

FARMERS & MERCHANTS BANCORP  
Form 10-Q  
August 08, 2016

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

FORM 10-Q

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

For the quarterly period ended June 30, 2016

or

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

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

Commission File Number: 000-26099

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

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

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

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

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

Yes No

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

No

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

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

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

Number of shares of common stock of the registrant 792,387 outstanding as of July 31, 2016.

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FARMERS & MERCHANTS BANCORP

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

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

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

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Balance Sheets

(in thousands, except shares)

|                                                                                                                                                                                                                | June 30,<br>2016<br>(Unaudited) | December 31,<br>2015 | June 30,<br>2015<br>(Unaudited) |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|----------------------|---------------------------------|
| <b>Assets</b>                                                                                                                                                                                                  |                                 |                      |                                 |
| <b>Cash and Cash Equivalents:</b>                                                                                                                                                                              |                                 |                      |                                 |
| Cash and Due from Banks                                                                                                                                                                                        | \$ 46,524                       | \$ 49,913            | \$ 45,017                       |
| Interest Bearing Deposits with Banks                                                                                                                                                                           | 23,232                          | 9,533                | 46,322                          |
| Total Cash and Cash Equivalents                                                                                                                                                                                | 69,756                          | 59,446               | 91,339                          |
| <b>Investment Securities:</b>                                                                                                                                                                                  |                                 |                      |                                 |
| Available-for-Sale                                                                                                                                                                                             | 362,223                         | 369,137              | 351,424                         |
| Held-to-Maturity                                                                                                                                                                                               | 60,949                          | 61,396               | 67,401                          |
| Total Investment Securities                                                                                                                                                                                    | 423,172                         | 430,533              | 418,825                         |
| <b>Loans &amp; Leases</b>                                                                                                                                                                                      |                                 |                      |                                 |
| Loans & Leases                                                                                                                                                                                                 | 2,068,107                       | 1,996,359            | 1,818,642                       |
| Less: Allowance for Credit Losses                                                                                                                                                                              | 44,118                          | 41,523               | 39,037                          |
| Loans & Leases, Net                                                                                                                                                                                            | 2,023,989                       | 1,954,836            | 1,779,605                       |
| <b>Premises and Equipment, Net</b>                                                                                                                                                                             |                                 |                      |                                 |
| Premises and Equipment, Net                                                                                                                                                                                    | 26,055                          | 26,575               | 27,195                          |
| Bank Owned Life Insurance                                                                                                                                                                                      | 56,846                          | 55,898               | 54,933                          |
| Interest Receivable and Other Assets                                                                                                                                                                           | 91,047                          | 88,057               | 84,862                          |
| Total Assets                                                                                                                                                                                                   | \$ 2,690,865                    | \$ 2,615,345         | \$ 2,456,759                    |
| <b>Liabilities</b>                                                                                                                                                                                             |                                 |                      |                                 |
| <b>Deposits:</b>                                                                                                                                                                                               |                                 |                      |                                 |
| Demand                                                                                                                                                                                                         | \$ 646,408                      | \$ 711,029           | \$ 613,042                      |
| Interest Bearing Transaction                                                                                                                                                                                   | 452,758                         | 377,594              | 349,404                         |
| Savings and Money Market                                                                                                                                                                                       | 726,580                         | 707,885              | 706,121                         |
| Time                                                                                                                                                                                                           | 502,200                         | 481,024              | 494,569                         |
| Total Deposits                                                                                                                                                                                                 | 2,327,946                       | 2,277,532            | 2,163,136                       |
| <b>Subordinated Debentures</b>                                                                                                                                                                                 |                                 |                      |                                 |
| Subordinated Debentures                                                                                                                                                                                        | 10,310                          | 10,310               | 10,310                          |
| Interest Payable and Other Liabilities                                                                                                                                                                         | 87,337                          | 75,668               | 42,149                          |
| Total Liabilities                                                                                                                                                                                              | 2,425,593                       | 2,363,510            | 2,215,595                       |
| <b>Shareholders' Equity</b>                                                                                                                                                                                    |                                 |                      |                                 |
| <b>Preferred Stock: No Par Value, 1,000,000 Shares Authorized,<br/>None Issued or Outstanding</b>                                                                                                              |                                 |                      |                                 |
|                                                                                                                                                                                                                | -                               | -                    | -                               |
| <b>Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized,<br/>792,387, 790,787 and 785,782 Shares Issued and Outstanding at<br/>June 30, 2016, December 31, 2015 and June 30, 2015,<br/>Respectively</b> |                                 |                      |                                 |
|                                                                                                                                                                                                                | 8                               | 8                    | 8                               |
| Additional Paid-In Capital                                                                                                                                                                                     | 82,004                          | 81,164               | 78,569                          |
| Retained Earnings                                                                                                                                                                                              | 179,382                         | 170,068              | 160,956                         |

