until the economy in the Central Valley of California improves.

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Aggressive competitor pricing for both loans & leases and deposits has often required the Company to respond in order to retain key customers.

The combination of these factors has caused the Company's net interest margin to decline from 4.89% in the second quarter of 2007 to 4.14% in the fourth quarter of 2013. The Company expects many of these factors to continue to push the net interest margin lower in 2014. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."

The Company's results can be significantly influenced by changes in the credit quality of its borrowers. Substandard loans & leases totaled \$5.8 million or 0.41% of total loans & leases at December 31, 2013 vs. \$21.5 million or 1.72% of total loans at December 31, 2012, and a peak of \$62.8 million or 5.17% of total loans at December 31, 2009. Management believes, based on information currently available, that these levels are adequately covered by the Company's \$34.3 million allowance for credit losses as of December 31, 2013. See "Results of Operations - Provision and Allowance for Credit Losses" and "Financial Condition - Classified Loans & Leases and Non-Performing Assets." The Company's provision for credit losses was \$425,000 in 2013, a significant decrease from \$1.9 million in 2012 and \$6.8 million in 2011. See "Item 1A. Risk Factors."

FDIC deposit insurance expense for the years 2013, 2012, and 2011 was \$981,000, \$968,000, and \$1.5 million, respectively. In 2011 the FDIC changed its methodology for calculating deposit premiums. See "Item 1. Business - Supervision and Regulation - Deposit Insurance." While FDIC deposit insurance assessments have declined some since 2011, they remain well above the pre-recession level of \$144,000 the Company paid in 2007.

Congress and the Obama Administration are continuing to implement broad changes to the regulation of consumer financial products and the financial services industry as a whole. These changes could significantly affect the Company's product offerings, pricing and profitability in areas such as debit and credit cards, home mortgages and deposit service charges.

The Company has expanded its geographic footprint to include Walnut Creek, CA and Irvine, CA and has established equipment leasing as a new line of business. Although Management believes that these initiatives will result in increased asset growth and earnings, along with reduced concentration risks, the start-up costs related to staff and facilities are not insignificant and may take 12-18 months to cover.

## Results of Operations

The following discussion and analysis is intended to provide a better understanding of Farmers & Merchants Bancorp and its subsidiaries' performance during each of the years in the three-year period ended December 31, 2013, and the material changes in financial condition, operating income, and expense of the Company and its subsidiaries as shown in the accompanying financial statements.

### Net Interest Income/Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the years ending 2013, 2012, and 2011. Average balance amounts for assets and liabilities are the computed average of daily balances.

Net interest income is the amount by which the interest and fees on loans & leases and other interest earning assets exceed the interest paid on interest-bearing sources of funds. For the purpose of analysis, the interest earned on tax-exempt investments and municipal loans is adjusted to an amount comparable to interest subject to normal income taxes. This adjustment is referred to as "tax equivalent" adjustment and is noted wherever applicable. The presentation of net interest income and net interest margin on a tax equivalent basis is a common practice within the banking industry.



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The Volume and Rate Analysis of Net Interest Income summarizes the changes in interest income and interest expense based on changes in average asset and liability balances (volume) and changes in average rates (rate). For each category of interest-earning assets and interest-bearing liabilities, information is provided with respect to changes attributable to: (1) changes in volume (change in volume multiplied by initial rate); (2) changes in rate (change in rate multiplied by initial volume); and (3) changes in rate/volume (allocated in proportion to the respective volume and rate components).

The Company's earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."

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

|  | Year Ended December 31,<br>2013 |          |        |
|--|---------------------------------|----------|--------|
|  | Balance                         | Interest | Rate   |
| Assets   |                                 |          |        |
| Interest Bearing Deposits with Banks                           | \$30,743                        | \$79     | 0.26 % |
| Investment Securities:   |                                 |          |        |
| Government Agency & Government-Sponsored Entities              | 28,033                          | 256      | 0.91 % |
| Obligations of States and Political Subdivisions - Non-Taxable | 68,832                          | 3,929    | 5.71 % |
| Mortgage Backed Securities                                     | 374,927                         | 8,117    | 2.16 % |
| Other  | 52,318                          | 598      | 1.14 % |
| Total Investment Securities                                    | 524,110                         | 12,900   | 2.46 % |
| Loans & Leases   |                                 |          |        |
| Real Estate  | 868,855                         | 46,056   | 5.30 % |
| Home Equity Lines & Loans                                      | 38,293                          | 2,187    | 5.71 % |
| Agricultural   | 204,103                         | 8,715    | 4.27 % |
| Commercial   | 150,456                         | 7,546    | 5.02 % |
| Consumer   | 4,888                           | 313      | 6.40 % |
| Other  | 230                             | 13       | 5.65 % |
| Leases   | 2,507                           | 91       | 3.63 % |
| Total Loans & Leases   | 1,269,332                       | 64,921   | 5.11 % |
| Total Earning Assets   | 1,824,185                       | \$77,900 | 4.27 % |
| Unrealized Gain on Securities Available-for-Sale               | 3,453                           |          |        |
| Allowance for Credit Losses                                    | (34,227 )                       |          |        |
| Cash and Due From Banks  | 33,648                          |          |        |
| All Other Assets   | 155,715                         |          |        |
| Total Assets   | \$1,982,774                     |          |        |
| Liabilities & Shareholders' Equity                             |                                 |          |        |
| Interest Bearing Deposits                                      |                                 |          |        |
| Interest Bearing DDA   | \$259,348                       | \$119    | 0.05 % |
| Savings and Money Market                                       | 577,214                         | 947      | 0.16 % |
| Time Deposits  | 444,605                         | 1,482    | 0.33 % |
| Total Interest Bearing Deposits                                | 1,281,167                       | 2,548    | 0.20 % |
| Other Borrowed Funds   | 12,265                          | 16       | 0.13 % |
| Subordinated Debt  | 10,310                          | 327      | 3.17 % |
| Total Interest Bearing Liabilities                             | 1,303,742                       | \$2,891  | 0.22 % |
| Interest Rate Spread   |                                 |          | 4.05 % |
| Demand Deposits  | 427,673                         |          |        |
| All Other Liabilities  | 42,783                          |          |        |
| Total Liabilities  | 1,774,198                       |          |        |
| Shareholders' Equity   | 208,576                         |          |        |
| Total Liabilities & Shareholders' Equity                       | \$1,982,774                     |          |        |
| Impact of Non-Interest Bearing Deposits and Other Liabilities  |                                 |          | 0.06 % |
| Net Interest Income and Margin on Total Earning Assets         |                                 | 75,009   | 4.11 % |



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|                           |                |
|---------------------------|----------------|
| Tax Equivalent Adjustment | (1,369 )       |
| Net Interest Income       | \$73,640 4.04% |

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$4.1 million for the year ended December 31, 2013. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

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

|  | Year Ended December 31,<br>2012 |          |        |
|--|---------------------------------|----------|--------|
|  | Balance                         | Interest | Rate   |
| Assets   |                                 |          |        |
| Interest Bearing Deposits with Banks                           | \$43,351                        | \$ 110   | 0.25 % |
| Investment Securities:   |                                 |          |        |
| Government Agency & Government-Sponsored Entities              | 56,396                          | 577      | 1.02 % |
| Obligations of States and Political Subdivisions - Non-Taxable | 70,432                          | 4,047    | 5.75 % |
| Mortgage Backed Securities                                     | 399,121                         | 9,182    | 2.30 % |
| Other  | 15,358                          | 182      | 1.19 % |
| Total Investment Securities                                    | 541,307                         | 13,988   | 2.58 % |
| Loans  |                                 |          |        |
| Real Estate  | 767,555                         | 44,329   | 5.78 % |
| Home Equity  | 46,405                          | 2,656    | 5.72 % |
| Agricultural   | 200,040                         | 9,888    | 4.94 % |
| Commercial   | 163,089                         | 8,455    | 5.18 % |
| Consumer   | 5,820                           | 456      | 7.84 % |
| Other  | 237                             | 13       | 5.49 % |
| Total Loans  | 1,183,146                       | 65,797   | 5.56 % |
| Total Earning Assets   | 1,767,804                       | \$79,895 | 4.52 % |
| Unrealized Gain on Securities Available-for-Sale               | 12,116                          |          |        |
| Allowance for Loan Losses                                      | (33,248 )                       |          |        |
| Cash and Due From Banks  | 33,941                          |          |        |
| All Other Assets   | 140,998                         |          |        |
| Total Assets   | \$1,921,611                     |          |        |
| Liabilities & Shareholders' Equity                             |                                 |          |        |
| Interest Bearing Deposits                                      |                                 |          |        |
| Interest Bearing DDA   | \$231,813                       | \$ 167   | 0.07 % |
| Savings and Money Market                                       | 540,063                         | 1,281    | 0.24 % |
| Time Deposits  | 496,327                         | 2,291    | 0.46 % |
| Total Interest Bearing Deposits                                | 1,268,203                       | 3,739    | 0.29 % |
| Securities Sold Under Agreement to Repurchase                  | 28,197                          | 1,018    | 3.61 % |
| Other Borrowed Funds   | 3,698                           | 36       | 0.97 % |
| Subordinated Debt  | 10,310                          | 347      | 3.37 % |
| Total Interest Bearing Liabilities                             | 1,310,408                       | \$5,140  | 0.39 % |
| Interest Rate Spread   |                                 |          | 4.13 % |
| Demand Deposits  | 374,677                         |          |        |
| All Other Liabilities  | 35,631                          |          |        |
| Total Liabilities  | 1,720,716                       |          |        |
| Shareholders' Equity   | 200,895                         |          |        |
| Total Liabilities & Shareholders' Equity                       | \$1,921,611                     |          |        |
| Impact of Non-Interest Bearing Deposits and Other Liabilities  |                                 |          | 0.10 % |
| Net Interest Income and Margin on Total Earning Assets         |                                 | 74,755   | 4.23 % |

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|                           |                 |
|---------------------------|-----------------|
| Tax Equivalent Adjustment | (1,404 )        |
| Net Interest Income       | \$73,351 4.15 % |

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$3.1 million for the year ended December 31, 2012. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

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

|  | Year Ended December 31,<br>2011 |          |        |
|--|---------------------------------|----------|--------|
|  | Balance                         | Interest | Rate   |
| Assets   |                                 |          |        |
| Interest Bearing Deposits with Banks                           | \$46,694                        | \$117    | 0.25 % |
| Investment Securities:   |                                 |          |        |
| Government Agency & Government-Sponsored Entities              | 201,666                         | 2,292    | 1.14 % |
| Obligations of States and Political Subdivisions - Non-Taxable | 66,142                          | 3,920    | 5.93 % |
| Mortgage Backed Securities                                     | 230,993                         | 7,167    | 3.10 % |
| Other  | 2,593                           | 31       | 1.20 % |
| Total Investment Securities                                    | 501,394                         | 13,410   | 2.67 % |
| Loans  |                                 |          |        |
| Real Estate  | 720,402                         | 45,146   | 6.27 % |
| Home Equity  | 54,964                          | 3,198    | 5.82 % |
| Agricultural   | 215,001                         | 12,013   | 5.59 % |
| Commercial   | 173,837                         | 9,345    | 5.38 % |
| Consumer   | 7,338                           | 465      | 6.34 % |
| Other  | 243                             | 13       | 5.35 % |
| Total Loans  | 1,171,785                       | 70,180   | 5.99 % |
| Total Earning Assets   | 1,719,873                       | \$83,707 | 4.87 % |
| Unrealized Gain on Securities Available-for-Sale               | 5,172                           |          |        |
| Allowance for Loan Losses                                      | (32,651 )                       |          |        |
| Cash and Due From Banks  | 30,808                          |          |        |
| All Other Assets   | 140,902                         |          |        |
| Total Assets   | \$1,864,104                     |          |        |
| Liabilities & Shareholders' Equity                             |                                 |          |        |
| Interest Bearing Deposits                                      |                                 |          |        |
| Interest Bearing DDA   | \$206,572                       | \$249    | 0.12 % |
| Savings and Money Market                                       | 488,540                         | 1,586    | 0.32 % |
| Time Deposits  | 543,547                         | 3,627    | 0.67 % |
| Total Interest Bearing Deposits                                | 1,238,659                       | 5,462    | 0.44 % |
| Securities Sold Under Agreement to Repurchase                  | 60,000                          | 2,148    | 3.58 % |
| Other Borrowed Funds   | 1,816                           | 33       | 1.82 % |
| Subordinated Debt  | 10,310                          | 330      | 3.20 % |
| Total Interest Bearing Liabilities                             | 1,310,785                       | \$7,973  | 0.61 % |
| Interest Rate Spread   |                                 |          | 4.26 % |
| Demand Deposits  | 334,698                         |          |        |
| All Other Liabilities  | 35,085                          |          |        |
| Total Liabilities  | 1,680,568                       |          |        |
| Shareholders' Equity   | 183,536                         |          |        |
| Total Liabilities & Shareholders' Equity                       | \$1,864,104                     |          |        |
| Impact of Non-Interest Bearing Deposits and Other Liabilities  |                                 |          | 0.14 % |
| Net Interest Income and Margin on Total Earning Assets         |                                 | 75,734   | 4.40 % |

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|                           |                 |
|---------------------------|-----------------|
| Tax Equivalent Adjustment | (1,354 )        |
| Net Interest Income       | \$74,380 4.32 % |

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$2.3 million for the year ended December 31, 2011. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

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Table of ContentsFarmers & Merchants Bancorp  
Volume and Rate Analysis of Net Interest Revenue

| (Interest and Rates on a Taxable Equivalent Basis)<br>(in thousands)   | 2013 versus 2012<br>Amount of Increase<br>(Decrease) Due to Change<br>in: |           |             |
|--|---|-----------|-------------|
|  | Volume  | Rate      | Net<br>Chg. |
| Interest Earning Assets  |   |           |             |
| Interest Bearing Deposits with Banks                                   | \$(32 )   | \$1       | \$(31 )     |
| Federal Funds Sold and Securities Purchased Under Agreements to Resell |   |           |             |
| Investment Securities:   |   |           |             |
| Government Agency & Government-Sponsored Entities                      | (264 )  | (57 )     | (321 )      |
| Obligations of States and Political Subdivisions - Non-Taxable         | (92 )   | (27 )     | (119 )      |
| Mortgage Backed Securities   | (540 )  | (525 )    | (1,065)     |
| Other  | 422   | (6 )      | 416         |
| Total Investment Securities  | (474 )  | (616 )    | (1,089)     |
| Loans & Leases:  |   |           |             |
| Real Estate  | 5,554   | (3,827)   | 1,727       |
| Home Equity  | (463 )  | (6 )      | (469 )      |
| Agricultural   | 197   | (1,370)   | (1,173)     |
| Commercial   | (640 )  | (269 )    | (909 )      |
| Consumer   | (67 )   | (76 )     | (143 )      |
| Leases   | 91  | -         | 91          |
| Total Loans & Leases   | 4,672   | (5,548)   | (876 )      |
| Total Earning Assets   | 4,166   | (6,163)   | \$(1,996)   |
| Interest Bearing Liabilities   |   |           |             |
| Interest Bearing Deposits:   |   |           |             |
| Interest Bearing DDA   | 18  | (66 )     | (48 )       |
| Savings and Money Market   | 83  | (417 )    | (334 )      |
| Time Deposits  | (221 )  | (589 )    | (809 )      |
| Total Interest Bearing Deposits  | (120 )  | (1,071)   | (1,191)     |
| Securities Sold Under Agreement to Repurchase                          | (1,018)   | -         | (1,018)     |
| Other Borrowed Funds   | 30  | (51 )     | (20 )       |
| Subordinated Debt  | -   | (20 )     | (20 )       |
| Total Interest Bearing Liabilities                                     | (1,107)   | (1,142)   | (2,249)     |
| Total Change   | \$5,273   | \$(5,020) | \$253       |

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

Table of ContentsFarmers & Merchants Bancorp  
Volume and Rate Analysis of Net Interest Revenue

| (Interest and Rates on a Taxable Equivalent Basis)<br>(in thousands) | 2012 versus 2011<br>Amount of Increase<br>(Decrease) Due to Change<br>in: |           |             |
|--|---|-----------|-------------|
|  | Volume  | Rate      | Net<br>Chg. |
| Interest Earning Assets  |   |           |             |
| Interest Bearing Deposits with Banks                                 | \$(8 )  | \$1       | \$(7 )      |
| Investment Securities:   |   |           |             |
| Government Agency & Government-Sponsored Entities                    | (1,506)   | (208 )    | (1,714)     |
| Obligations of States and Political Subdivisions - Non-Taxable       | 249   | (122 )    | 126         |
| Mortgage Backed Securities   | 4,221   | (2,206)   | 2,015       |
| Other  | 152   | -         | 151         |
| Total Investment Securities  | 3,116   | (2,536)   | 578         |
| Loans:   |   |           |             |
| Real Estate  | 2,850   | (3,666)   | (817 )      |
| Home Equity  | (491 )  | (51 )     | (542 )      |
| Agricultural   | (800 )  | (1,325)   | (2,125)     |
| Commercial   | (565 )  | (325 )    | (890 )      |
| Consumer   | (107 )  | 98        | (9 )        |
| Total Loans  | 887   | (5,269)   | (4,383)     |
| Total Earning Assets   | 3,994   | (7,804)   | (3,812)     |
| Interest Bearing Liabilities   |   |           |             |
| Interest Bearing Deposits:   |   |           |             |
| Interest Bearing DDA   | 27  | (109 )    | (82 )       |
| Savings and Money Market   | 154   | (459 )    | (305 )      |
| Time Deposits  | (294 )  | (1,042)   | (1,336)     |
| Total Interest Bearing Deposits                                      | (112 )  | (1,610)   | (1,723)     |
| Securities Sold Under Agreement to Repurchase                        | (1,148)   | 18        | (1,130)     |
| Other Borrowed Funds   | 23  | (20 )     | 3           |
| Subordinated Debt  | -   | 17        | 17          |
| Total Interest Bearing Liabilities                                   | (1,237)   | (1,596)   | (2,833)     |
| Total Change   | \$5,231   | \$(6,208) | \$(979 )    |

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

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2013 Compared to 2012

Net interest income increased 0.4% to \$73.6 million during 2013. On a fully tax equivalent basis, net interest income increased 0.3% and totaled \$75.0 million during 2013 compared to \$74.8 million for 2012. As more fully discussed below, the increase in net interest income was primarily due to an increase in average earning assets offset somewhat by a decrease in the net interest margin.

Net interest income on a tax equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For 2013, the Company's net interest margin was 4.11% compared to 4.23% in 2012. This decrease in net interest margin was due primarily to declining yields on earning assets that exceeded a corresponding drop in funding costs, offset somewhat by an increase in the mix of loans & leases as a percentage of total earning assets.

Average loans & leases totaled \$1.3 billion for the year ended December 31, 2013; an increase of \$86.2 million compared to the year ended December 31, 2012. Loans & leases increased from 66.9% of average earning assets during 2012 to 69.6% in 2013. As a result of the impact of decreases in market interest rates from mid-September 2007 through December 2008, and the continuing low rate environment since then, the year-to-date yield on the loan & lease portfolio declined to 5.11% for the year ended December 31, 2013, compared to 5.56% for the year ended December 31, 2012. This lower yield offset the impact of an increase in average loan & lease balances resulting in interest revenue from loans & leases decreasing 1.3% to \$64.9 million for 2013. The Company has been experiencing aggressive competitor pricing for loans & leases to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan & lease yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Historically, the Company invested primarily in: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2012, the Company began to selectively add corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities. Since the risk factor for these types of investments is generally lower than that of loans & leases, the yield earned on investments is generally less than that of loans & leases.

Average investment securities decreased \$17.2 million in 2013 compared to the average balance during 2012. As a result, tax equivalent interest income on securities decreased \$1.1 million to \$12.9 million for the year ended December 31, 2013, compared to \$14.0 million for the year ended December 31, 2012. The average yield, on a tax equivalent basis, in the investment portfolio was 2.46% in 2013 compared to 2.58% in 2012. This overall decrease in yield was caused primarily by a decrease in the mix of mortgage-backed securities as a percentage of total securities and a decline in the yield on the Company's mortgage-backed securities portfolio due to a shift in mix from 30 year MBS to 10, 15 and 20 year MBS. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2013. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statements of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest-bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Average interest-bearing deposits with banks consisted of: (1) \$611,000 in Community Reinvestment Act ('CRA') qualified CD's with various banks; and (2) \$30.1 million in FRB deposits. The average rate paid on CRA qualified CD's for 2013 was 0.38% and balances with the FRB earn interest at the Fed Funds rate, which has been 0.25% since December 2008. Average interest-bearing deposits with banks for the year ended December 31, 2013, was \$30.7 million, a decrease of \$12.6 million compared to the average balance for the year ended December 31, 2012. Interest income on interest-bearing deposits with banks for the year ended December 31, 2013, decreased



\$31,000 to \$79,000 from the year ended December 31, 2012.

Average interest-bearing liabilities decreased \$6.7 million or 0.5% during the twelve months ended December 31, 2013. Of that decrease: (1) interest-bearing deposits increased \$12.9 million; (2) FHLB Advances increased \$8.6 million; and (3) securities sold under agreement to repurchase and subordinated debt decreased \$28.2 million.

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The \$12.9 million increase in average interest-bearing deposits was primarily in lower cost interest-bearing DDA, and savings and money market deposits, which increased \$64.7 million since 2012, as higher cost time deposits decreased by \$51.7 million. See “Financial Condition – Deposits” for a discussion of trends in the Company’s deposit base. Total interest expense on deposits was \$2.5 million for 2013 as compared to \$3.7 million for 2012. The average rate paid on interest-bearing deposits was 0.20% in 2013 and 0.29% in 2012. Since most of the Company’s interest-bearing deposits are priced off of short-term market rates, the Company is benefiting from the impact of these lower market rates. The Company anticipates that future declines in deposit rates, if any, will be much more modest. See “Overview – Looking Forward: 2014 and Beyond” for a discussion of factors impacting the Company’s future deposit rates and their impact on net interest margin.

Section 627 of the Dodd-Frank Act repealed Regulation Q effective July 21, 2011, thereby eliminating the prohibition on the payment of interest on demand deposits. Given the historically low rate environment since then, this change has not had any material impact on the Company; however, when rates begin to rise, the impact on the Company’s future cost of deposits, particularly business checking accounts, cannot yet be determined.

### 2012 Compared to 2011

Net interest income decreased 1.4% to \$73.4 million during 2012. On a fully tax equivalent basis, net interest income decreased 1.3% and totaled \$74.8 million during 2012 compared to \$75.7 million for 2011. As more fully discussed below, the decrease in net interest income was primarily due to a decrease in the net interest margin, offset somewhat by growth in average earning assets.

For 2012, the Company’s net interest margin was 4.23% compared to 4.40% in 2011. This decrease in net interest margin was due primarily to: (1) a decline in the mix of loans & leases as a percentage of total earning assets; and (2) declining yields on earning assets that exceeded a corresponding drop in funding costs.

Average loans totaled \$1.2 billion for the year ended December 31, 2012; an increase of \$11.4 million compared to the year ended December 31, 2011. Loans decreased from 68.1% of average earning assets during 2011 to 66.9% in 2012. As a result of the impact of decreases in market interest rates from mid-September 2007 through December 2008, and the continuing low rate environment since then, the year-to-date yield on the loan portfolio declined to 5.56% for the year ended December 31, 2012, compared to 5.99% for the year ended December 31, 2011. This lower yield offset the impact of an increase in average loan balances resulting in interest revenue from loans decreasing 6.3% to \$65.8 million for 2012.

Average investment securities increased \$39.9 million in 2012 compared to the average balance during 2011. As a result, tax equivalent interest income on securities increased \$578,000 to \$14.0 million for the year ended December 31, 2012, compared to \$13.4 million for the year ended December 31, 2011. The average yield, on a tax equivalent basis, in the investment portfolio was 2.6% in 2012 compared to 2.7% in 2011. This decrease in yield was caused by a significant decline in the yield on the Company’s mortgage-backed securities portfolio due to: (1) a shift in mix from 30 year MBS to 10, 15 and 20 year MBS; (2) a decline in overall mortgage rates; and (3) increased prepayment speeds on MBS purchased at a premium requiring those premiums to be amortized over a shorter period. This decline was partially offset by a shift in mix from short-term government agencies securities into mortgage-back securities and corporate securities.

Interest-bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Average interest-bearing deposits with banks consisted of: (1) \$149,000 in Community Reinvestment Act (‘CRA’) qualified CD’s with various banks; and (2) \$43.2 million in FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB account, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during 2012 and 2011. These balances earn interest at the Fed Funds rate, which has been 0.25% since December, 2008. Total average interest-bearing deposits with banks for the

year ended December 31, 2012 was \$43.4 million, a decrease of \$3.3 million from the average balance for the year ended December 31, 2011. The Company had no Federal Funds Sold during 2012 or 2011.

Average interest-bearing liabilities decreased \$377,000 or 0.03% during the twelve months ended December 31, 2012. Of that decrease: (1) interest-bearing deposits increased \$29.5 million; (2) FHLB Advances increased \$1.9 million; and (3) securities sold under agreement to repurchase and subordinated debt decreased \$31.8 million.

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The \$29.5 million increase in average interest-bearing deposits was primarily in lower cost interest-bearing DDA, and savings and money market deposits, which increased \$76.7 million since 2011, as higher cost time deposits decreased by \$47.2 million. Total interest expense on deposits was \$3.7 million for 2012 as compared to \$5.5 million for 2011. The average rate paid on interest-bearing deposits was 0.29% in 2012 and 0.44% in 2011. Since most of the Company's interest-bearing deposits are priced off of short-term market rates, the Company is benefiting from the impact of these lower market rates.

### Provision and Allowance for Credit Losses

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

### Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance-sheet date. The allowance is established through a provision for credit losses, which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to impaired loans & leases and general reserves for inherent losses related to loans & leases collectively evaluated for impairment.

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

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

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

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The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1<sup>st</sup> mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer & other; and (9) leases. See “Financial Condition – Loans & Leases” for examples of loans & leases made by the Company. The allowance for credit losses attributable to each portfolio segment, which includes both impaired loans & leases and loans & leases that are not impaired, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. A credit grade is established at inception for smaller balance loans, such as consumer and residential real estate, and then updated only when the loan becomes contractually delinquent or when the borrower requests a modification. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan & lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### Provision for Credit Losses

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

The Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy appears to have stabilized throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country. Although, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of December 31, 2013, compare very favorably to our peers at the present time, carefully managing credit risk is always a key focus of the Company.





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The provision for credit losses totaled \$425,000 in 2013 compared to \$1.9 million in 2012 and \$6.8 million in 2011. Net charge-offs during 2013 were \$368,000 compared to \$650,000 in 2012 and \$6.0 million in 2011. Net charge-offs represented 0.03% of average loans & leases during 2013, a level that in management's opinion compares very favorably to the Company's peers at the present time. The reduction in the provision over the prior two years reflects management's assessment of the overall adequacy of the allowance as well as the reduction in net charge offs in 2013 compared to 2012 and 2011. See "Overview – Looking Forward: 2014 and Beyond," "Critical Accounting Policies and Estimates – Allowance for Credit Losses" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk." The following tables summarize the activity and the allocation of the allowance for credit losses for the years indicated. (in thousands)

|   | 2013     | 2012     | 2011     | 2010     | 2009     |
|---|----------|----------|----------|----------|----------|
| Allowance for Credit Losses Beginning of Year | \$34,217 | \$33,017 | \$32,261 | \$29,813 | \$20,034 |
| Provision Charged to Expense                  | 425      | 1,850    | 6,775    | 14,735   | 15,420   |
| Charge-Offs:                                  |          |          |          |          |          |
| Commercial Real Estate                        | 6        | -        | 25       | 1,629    | -        |
| Agricultural Real Estate                      | 575      | -        | 384      | 559      | -        |
| Real Estate Construction                      | -        | -        | -        | 4,095    | 641      |
| Residential 1st Mortgages                     | 16       | 152      | 449      | 759      | 749      |
| Home Equity Lines and Loans                   | 91       | 259      | 751      | 310      | 391      |
| Agricultural                                  | 23       | 294      | 3,559    | 916      | 123      |
| Commercial                                    | 60       | 198      | 788      | 4,143    | 3,868    |
| Consumer & Other                              | 120      | 145      | 190      | 112      | 159      |
| Total Charge-Offs                             | 891      | 1,048    | 6,146    | 12,523   | 5,931    |
| Recoveries:                                   |          |          |          |          |          |
| Commercial Real Estate                        | -        | -        | -        | -        | -        |
| Agricultural Real Estate                      | -        | 90       | 18       | 2        | -        |
| Real Estate Construction                      | -        | -        | -        | -        | -        |
| Residential 1st Mortgages                     | -        | 53       | 4        | 7        | 3        |
| Home Equity Lines and Loans                   | 115      | 14       | 13       | -        | 1        |
| Agricultural                                  | 42       | 61       | 10       | 68       | 50       |
| Commercial                                    | 312      | 117      | 21       | 92       | 104      |
| Consumer & Other                              | 54       | 63       | 61       | 67       | 132      |
| Total Recoveries                              | 523      | 398      | 127      | 236      | 290      |
| Net Charge-Offs                               | (368 )   | (650 )   | (6,019 ) | (12,287) | (5,641 ) |
| Total Allowance for Credit Losses             | \$34,274 | \$34,217 | \$33,017 | \$32,261 | \$29,813 |
| Ratios:                                       |          |          |          |          |          |
| Allowance for Credit Losses to:               |          |          |          |          |          |
| Total Loans & Leases at Year End              | 2.46 %   | 2.74 %   | 2.83 %   | 2.74 %   | 2.45 %   |
| Average Loans & Leases                        | 2.70 %   | 2.89 %   | 2.82 %   | 2.73 %   | 2.52 %   |
| Consolidated Net Charge-Offs to:              |          |          |          |          |          |
| Total Loans & Leases at Year End              | 0.03 %   | 0.05 %   | 0.52 %   | 1.04 %   | 0.46 %   |
| Average Loans & Leases                        | 0.03 %   | 0.05 %   | 0.51 %   | 1.04 %   | 0.48 %   |

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

| December 31, 2013 | Commercial Real Estate | Agricultural Real Estate | Real Estate Construction | Residential 1st Mortgage | Home Equity Lines & | Agricultural | Commercial | Consumer & Other | Leases Unallocated | Total |
|-------------------|------------------------|--------------------------|--------------------------|--------------------------|---------------------|--------------|------------|------------------|--------------------|-------|
|-------------------|------------------------|--------------------------|--------------------------|--------------------------|---------------------|--------------|------------|------------------|--------------------|-------|

## Loans

## Year-To-Date

Allowance  
for Credit

## Losses:

## Beginning

## Balance-

January 1,

|             |         |         |        |         |         |          |         |       |     |       |          |
|-------------|---------|---------|--------|---------|---------|----------|---------|-------|-----|-------|----------|
| 2013        | \$6,464 | \$2,877 | \$986  | \$1,219 | \$3,235 | \$10,437 | \$7,963 | \$182 | \$- | \$854 | \$34,217 |
| Charge-Offs | (6 )    | (575 )  | -      | (16 )   | (91 )   | (23 )    | (60 )   | (120) | -   | -     | (891 )   |
| Recoveries  | -       | -       | -      | -       | 115     | 42       | 312     | 54    | -   | -     | 523      |
| Provision   | (1,280) | 1,274   | (332 ) | (95 )   | (492 )  | 1,749    | (2,518) | 60    | 639 | 1,420 | 425      |

## Ending

## Balance-

December 31,

|      |         |         |       |         |         |          |         |       |       |         |          |
|------|---------|---------|-------|---------|---------|----------|---------|-------|-------|---------|----------|
| 2013 | \$5,178 | \$3,576 | \$654 | \$1,108 | \$2,767 | \$12,205 | \$5,697 | \$176 | \$639 | \$2,274 | \$34,274 |
|------|---------|---------|-------|---------|---------|----------|---------|-------|-------|---------|----------|

The Allowance for Credit Losses as of December 31, 2013 increased a modest \$57,000 from December 31, 2012. However, the allowance allocated to the following categories of loans did change materially during the twelve months ended December 31, 2013:

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Commercial Real Estate allowance balances decreased \$1.3 million, primarily a result of a \$15.5 million decline in special mention and substandard loans.

Agricultural allowance balances increased \$1.8 million, primarily as a result of additional allowances placed against these loans to cover the potential impact of an extended drought in California.

Commercial allowance balances decreased \$2.3 million. Despite a \$12.3 million increase in special mention and substandard loans, the Company has been able to obtain significant levels of collateral or guarantees to cover these loans, resulting in a reduction of required allowances.

Unallocated allowance balances increased \$1.4 million due to the imprecision in estimating and allocating allowance balances associated with macro factors such as: (1) the continuing sluggish economic conditions in the Central Valley (see Item 1A. Risk Factors – Risks Associated With Our Business - Continuing Difficult Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses); and (2) the long term impact of drought conditions currently being experienced in California (see Item 1A. Risk Factors – Risks Associated With Our Business - Our Financial Results Can Be Impacted By The Cyclicity and Seasonality Of Our Agricultural Business And The Risks Related Thereto).

|                             | Allowance Allocation at December 31, |  |          |  |          |  |          |  |          |  |  |
|-----------------------------|--------------------------------------|--|----------|--|----------|--|----------|--|----------|--|--|
|                             | 2013                                 | Percent of Loans in Each Category to Total | 2012     | Percent of Loans in Each Category to Total | 2011     | Percent of Loans in Each Category to Total | 2010     | Percent of Loans in Each Category to Total | 2009     | Percent of Loans in Each Category to Total |  |
| (in thousands)              | Amount                               | Loans                                      | Amount   | Loans                                      | Amount   | Loans                                      | Amount   | Loans                                      | Amount   | Loans                                      |  |
| Commercial Real Estate      | \$5,178                              | 29.5 %                                     | \$6,464  | 28.2 %                                     | \$5,823  | 26.4 %                                     | \$7,631  | 27.0 %                                     | \$12,845 | 23.9 %                                     |  |
| Agricultural Real Estate    | 3,576                                | 23.6 %                                     | 2,877    | 25.0 %                                     | 2,583    | 24.0 %                                     | 1,539    | 21.6 %                                     | 1,099    | 21.4 %                                     |  |
| Real Estate Construction    | 654                                  | 3.0 %                                      | 986      | 2.6 %                                      | 1,933    | 2.5 %                                      | 2,160    | 3.2 %                                      | 4,089    | 5.9 %                                      |  |
| Residential 1st Mortgages   | 1,108                                | 10.9 %                                     | 1,219    | 11.2 %                                     | 1,251    | 9.2 %                                      | 1,164    | 8.8 %                                      | 552      | 8.7 %                                      |  |
| Home Equity Lines and Loans | 2,767                                | 2.5 %                                      | 3,235    | 3.4 %                                      | 3,746    | 4.4 %                                      | 3,724    | 5.0 %                                      | 1,349    | 5.4 %                                      |  |
| Agricultural Commercial     | 12,205                               | 18.4 %                                     | 10,437   | 17.7 %                                     | 8,127    | 18.6 %                                     | 6,733    | 19.6 %                                     | 2,298    | 17.9 %                                     |  |
| Consumer & Other            | 5,697                                | 10.8 %                                     | 7,963    | 11.5 %                                     | 8,733    | 14.2 %                                     | 9,084    | 14.0 %                                     | 6,449    | 15.8 %                                     |  |
| Leases                      | 176                                  | 0.4 %                                      | 182      | 0.4 %                                      | 207      | 0.7 %                                      | 216      | 0.8 %                                      | 325      | 1.0 %                                      |  |
| Unallocated                 | 639                                  | 0.9 %                                      | -        | 0.0 %                                      | -        | 0.0 %                                      | -        | 0.0 %                                      | -        | 0.0 %                                      |  |
| Total                       | 2,274                                |  | 854      |  | 614      |  | 10       |  | 807      |  |  |
|                             | \$34,274                             | 100.0 %                                    | \$34,217 | 100.0 %                                    | \$33,017 | 100.0 %                                    | \$32,261 | 100.0 %                                    | \$29,813 | 100.0 %                                    |  |

As of December 31, 2013, the allowance for credit losses was \$34.3 million, which represented 2.46% of the total loan & lease balance. At December 31, 2012, the allowance for credit losses was \$34.2 million or 2.74% of the total loan & lease balance. After reviewing all factors above, based upon information currently available, management

concluded that the allowance for credit losses as of December 31, 2013, was adequate.

#### Non-Interest Income

Non-interest income includes: (1) service charges and fees from deposit accounts; (2) net gains and losses from investment securities; (3) increases in the cash surrender value of bank owned life insurance; (4) debit card and ATM fees; (5) net gains and losses on non-qualified deferred compensation plan investments; and (6) fees from other miscellaneous business services. See “Overview – Looking Forward: 2014 and Beyond.”

#### 2013 Compared to 2012

Non interest income totaled \$15.9 million, an increase of \$1.8 million or 13.0% from non-interest income of \$14.1 million for 2012.

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Service charges on deposit accounts totaled \$4.4 million, a decrease of \$541,000 or 11.1% from service charges on deposit accounts of \$4.9 million in 2012. This was due primarily to a decrease in fees related to the Company's Overdraft Privilege Service.

Net loss on investment securities was \$229,000 in 2013 compared to a net gain of \$158,000 for 2012. See "Financial Condition-Investment Securities" for a discussion of the Company's investment strategy.

Debit Card and ATM fees totaled \$3.1 million, an increase of \$131,000 or 4.5% over fees in 2012. These are: (1) fees paid to the Company by card associations and networks (such as Visa, Pulse, etc. when the Company's cardholders (ATM Card or Debit Card) use their cards to complete transactions; (2) fees earned by the Company when non-customers use our ATM's; and (3) monthly transaction fees paid by our customers.

Net Gains on deferred compensation investments were \$3.4 million in 2013 compared to net gains of \$1.7 million in 2012. See Note 16, located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company's net income.

Other non-interest income was \$3.5 million, an increase of \$925,000 or 35.6% over 2012. This increase was primarily due to: (1) the gain on sale of our Modesto Village branch building in the amount of \$706,000; and (2) an increase of \$227,000 in FHLB cash dividends.

### 2012 Compared to 2011

Non interest income totaled \$14.1 million, an increase of \$1.8 million or 15.0% from non-interest income of \$12.3 million for 2011.

Service charges on deposit accounts totaled \$4.9 million, a decrease of \$504,000 or 9.3% from service charges on deposit accounts of \$5.4 million in 2011. This was due primarily to a decrease in fees related to the Company's Overdraft Privilege Service.

Net gain on investment securities was \$158,000 in 2012 compared to a net gain of \$95,000 for 2011.

Debit Card and ATM fees totaled \$2.9 million, an increase of \$178,000 or 6.5% over fees in 2011. These are: (1) fees paid to the Company by VISA merchants when the Company's VISA Money Card holders use their cards to complete purchases; (2) fees earned by the Company when non-customers use our ATM's; and (3) monthly transaction fees paid by our customers.

Net Gains on deferred compensation investments were \$1.7 million in 2012 compared to net gains of \$199,000 in 2011.