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|                                            |              |              |              |
|--------------------------------------------|--------------|--------------|--------------|
| Accumulated Other Comprehensive Income     | 3,878        | 595          | 1,631        |
| Total Shareholders' Equity                 | 265,272      | 251,835      | 241,164      |
| Total Liabilities and Shareholders' Equity | \$ 2,690,865 | \$ 2,615,345 | \$ 2,456,759 |

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

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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Income (Unaudited)

| (in thousands except per share data)                  | Three Months           |          | Six Months             |          |
|-------------------------------------------------------|------------------------|----------|------------------------|----------|
|                                                       | Ended June 30,<br>2016 | 2015     | Ended June 30,<br>2016 | 2015     |
| Interest Income                                       |                        |          |                        |          |
| Interest and Fees on Loans & Leases                   | \$22,492               | \$19,606 | \$44,386               | \$38,733 |
| Interest on Deposits with Banks                       | 36                     | 65       | 82                     | 123      |
| Interest on Investment Securities:                    |                        |          |                        |          |
| Taxable                                               | 1,301                  | 1,582    | 2,903                  | 3,168    |
| Exempt from Federal Tax                               | 485                    | 503      | 969                    | 1,025    |
| Total Interest Income                                 | 24,314                 | 21,756   | 48,340                 | 43,049   |
| Interest Expense                                      |                        |          |                        |          |
| Deposits                                              | 859                    | 754      | 1,687                  | 1,466    |
| Borrowed Funds                                        | -                      | -        | 4                      | -        |
| Subordinated Debentures                               | 92                     | 81       | 180                    | 161      |
| Total Interest Expense                                | 951                    | 835      | 1,871                  | 1,627    |
| Net Interest Income                                   | 23,363                 | 20,921   | 46,469                 | 41,422   |
| Provision for Credit Losses                           | -                      | 50       | 2,600                  | 650      |
| Net Interest Income After Provision for Credit Losses | 23,363                 | 20,871   | 43,869                 | 40,772   |
| Non-Interest Income                                   |                        |          |                        |          |
| Service Charges on Deposit Accounts                   | 826                    | 865      | 1,640                  | 1,763    |
| Net Gain (Loss) on Sale of Investment Securities      | -                      | 5        | (289 )                 | 6        |
| Increase in Cash Surrender Value of Life Insurance    | 474                    | 479      | 948                    | 943      |
| Debit Card and ATM Fees                               | 858                    | 804      | 1,693                  | 1,581    |
| Net Gain (Loss) on Deferred Compensation Investments  | 48                     | (216 )   | 339                    | 549      |
| Other                                                 | 669                    | 889      | 1,265                  | 2,648    |
| Total Non-Interest Income                             | 2,875                  | 2,826    | 5,596                  | 7,490    |
| Non-Interest Expense                                  |                        |          |                        |          |
| Salaries and Employee Benefits                        | 10,083                 | 9,566    | 21,789                 | 19,665   |
| Net Gain (Loss) on Deferred Compensation Investments  | 48                     | (216 )   | 339                    | 549      |
| Occupancy                                             | 713                    | 746      | 1,454                  | 1,385    |
| Equipment                                             | 842                    | 776      | 1,699                  | 1,508    |
| Marketing                                             | 363                    | 186      | 662                    | 322      |
| FDIC Insurance                                        | 324                    | 297      | 640                    | 581      |
| Gain on Sale of ORE                                   | (257 )                 | (299 )   | (5,941 )               | (299 )   |
| Other                                                 | 2,621                  | 1,705    | 6,114                  | 3,268    |
| Total Non-Interest Expense                            | 14,737                 | 12,761   | 26,756                 | 26,979   |
| Income Before Income Taxes                            | 11,501                 | 10,936   | 22,709                 | 21,283   |
| Provision for Income Taxes                            | 4,169                  | 4,187    | 8,205                  | 8,131    |
| Net Income                                            | \$7,332                | \$6,749  | \$14,504               | \$13,152 |
| Basic Earnings Per Common Share                       | \$9.25                 | \$8.59   | \$18.31                | \$16.74  |