Other non-interest income was \$2.6 million, an increase of \$609,000 or 30.6% over 2011. This increase was primarily due to SWAP referral fees paid to F&M Bank. Swap fee income results from the Bank arranging for a borrower to enter into a swap directly with a counterparty. These transactions result in both the Bank and the borrower achieving their interest rate risk management objectives without requiring the Bank to assume the hedge accounting or mark-to-market risk exposure of a swap. Whereas the Bank may still need to provide certain credit guarantees to the counterparty, if the loan is appropriately "over-collateralized," that credit risk can be mitigated or eliminated.

### Non-Interest Expense

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

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2013 Compared to 2012

Overall, non-interest expense totaled \$50.9 million, an increase of \$2.6 million or 5.4% for the year ended December 31, 2013.

Salaries and employee benefits increased \$2.0 million or 6.4% primarily related to: (1) new staff added for the LPO's in Walnut Creek and Irvine; (2) bank wide raises and (3) increased medical insurance premiums.

Net Gains on deferred compensation investments were \$3.4 million in 2013 compared to net gains of \$1.7 million in 2012. See Note 16. located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest expense, an offsetting entry is also required to be made to non-interest income resulting in no effect on the Company's net income.

Equipment expense in 2013 totaled \$2.8 million, a decrease of \$345,000 or 11.0% from 2012. This decrease is primarily due to reduced software maintenance contracts and Americans with Disabilities Act ('ADA') upgrades to all of our ATM machines that took place in 2012.

ORE holding costs in 2013 totaled \$91,000, a decrease of \$31,000 or 25.4% as compared to \$122,000 in 2012. This decrease is primarily due to a decrease in the number of ORE properties the Company owns and stabilization of real estate values.

The Company's total FDIC insurance costs increased \$13,000 in 2013 to \$981,000, a 1.3% increase from \$968,000 in 2012. See "Supervision and Regulation – Deposit Insurance" for further discussion of the Company's deposit insurance.

Legal fee expense decreased \$470,000 or 45.2% from 2012. This decrease is primarily related to the decline in the level of the Company's problem loans.

On June 21, 2012, the Company terminated repurchase agreements with Citigroup resulting in an early termination fee totaling \$1.7 million. The Company determined that the time was appropriate to replace these relatively "high-cost" borrowings with short-term FHLB advances at substantially lower rates. This rate differential will positively impact the Company's net interest margin over the next 6-9 months, the period during which the repurchase agreements were scheduled to mature.

Other non-interest expense increased \$1.4 million, or 26.2%, to \$6.9 million in 2013 compared to \$5.5 million in 2012. During 2013, the Company incurred increased expenses related to employee training, ATM/Debit card activities, consulting services and customer operating losses.

2012 Compared to 2011

Overall, non-interest expense totaled \$48.3 million, an increase of \$3.2 million or 7.2% for the year ended December 31, 2012.

Salaries and employee benefits increased \$2.0 million or 6.6% primarily related to increases in salary and medical insurance premiums.

Net Gains on deferred compensation investments were \$1.7 million in 2012 compared to net gains of \$199,000 in 2011.

Equipment expense in 2012 totaled \$3.1 million, an increase of \$284,000 or 10.0% from 2011. This increase is due to increases in software maintenance contracts and Americans with Disabilities Act ('ADA') upgrades to all of our ATM



machines.

ORE holding costs in 2012 totaled \$122,000, a decrease of \$1.7 million or 93.2% as compared to \$1.8 million in 2011. This decrease is primarily due to a decrease in the number of ORE properties the Company owns and stabilization of real estate values.

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The Company's total FDIC insurance costs decreased \$493,000 in 2012 to \$968,000, a 33.7% decrease from \$1.5 million in 2011. The FDIC changed to a new methodology for determining assessment rates in second quarter 2011.

Legal fee expense increased \$163,000 or 18.6% from 2011. This increase is primarily related to the management and collection of our problem loans.

On June 21, 2012, the Company terminated both repurchase agreements with Citigroup resulting in an early termination fee totaling \$1.7 million. The Company determined that the time was appropriate to replace these relatively "high-cost" borrowings with short-term FHLB advances at substantially lower rates. This rate differential will positively impact the Company's net interest margin over the next 6-9 months, the period during which the repurchase agreements were scheduled to mature.

Other non-interest expense decreased \$138,000, or 2.5%, to \$5.5 million in 2012 compared to \$5.6 million in 2011. This decrease was primarily due to the write-off of other repossessed assets in the amount of \$271,000, which took place in 2011. Only \$20,000 was written-off in 2012.

### Income Taxes

The provision for income taxes increased \$236,000 during 2013. The effective tax rate in 2013 was 37.2% compared to 37.5% in 2012 and 36.3% in 2011. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance, California enterprise zone interest income exclusion, and tax-exempt interest income on municipal securities and loans.

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

### Financial Condition

#### Investment Securities and Federal Funds Sold

The investment portfolio provides the Company with an income alternative to loans & leases. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2012 and continuing in 2013, the Company began to selectively add investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities.

The Company's investment portfolio at the end of 2013 was \$473.1 million, a decrease of \$13.2 million or 2.7% from 2012. The mix of the investment portfolio has changed over the past three to five years. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company has invested most of its available funds in either shorter term government agency & government-sponsored entity securities or shorter term (10, 15, and 20 year) mortgage-backed securities. Beginning in late May 2013 rates on 10-year treasuries began to increase from under 2% to a peak of just below 3% in early September 2013, before dropping to around 2.65% at September 30, 2013. As a result of these overall increases in rates, the market value of the Company's security portfolio has declined. In late September 2013, the Company took advantage of the pull back in rates to sell \$28.2 million of 20-year mortgage-backed securities for a loss of \$1.1 million.



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As of December 31, 2013, the Company held \$65.7 million of municipal investments, of which \$51.0 million were bank-qualified municipal bonds, all classified as held-to-maturity. The financial problems experienced by certain municipalities over the past five years, along with the financial stresses exhibited by some of the large monoline bond insurers, have increased the overall risk associated with bank-qualified municipal bonds. This situation caused the Company not to purchase any municipal bonds between late 2006 and year-end 2011. However, during the first quarter of 2012 the Company began investing in bank-qualified investment grade municipals. As of December 31, 2013, ninety-three percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or the issuer level, and all of these ratings are "investment grade." Additionally, in order to comply with Section 939A of the Dodd-Frank Act, the Company performs its own credit analysis on new purchases of municipal bonds and corporate securities. The Company monitors the status of the approximately seven percent (\$3.6 million) of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

Not included in the investment portfolio are interest-bearing deposits with banks and overnight investments in Federal Funds Sold. Interest-bearing deposits with banks consist of: (1) Community Reinvestment Act ('CRA') qualified CD's with various banks; and (2) FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. Interest-bearing deposits with banks totaled \$42.7 million at December 31, 2013 and \$82.1 million at December 31, 2012.

The Company classifies its investments as held-to-maturity, trading, or available-for-sale. Securities are classified as held-to-maturity and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of December 31, 2013 and 2012, there were no securities in the trading portfolio. Securities classified as available-for-sale include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes.

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## Investment Portfolio

The following table summarizes the balances and distributions of the investment securities held on the dates indicated.

|   | Available<br>for Sale<br>2013 | Held to<br>Maturity | Available<br>for Sale<br>2012 | Held to<br>Maturity | Available<br>for Sale<br>2011 | Held to<br>Maturity |
|---|-------------------------------|---------------------|-------------------------------|---------------------|-------------------------------|---------------------|
| December 31: (in thousands)                                       |                               |                     |                               |                     |                               |                     |
| Government Agency & Government Sponsored<br>Entities              | \$28,436                      | \$-                 | \$26,823                      | \$-                 | \$82,595                      | \$-                 |
| Obligations of States and Political Subdivisions -<br>Non-Taxable | -                             | 65,685              | 5,665                         | 65,694              | 5,782                         | 59,640              |
| Mortgage Backed Securities  | 324,929                       | 45                  | 352,772                       | 484                 | 391,033                       | 1,205               |
| Corporate Securities  | 49,380                        | -                   | 22,558                        | -                   | -                             | -                   |
| Other   | 1,894                         | 2,775               | 10,173                        | 2,214               | 410                           | 2,247               |
| Total Book Value  | \$404,639                     | \$68,505            | \$417,991                     | \$68,392            | \$479,820                     | \$63,092            |
| Fair Value  | \$404,639                     | \$68,689            | \$417,991                     | \$70,697            | \$479,820                     | \$65,874            |

## Analysis of Investment Securities Available-for-Sale

The following table is a summary of the relative maturities and yields of the Company's investment securities Available-for-Sale as of December 31, 2013. Non-taxable Obligations of States and Political Subdivisions have been calculated on a fully taxable equivalent basis.

|   | Fair<br>Value | Average<br>Yield |   |
|---|---------------|------------------|---|
| December 31, 2013 (in thousands)                        |               |                  |   |
| Government Agency & Government Sponsored Entities       |               |                  |   |
| One year or less  | \$15,080      | 0.80             | % |
| After one year through five years                       | 10,007        | 0.63             | % |
| After five years through ten years                      | 3,349         | 2.80             | % |
| Total Government Agency & Government Sponsored Entities | 28,436        | 0.97             | % |
| Corporate Securities                                    |               |                  |   |
| One year or less  | 3,255         | 0.81             | % |
| After one year through five years                       | 46,125        | 1.40             | % |
| Total Corporate Securities                              | 49,380        | 1.37             | % |
| Other   |               |                  |   |
| One year or less  | 1,894         | 0.55             | % |
| Total Other Securities                                  | 1,894         | 0.55             | % |
| Mortgage Backed Securities                              | 324,929       | 2.40             | % |
| Total Investment Securities Available-for-Sale          | \$404,639     | 2.16             | % |

Note: The average yield for floating rate securities is calculated using the current stated yield.

## Analysis of Investment Securities Held-to-Maturity

The following table is a summary of the relative maturities and yields of the Company's investment securities Held-to-Maturity as of December 31, 2013. Non-taxable Obligations of States and Political Subdivisions have been calculated on a fully taxable equivalent basis.

|  | Book<br>Value | Average<br>Yield |   |
|--|---------------|------------------|---|
| December 31, 2013 (in thousands)                               |               |                  |   |
| Obligations of States and Political Subdivisions - Non-Taxable |               |                  |   |
| One year or less   | \$2,449       | 4.92             | % |
| After one year through five years                              | 16,091        | 6.12             | % |

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|  |          |      |   |
|--|----------|------|---|
| After five years through ten years                                   | 26,891   | 5.71 | % |
| After ten years  | 20,254   | 4.81 | % |
| Total Obligations of States and Political Subdivisions - Non-Taxable | 65,685   | 5.50 | % |
| Other  |          |      |   |
| After one year through five years                                    | 2,775    | 0.00 | % |
| Total Other Securities   | 2,775    | 1.05 | % |
| Mortgage Backed Securities   | 45       | 2.96 | % |
| Total Investment Securities Held-to-Maturity                         | \$68,505 | 5.32 | % |

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### Loans & Leases

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

**Commercial and Agricultural Real Estate** - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties within our market area. Commercial mortgage term loans can be made if the property is either income producing or scheduled to become income producing based upon acceptable pre-leasing, and the income will be the Bank's primary source of repayment for the loan. Loans are made both on owner occupied and investor properties; generally do not exceed 15 years (and may have pricing adjustments on a shorter timeframe); have debt service coverage ratios of 1.00 or better with a target of greater than 1.20; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

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

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

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

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

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

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

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

See “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk” for a discussion about the credit risks the Company assumes and its overall credit risk management practices.

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

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

In order to be responsive to borrower needs, the Company prices loans & leases: (1) on both a fixed rate and adjustable rate basis; (2) over different terms; and (3) based upon different rate indices; as long as these structures are consistent with the Company’s interest rate risk management policies and procedures. See “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk.”

Overall, the Company's loan & lease portfolio at December 31, 2013, increased \$141.3 million or 11.3% from December 31, 2012. These increases have occurred despite what continues to be a difficult economic environment in the Central Valley combined with a very competitive pricing environment, and are a result of the Company’s intensified business development efforts directed toward credit-qualified borrowers. No assurances can be given that this growth in the loan & lease portfolio will continue until the economy in the Central Valley of California improves.

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The following table sets forth the distribution of the loan & lease portfolio by type and percent as of December 31 of the years indicated.

|                | 2013        |         | 2012        |         | 2011        |         | 2010        |         | 2009        |         |
|----------------|-------------|---------|-------------|---------|-------------|---------|-------------|---------|-------------|---------|
| (in thousands) | Amount      | Percent | Amount      | Percent | Amount      | Percent | Amount      | Percent | Amount      | Percent |
| Commercial     |             |         |             |         |             |         |             |         |             |         |
| Real Estate    | \$411,037   | 29.5 %  | \$353,109   | 28.3 %  | \$307,670   | 26.4 %  | \$318,341   | 27.0 %  | \$290,473   | 23.9 %  |
| Agricultural   |             |         |             |         |             |         |             |         |             |         |
| Real Estate    | 328,264     | 23.6 %  | 311,992     | 25.0 %  | 280,139     | 24.0 %  | 254,575     | 21.6 %  | 260,000     | 21.4 %  |
| Real Estate    |             |         |             |         |             |         |             |         |             |         |
| Construction   | 41,092      | 3.0 %   | 32,680      | 2.6 %   | 29,607      | 2.5 %   | 37,486      | 3.2 %   | 71,647      | 5.9 %   |
| Residential    |             |         |             |         |             |         |             |         |             |         |
| 1st            |             |         |             |         |             |         |             |         |             |         |
| Mortgages      | 151,292     | 10.9 %  | 140,257     | 11.2 %  | 107,421     | 9.2 %   | 103,574     | 8.8 %   | 105,850     | 8.7 %   |
| Home Equity    |             |         |             |         |             |         |             |         |             |         |
| Lines and      |             |         |             |         |             |         |             |         |             |         |
| Loans          | 35,477      | 2.5 %   | 42,042      | 3.4 %   | 50,956      | 4.4 %   | 58,971      | 5.0 %   | 65,541      | 5.4 %   |
| Agricultural   | 256,414     | 18.4 %  | 221,032     | 17.7 %  | 217,227     | 18.6 %  | 231,150     | 19.6 %  | 217,989     | 17.9 %  |
| Commercial     | 150,398     | 10.8 %  | 143,293     | 11.5 %  | 165,089     | 14.2 %  | 165,263     | 14.0 %  | 191,949     | 15.8 %  |
| Consumer &     |             |         |             |         |             |         |             |         |             |         |
| Other          | 5,052       | 0.4 %   | 5,058       | 0.3 %   | 6,935       | 0.7 %   | 8,712       | 0.8 %   | 11,400      | 1.0 %   |
| Leases         | 12,733      | 0.9 %   | -           | 0.0 %   | -           | 0.0 %   | -           | 0.0 %   | -           | 0.0 %   |
| Total Gross    |             |         |             |         |             |         |             |         |             |         |
| Loans &        |             |         |             |         |             |         |             |         |             |         |
| Leases         | 1,391,759   | 100.0%  | 1,249,463   | 100.0%  | 1,165,044   | 100.0%  | 1,178,072   | 100.0%  | 1,214,849   | 100.0%  |
| Less:          |             |         |             |         |             |         |             |         |             |         |
| Unearned       |             |         |             |         |             |         |             |         |             |         |
| Income         | 3,523       |         | 2,561       |         | 1,966       |         | 2,070       |         | 2,131       |         |
| Subtotal       | 1,388,236   |         | 1,246,902   |         | 1,163,078   |         | 1,176,002   |         | 1,212,718   |         |
| Less:          |             |         |             |         |             |         |             |         |             |         |
| Allowance      |             |         |             |         |             |         |             |         |             |         |
| for Credit     |             |         |             |         |             |         |             |         |             |         |
| Losses         | 34,274      |         | 34,217      |         | 33,017      |         | 32,261      |         | 29,813      |         |
| Loans &        |             |         |             |         |             |         |             |         |             |         |
| Leases, Net    | \$1,353,962 |         | \$1,212,685 |         | \$1,130,061 |         | \$1,143,741 |         | \$1,182,905 |         |

There were no concentrations of loans exceeding 10% of total loans which were not otherwise disclosed as a category of loans in the above table.

The following table shows the maturity distribution and interest rate sensitivity of the loan portfolio of the Company on December 31, 2013.

| (in thousands)           | One Year or Less | Over One Year to Five Years | Over Five Years | Total     |
|--------------------------|------------------|-----------------------------|-----------------|-----------|
| Commercial Real Estate   | \$11,834         | \$112,242                   | \$283,438       | \$407,514 |
| Agricultural Real Estate | 12,818           | 114,344                     | 201,102         | 328,264   |
| Real Estate Construction | 18,216           | 19,422                      | 3,454           | 41,092    |

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|                             |           |           |           |             |
|-----------------------------|-----------|-----------|-----------|-------------|
| Residential 1st Mortgages   | 182       | 1,478     | 149,632   | 151,292     |
| Home Equity Lines and Loans | 51        | 1,780     | 33,646    | 35,477      |
| Agricultural                | 123,055   | 99,603    | 33,756    | 256,414     |
| Commercial                  | 57,443    | 57,929    | 35,026    | 150,398     |
| Consumer & Other            | 1,498     | 3,046     | 508       | 5,052       |
| Leases                      | -         | 1,656     | 11,077    | 12,733      |
| Total                       | \$225,097 | \$411,500 | \$751,639 | \$1,388,236 |
| Rate Sensitivity:           |           |           |           |             |
| Fixed Rate                  | \$175,252 | \$279,923 | \$398,456 | \$853,631   |
| Variable Rate               | 49,846    | 131,577   | 353,182   | 534,605     |
| Total                       | \$225,098 | \$411,500 | \$751,638 | \$1,388,236 |
| Percent                     | 16.22 %   | 29.64 %   | 54.14 %   | 100.00 %    |

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### Classified Loans & Leases and Non-Performing Assets

All loans & leases are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See “Results of Operations - Provision and Allowance for Credit Losses” for more detail on risk grades. The Company utilizes the services of a third-party independent loan & lease review firm to perform evaluations of individual loans & leases and review the credit risk grades the Company places on loans & leases. Loans & leases that are judged to exhibit a higher risk profile are referred to as “classified loans & leases,” and these loans & leases receive increased management attention. As of December 31, 2013, classified loans & leases totaled \$5.8 million compared to \$21.5 million at December 31, 2012. This decline was primarily a result of \$5.1 million of CRE loans being upgraded to special mention or pass and another \$11.0 million of Agricultural or Agricultural Real Estate loans paying off during 2013.

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

Non-Accrual Loans & Leases - Accrual of interest on loans & leases is generally discontinued when a loan or lease becomes contractually past due by 90 days or more with respect to interest or principal. When loans & leases are 90 days past due, but in management's judgment are well secured and in the process of collection, they may not be classified as non-accrual. When a loan or lease is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans & leases is then recognized only to the extent that cash is received and where the future collection of principal is probable. As of December 31, 2013 and 2012, non-accrual loans & leases totaled \$2.6 million and \$9.3 million. The decrease in non-accrual loans & leases was primarily a result of workouts with problem credits related to the dairy industry.

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

As of December 31, 2013, restructured loans totaled \$6.8 million with \$4.6 million performing. At December 31, 2012, restructured loans totaled \$2.6 million with \$2.3 million performing.

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

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The following table sets forth the amount of the Company's non-performing loans & leases and ORE as of December 31 of the years indicated.

| (in thousands)   | December 31, |          |         |          |          |
|--|--------------|----------|---------|----------|----------|
|  | 2013         | 2012     | 2011    | 2010     | 2009     |
| Non-Accrual Loans & Leases   |              |          |         |          |          |
| Commercial Real Estate   | \$-          | \$-      | \$1,354 | \$2,348  | \$1,294  |
| Agricultural Real Estate   | -            | 5,423    | 954     | 1,797    | 2,589    |
| Real Estate Construction   | -            | -        | -       | -        | 1,225    |
| Residential 1st Mortgages  | 324          | 445      | 284     | 954      | -        |
| Home Equity Lines and Loans  | 406          | 213      | 194     | -        | 325      |
| Agricultural   | 35           | 3,198    | 1,202   | -        | 1,080    |
| Commercial   | 1,815        | -        | 217     | 207      | 2,696    |
| Consumer & Other   | 16           | 19       | 23      | 2        | -        |
| Total Non-Accrual Loans & leases                                   | 2,596        | 9,298    | 4,228   | 5,308    | 9,209    |
| Accruing Loans & Leases Past Due 90 Days or More                   |              |          |         |          |          |
| Commercial Real Estate   | -            | -        | -       | -        | -        |
| Agricultural Real Estate   | -            | -        | -       | -        | -        |
| Real Estate Construction   | -            | -        | -       | -        | -        |
| Residential 1st Mortgages  | -            | -        | -       | -        | -        |
| Home Equity Lines and Loans  | -            | -        | -       | -        | -        |
| Agricultural   | -            | -        | -       | -        | -        |
| Commercial   | -            | -        | -       | -        | -        |
| Consumer & Other   | -            | -        | -       | -        | -        |
| Total Accruing Loans & Leases Past Due 90 Days or More             | -            | -        | -       | -        | -        |
| Total Non-Performing Loans & Leases                                | \$2,596      | \$9,298  | \$4,228 | \$5,308  | \$9,209  |
| Other Real Estate Owned  | \$4,611      | \$2,553  | \$2,924 | \$8,039  | \$8,418  |
| Total Non-Performing Assets  | \$7,207      | \$11,851 | \$7,152 | \$13,347 | \$17,627 |
| Restructured Loans & Leases (Performing)                           | \$4,649      | \$2,300  | \$4,710 | \$27,652 | \$556    |
| Non-Performing Loans & leases as a Percent of Total Loans & Leases | 0.19 %       | 0.74 %   | 0.36 %  | 0.45 %   | 0.76 %   |

Although management believes that non-performing loans & leases are generally well-secured and that potential losses are provided for in the Company's allowance for credit losses, there can be no assurance that future deterioration in economic conditions and/or collateral values will not result in future credit losses. See Note 5 located in "Item 8. Financial Statements and Supplementary Data" for an allocation of the allowance classified to impaired loans & Leases.

The Company reported \$4.6 million of ORE at December 31, 2013, and \$2.6 million at December 31, 2012. The increase in ORE during 2013 was a result of the Company acquiring two new agricultural real estate properties through foreclosure proceedings. The December 31, 2013, carrying value of \$4.6 million is net of a \$3.7 million reserve for ORE valuation adjustments. ORE at December 31, 2013 includes a mix of agricultural real estate, raw land and residential finished lots.

Except for those classified and non-performing loans discussed above, the Company's management is not aware of any loans as of December 31, 2013, for which known financial problems of the borrower would cause serious doubts as to the ability of these borrowers to materially comply with their present loan repayment terms or lease payments, or any known events that would result in the loan or lease being designated as non-performing at some future date. However, the Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy appears to have stabilized

throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country. See “Part I, Item 1A. Risk Factors.”

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Deposits

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

The following table sets forth, by time remaining to maturity, the Company's time deposits in amounts of \$100,000 or more at December 31, 2013.

(in thousands)

|  |            |
|--|------------|
| Time Deposits of \$100,000 or More       |            |
| Three Months or Less                     | \$ 149,923 |
| Over Three Months Through Six Months     | 77,596     |
| Over Six Months Through Twelve Months    | 52,472     |
| Over Twelve Months                       | 33,669     |
| Total Time Deposits of \$100,000 or More | \$ 313,660 |

Refer to the Year-To-Date Average Balances and Rate Schedules located in this "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" for information on separate deposit categories.

At December 31, 2013, deposits totaled \$1.8 billion. This represents an increase of 5.0% or \$85.7 million from December 31, 2012. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) the Federal government's decision to permanently increase FDIC deposit insurance limits from \$100,000 to \$250,000 per depositor; and (2) the Company's strong financial results and position and F&M Bank's reputation as one of the most safe and sound banks in its market territory. The Company expects that, at some point, deposit customers may begin to diversify how they invest their money (e.g., move funds back into the stock market or other investments) and this could impact future deposit growth.

Although total deposits have increased 5.0% since December 31, 2012, the Company's focus has been on increasing low cost transaction and savings accounts, which have grown at a much faster pace:

- Demand and interest-bearing transaction accounts increased \$66.4 million or 9.2% since December 31, 2012.
- Savings and money market accounts have increased \$48.0 million or 8.9% since December 31, 2012.

Time deposit accounts have decreased \$28.7 million or 6.3% since December 31, 2012. This decline was the continuing result of an explicit pricing strategy adopted by the Company beginning in 2009 based upon the recognition that market CD rates were greater than the yields that the Company could obtain reinvesting these funds in short-term government agency & government-sponsored entity securities or overnight Fed Funds. Beginning in April 2009, management carefully reviewed time deposit customers and reduced our deposit rates to customers that did not also have transaction, money market, and/or savings balances with us (i.e., depositors who were not "relationship customers"). Given the Company's strong deposit growth in transaction, savings and money market accounts, this time deposit decline has not presented any liquidity issues and it has significantly enhanced the Company's net interest margin and earnings.

Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings

Lines of Credit with the Federal Reserve Bank and Federal Home Loan Bank are other key sources of funds to support earning assets. These sources of funds are also used to manage the Bank's interest rate risk exposure; and, as opportunities arise, to borrow and invest the proceeds at a positive spread through the investment portfolio. There were no FHLB advances at December 31, 2013 or 2012. There were no Federal Funds purchased or advances from the FRB at December 31, 2013 or 2012.





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#### Securities Sold Under Agreement to Repurchase

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

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

At December 31, 2013 and December 31, 2012, the Company had no securities sold under agreement to repurchase.

#### Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities. See Note 13 located in “Item 8. Financial Statements and Supplementary Data.” Although this amount is reflected as subordinated debt on the Company’s balance sheet, under current regulatory guidelines, our trust preferred securities will continue to qualify as regulatory capital (See “Basel III Regulatory Capital Rules” for a discussion of the potential impact of proposed regulatory guidelines on this qualification). These securities accrue interest at a variable rate based upon 3-month LIBOR plus 2.85%. Interest rates reset quarterly (the next reset is March 16, 2014) and the rate was 3.09% as of December 31, 2013. The average rate paid for these securities was 3.2% in 2013 and 3.4% in 2012. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company’s common stock.

#### Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders’ Equity totaled \$209.9 million at December 31, 2013, and \$205.0 million at the end of 2012.

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets (as defined in the regulations), and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of December 31, 2013, that the Company and the Bank meet all capital adequacy requirements to which they are subject. In addition, the most recent notification from the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank’s category. For further information on the Company’s and the Bank’s risk-based capital ratios, see Note 14 located in “Item 8. Financial Statements and Supplementary Data.”

As previously discussed (see “Subordinated Debentures”), in order to supplement its regulatory capital base, during December 2003 the Company issued \$10 million of trust preferred securities. See Note 13 located in “Item 8. Financial Statements and Supplementary Data.” On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of trust preferred securities (“TPS”) by bank holding companies

("BHCs"). Under the final rule BHCs are able to include TPS in Tier 1 capital in an amount equal to 25% of the sum of core capital net of goodwill. Any portion of trust-preferred securities not qualifying as Tier 1 capital would qualify as Tier 2 capital subject to certain limitations. The Company has received notification from the Federal Reserve Bank of San Francisco that all of the Company's trust preferred securities currently qualify as Tier 1 capital.

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In accordance with the provisions of the “Consolidation” topic of the FASB Accounting Standards Codification (“ASC”), the Company does not consolidate the subsidiary trust, which has issued the trust-preferred securities.

In 1998, the Board approved the Company’s first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on September 11, 2012, the Board of Directors approved increasing the funds available for the Company’s common stock repurchase program to \$20 million over the three-year period ending September 30, 2015. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.”

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

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

### Basel III Regulatory Capital Rules

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

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

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

### Critical Accounting Policies and Estimates

This “Management’s Discussion and Analysis of Financial Condition and Results of Operations” is based upon the Company’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing the Company’s financial statements management makes estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses. Management believes that the most significant subjective judgments that it makes include the following:

**Allowance for Credit Losses** - As a financial institution, which assumes lending and credit risks as a principal element in its business, the Company anticipates that credit losses will be experienced in the normal course of business. Accordingly, the allowance for credit losses is maintained at a level considered adequate by management to provide

for losses that are inherent in the portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Management employs a systematic methodology for determining the allowance for credit losses. On a quarterly basis, management reviews the credit quality of the loan & lease portfolio and considers problem loans & leases, delinquencies, internal credit reviews, current economic conditions, loan & lease loss experience, and other factors in determining the adequacy of the allowance balance.

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While the Company utilizes a systematic methodology in determining its allowance, the allowance is based on estimates, and ultimate losses may vary from current estimates. The estimates are reviewed periodically and, as adjustments become necessary, are reported in earnings in the periods in which they become known. For additional information, see Note 5 located in “Item 8. Financial Statements and Supplementary Data.”

**Fair Value** - The Company discloses the fair value of financial instruments and the methods and significant assumptions used to estimate those fair values. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization. For additional information, see “Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Credit Risk” and Notes 17 and 18 located in “Item 8. Financial Statements and Supplementary Data.”

**Income Taxes** - The Company uses the liability method of accounting for income taxes. This method results in the recognition of deferred tax assets and liabilities that are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The deferred provision for income taxes is the result of the net change in the deferred tax asset and deferred tax liability balances during the year. This amount combined with the current taxes payable or refundable results in the income tax expense for the current year. For additional information, see Note 1 located in “Item 8. Financial Statements and Supplementary Data.”

**Off Balance Sheet Arrangements**

Off-balance sheet arrangements are any contractual arrangement to which an unconsolidated entity is a party, under which the Company has: (1) any obligation under a guarantee contract; (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity, or market risk support to that entity for such assets; (3) any obligation under certain derivative instruments; or (4) any obligation under a material variable interest held by us in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to the Company, or engages in leasing, hedging, or research and development services with the Company. The Company had the following off balance sheet commitments as of the dates indicated.

| (in thousands)  | December<br>31, 2013 | December<br>31, 2012 |
|---|----------------------|----------------------|
| Commitments to Extend Credit  | \$445,294            | \$334,772            |
| Letters of Credit   | 7,393                | 5,281                |
| Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our<br>Borrowing Customers and Third Parties | -                    | 1,796                |

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

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. Most standby letters of credit are issued for 12 months or less. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Additionally, the Company

maintains a reserve for off balance sheet commitments, which totaled \$142,000 at December 31, 2013 and December 31, 2012. We do not anticipate any material losses as a result of these transactions.

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## Aggregate Contractual Obligations and Commitments

The following table presents, as of December 31, 2013, our significant and determinable contractual obligations by payment date. The payment amounts represent those amounts contractually due to the recipient and do not include any unamortized premiums or discounts, hedge basis adjustments, or other similar carrying value adjustments. For further information on the nature of each obligation type, see applicable note disclosures located in “Item 8. Financial Statements and Supplementary Data.”

| (in thousands)                       | Total    | 1<br>Year<br>or |              |              |          | More<br>Than 5<br>Years |
|--------------------------------------|----------|-----------------|--------------|--------------|----------|-------------------------|
|                                      |          | Less            | 2-3<br>Years | 4-5<br>Years | Years    |                         |
| Operating Lease Obligations          | \$1,221  | \$341           | \$531        | \$164        | \$185    |                         |
| Long-Term Subordinated Debentures    | 10,310   | -               | -            | -            | 10,310   |                         |
| Deferred Compensation <sup>(1)</sup> | 33,872   | 383             | 660          | 294          | 32,535   |                         |
| Total                                | \$45,403 | \$724           | \$1,191      | \$458        | \$43,030 |                         |

<sup>(1)</sup> These amounts represent obligations to participants under the Company's various non-qualified deferred compensation plans. See Note 16 located in “Item 8. Financial Statements and Supplementary Data.”

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## Quarterly Unaudited Financial Data

The following tables set forth certain unaudited historical quarterly financial data for each of the eight consecutive quarters in 2013 and 2012. This information is derived from unaudited consolidated financial statements that include, in management's opinion, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation when read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Form 10-K.

| 2013<br>(in thousands except per share data)          | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total    |
|---|------------------|-------------------|------------------|-------------------|----------|
| Total Interest Income                                 | \$18,255         | \$18,945          | \$19,615         | \$19,716          | \$76,531 |
| Total Interest Expense                                | 764              | 719               | 721              | 687               | 2,891    |
| Net Interest Income                                   | 17,491           | 18,226            | 18,894           | 19,029            | 73,640   |
| Provision for Credit Losses                           | -                | 250               | -                | 175               | 425      |
| Net Interest Income After Provision for Credit Losses | 17,491           | 17,976            | 18,894           | 18,854            | 73,215   |
| Total Non-Interest Income                             | 5,497            | 2,964             | 3,448            | 4,028             | 15,937   |
| Total Non-Interest Expense                            | 12,959           | 12,102            | 12,185           | 13,624            | 50,870   |
| Income Before Income Taxes                            | 10,029           | 8,838             | 10,157           | 9,258             | 38,282   |
| Provision for Income Taxes                            | 3,778            | 3,273             | 3,805            | 3,365             | 14,221   |
| Net Income  | \$6,251          | \$5,565           | \$6,352          | \$5,893           | \$24,061 |
| Earnings Per Share                                    | \$8.04           | \$7.15            | \$8.17           | \$7.57            | \$30.93  |

| 2012<br>(in thousands except per share data)          | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total    |
|---|------------------|-------------------|------------------|-------------------|----------|
| Total Interest Income                                 | \$19,966         | \$19,813          | \$19,499         | \$19,213          | \$78,491 |
| Total Interest Expense                                | 1,688            | 1,555             | 1,033            | 864               | 5,140    |
| Net Interest Income                                   | 18,278           | 18,258            | 18,466           | 18,349            | 73,351   |
| Provision for Credit Losses                           | 220              | 280               | 600              | 750               | 1,850    |
| Net Interest Income After Provision for Credit Losses | 18,058           | 17,978            | 17,866           | 17,599            | 71,501   |
| Total Non-Interest Income                             | 3,923            | 2,811             | 4,053            | 3,323             | 14,110   |
| Total Non-Interest Expense                            | 12,122           | 12,671            | 11,760           | 11,724            | 48,277   |
| Income Before Income Taxes                            | 9,859            | 8,118             | 10,159           | 9,198             | 37,334   |
| Provision for Income Taxes                            | 3,669            | 2,956             | 3,827            | 3,533             | 13,985   |
| Net Income  | \$6,190          | \$5,162           | \$6,332          | \$5,665           | \$23,349 |
| Earnings Per Share                                    | \$7.94           | \$6.63            | \$8.13           | \$7.29            | \$29.99  |



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Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Risk Management

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

Credit Risk

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

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

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

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

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

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

Based on the risk rating system, specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicates that the loan or lease is

impaired and there is a probability of loss. Management performs a detailed analysis of these loans & leases, including, but not limited to, cash flows, appraisals of the collateral, conditions of the marketplace for liquidating the collateral, and assessment of the guarantors. Management then determines the inherent loss potential and allocates a portion of the allowance for losses as a specific allowance for each of these credits.

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

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

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

Part 3 - An unallocated allowance often occurs due to the imprecision in estimating and allocating allowance balances associated with macro factors such as: (1) the continuing sluggish economic conditions in the Central Valley (see Item 1A. Risk Factors – Risks Associated With Our Business - Continuing Difficult Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses); and (2) the long term impact of drought conditions currently being experienced in California (see Item 1A. Risk Factors – Risks Associated With Our Business - Our Financial Results Can Be Impacted By The Cyclical and Seasonality Of Our Agricultural Business And The Risks Related Thereto).

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

Management believes that based upon the preceding methodology, and using information currently available, the allowance for credit losses at December 31, 2013 was adequate. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans & leases, or net loan & lease charge-offs that would require increases in the provision for credit losses and thereby adversely affect the results of operations.

### Interest Rate Risk

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

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

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

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

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

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

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

### Liquidity Risk

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

The Company's principal operating sources of liquidity include (see "Item 8. Financial Statements and Supplementary Data – Consolidated Statements of Cash Flows") cash and cash equivalents, cash provided by operating activities, principal payments on loans & leases, proceeds from the maturity or sale of investments, and growth in deposits. To supplement these operating sources of funds the Company maintains Federal Funds credit lines of \$71.0 million and repurchase lines of \$100.0 million with major banks. In addition, as of December 31, 2013 the Company has available borrowing capacity of \$347.1 million at the Federal Home Loan Bank and \$369.7 million at the Federal Reserve Bank.

At December 31, 2013, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities of approximately \$206 million, which represents 9.94% of total assets.

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Item 8. Financial Statements and Supplementary Data

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Farmers & Merchants Bancorp

Report of Management on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting at Farmers & Merchants Bancorp (“the Company”). Internal control over financial reporting includes controls over the preparation of financial statements in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to comply with the reporting requirements of Part 363 of the Federal Deposit Insurance Corporation Rules and Regulations.

Management has assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2013, based on criteria described in “Internal Control-Integrated Framework (1992)” issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on that assessment, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2013.

Moss Adams LLP, the independent registered public accounting firm that audited the financial statements included in this Annual Report, was engaged to express an opinion as to the fairness of presentation of such financial statements. Moss Adams LLP was also engaged to audit the effectiveness of the Company’s internal control over financial reporting. The report of Moss Adams LLP follows this report.

/s/ Kent A. Steinwert

/s/ Stephen W. Haley

Kent A. Steinwert

Stephen W. Haley

Chairman, President & Chief Executive Officer

Executive Vice President & Chief Financial Officer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Farmers & Merchants Bancorp

We have audited the accompanying consolidated balance sheet of Farmers & Merchants Bancorp and subsidiaries (the Company) as of December 31, 2013 and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the year then ended. We have also audited the Company's internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report On Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall consolidated financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Farmers & Merchants Bancorp and subsidiaries as of December 31, 2013 and the consolidated results of their operations and cash flows for the year then ended in conformity with generally accepted accounting principles in the United States of America. Also, in our opinion Farmers & Merchants Bancorp maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring



Organizations of the Treadway Commission.

/s/ Moss Adams LLP

Stockton, California

March 14, 2014

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors

Farmers & Merchants Bancorp

Lodi, California

We have audited the accompanying consolidated balance sheet of Farmers & Merchants Bancorp and subsidiaries (the "Company") as of December 31, 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the two years in the period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Farmers & Merchants Bancorp and subsidiaries as of December 31, 2012, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America.