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





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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Comprehensive Income (Unaudited)

| (in thousands)                                                                                               | Three Months   |          | Six Months     |           |
|--------------------------------------------------------------------------------------------------------------|----------------|----------|----------------|-----------|
|                                                                                                              | Ended June 30, |          | Ended June 30, |           |
|                                                                                                              | 2016           | 2015     | 2016           | 2015      |
| Net Income                                                                                                   | \$ 7,332       | \$ 6,749 | \$ 14,504      | \$ 13,152 |
| Other Comprehensive Income (Loss)                                                                            |                |          |                |           |
| Change in Net Unrealized Gain (Loss) on Available-for-Sale Securities                                        | 1,181          | (3,177 ) | 5,376          | (1,550 )  |
| Deferred Tax (Expense) Benefit Related to Unrealized Gains                                                   | (497 )         | 1,335    | (2,261 )       | 651       |
| Reclassification Adjustment for Realized (Gain) Loss on Available-for-Sale Securities Included in Net Income | -              | (5 )     | 289            | (6 )      |
| Deferred Tax (Expense) Benefit Related to Reclassification Adjustment                                        | (410 )         | 4        | (121 )         | 3         |
| Change in Net Unrealized Gain (Loss) on Available-for-Sale Securities, Net of Tax                            | 274            | (1,843 ) | 3,283          | (902 )    |
| Total Other Comprehensive Income (Loss)                                                                      | 274            | (1,843 ) | 3,283          | (902 )    |
| Comprehensive Income                                                                                         | \$ 7,606       | \$ 4,906 | \$ 17,787      | \$ 12,250 |

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

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## FARMERS &amp; MERCHANTS BANCORP

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

| (in thousands except share data)                                                     | Common<br>Shares<br>Outstanding | Common<br>Stock<br>\$ | Additional<br>Paid-In<br>Capital<br>\$ | Retained<br>Earnings<br>\$ | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss), net<br>\$ | Total<br>Shareholders'<br>Equity<br>\$ |
|--------------------------------------------------------------------------------------|---------------------------------|-----------------------|----------------------------------------|----------------------------|----------------------------------------------------------------------|----------------------------------------|
| Balance, January 1, 2015                                                             | 784,082                         | 8                     | \$ 77,804                              | \$ 152,833                 | \$ 2,533                                                             | \$ 233,178                             |
| Net Income                                                                           |                                 | -                     | -                                      | 13,152                     | -                                                                    | 13,152                                 |
| Cash Dividends Declared on Common<br>Stock (\$6.40 per share)                        |                                 | -                     | -                                      | (5,029 )                   | -                                                                    | (5,029 )                               |
| Issuance of Common Stock                                                             | 1,700                           | -                     | 765                                    | -                          | -                                                                    | 765                                    |
| Change in Net Unrealized Gain (Loss) on<br>Securities Available-for-Sale, Net of Tax |                                 | -                     | -                                      | -                          | (902 )                                                               | (902 )                                 |
| Balance, June 30, 2015                                                               | 785,782                         | 8                     | \$ 78,569                              | \$ 160,956                 | \$ 1,631                                                             | \$ 241,164                             |
| Balance, January 1, 2016                                                             | 790,787                         | 8                     | \$ 81,164                              | \$ 170,068                 | \$ 595                                                               | \$ 251,835                             |
| Net Income                                                                           |                                 | -                     | -                                      | 14,504                     | -                                                                    | 14,504                                 |
| Cash Dividends Declared on Common<br>Stock (\$6.55 per share)                        |                                 | -                     | -                                      | (5,190 )                   | -                                                                    | (5,190 )                               |
| Issuance of Common Stock                                                             | 1,600                           | -                     | 840                                    | -                          | -                                                                    | 840                                    |
| Change in Net Unrealized Gain (Loss) on<br>Securities Available-for-Sale, Net of Tax |                                 | -                     | -                                      | -                          | 3,283                                                                | 3,283                                  |
| Balance, June 30, 2016                                                               | 792,387                         | 8                     | \$ 82,004                              | \$ 179,382                 | \$ 3,878                                                             | \$ 265,272                             |

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

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## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Cash Flows (Unaudited)