/s/ Crowe Horwath LLP

Crowe Horwath LLP

San Francisco, California

March 13, 2013

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Farmers &amp; Merchants Bancorp

Consolidated Balance Sheets

(in thousands except share and per share data)

|  | December 31, |             |
|--|--------------|-------------|
|  | 2013         | 2012        |
| Assets   |              |             |
| Cash and Cash Equivalents:   |              |             |
| Cash and Due from Banks  | \$40,966     | \$47,366    |
| Interest Bearing Deposits with Banks   | 42,711       | 82,060      |
| Total Cash and Cash Equivalents  | 83,677       | 129,426     |
| Investment Securities:   |              |             |
| Available-for-Sale   | 404,639      | 417,991     |
| Held-to-Maturity   | 68,505       | 68,392      |
| Total Investment Securities  | 473,144      | 486,383     |
| Loans & Leases:  | 1,388,236    | 1,246,902   |
| Less: Allowance for Credit Losses  | 34,274       | 34,217      |
| Loans & Leases, Net  | 1,353,962    | 1,212,685   |
| Premises and Equipment, Net  | 22,887       | 22,901      |
| Bank Owned Life Insurance  | 52,109       | 50,253      |
| Interest Receivable and Other Assets   | 90,294       | 73,038      |
| Total Assets   | \$2,076,073  | \$1,974,686 |
| Liabilities  |              |             |
| Deposits:  |              |             |
| Demand   | \$495,963    | \$462,251   |
| Interest-Bearing Transaction   | 291,795      | 259,141     |
| Savings and Money Market   | 589,511      | 541,526     |
| Time   | 430,422      | 459,108     |
| Total Deposits   | 1,807,691    | 1,722,026   |
| Subordinated Debentures  | 10,310       | 10,310      |
| Interest Payable and Other Liabilities   | 48,168       | 37,317      |
| Total Liabilities  | 1,866,169    | 1,769,653   |
| Commitments & Contingencies (See Note 19)  |              |             |
| Shareholders' Equity   |              |             |
| Preferred Stock: No Par Value, 1,000,000 Shares Authorized, None Issued or Outstanding   | -            | -           |
| Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized, 777,882 Shares Issued and Outstanding at Both December 31, 2013 and 2012. | 8            | 8           |
| Additional Paid-In Capital   | 75,014       | 75,014      |
| Retained Earnings  | 137,350      | 123,012     |
| Accumulated Other Comprehensive (Loss) Income  | (2,468 )     | 6,999       |
| Total Shareholders' Equity   | 209,904      | 205,033     |
| Total Liabilities and Shareholders' Equity   | \$2,076,073  | \$1,974,686 |

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

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Farmers & Merchants Bancorp  
 Consolidated Statements of Income  
 (in thousands except per share data)

|   | Year Ended December 31, |          |          |
|---|-------------------------|----------|----------|
|   | 2013                    | 2012     | 2011     |
| Interest Income                                       |                         |          |          |
| Interest and Fees on Loans & Leases                   | \$64,921                | \$65,798 | \$70,180 |
| Interest on Deposits with Banks                       | 79                      | 110      | 117      |
| Interest on Investment Securities:                    |                         |          |          |
| Taxable   | 8,971                   | 9,940    | 9,490    |
| Exempt from Federal Tax                               | 2,560                   | 2,643    | 2,567    |
| Total Interest Income                                 | 76,531                  | 78,491   | 82,354   |
| Interest Expense                                      |                         |          |          |
| Deposits  | 2,548                   | 3,739    | 5,463    |
| Borrowed Funds  | 16                      | 1,054    | 2,181    |
| Subordinated Debentures                               | 327                     | 347      | 330      |
| Total Interest Expense                                | 2,891                   | 5,140    | 7,974    |
| Net Interest Income                                   | 73,640                  | 73,351   | 74,380   |
| Provision for Credit Losses                           | 425                     | 1,850    | 6,775    |
| Net Interest Income After Provision for Credit Losses | 73,215                  | 71,501   | 67,605   |
| Non-Interest Income                                   |                         |          |          |
| Service Charges on Deposit Accounts                   | 4,350                   | 4,891    | 5,395    |
| Net (Loss) Gain on Investment Securities              | (229 )                  | 158      | 95       |
| Increase in Cash Surrender Value of Life Insurance    | 1,856                   | 1,836    | 1,834    |
| Debit Card and ATM Fees                               | 3,069                   | 2,938    | 2,760    |
| Net Gain on Deferred Compensation Investments         | 3,366                   | 1,687    | 199      |
| Other   | 3,525                   | 2,600    | 1,991    |
| Total Non-Interest Income                             | 15,937                  | 14,110   | 12,274   |
| Non-Interest Expense                                  |                         |          |          |
| Salaries and Employee Benefits                        | 33,658                  | 31,635   | 29,670   |
| Net Gain on Deferred Compensation Investments         | 3,366                   | 1,687    | 199      |
| Occupancy   | 2,513                   | 2,565    | 2,579    |
| Equipment   | 2,783                   | 3,128    | 2,844    |
| ORE Holding Costs                                     | 91                      | 122      | 1,785    |
| FDIC Insurance  | 981                     | 968      | 1,461    |
| Legal Fees  | 569                     | 1,039    | 876      |
| Termination Fee Related to Repurchase Agreement       | -                       | 1,657    | -        |
| Other   | 6,909                   | 5,476    | 5,614    |
| Total Non-Interest Expense                            | 50,870                  | 48,277   | 45,028   |
| Income Before Income Taxes                            | 38,282                  | 37,334   | 34,851   |
| Provision for Income Taxes                            | 14,221                  | 13,985   | 12,642   |
| Net Income  | \$24,061                | \$23,349 | \$22,209 |
| Basic Earnings Per Common Share                       | \$30.93                 | \$29.99  | \$28.49  |

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

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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Comprehensive Income

(in thousands)

|   | Year Ended December 31, |          |          |
|---|-------------------------|----------|----------|
|   | 2013                    | 2012     | 2011     |
| Net Income  | \$24,061                | \$23,349 | \$22,209 |
| Other Comprehensive Income (Loss)   |                         |          |          |
| (Decrease) Increase in Net Unrealized (Loss) Gain on Available-for-Sale Securities    | (16,564)                | 4,182    | 5,364    |
| Reclassification Adjustment for Realized Loss (Gain) on Available-for-Sale Securities |                         |          |          |
| Included in Net Income  | 229                     | (158 )   | (95 )    |
| Deferred Tax Benefit (Expense)  | 6,868                   | (1,692 ) | (2,215 ) |
| Change in Net Unrealized (Loss) Gain on Available-for-Sale Securities, Net of Tax     | (9,467 )                | 2,332    | 3,054    |
| Total Other Comprehensive (Loss) Income   | (9,467 )                | 2,332    | 3,054    |
| Comprehensive Income  | \$14,594                | \$25,681 | \$25,263 |

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

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Farmers &amp; Merchants Bancorp

Consolidated Statements of Changes in Shareholders' Equity

(in thousands except share and per share data)

|   | Common<br>Shares<br>Outstanding | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>(Loss) | Total<br>Shareholders'<br>Equity |
|---|---------------------------------|-----------------|----------------------------------|----------------------|---|----------------------------------|
| Balance, January 1, 2011  | 779,424                         | \$ 8            | \$ 75,590                        | \$96,030             | \$ 1,613  | \$ 173,241                       |
| Net Income  |                                 |                 |                                  | 22,209               |   | 22,209                           |
| Cash Dividends Declared on Common<br>Stock (\$11.75 per share)      |                                 |                 |                                  | (9,158 )             |   | (9,158 )                         |
| Change in Net Unrealized Gain on<br>Securities Available-for-Sale   |                                 |                 |                                  |                      | 3,054   | 3,054                            |
| Balance, December 31, 2011  | 779,424                         | \$ 8            | \$ 75,590                        | \$109,081            | \$ 4,667  | \$ 189,346                       |
| Net Income  |                                 |                 |                                  | 23,349               |   | 23,349                           |
| Cash Dividends Declared on Common<br>Stock (\$12.10 per share)      |                                 |                 |                                  | (9,418 )             |   | (9,418 )                         |
| Repurchase of Common Stock  | (1,542 )                        |                 | (576 )                           |                      |   | (576 )                           |
| Change in Net Unrealized Gain on<br>Securities Available-for-Sale   |                                 |                 |                                  |                      | 2,332   | 2,332                            |
| Balance, December 31, 2012  | 777,882                         | \$ 8            | \$ 75,014                        | \$123,012            | \$ 6,999  | \$ 205,033                       |
| Net Income  |                                 |                 |                                  | 24,061               |   | 24,061                           |
| Cash Dividends Declared on Common<br>Stock (\$12.50 per share)      |                                 |                 |                                  | (9,723 )             |   | (9,723 )                         |
| Change in Net Unrealized (Loss) on<br>Securities Available-for-Sale |                                 |                 |                                  |                      | (9,467 )  | (9,467 )                         |
| Balance, December 31, 2013  | 777,882                         | \$ 8            | \$ 75,014                        | \$137,350            | \$ (2,468 )                                     | \$ 209,904                       |

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

Table of ContentsFarmers & Merchants Bancorp  
Consolidated Statements of Cash Flows  
(in thousands)

|   | Year Ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2013                    | 2012      | 2011      |
| Operating Activities  |                         |           |           |
| Net Income  | \$24,061                | \$23,349  | \$22,209  |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                         |           |           |
| Provision for Credit Losses   | 425                     | 1,850     | 6,775     |
| Depreciation and Amortization   | 1,506                   | 1,704     | 1,801     |
| Provision for Deferred Income Taxes   | (8,501 )                | (2,548 )  | (1,260 )  |
| Net Amortization of Investment Security Premium & Discounts                       | 3,068                   | 3,944     | 1,230     |
| Net Loss (Gain) on Investment Securities  | 229                     | (158 )    | (95 )     |
| Net Gain on Sale of Property & Equipment  | (721 )                  | -         | (5 )      |
| Net Change in Operating Assets & Liabilities:                                     |                         |           |           |
| Net Increase in Interest Receivable and Other Assets                              | (3,719 )                | (434 )    | (2,750 )  |
| Net Increase in Interest Payable and Other Liabilities                            | 10,851                  | 4,016     | 2,455     |
| Net Cash Provided by Operating Activities   | 27,199                  | 31,723    | 30,360    |
| Investing Activities  |                         |           |           |
| Purchase of Investment Securities Available-for-Sale                              | (221,745)               | (143,295) | (296,852) |
| Proceeds from Sold, Matured, or Called Securities Available-for-Sale              | 208,962                 | 205,374   | 249,930   |
| Purchase of Investment Securities Held-to-Maturity                                | (2,077 )                | (10,739 ) | (1,580 )  |
| Proceeds from Matured, or Called Securities Held-to-Maturity                      | 8,443                   | 5,419     | 3,402     |
| Purchase of Life Insurance Contracts  | -                       | (1,000 )  | -         |
| Net Loans & Leases Paid, Originated or Acquired                                   | (142,225)               | (84,872 ) | 6,778     |
| Principal Collected on Loans & Leases Previously Charged Off                      | 523                     | 398       | 127       |
| Additions to Premises and Equipment   | (1,614 )                | (547 )    | (1,660 )  |
| Proceeds from Sale of Property & Equipment  | 843                     | -         | 20        |
| Net Cash Used by Investing Activities   | (148,890)               | (29,262 ) | (39,835 ) |
| Financing Activities  |                         |           |           |
| Net Increase in Deposits  | 85,665                  | 95,829    | 59,694    |
| Net Change in Other Borrowings  | -                       | (530 )    | (61 )     |
| Net Decrease in Securities Sold Under Agreement to Repurchase                     | -                       | (60,000 ) | -         |
| Stock Repurchases   | -                       | (576 )    | -         |
| Cash Dividends  | (9,723 )                | (9,418 )  | (9,158 )  |
| Net Cash Provided by Financing Activities   | 75,942                  | 25,305    | 50,475    |
| (Decrease) Increase in Cash and Cash Equivalents                                  | (45,749 )               | 27,766    | 41,000    |
| Cash and Cash Equivalents at Beginning of Year                                    | 129,426                 | 101,660   | 60,660    |
| Cash and Cash Equivalents at End of Year  | \$83,677                | \$129,426 | \$101,660 |
| Supplementary Data  |                         |           |           |
| Loans Transferred to Foreclosed Assets (ORE)                                      | \$4,403                 | \$58      | \$1,092   |
| Cash Payments Made for Income Taxes   | \$17,285                | \$17,472  | \$12,070  |
| Interest Paid   | \$3,037                 | \$5,553   | \$8,474   |

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



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### Notes to Consolidated Financial Statements

#### 1. Significant Accounting Policies

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

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

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and prevailing practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

#### Basis of Presentation

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

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

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

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

#### Cash and Cash Equivalents

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

#### Investment Securities

Investment securities are classified at the time of purchase as held-to-maturity if it is management’s intent and the Company has the ability to hold the securities until maturity. These securities are carried at cost, adjusted for

amortization of premium and accretion of discount using a level yield of interest over the estimated remaining period until maturity. Losses, reflecting a decline in value judged by the Company to be other than temporary, are recognized in the period in which they occur.

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

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

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

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

### Loans & Leases

Loans & leases are reported at the principal amount outstanding net of unearned discounts and deferred loan & lease fees and costs. Interest income on loans & leases is accrued daily on the outstanding balances using the simple interest method. Loan & lease origination fees are deferred and recognized over the contractual life of the loan or lease as an adjustment to the yield. Loans & leases are placed on non-accrual status when the collection of principal or interest is in doubt or when they become past due for 90 days or more unless they are both well-secured and in the process of collection. For this purpose a loan or lease is considered well secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or lease or is guaranteed by a financially capable party. When a loan or lease is placed on non-accrual status, the accrued and unpaid interest receivable is reversed and charged against current income; thereafter, interest income is recognized only as it is collected in cash. Additionally, cash would be applied to principal if all principal was not expected to be collected. Loans & leases placed on non-accrual status are returned to accrual status when the loans or leases are paid current as to principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan or lease.

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



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

### Allowance for Credit Losses

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

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

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

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

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. A credit grade is established at inception for smaller balance loans, such as consumer and residential real estate, and then updated only when the loan becomes contractually delinquent or when the borrower requests a modification. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

### Premises and Equipment

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

### Other Real Estate

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

### Income Taxes

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

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

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

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

### Dividends and Basic Earnings Per Common Share

The Company's common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. There are no common stock equivalent shares therefore there is no presentation of diluted earnings per common share. See Note 15 for additional information.

### Segment Reporting

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

### Derivative Instruments and Hedging Activities

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

From time to time, the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps, and collars. These instruments are purchased and/or sold to reduce the Company's exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments as of or for the years ended December 31, 2013, 2012 and 2011.

### Comprehensive Income

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

### Loss Contingencies

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



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## 2. Investment Securities

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

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

|   | Amortized<br>Cost | Gross<br>Gains | Unrealized<br>Losses | Fair/Book<br>Value |
|---|-------------------|----------------|----------------------|--------------------|
| December 31, 2012                                 |                   |                |                      |                    |
| Government Agency & Government-Sponsored Entities | \$ 26,546         | \$ 277         | \$-                  | \$ 26,823          |
| Obligations of States and Political Subdivisions  | 5,665             | -              | -                    | 5,665              |
| Mortgage Backed Securities <sup>(1)</sup>         | 341,212           | 11,570         | 10                   | 352,772            |
| Corporate Securities                              | 22,318            | 252            | 12                   | 22,558             |
| Other   | 10,173            | -              | -                    | 10,173             |
| Total   | \$ 405,914        | \$ 12,099      | \$ 22                | \$ 417,991         |

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

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

|  | Book<br>Value | Gross<br>Unrealized |        | Fair<br>Value |
|--|---------------|---------------------|--------|---------------|
|  |               | Gains               | Losses |               |
| December 31, 2012                                |               |                     |        |               |
| Obligations of States and Political Subdivisions | \$ 65,694     | \$ 2,296            | \$ 3   | \$ 67,987     |
| Mortgage Backed Securities <sup>(1)</sup>        | 484           | 12                  | -      | 496           |
| Other  | 2,214         | -                   | -      | 2,214         |
| Total  | \$ 68,392     | \$ 2,308            | \$ 3   | \$ 70,697     |

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

<sup>(1)</sup> All Mortgage Backed Securities were issued by an agency or government sponsored entity of the U.S. government.

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

|  | Available-for-Sale |                 | Held-to-Maturity |            |
|--|--------------------|-----------------|------------------|------------|
|  | Amortized Cost     | Fair/Book Value | Book Value       | Fair Value |
| December 31, 2013  |                    |                 |                  |            |
| Within One Year  | \$20,191           | \$20,229        | \$2,449          | \$2,467    |
| After One Year Through Five Years                        | 55,970             | 56,132          | 18,866           | 19,286     |
| After Five Years Through Ten Years                       | 3,267              | 3,349           | 26,891           | 27,266     |
| After Ten Years  | -                  | -               | 20,254           | 19,626     |
|  | 79,428             | 79,710          | 68,460           | 68,645     |
| Investment Securities Not Due at a Single Maturity Date: |                    |                 |                  |            |
| Mortgage Backed Securities                               | 329,469            | 324,929         | 45               | 45         |
| Total  | \$408,897          | \$404,639       | \$68,505         | \$68,690   |

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

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

| December 31, 2013 | Less Than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|-------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|                   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |

Securities Available-for-Sale

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

Securities Held-to-Maturity

|  |         |        |     |      |         |        |
|--|---------|--------|-----|------|---------|--------|
| Obligations of States and Political Subdivisions | \$9,518 | \$ 627 | \$- | \$ - | \$9,518 | \$ 627 |
| Total  | \$9,518 | \$ 627 | \$- | \$ - | \$9,518 | \$ 627 |

| December 31, 2012 | Less Than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|-------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|                   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |

Securities Available-for-Sale

|                            |         |       |     |      |         |       |
|----------------------------|---------|-------|-----|------|---------|-------|
| Mortgage Backed Securities | \$4,542 | \$ 10 | \$- | \$ - | \$4,542 | \$ 10 |
| Corporate Securities       | 3,442   | 12    | -   | -    | 3,442   | 12    |
| Total                      | \$7,984 | \$ 22 | \$- | \$ - | \$7,984 | \$ 22 |

Securities Held-to-Maturity

|  |       |      |     |      |       |      |
|--|-------|------|-----|------|-------|------|
| Obligations of States and Political Subdivisions | \$528 | \$ 3 | \$- | \$ - | \$528 | \$ 3 |
| Total  | \$528 | \$ 3 | \$- | \$ - | \$528 | \$ 3 |

As of December 31, 2013, the Company held 352 investment securities of which 72 were in an unrealized loss position for less than twelve months. Two securities were in an unrealized loss position for twelve months or more.

Management periodically evaluates each investment security for other-than-temporary impairment relying primarily on industry analyst reports and observations of market conditions and interest rate fluctuations. Management believes it will be able to collect all amounts due according to the contractual terms of the underlying investment securities.

Securities of Government Agency and Government Sponsored Entities – There were no unrealized losses on the Company's investments in securities of government agency and government sponsored entities at December 31, 2013 and December 31, 2012.

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**Mortgage Backed Securities** - The unrealized losses on the Company's investment in mortgage-backed securities were \$7.6 million at December 31, 2013 and \$10,000 at December 31, 2012, respectively. The unrealized losses on the Company's investment in mortgage-backed securities were caused by interest rate fluctuations. The contractual cash flows of these investments are guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2013 or 2012.

**Obligations of States and Political Subdivisions** - The continuing financial problems being experienced by certain municipalities, along with the financial stresses exhibited by some of the large monoline bond insurers have increased the overall risk associated with bank-qualified municipal bonds. As of December 31, 2013, over ninety-three percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or the issuer level, and all of these ratings are "investment grade." The Company monitors the status of the seven percent of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

The unrealized losses on the Company's investment in obligation of states and political subdivision were \$627,000 at December 31, 2013 and \$3,000 at December 31, 2012. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were caused by interest rate fluctuations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company did not intend to sell the securities and it is more likely than not that the Company would not have to sell the securities before recovery of their cost basis, the Company did not consider these investments to be other-than-temporarily impaired at December 31, 2013 and December 31, 2012.

**Corporate Securities** - The unrealized losses on the Company's investment in corporate securities were \$147,000 at December 31, 2013 and \$12,000 at December 31, 2012. Changes in the prices of corporate securities are primarily influenced by: (1) changes in market interest rates; (2) changes in perceived credit risk in the general economy or in particular industries; (3) changes in the perceived credit risk of a particular company; and (4) day to day trading supply, demand and liquidity. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2013 or 2012.

Proceeds from sales and calls of securities available-for-sale were as follows:

| (in thousands) | Gross<br>Proceeds | Gross<br>Gains | Gross<br>Losses |
|----------------|-------------------|----------------|-----------------|
| 2013           | \$81,390          | \$1,208        | \$1,437         |
| 2012           | 55,986            | 158            | -               |
| 2011           | 201,135           | 95             | -               |

As of December 31, 2013, securities carried at \$334.8 million were pledged to secure public deposits, FHLB borrowings, and other government agency deposits as required by law. This amount at December 31, 2012, was \$296.9 million.

### 3. Federal Home Loan Bank of San Francisco Stock

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified



as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. FHLB stock is reported in Other Assets and Interest Receivable on the Company's Consolidated Balance Sheets and totaled \$7.2 million at December 31, 2013 and \$7.4 million at December 31, 2012.

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## 4. Loans &amp; Leases

Loans & leases as of December 31 consisted of the following:

| (in thousands)                    | 2013        | 2012        |
|-----------------------------------|-------------|-------------|
| Commercial Real Estate            | \$411,037   | \$353,109   |
| Agricultural Real Estate          | 328,264     | 311,992     |
| Real Estate Construction          | 41,092      | 32,680      |
| Residential 1st Mortgages         | 151,292     | 140,257     |
| Home Equity Lines and Loans       | 35,477      | 42,042      |
| Agricultural                      | 256,414     | 221,032     |
| Commercial                        | 150,398     | 143,293     |
| Consumer & Other                  | 5,052       | 5,058       |
| Leases                            | 12,733      | -           |
| Total Gross Loans & Leases        | 1,391,759   | 1,249,463   |
| Less: Unearned Income             | 3,523       | 2,561       |
| Subtotal                          | 1,388,236   | 1,246,902   |
| Less: Allowance for Credit Losses | 34,274      | 34,217      |
| Loans & Leases, Net               | \$1,353,962 | \$1,212,685 |

At December 31, 2013, the portion of loans that were approved for pledging as collateral on borrowing lines with the Federal Home Loan Bank (“FHLB”) and the Federal Reserve Bank (“FRB”) were \$456.5 million and \$496.5 million, respectively. The borrowing capacity on these loans was \$346.4 million from FHLB and \$369.4 million from the FRB.

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5. Allowance for Credit Losses

The following tables show the allocation of the allowance for credit losses at December 31, 2013 and December 31, 2012 by portfolio segment and by impairment methodology (in thousands):

|   | Commercial<br>Real Estate | Agricultural<br>Real Estate | Real Estate<br>Construction | Residential<br>1st Mortgages | Home<br>Equity<br>Lines &<br>Loans | Agricultural | Commercial | Consumer<br>&<br>Other | Leases   | Unallocated | Total       |
|---|---------------------------|-----------------------------|-----------------------------|------------------------------|------------------------------------|--------------|------------|------------------------|----------|-------------|-------------|
| Year-To-Date Allowance for Credit Losses:   |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| Beginning<br>Balance-<br>January 1,<br>2013   | \$6,464                   | \$2,877                     | \$986                       | \$1,219                      | \$3,235                            | \$10,437     | \$7,963    | \$182                  | \$-      | \$854       | \$34,865    |
| Charge-Offs   | (6 )                      | (575 )                      | -                           | (16 )                        | (91 )                              | (23 )        | (60 )      | (120 )                 | -        | -           | (891 )      |
| Recoveries  | -                         | -                           | -                           | -                            | 115                                | 42           | 312        | 54                     | -        | -           | 523         |
| Provision   | (1,280 )                  | 1,274                       | (332 )                      | (95 )                        | (492 )                             | 1,749        | (2,518 )   | 60                     | 639      | 1,420       | 425         |
| Ending<br>Balance-<br>December<br>31, 2013  | \$5,178                   | \$3,576                     | \$654                       | \$1,108                      | \$2,767                            | \$12,205     | \$5,697    | \$176                  | \$639    | \$2,274     | \$34,865    |
| Ending<br>Balance<br>Individually<br>Evaluated<br>for<br>Impairment                       | -                         | -                           | -                           | 414                          | 209                                | 122          | 820        | 51                     | -        | -           | 1,626       |
| Ending<br>Balance<br>Collectively<br>Evaluated<br>for<br>Impairment<br>Loans &<br>Leases: | 5,178                     | 3,576                       | 654                         | 694                          | 2,558                              | 12,083       | 4,877      | 125                    | 639      | 2,274       | 32,239      |
| Ending<br>Balance<br>Individually<br>Evaluated<br>for<br>Impairment                       | \$407,514                 | \$328,264                   | \$41,092                    | \$151,292                    | \$35,477                           | \$256,414    | \$150,398  | \$5,052                | \$12,733 | \$-         | \$1,337,836 |
| Ending<br>Balance<br>Collectively<br>Evaluated<br>for<br>Impairment                       | 22,176                    | -                           | 4,500                       | 2,072                        | 1,045                              | 522          | 5,250      | 51                     | -        | -           | 35,566      |
| Ending<br>Balance<br>Collectively<br>Evaluated<br>for<br>Impairment                       | 385,338                   | 328,264                     | 36,592                      | 149,220                      | 34,432                             | 255,892      | 145,148    | 5,001                  | 12,733   | -           | 1,302,270   |

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| December 31, 2012                                    | Commercial Real Estate | Agricultural Real Estate | Real Estate Construction | Residential 1st Mortgages | Home Equity Lines & Loans | Agricultural | Commercial | Consumer & Other | Leases | Unallocated | Total     |
|--|------------------------|--------------------------|--------------------------|---------------------------|---------------------------|--------------|------------|------------------|--------|-------------|-----------|
| Year-To-Date Allowance for Credit Losses:            |                        |                          |                          |                           |                           |              |            |                  |        |             |           |
| Beginning Balance- January 1, 2012                   | \$5,823                | \$2,583                  | \$1,933                  | \$1,251                   | \$3,746                   | \$8,127      | \$8,733    | \$207            | \$-    | \$614       | \$33,900  |
| Charge-Offs  | -                      | -                        | -                        | (152 )                    | (259 )                    | (294 )       | (198 )     | (145 )           | -      | -           | (1,048)   |
| Recoveries   | -                      | 90                       | -                        | 53                        | 14                        | 61           | 117        | 63               | -      | -           | 398       |
| Provision  | 641                    | 204                      | (947 )                   | 67                        | (266 )                    | 2,543        | (689 )     | 57               | -      | 240         | 1,846     |
| Ending Balance- December 31, 2012                    | \$6,464                | \$2,877                  | \$986                    | \$1,219                   | \$3,235                   | \$10,437     | \$7,963    | \$182            | \$-    | \$854       | \$34,988  |
| Ending Balance Individually Evaluated for Impairment | 1,272                  | -                        | 259                      | 55                        | 182                       | 996          | 151        | 61               | -      | -           | 2,916     |
| Ending Balance Collectively Evaluated for Impairment | 5,192                  | 2,877                    | 727                      | 1,164                     | 3,053                     | 9,441        | 7,812      | 121              | -      | 854         | 31,072    |
| Ending Balance Individually Evaluated for Impairment | 22,835                 | 5,423                    | 4,603                    | 1,849                     | 1,199                     | 3,937        | 309        | 61               | -      | -           | 40,116    |
| Ending Balance Collectively Evaluated for Impairment | 327,713                | 306,569                  | 28,077                   | 138,408                   | 40,843                    | 217,095      | 142,984    | 4,997            | -      | -           | 1,268,626 |

The ending balance of loans individually evaluated for impairment includes restructured loans in the amount of \$28.4 million and \$28.6 million at December 31, 2013 and 2012, respectively, which are no longer disclosed or classified as TDR's.



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The following tables show the loan & lease portfolio allocated by management's internal risk ratings at December 31, 2013 and December 31, 2012 (in thousands):

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

| December 31, 2012         | Pass        | Special<br>Mention | Substandard | Total<br>Loans |
|---------------------------|-------------|--------------------|-------------|----------------|
| Loans:                    |             |                    |             |                |
| Commercial Real Estate    | \$326,037   | \$15,528           | \$ 8,983    | \$350,548      |
| Agricultural Real Estate  | 299,642     | 6,605              | 5,745       | 311,992        |
| Real Estate Construction  | 26,445      | 6,235              | -           | 32,680         |
| Residential 1st Mortgages | 137,998     | 1,192              | 1,067       | 140,257        |
| Home Equity Lines & Loans | 40,866      | -                  | 1,176       | 42,042         |
| Agricultural              | 216,164     | 1,168              | 3,700       | 221,032        |
| Commercial                | 137,217     | 5,586              | 490         | 143,293        |
| Consumer & Other          | 4,737       | -                  | 321         | 5,058          |
| Total                     | \$1,189,106 | \$36,314           | \$ 21,482   | \$1,246,902    |

See Note 1. Significant Accounting Policies – Allowance for Credit Losses for a description of the internal risk ratings used by the Company. There were no loans & leases outstanding at December 31, 2013 and 2012 rated doubtful or loss.

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The following tables show an aging analysis of the loan & lease portfolio by the time past due at December 31, 2013 and December 31, 2012 (in thousands):

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

| December 31, 2012         | 30-89<br>Days<br>Past<br>Due | 90 Days<br>and<br>Still<br>Accruing | Nonaccrual | Total<br>Past<br>Due | Current      | Total<br>Loans |
|---------------------------|------------------------------|-------------------------------------|------------|----------------------|--------------|----------------|
| Loans:                    |                              |                                     |            |                      |              |                |
| Commercial Real Estate    | \$ 150                       | \$ -                                | \$ -       | \$ 150               | \$ 350,398   | \$ 350,548     |
| Agricultural Real Estate  | -                            | -                                   | 5,423      | 5,423                | 306,569      | 311,992        |
| Real Estate Construction  | -                            | -                                   | -          | -                    | 32,680       | 32,680         |
| Residential 1st Mortgages | 23                           | -                                   | 445        | 468                  | 139,789      | 140,257        |
| Home Equity Lines & Loans | 70                           | -                                   | 213        | 283                  | 41,759       | 42,042         |
| Agricultural              | -                            | -                                   | 3,198      | 3,198                | 217,834      | 221,032        |
| Commercial                | 293                          | -                                   | -          | 293                  | 143,000      | 143,293        |
| Consumer & Other          | 11                           | -                                   | 19         | 30                   | 5,028        | 5,058          |
| Total                     | \$ 547                       | \$ -                                | \$ 9,298   | \$ 9,845             | \$ 1,237,057 | \$ 1,246,902   |

Non-accrual loans & leases at December 31, 2013 and 2012 were \$2.6 million and \$9.3 million, respectively. Interest income forgone on loans & leases placed on non-accrual status was \$30,500, \$209,000, and \$385,000 for the years ended December 31, 2013, 2012, and 2011, respectively.

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The following tables show information related to impaired loans & leases at and for the year ended December 31, 2013 and December 31, 2012 (in thousands):

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

|                                     | Recorded   | Unpaid    | Related   | Average    | Interest   |
|-------------------------------------|------------|-----------|-----------|------------|------------|
|                                     | Investment | Principal | Allowance | Recorded   | Income     |
| December 31, 2012                   |            | Balance   |           | Investment | Recognized |
| With no related allowance recorded: |            |           |           |            |            |
| Commercial Real Estate              | \$ 289     | \$ 289    | \$ -      | \$ 506     | \$ 20      |
| Agricultural Real Estate            | 5,437      | 5,454     | -         | 2,611      | -          |
| Real Estate Construction            | -          | -         | -         | -          | -          |
| Residential 1st Mortgages           | 658        | 761       | -         | 458        | 3          |
| Home Equity Lines & Loans           | 792        | 871       | -         | 775        | 23         |
| Agricultural                        | 1,932      | 1,954     | -         | 1,159      | 19         |
| Commercial                          | 106        | 106       | -         | 144        | 6          |
| Consumer & Other                    | -          | -         | -         | -          | -          |
|                                     | \$ 9,214   | \$ 9,435  | \$ -      | \$ 5,653   | \$ 71      |
| With an allowance recorded:         |            |           |           |            |            |
| Commercial Real Estate              | \$ -       | \$ -      | \$ -      | \$ -       | \$ -       |
| Agricultural Real Estate            | -          | -         | -         | -          | -          |
| Real Estate Construction            | -          | -         | -         | -          | -          |
| Residential 1st Mortgages           | -          | -         | -         | 54         | -          |
| Home Equity Lines & Loans           | 194        | 237       | 173       | 182        | 4          |
| Agricultural                        | 2,006      | 2,019     | 996       | 997        | 1          |
| Commercial                          | 144        | 144       | 144       | 159        | 4          |
| Consumer & Other                    | 61         | 63        | 61        | 31         | -          |



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|       |           |           |          |          |       |
|-------|-----------|-----------|----------|----------|-------|
|       | \$ 2,405  | \$2,463   | \$ 1,374 | \$ 1,423 | \$ 9  |
| Total | \$ 11,619 | \$ 11,898 | \$ 1,374 | \$ 7,076 | \$ 80 |

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

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At December 31, 2013, the Company allocated \$1.2 million of specific reserves to \$6.8 million of troubled debt restructured loans, of which \$4.6 million were performing. At December 31, 2012, the Company allocated \$401,000 of specific reserves to \$2.6 million of troubled debt restructured loans, of which \$2.3 million were performing. The Company had no commitments at December 31, 2013 and December 31, 2012 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the period ending December 31, 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

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

The following table presents loans by class modified as troubled debt restructured loans for the period ended December 31, 2013 (in thousands):

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

The troubled debt restructurings described above did not increase the allowance for credit losses but did result in charge-offs of \$43,000 for the twelve months ended December 31, 2013.

As of December 31, 2013, there was one commercial loan with an outstanding balance of \$174,000 that was previously modified as a troubled debt restructuring within the previous 12 months that subsequently defaulted during the twelve months ended December 31, 2013. This defaulted loan did not increase the allowance for credit loss and did not result in any charge offs during the twelve-month period ending December 31, 2013. The Company considers a loan to be in payment default once it is greater than 90 days contractually past due under the modified terms.

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The following table presents loans by class modified as troubled debt restructured loans for the period ended December 31, 2012 (in thousands):

|                              | December 31, 2012                         |  |
|------------------------------|---|--|
|                              | Pre-Modification<br>Number<br>of<br>Loans | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Troubled Debt Restructurings |   |  |
| Commercial Real Estate       | 1   | \$ 116   |
| Agricultural Real Estate     | -   | -  |
| Real Estate Construction     | -   | -  |
| Residential 1st Mortgages    | 2   | 216  |
| Home Equity Lines & Loans    | 7   | 529  |
| Agricultural                 | 4   | 858  |
| Commercial                   | 3   | 273  |
| Consumer & Other             | 1   | 41   |
| Total                        | 18  | \$ 2,033   |

The troubled debt restructurings described above increased the allowance for loan losses by \$53,000 and resulted in charge-offs of \$64,000 during the year ended December 31, 2012.

During the period ended December 31, 2012, there were no payment defaults on loans modified as troubled debt restructurings within twelve months following the modification.

## 6. Premises and Equipment

Premises and equipment as of December 31, consisted of the following:

| (in thousands)                                  | 2013     | 2012     |
|---|----------|----------|
| Land and Buildings                              | \$33,354 | \$32,843 |
| Furniture, Fixtures, and Equipment              | 16,770   | 17,024   |
| Leasehold Improvements                          | 2,060    | 2,054    |
| Subtotal  | 52,184   | 51,921   |
| Less: Accumulated Depreciation and Amortization | 29,297   | 29,020   |
| Total   | \$22,887 | \$22,901 |

Depreciation and amortization on premises and equipment included in occupancy and equipment expense amounted to \$1,506,000, \$1,704,000, and \$1,801,000 for the years ended December 31, 2013, 2012, and 2011, respectively. Total rental expense for premises was \$411,000, \$391,000, and \$386,000 for the years ended December 31, 2013, 2012, and 2011, respectively. Rental income was \$102,000, \$148,000, and \$130,000 for the years ended December 31, 2013, 2012, and 2011, respectively.

## 7. Other Real Estate

The Bank reported \$4.6 million, net of \$3.7 million reserve, in other real estate at December 31, 2013, and \$2.6 million, net of \$4.1 million reserve, in 2012. Other real estate includes property no longer utilized for business operations and property acquired through foreclosure proceedings. These properties are carried at fair value less selling costs determined at the date acquired. Losses, if any, arising from properties acquired through foreclosure are charged against the allowance for loan losses at the time of foreclosure. Subsequent declines in value, periodic holding costs, and net gains or losses on disposition are included in other operating expense as incurred. Other real estate is

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reported in Interest Receivable and Other Assets on the Company's Consolidated Balance Sheets.

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## 8. Time Deposits

Time Deposits of \$100,000 or more as of December 31 were as follows:

|                |           |           |
|----------------|-----------|-----------|
| (in thousands) | 2013      | 2012      |
| Balance        | \$313,660 | \$328,014 |

At December 31, 2013, the scheduled maturities of time deposits were as follows:

|                |            |
|----------------|------------|
|                | Scheduled  |
| (in thousands) | Maturities |
| 2014           | \$381,392  |
| 2015           | 25,665     |
| 2016           | 12,292     |
| 2017           | 9,010      |
| 2018           | 2,063      |
| Total          | \$430,422  |

## 9. Income Taxes

Current and deferred income tax expense (benefit) provided for the years ended December 31 consisted of the following:

|                           |          |          |          |
|---------------------------|----------|----------|----------|
| (in thousands)            | 2013     | 2012     | 2011     |
| Current                   |          |          |          |
| Federal                   | \$11,497 | \$12,252 | \$10,168 |
| State                     | 4,357    | 4,281    | 3,734    |
| Total Current             | 15,854   | 16,533   | 13,902   |
| Deferred                  |          |          |          |
| Federal                   | (998 )   | (2,041 ) | (685 )   |
| State                     | (635 )   | (507 )   | (575 )   |
| Total Deferred            | (1,633 ) | (2,548 ) | (1,260 ) |
| Total Provision for Taxes | \$14,221 | \$13,985 | \$12,642 |

The total provision for income taxes differs from the federal statutory rate as follows:

|   |          |         |          |         |          |         |
|---|----------|---------|----------|---------|----------|---------|
|   | 2013     |         | 2012     |         | 2011     |         |
| (in thousands)  | Amount   | Rate    | Amount   | Rate    | Amount   | Rate    |
| Tax Provision at Federal Statutory Rate   | \$13,399 | 35.0%   | \$13,067 | 35.0%   | \$12,198 | 35.0%   |
| Interest on Obligations of States and Political Subdivisions exempt from Federal Taxation | (894 )   | (2.3 %) | (917 )   | (2.5 %) | (884 )   | (2.5 %) |
| State and Local Income Taxes, Net of Federal Income Tax Benefit                           | 2,419    | 6.3 %   | 2,453    | 6.6 %   | 2,053    | 5.9 %   |
| Bank Owned Life Insurance   | (702 )   | (1.8 %) | (675 )   | (1.8 %) | (663 )   | (1.9 %) |
| Low-Income Housing Tax Credit   | (129 )   | (0.3 %) | -        | -       | -        | -       |
| Other, Net  | 128      | 0.3 %   | 57       | 0.2 %   | (62 )    | (0.2 %) |
| Total Provision for Taxes   | \$14,221 | 37.1%   | \$13,985 | 37.5%   | \$12,642 | 36.3%   |

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The components of net deferred tax assets as of December 31 are as follows:

| (in thousands)                                   | 2013     | 2012     |
|--|----------|----------|
| Deferred Tax Assets                              |          |          |
| Allowance for Credit Losses                      | \$14,470 | \$14,446 |
| Accrued Liabilities                              | 7,723    | 6,283    |
| Deferred Compensation                            | 8,859    | 7,015    |
| State Franchise Tax                              | 1,525    | 1,498    |
| Capital Loss Carry Forward                       | -        | 210      |
| Interest on Non-Accrual Loans                    | 15       | 96       |
| ORE Writedown and Holding Costs                  | 1,713    | 1,852    |
| Unrealized Loss on Securities Available-for-Sale | 1,790    | -        |
| Low-Income Housing Investment                    | 21       | -        |
| Total Deferred Tax Assets                        | \$36,116 | \$31,400 |
| Deferred Tax Liabilities                         |          |          |
| Premises and Equipment                           | (213 )   | (415 )   |
| Securities Accretion                             | (966 )   | (996 )   |
| Unrealized Gain on Securities Available-for-Sale | -        | (5,078 ) |
| Leasing Activities                               | (1,501 ) | -        |
| Other  | (787 )   | (763 )   |
| Total Deferred Tax Liabilities                   | (3,467 ) | (7,252 ) |
| Net Deferred Tax Assets                          | \$32,649 | \$24,148 |

The net deferred tax assets are reported in Interest Receivable and Other Assets on the Company's Consolidated Balance Sheet.

The Company and its subsidiaries file income tax returns in the U.S. federal and California jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2007.

#### 10. Short Term Borrowings

As of December 31, 2013 and 2012, the Company had unused lines of credit available for short-term liquidity purposes of \$887.8 million and \$760.9 million, respectively. Federal Funds purchased and advances are generally issued on an overnight basis. There were no advances from the FHLB at December 31, 2013 or 2012. There were no Federal Funds purchased or advances from the FRB at December 31, 2013 or 2012.

#### 11. Securities Sold Under Agreement to Repurchase

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

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

At December 31, 2013 and December 31, 2012, the Company had no securities sold under agreement to repurchase.

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12. Federal Home Loan Bank Advances

The Company had no short-term or long-term advances from the Federal Home Loan Bank of San Francisco at December 31, 2013 or at December 31, 2012. At December 31, 2011, the Company had a \$530,000, 5.60% amortizing note, interest and principal payable monthly with final maturity of September 25, 2018. On December 31, 2012 the Company paid off the long-term advance from the FHLB resulting in a prepayment fee of \$70,000. The Company determined that the time was appropriate to eliminate this relatively “high cost” advance given the Company’s liquidity position.

In accordance with the Collateral Pledge and Security Agreement, advances are secured by all FHLB stock held by the Company and by government agency & government-sponsored entity securities and mortgage-backed securities with borrowing capacity of \$1.0 million. At December 31, 2013, \$456.5 million in loans were approved for pledging as collateral on borrowing lines with the FHLB. The borrowing capacity on these loans was \$346.4 million.

13. Long-term Subordinated Debentures

In December 2003, the Company formed a wholly owned Connecticut statutory business trust, FMCB Statutory Trust I (“Statutory Trust I”), which issued \$10,000,000 of guaranteed preferred beneficial interests in the Company’s junior subordinated deferrable interest debentures (the “Trust Preferred Securities”). The Company is not considered the primary beneficiary of the trust (variable interest entity), therefore the trust is not consolidated in the Company’s financial statements, but rather the subordinated debentures are shown as a liability. These debentures qualify as Tier 1 capital under current regulatory guidelines. All of the common securities of Statutory Trust I are owned by the Company. The proceeds from the issuance of the common securities and the Trust Preferred Securities were used by FMCB Statutory Trust to purchase \$10,310,000 of junior subordinated debentures of the Company, which carry a floating rate based on three-month LIBOR plus 2.85%. The debentures represent the sole asset of Statutory Trust I. The Trust Preferred Securities accrue and pay distributions at a floating rate of three-month LIBOR plus 2.85% per annum of the stated liquidation value of \$1,000 per capital security. The Company has entered into contractual arrangements which, taken collectively, fully and unconditionally guarantee payment to the extent that Statutory Trust I has funds available therefore of: (i) accrued and unpaid distributions required to be paid on the Trust Preferred Securities; (ii) the redemption price with respect to any Trust Preferred Securities called for redemption by Statutory Trust I; and (iii) payments due upon a voluntary or involuntary dissolution, winding up, or liquidation of Statutory Trust I. The Trust Preferred Securities are mandatorily redeemable upon maturity of the subordinated debentures on December 17, 2033, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the subordinated debentures purchased by Statutory Trust I, in whole or in part, on or after December 17, 2008. As specified in the indenture, if the subordinated debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company’s common stock.

14. Shareholders' Equity

In 1998, the Board approved the Company’s first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on September 11, 2012, the Board of Directors approved increasing the funds available for the Company’s common stock repurchase program to \$20 million over the three-year period ending September 30, 2015.

Repurchases under the program will continue to be made on the open market or through private transactions. The repurchase program also requires that no purchases may be made if the Bank would not remain “well-capitalized” after the repurchase.

Dividends from the Bank constitute the principal source of cash to the Company. The Company is a legal entity separate and distinct from the Bank. Under regulations controlling California state chartered banks, the Bank is, to some extent, limited in the amount of dividends that can be paid to the Company without prior approval of the California DBO. These regulations require approval if total dividends declared by a state chartered bank in any calendar year exceed the bank's net profits for that year combined with its retained net profits for the preceding two calendar years.

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios set forth in the following table of Total and Tier 1 capital to risk-weighted assets (as defined in the regulations), and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of December 31, 2013, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

In addition, the most recent notification from the FDIC categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since that notification that management believes have changed the Bank's category.

| (in thousands)                                      | Actual    |        | Regulatory   |              | Well Capitalized  |                   |
|---|-----------|--------|--------------|--------------|-------------------|-------------------|
|   |           |        | Capital      |              | Under Prompt      |                   |
|   |           |        | Requirements | Requirements | Corrective Action | Corrective Action |
| December 31, 2013                                   | Amount    | Ratio  | Amount       | Ratio        | Amount            | Ratio             |
| Total Bank Capital to Risk Weighted Assets          | \$244,087 | 13.98% | \$139,674    | 8.0 %        | \$174,593         | 10.0 %            |
| Total Consolidated Capital to Risk Weighted Assets  | \$244,354 | 13.99% | \$139,689    | 8.0 %        | N/                | A N/ A            |
| Tier 1 Bank Capital to Risk Weighted Assets         | \$222,108 | 12.72% | \$69,837     | 4.0 %        | \$104,756         | 6.0 %             |
| Tier 1 Consolidated Capital to Risk Weighted Assets | \$222,372 | 12.74% | \$69,845     | 4.0 %        | N/                | A N/ A            |
| Tier 1 Bank Capital to Average Assets               | \$222,108 | 11.02% | \$80,633     | 4.0 %        | \$100,791         | 5.0 %             |
| Tier 1 Consolidated Capital to Average Assets       | \$222,372 | 11.01% | \$80,755     | 4.0 %        | N/                | A N/ A            |

| (in thousands)                                      | Actual    |        | Regulatory   |              | Well Capitalized  |                   |
|---|-----------|--------|--------------|--------------|-------------------|-------------------|
|   |           |        | Capital      |              | Under Prompt      |                   |
|   |           |        | Requirements | Requirements | Corrective Action | Corrective Action |
| December 31, 2012                                   | Amount    | Ratio  | Amount       | Ratio        | Amount            | Ratio             |
| Total Bank Capital to Risk Weighted Assets          | \$226,931 | 14.94% | \$121,506    | 8.0 %        | \$151,883         | 10.0 %            |
| Total Consolidated Capital to Risk Weighted Assets  | \$227,214 | 14.96% | \$121,536    | 8.0 %        | N/                | A N/ A            |
| Tier 1 Bank Capital to Risk Weighted Assets         | \$207,756 | 13.68% | \$60,753     | 4.0 %        | \$91,130          | 6.0 %             |
| Tier 1 Consolidated Capital to Risk Weighted Assets | \$208,034 | 13.69% | \$60,768     | 4.0 %        | N/                | A N/ A            |
| Tier 1 Bank Capital to Average Assets               | \$207,756 | 10.86% | \$76,493     | 4.0 %        | \$95,616          | 5.0 %             |
| Tier 1 Consolidated Capital to Average Assets       | \$208,034 | 10.86% | \$76,605     | 4.0 %        | N/                | A N/ A            |

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## 15. Dividends and Basic Earnings Per Common Share

Total cash dividends during 2013 were \$9,723,000 or \$12.50 per share of common stock, an increase of 3.3% per share from \$9,418,000 or \$12.10 per share in 2012. In 2011, cash dividends totaled \$9,158,000 or \$11.75 per share.

Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the basic earnings per common share for the periods indicated.

| (net income in thousands)                   | 2013     | 2012     | 2011     |
|---|----------|----------|----------|
| Net Income                                  | \$24,061 | \$23,349 | \$22,209 |
| Average Number of Common Shares Outstanding | 777,882  | 778,648  | 779,424  |
| Basic Earnings Per Common Share             | \$30.93  | \$29.99  | \$28.49  |

## 16. Employee Benefit Plans

## Profit Sharing Plan

The Company, through the Bank, sponsors a Profit Sharing Plan for substantially all full-time employees of the Company with one or more years of service. Participants receive up to two annual employer contributions, one is discretionary and the other is mandatory. The discretionary contributions to the Profit Sharing Plan are determined annually by the Board of Directors. The discretionary contributions totaled \$825,000, \$800,000, and \$775,000 for the years ended December 31, 2013, 2012, and 2011, respectively. The mandatory contributions to the Profit Sharing Plan are made according to a predetermined set of criteria. Mandatory contributions totaled \$952,000, \$941,000, and \$868,000 for the years ended December 31, 2013, 2012, and 2011, respectively. Company employees are permitted, within limitations imposed by tax law, to make pretax contributions to the 401(k) feature of the Profit Sharing Plan. The Company does not match employee contributions within the 401(k) feature of the Profit Sharing Plan and the Company can terminate the Profit Sharing Plan at any time. Benefits pursuant to the Profit Sharing Plan vest 0% during the first year of participation, 25% per full year thereafter and after five years such benefits are fully vested.

## Executive Retirement Plan and Life Insurance Arrangements

The Company, through the Bank, sponsors an Executive Retirement Plan for certain executive level employees. The Executive Retirement Plan is a non-qualified defined contribution plan and was developed to supplement the Company's Profit Sharing Plan, which, as a qualified retirement plan, has a ceiling on benefits as set by the Internal Revenue Service. The Plan is comprised of: (1) a Performance Component which makes contributions based upon long-term cumulative profitability and increase in market value of the Company, and vests 50% during the first and second years of participation; (2) a Retention Component applicable to participants employed by the Company as of January 1, 2005 (contributions to this component were frozen effective December 31, 2010); (3) a Salary Component which makes contributions based upon participant salary levels and cliff vests after five years of service; and (4) an Equity Component for which contributions are discretionary and subject to Board of Directors approval and vests 50% during the first and second year of participation. Executive Retirement Plan contributions are invested in a mix of financial instruments; however Equity Component contributions are invested primarily in stock of the Company.

The Company expensed \$2.7 million to the Executive Retirement Plan during the year ended December 31, 2013, \$2.6 million during the year ended December 31, 2012 and \$2.3 million during the year ended December 31, 2011. The Company's total accrued liability under the Executive Retirement Plan was \$24.1 million as of December 31, 2013 and \$19.3 million as of December 31, 2012.

The Company has purchased single premium life insurance policies on the lives of certain key employees of the Company. These policies provide: (1) financial protection to the Company in the event of the death of a key employee; and (2) since the interest earned on the cash surrender value of the policies is tax exempt as long as the

policies are used to finance employee benefits, significant income to the Company to offset the expense associated with the Executive Retirement Plan and other employee benefit plans. As compensation to each employee for agreeing to allow the Company to purchase an insurance policy on his or her life, split dollar agreements have been entered into with those employees. These agreements provide for a division of the life insurance death proceeds between the Company and each employee's designated beneficiary or beneficiaries.

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The Company earned tax-exempt interest on the life insurance policies of \$1.9 million for the year ended December 31, 2013, and \$1.8 million for the years ended December 31, 2012, and 2011. As of December 31, 2013 and 2012, the total cash surrender value of the insurance policies was \$52.1 million and \$50.3 million, respectively.

### Senior Management Retention Plan

The Company, through the Bank, sponsors a Senior Management Retention Plan (SMRP) for certain senior level employees. The SMRP is a non-qualified defined contribution plan and was developed to supplement the Company's Profit Sharing Plan, which, as a qualified retirement plan, has a ceiling on benefits as set by the Internal Revenue Service. All contributions are discretionary and subject to the Board of Directors approval and vests 50% during the first and second year of participation. Contributions are invested primarily in stock of the Company. The Company expensed \$536,000 to the SMRP during the year ended December 31, 2013 and \$206,000 during the year ended December 31, 2012, the first year the plan was in place.

### 17. Fair Value Measurements

The Company follows the "Fair Value Measurement and Disclosures" topic of the FASB ASC, which establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. This standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, this standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Securities classified as available-for-sale are reported at fair value on a recurring basis utilizing Level 1, 2 and 3 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

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The Company does not record all loans & leases at fair value on a recurring basis. However, from time to time, a loan or lease is considered impaired and an allowance for credit losses is established. Once a loan or lease is identified as individually impaired, management measures impairment in accordance with the “Receivable” topic of the FASB ASC. The fair value of impaired loans or leases is estimated using one of several methods, including collateral value when the loan is collateral dependent, market value of similar debt, enterprise value, and discounted cash flows. Impaired loans & leases not requiring an allowance represent loans & leases for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans & leases. Impaired loans & leases where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. The fair value of collateral dependent impaired loans is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including sales comparison, cost and the income approach. Adjustments are often made in the appraisal process by the appraisers to take in to account differences between the comparable sales and income and other available data. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for Level 3 nonrecurring impaired loans is primarily the sales comparison approach less selling costs of 10%.

Other Real Estate (“ORE”) is reported at fair value on a non-recurring basis. Fair values are based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including sales comparison, cost and the income approach. Adjustments are often made in the appraisal process by the appraisers to take in to account differences between the comparable sales and income and other available data. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for Level 3 nonrecurring OREO is primarily the sales comparison approach less selling costs of 10%.

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

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

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| (in thousands)   | Fair Value | Fair Value Measurements<br>At December 31, 2012, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets |  |  |
|--|------------|---|--|--|
|  |            | for<br>Identical<br>Assets<br>(Level<br>1)  | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-Sale Securities:                           |            |   |  |  |
| Government Agency & Government-Sponsored Entities        | \$26,823   | \$21,731  | \$ 5,092                                   | \$ -   |
| Obligations of States and Political Subdivisions         | 5,665      | -   | -  | 5,665  |
| Mortgage Backed Securities                               | 352,772    | -   | 352,772                                    | -  |
| Corporate Securities                                     | 22,558     | 4,020   | 18,538                                     | -  |
| Other  | 10,173     | 9,863   | 310  | -  |
| Total Assets Measured at Fair Value On a Recurring Basis | \$417,991  | \$35,614  | \$ 376,712                                 | \$ 5,665   |

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the year ended December 31, 2013, \$5.6 million were transferred out of level 3 available-for-sale investment securities into held-to-maturity investment securities. During the year ended December 31, 2012, there were no transfers out of level 2 to level 3. The following table presents information about the activity of level 3 assets.

| (in thousands)   | 2013    | 2012    |
|--|---------|---------|
| Balance at Beginning of Period   | \$5,665 | \$5,782 |
| Total Realized and Unrealized Gains/(Losses) Included in Income        | -       | -       |
| Total Unrealized Gains/(Losses) Included in Other Comprehensive Income | -       | -       |
| Purchase of Securities   | -       | -       |
| Sales, Maturities, and Calls of Securities                             | (84 )   | (117 )  |
| Net Transfers out of Available for Sale Securities                     | (5,581) | -       |
| Balance at End of Period   | \$-     | \$5,665 |

Available for sale investments securities categorized as Level 3 assets primarily consist of obligations of states and political subdivisions. These bonds were issued by local housing authorities and have no active market. These bonds are carried at historical cost, which approximates fair value, unless economic conditions for the municipality changes to a degree requiring a valuation adjustment.

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

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

|                             | Fair Value Measurements<br>At December 31, 2012, Using |   |                                   |  |
|-----------------------------|--|---|-----------------------------------|--|
|                             | Fair Value   | Quoted Prices<br>in<br>Active<br>Markets<br>for Other<br>Identifiable<br>Assets<br>(Level<br>1) |                                   | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands)              |  | Total   | Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3)                |
| Impaired Loans              |  |   |                                   |  |
| Residential 1st Mortgage    | \$235  | \$-   | \$-                               | \$ 235   |
| Home Equity Lines and Loans | 462  | -   | -                                 | 462  |
| Agricultural                | 1,010  | -   | -                                 | 1,010  |
| Total Impaired Loans        | 1,707  | -   | -                                 | 1,707  |
| Other Real Estate           |  |   |                                   |  |
| Real Estate Construction    | 2,553  | -   | -                                 | 2,553  |

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|  |         |     |     |          |
|--|---------|-----|-----|----------|
| Total Other Real Estate                                      | 2,553   | -   | -   | 2,553    |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$4,260 | \$- | \$- | \$ 4,260 |

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



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The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at December 31, 2013:

| (in thousands)              | Fair Value | Valuation Technique       | Unobservable Inputs                                | Range, Weighted Avg. |
|-----------------------------|------------|---------------------------|--|----------------------|
| Impaired Loans              |            |                           |  |                      |
| Residential 1st Mortgage    | \$614      | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 1% -35%,<br>22 %     |
| Home Equity Lines and Loans | \$551      | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 2% - 34%,<br>11 %    |
| Agricultural                | \$366      | Income Approach           | Capitalization Rate                                | 14% - 14%,<br>14 %   |
| Commercial                  | \$820      | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 15% - 15%,<br>15 %   |
| Other Real Estate           |            |                           |  |                      |
| Real Estate Construction    | \$2,399    | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 10% - 10%,<br>10 %   |
| Agricultural Real Estate    | \$2,212    | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 10% - 10%,<br>10 %   |

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## 18. Fair Value of Financial Instruments

U.S. GAAP requires disclosure of fair value information about financial instruments, whether or not recognized on the balance sheet, for which it is practical to estimate that value. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization.

The following tables summarize the book value and estimated fair value of financial instruments for the periods indicated:

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

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|   |           |           |         |           |           |
|---|-----------|-----------|---------|-----------|-----------|
| Agricultural  | 244,209   | -         | -       | 242,950   | 242,950   |
| Commercial  | 144,701   | -         | -       | 145,131   | 145,131   |
| Consumer & Other  | 4,876     | -         | -       | 4,912     | 4,912     |
| Leases  | 12,094    | -         | -       | 11,851    | 11,851    |
| Unallocated Allowance                                     | (2,274 )  | -         | -       | (2,274 )  | (2,274 )  |
| Total Loans & Leases, Net of Deferred Fees<br>& Allowance | 1,353,962 | -         | -       | 1,364,466 | 1,364,466 |
| Accrued Interest Receivable                               | 6,941     | -         | 6,941   | -         | 6,941     |
| Liabilities:  |           |           |         |           |           |
| Deposits:   |           |           |         |           |           |
| Demand  | 495,963   | 495,963   | -       | -         | 495,963   |
| Interest Bearing Transaction                              | 291,795   | 291,795   | -       | -         | 291,795   |
| Savings and Money Market                                  | 589,511   | 589,511   | -       | -         | 589,511   |
| Time  | 430,422   | -         | 430,752 | -         | 430,752   |
| Total Deposits  | 1,807,691 | 1,377,269 | 430,752 | -         | 1,808,021 |
| Subordinated Debentures                                   | 10,310    | -         | 6,224   | -         | 6,224     |
| Accrued Interest Payable                                  | 352       | -         | 352     | -         | 352       |

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| December 31, 2012<br>(in thousands)   | Carrying<br>Amount | Fair Value of Financial Instruments Using<br>Quoted<br>Prices in<br>Active<br>Markets<br>for |  |  |           | Total<br>Estimated<br>Fair Value |           |    |   |
|---|--------------------|--|--|--|-----------|----------------------------------|-----------|----|---|
|   |                    | Identical<br>Assets<br>(Level 1)   | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |           |                                  |           |    |   |
| Assets:   |                    |  |  |  |           |                                  |           |    |   |
| Cash and Cash Equivalents   | \$ 129,426         | \$ 129,426   | \$ -                                       | \$ -   |           | \$ 129,426                       |           |    |   |
| Investment Securities Available-for-Sale:   |                    |  |  |  |           |                                  |           |    |   |
| Government Agency &<br>Government-Sponsored Entities<br>Obligations of States and Political<br>Subdivisions | 26,823             | 21,731   | 5,092                                      | -  |           | 26,823                           |           |    |   |
| Mortgage Backed Securities  | 5,665              | -  | -  | 5,665  |           | 5,665                            |           |    |   |
| Corporate Securities  | 352,772            | -  | 352,772                                    | -  |           | 352,772                          |           |    |   |
| Other   | 22,558             | 4,020  | 18,538                                     | -  |           | 22,558                           |           |    |   |
| Total Investment Securities<br>Available-for-Sale   | 10,173             | 9,863  | 310  | -  |           | 10,173                           |           |    |   |
|   | 417,991            | 35,614   | 376,712                                    | 5,665  |           | 417,991                          |           |    |   |
| Investment Securities Held-to-Maturity:   |                    |  |  |  |           |                                  |           |    |   |
| Obligations of States and Political<br>Subdivisions   | 65,694             | -  | 60,177                                     | 7,810  |           | 67,987                           |           |    |   |
| Mortgage Backed Securities  | 484                | -  | 496  | -  |           | 496                              |           |    |   |
| Other   | 2,214              | -  | 2,214                                      | -  |           | 2,214                            |           |    |   |
| Total Investment Securities<br>Held-to-Maturity   | 68,392             | -  | 62,887                                     | 7,810  |           | 70,697                           |           |    |   |
| FHLB Stock  | 7,368              | N/   | A  | N/   | A         | N/                               | A         | N/ | A |
| Loans, Net of Deferred Loan Fees &<br>Allowance:  |                    |  |  |  |           |                                  |           |    |   |
| Commercial Real Estate  | 344,084            | -  | -  |  | 349,524   |                                  | 349,524   |    |   |
| Agricultural Real Estate  | 309,115            | -  | -  |  | 316,302   |                                  | 316,302   |    |   |
| Real Estate Construction  | 31,694             | -  | -  |  | 32,024    |                                  | 32,024    |    |   |
| Residential 1st Mortgages   | 139,038            | -  | -  |  | 144,203   |                                  | 144,203   |    |   |
| Home Equity Lines and Loans   | 38,807             | -  | -  |  | 41,419    |                                  | 41,419    |    |   |
| Agricultural  | 210,595            | -  | -  |  | 209,578   |                                  | 209,578   |    |   |
| Commercial  | 135,330            | -  | -  |  | 134,647   |                                  | 134,647   |    |   |
| Consumer & Other  | 4,876              | -  | -  |  | 4,847     |                                  | 4,847     |    |   |
| Unallocated Allowance   | (854 )             | -  | -  |  | (854 )    |                                  | (854 )    |    |   |
| Total Loans, Net of Deferred Loan Fees &<br>Allowance   | 1,212,685          | -  | -  |  | 1,231,690 |                                  | 1,231,690 |    |   |
| Accrued Interest Receivable   | 6,389              | -  | -  |  | 6,389     |                                  | 6,389     |    |   |
| Liabilities:  |                    |  |  |  |           |                                  |           |    |   |
| Deposits:   |                    |  |  |  |           |                                  |           |    |   |
| Demand  | 462,251            | 462,251  | -  |  | -         |                                  | 462,251   |    |   |

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|                              |           |           |         |   |           |
|------------------------------|-----------|-----------|---------|---|-----------|
| Interest Bearing Transaction | 259,141   | 259,141   | -       | - | 259,141   |
| Savings and Money Market     | 541,526   | 541,526   | -       | - | 541,526   |
| Time                         | 459,108   | -         | 459,993 | - | 459,993   |
| Total Deposits               | 1,722,026 | 1,262,918 | 459,993 | - | 1,722,911 |
| Subordinated Debentures      | 10,310    | -         | 5,750   | - | 5,750     |
| Accrued Interest Payable     | 498       | -         | 498     | - | 498       |

Fair value estimates presented herein are based on pertinent information available to management as of December 31, 2013 and December 31, 2012. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purpose of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above. The methods and assumptions used to estimate the fair value of each class of financial instrument listed in the table above are explained below.

Cash and Cash Equivalents - The carrying amounts reported in the balance sheet for cash and due from banks, interest-bearing deposits with banks, federal funds sold, and securities purchased under agreements to resell are a reasonable estimate of fair value. All cash and cash equivalents are classified as Level 1.

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Investment Securities - Fair values for investment securities consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Based on the available market information the classification level could be 1, 2, or 3.

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

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

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

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

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

## 19. Commitments and Contingencies

In the normal course of business, the Company enters in to financial instruments with off balance sheet risk in order to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These instruments include commitments to extend credit, letters of credit, and other types of financial guarantees. The Company had the following off balance sheet commitments as of the dates indicated.

| (in thousands)  | December<br>31, 2013 | December<br>31, 2012 |
|---|----------------------|----------------------|
| Commitments to Extend Credit  | \$445,294            | \$334,772            |
| Letters of Credit   | 7,393                | 5,281                |
| Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our<br>Borrowing Customers and Third Parties | -                    | 1,796                |

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

creditworthiness are performed on a case-by-case basis.

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. Outstanding standby letters of credit have maturity dates ranging from 1 to 58 months with final expiration in October 2018. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee.

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The Company is obligated under a number of noncancellable operating leases for premises and equipment used for banking purposes. Minimum future rental commitments under noncancellable operating leases as of December 31, 2013, were \$341,000, \$344,000, \$187,000, \$87,000, and \$77,000 for the years 2014 through 2018.

In the ordinary course of business, the Company becomes involved in litigation arising out of its normal business activities. Management, after consultation with legal counsel, believes that the ultimate liability, if any, resulting from the disposition of such claims would not be material in relation to the financial position of the Company.

The Company may be required to maintain average reserves on deposit with the Federal Reserve Bank primarily based on deposits outstanding. There were no reserve requirements during 2013 or 2012.

## 20. Recent Accounting Developments

In February 2013, the FASB issued Accounting Standards Update (ASU) No. 2013-02, Comprehensive Income (Topic 220)—Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of this Update is to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this Update seek to attain that objective by requiring an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles (GAAP) to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. The new guidance is effective for reporting periods beginning after December 15, 2012. The adoption of this ASU did not have a material impact on the Company's financial position, results of operation, cash flows, or disclosure.

## 21. Parent Company Financial Information

The following financial information is presented as of December 31 for the periods indicated.

Farmers & Merchants Bancorp  
Condensed Balance Sheets

| (in thousands)   | 2013      | 2012      |
|--|-----------|-----------|
| Cash   | \$416     | \$212     |
| Investment in Farmers & Merchants Bank of Central California | 219,640   | 214,755   |
| Investment Securities  | 410       | 410       |
| Other Assets   | 87        | 267       |
| Total Assets   | \$220,553 | \$215,644 |
| Subordinated Debentures                                      | \$10,310  | \$10,310  |
| Liabilities  | 339       | 301       |
| Shareholders' Equity   | 209,904   | 205,033   |
| Total Liabilities and Shareholders' Equity                   | \$220,553 | \$215,644 |



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Condensed Statements of Income

| (in thousands)   | Year Ended December 31, |          |          |
|--|-------------------------|----------|----------|
|  | 2013                    | 2012     | 2011     |
| Equity in Undistributed Earnings in Farmers & Merchants Bank of Central California | \$14,352                | \$13,247 | \$12,715 |
| Dividends from Subsidiary  | 10,450                  | 10,900   | 10,325   |
| Interest Income  | 10                      | 10       | 10       |
| Other Expenses, Net  | (1,288)                 | (1,386)  | (1,443)  |
| Tax Benefit  | 537                     | 578      | 602      |
| Net Income   | \$24,061                | \$23,349 | \$22,209 |

Farmers & Merchants Bancorp  
Condensed Statements of Cash Flows

| (in thousands)  | Year Ended December 31, |          |          |
|---|-------------------------|----------|----------|
|   | 2013                    | 2012     | 2011     |
| Cash Flows from Operating Activities:   |                         |          |          |
| Net Income  | \$24,061                | \$23,349 | \$22,209 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                         |          |          |
| Equity in Undistributed Net Earnings from Subsidiary                              | (14,352)                | (13,247) | (12,715) |
| Net Decrease (Increase) in Other Assets   | 38                      | (216)    | (3)      |
| Net Increase (Decrease) in Liabilities  | 180                     | (78)     | 56       |
| Net Cash Provided by Operating Activities   | 9,927                   | 9,808    | 9,547    |
| Investing Activities:   |                         |          |          |
| Securities Purchased  | -                       | -        | (1,296)  |
| Securities Sold or Matured  | -                       | -        | 1,196    |
| Net Cash Used by Investing Activities   | -                       | -        | (100)    |
| Financing Activities:   |                         |          |          |
| Stock Repurchased   | -                       | (576)    | -        |
| Cash Dividends  | (9,723)                 | (9,418)  | (9,158)  |
| Net Cash Used by Financing Activities   | (9,723)                 | (9,994)  | (9,158)  |
| Increase (Decrease) in Cash and Cash Equivalents                                  | 204                     | (186)    | 289      |
| Cash and Cash Equivalents at Beginning of Year                                    | 212                     | 398      | 109      |
| Cash and Cash Equivalents at End of Year  | \$416                   | \$212    | \$398    |

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

The Company maintains controls and procedures designed to ensure that all relevant information is recorded and reported in all filings of financial reports. Such information is reported to the Company's management, including its Chief Executive Officer and its Chief Financial Officer to allow timely and accurate disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e). In accordance with Rule 13a-15(b) of the Exchange Act, we carried out an evaluation as of December 31, 2013, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective as of December 31, 2013.

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

Management's report on internal control over financial reporting is set forth in "Item 8. Financial Statements and Supplementary Data," and is incorporated herein by reference. Moss Adams LLP, the independent registered public accounting firm that audited the consolidated financial statements included in this Annual Report, was engaged to audit the effectiveness of the Company's internal control over financial reporting. The report of Moss Adams LLP, which is set forth in "Item 8. Financial Statements and Supplementary Data," is incorporated herein by reference.

Item 9B. Other Information

None

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## PART III

## Item 10. Directors, Executive Officers and Corporate Governance

Set forth below is certain information regarding the Named Executive Officers of the Company and/or Bank:

| <u>Name and Position(s)</u>   | <u>Age</u> | <u>Principal Occupation during the Past Five Years</u>  |
|---|------------|---|
| Kent A. Steinwert<br>Chairman, President<br>& Chief Executive Officer<br>of the Company and Bank                    | 61         | Chairman, President & Chief Executive Officer of the Company and Bank since May 1, 2010.<br><br>President & Chief Executive Officer of the Company and Bank up to April 30, 2010.           |
| Deborah E. Skinner<br>Executive Vice President & Chief<br>Administrative Officer of the Bank                        | 51         | Executive Vice President & Chief Administrative Officer of the Bank.  |
| Stephen W. Haley<br>Executive Vice President<br>& Chief Financial Officer & Secretary of the<br>Company and<br>Bank | 60         | Executive Vice President & Chief Financial Officer of the Company and Bank.   |
| Kenneth W. Smith<br>Executive Vice President<br>& Senior Credit Officer<br>of the Company and Bank                  | 54         | Executive Vice President & Senior Credit Officer of the Company and Bank since August 9, 2011.<br><br>Executive Vice President & Head of Business Markets of the Bank up to August 8, 2011. |
| Vicki P. Kennedy<br>Executive Vice President<br>& Retail Banking Manager<br>of the Bank                             | 65         | Executive Vice President & Retail Banking Manager of the Bank.  |

Also, see “Election of Directors” and “Compliance with Section 16(a) of the Exchange Act” in the Company’s definitive proxy statement for the 2014 Annual Meeting of Stockholders which will be filed with the SEC and which is incorporated herein by reference. During 2013 there were no changes in procedures for the election of directors.

The Company has adopted a Code of Conduct, which complies with the Code of Ethics requirements of the SEC. A copy of the Code of Conduct is posted on the Company’s website. The Company intends to disclose promptly any amendment to, or waiver from any provision of, the Code of Conduct applicable to senior financial officers, and any waiver from any provision of the Code of Conduct applicable to directors, on its website on the About Us page. The Company’s website address is [www.fmbonline.com](http://www.fmbonline.com).

## Item 11. Executive Compensation

The information required by Item 11 of Form 10-K is incorporated by reference from the information contained in the Company’s definitive proxy statement for the 2014 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by Item 12 of Form 10-K is incorporated by reference from the information contained in the Company's definitive proxy statement for the 2014 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A. The Company does not have any equity compensation plans, which require disclosure under Item 201(d) of Regulation S-K.

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Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by Item 13 of Form 10-K is incorporated by reference from the information contained in the Company's definitive proxy statement for the 2014 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A.

Item 14. Principal Accounting Fees and Services

The information required by Item 14 of Form 10-K is incorporated by reference from the information contained in the Company's definitive proxy statement for the 2014 Annual Meeting of Stockholders, which will be filed pursuant to Regulation 14A.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) (1) Financial Statements. Incorporated herein by reference, are listed in Item 8 hereof.

(2) Financial Statement Schedules. None

(b) See "Index to Exhibits"

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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  
(Registrant)

By/s/ Stephen W. Haley

Dated: March 14, 2014      Stephen W. Haley  
Executive Vice President &  
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 14, 2014.

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

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

/s/ Bruce A. Mettler              /s/ Calvin Suess  
Bruce A. Mettler, Director      Calvin Suess, Director

/s/ Stewart C. Adams, Jr.        /s/ Kevin Sanguinetti  
Stewart C. Adams, Jr., Director      Kevin Sanguinetti, Director

/s/ Edward Corum, Jr.            /s/ Carl Wishek, Jr.  
Edward Corum, Jr., Director      Carl Wishek, Jr., Director

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Index to Exhibit

Exhibit

No.      Description

|              |   |
|--------------|---|
| 3.1          | Amended Certificate of Incorporation (incorporated by reference to Appendices 1 and 2 to the Registrant's Definitive Proxy Statement on Schedule 14A for its 2007 Annual Meeting of Stockholders and Exhibit 3(i) to the Registrant's Current Report on Form 8-K dated April 30, 1999).   |
| 3.2          | Amended By-Laws (incorporated by reference to the Registrant's Current Report on Form 8-K dated September 19, 2008, Appendix 3 to the Registrant's Definitive Proxy Statement on Schedule 14A for its 2007 Annual Meeting of Stockholders, Exhibit 3.1 to the Registrant's Current Report on Form 8-K dated June 7, 2005, and Exhibit 3(ii) to the Registrant's Current Report on Form 8-K dated April 30, 1999). |
| 3.3          | Certificate of Designation for the Series A Junior Participating Preferred Stock (included as Exhibit A to the Rights Agreement between Farmers & Merchants Bancorp and Registrar and Transfer Company, dated as of August 5, 2008, filed as Exhibit 4.1 below), filed on the Registrant's Form 10-Q for the quarter ended June 30, 2008, is incorporated herein by reference.                                    |
| 4.1          | Rights Agreement between Farmers & Merchants Bancorp and Registrar and Transfer Company, dated as of August 5, 2008, including Form of Right Certificate attached thereto as Exhibit B, filed on the Registrant's Form 10-Q for the quarter ended June 30, 2008, is incorporated herein by reference.   |
| <u>10.1</u>  | Amended and Restated Employment Agreement effective April 1, 2014, between Farmers & Merchants Bank of Central California and Kent A. Steinwert, filed on Registrant's Form 10-K for the year ended December 31, 2013.  |
| <u>10.3</u>  | Amended and Restated Employment Agreement effective April 1, 2014, between Farmers & Merchants Bank of Central California and Deborah E. Skinner, filed on Registrant's Form 10-K for the year ended December 31, 2013.   |
| <u>10.4</u>  | Amended and Restated Employment Agreement effective April 1, 2014, between Farmers & Merchants Bank of Central California and Kenneth W. Smith, filed on Registrant's Form 10-K for the year ended December 31, 2013.   |
| 10.5         | Amended and Restated Employment Agreement effective April 1, 2009, between Farmers & Merchants Bank of Central California and Richard S. Erichson, filed on Registrant's Form 10-K for the year ended December 31, 2008, is incorporated herein by reference.   |
| <u>10.6</u>  | Amended and Restated Employment Agreement effective April 1, 2014, between Farmers & Merchants Bank of Central California and Stephen W. Haley, filed on Registrant's Form 10-K for the year ended December 31, 2013.   |
| <u>10.8</u>  | Employment Agreement effective April 1, 2014, between Farmers & Merchants Bank of Central California and Jay Colombini, filed on Registrant's Form 10-K for the year ended December 31, 2013.   |
| <u>10.9</u>  | Employment Agreement effective April 1, 2014, between Farmers & Merchants Bank of Central California and James Daugherty, filed on Registrant's Form 10-K for the year ended December 31, 2013.   |
| 10.15        | Executive Retirement Plan – Performance Component as amended on November 5, 2010, filed on Registrant's Form 10-Q for the period ended September 30, 2010, is incorporated herein by reference.   |
| 10.16        | Executive Retirement Plan – Retention Component as amended on November 5, 2010, filed on Registrant's Form 10-Q for the period ended September 30, 2010, is incorporated herein by reference.   |
| <u>10.17</u> | Executive Retirement Plan – Salary Component, amended and restated on February 27, 2014, filed on Registrant's Form 10-K for the year ended December 31, 2013.  |
| 10.18        | Deferred Compensation Plan of Farmers & Merchants Bank of Central California, as amended on November 5, 2010, filed on Registrant's Form 10-Q for the period ended September 30, 2010, is incorporated herein by reference.   |
| <u>10.19</u> | Executive Retirement Plan – Equity Component, amended and restated on November 22, 2013, filed on Registrant's Form 10-K for the year ended December 31, 2013.  |
| <u>10.20</u> |   |

Senior Management Retention Plan, amended and restated on November 22, 2013, filed on Registrant's Form 10-K for the year ended December 31, 2013.



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|              |  |
|--------------|--|
| 14           | Code of Conduct of Farmers & Merchants Bancorp, filed on Registrant's Form 10-K for the year ended December 31, 2003, is incorporated herein by reference.                         |
| 21           | Subsidiaries of the Registrant, filed on Registrant's Form 10-K for the year ended December 31, 2003, is incorporated herein by reference.   |
| <u>31(a)</u> | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| <u>31(b)</u> | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| <u>32</u>    | Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS      | XBRL Instance Document   |
| 101.SCH      | XBRL Schema Document   |
| 101.CAL      | XBRL Calculation Linkbase Document   |
| 101.LAB      | XBRL Label Linkbase Document   |
| 101.PRE      | XBRL Presentation Linkbase Document  |
| 101.DEF      | XBRL Definition Linkbase Document  |