| (in thousands)                                                                       | Six Months Ended |                  |
|--------------------------------------------------------------------------------------|------------------|------------------|
|                                                                                      | June 30,<br>2016 | June 30,<br>2015 |
| Operating Activities:                                                                |                  |                  |
| Net Income                                                                           | \$14,504         | \$13,152         |
| Adjustments to Reconcile Net Income to Net<br>Cash Provided by Operating Activities: |                  |                  |
| Provision for Credit Losses                                                          | 2,600            | 650              |
| Depreciation and Amortization                                                        | 950              | 751              |
| Net Amortization of Investment Security Premiums & Discounts                         | 730              | 778              |
| Net Gain on Sale of Investment Securities                                            | 289              | (6 )             |
| Net Gain on Sale of Property & Equipment                                             | 4                | -                |
| Net Gain on Sale of Other Real Estate                                                | (5,941 )         | (299 )           |
| Net Change in Operating Assets & Liabilities:                                        |                  |                  |
| Net (Increase) Decrease in Interest Receivable and Other Assets                      | (2,666 )         | 1,669            |
| Net Decrease (Increase) in Interest Payable and Other Liabilities                    | 194              | (729 )           |
| Net Cash Provided by Operating Activities                                            | 10,664           | 15,966           |
| Investing Activities:                                                                |                  |                  |
| Purchase of Investment Securities Available-for-Sale                                 | (188,885)        | (80,210 )        |
| Proceeds from Sold, Matured or Called Securities Available-for-Sale                  | 212,313          | 93,217           |
| Purchase of Investment Securities Held-to-Maturity                                   | (1,246 )         | (8,753 )         |
| Proceeds from Matured or Called Securities Held-to-Maturity                          | 1,668            | 5,185            |
| Net Loans & Leases Paid, Originated or Acquired                                      | (71,853 )        | (106,444)        |
| Principal Collected on Loans & Leases Previously Charged Off                         | 100              | 3,032            |
| Additions to Premises and Equipment                                                  | (434 )           | (2,125 )         |
| Purchase of Other Investments                                                        | (5,523 )         | (844 )           |
| Proceeds from Sale of Other Real Estate                                              | 8,282            | 1,156            |
| Net Cash Used by Investing Activities                                                | (45,578 )        | (95,786 )        |
| Financing Activities:                                                                |                  |                  |
| Net Increase in Deposits                                                             | 50,414           | 99,063           |
| Cash Dividends                                                                       | (5,190 )         | (5,029 )         |
| Net Cash Provided by Financing Activities                                            | 45,224           | 94,034           |
| Increase in Cash and Cash Equivalents                                                | 10,310           | 14,214           |
| Cash and Cash Equivalents at Beginning of Period                                     | 59,446           | 77,125           |
| Cash and Cash Equivalents at End of Period                                           | \$69,756         | \$91,339         |
| Supplementary Data                                                                   |                  |                  |
| Loans Transferred to Foreclosed Assets (ORE)                                         | \$538            | \$-              |
| Cash Payments Made for Income Taxes                                                  | \$7,461          | \$3,055          |
| Issuance of Common Stock to the Bank's Non-Qualified Retirement Plans                | \$840            | \$765            |
| Interest Paid                                                                        | \$1,814          | \$1,449          |

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

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FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

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

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

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

Basis of Presentation

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

These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with U.S. GAAP have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015. The results of operations for the three-month and six-month periods ended June 30, 2016 may not necessarily be indicative of future operating results.

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

The preparation of consolidated financial statements in conformity with U. S. GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

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



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### Cash and Cash Equivalents

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

### Investment Securities

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

Securities are classified as available-for-sale (“AFS”) 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.

### 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. Impaired loans or leases are either: (1) non-accrual loans & leases; or (2) restructured loans & leases that are still accruing interest. Loans or leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

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

Generally, the Company will not restructure loans or leases for borrowers unless: (1) the existing loan or lease is brought current as to principal and interest payments; and (2) the restructured loan or lease can be underwritten to reasonable underwriting standards. If these standards are not met other actions will be pursued (e.g., foreclosure) to collect outstanding loan or lease amounts. After restructure a determination is made whether the loan or lease will be kept on accrual status based upon the underwriting and historical performance of the restructured credit.

### Allowance for Credit Losses

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

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

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

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to



examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

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

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

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

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

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

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

Commercial Real Estate – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

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

Commercial – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agricultural Real Estate and Agricultural – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related

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

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

Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the correction in residential real estate values that occurred between 2007 and 2012. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

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

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

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

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

### Premises and Equipment

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

### Other Real Estate

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

#### Income Taxes

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

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

The Company accounts for leases with Investment Tax Credits (ITC) under the deferred method as established in ASC 740-10. ITC are viewed and accounted for as a reduction of the cost of the related assets and presented as deferred income on the Company’s financial statement.

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 would be reflected as a liability for unrecognized tax benefits in the consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest expense and penalties associated with unrecognized tax benefits, if any, are included in the provision for income taxes in the Unaudited Consolidated Statements of Income. As of June 30, 2016 and 2015, the Company had no interest expense or penalties associated with unrecognized tax benefits.

### 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 6 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 reports one segment.

### Low Income Housing Tax Credit Investments (LIHTC)

The Company accounts for its interest in LIHTC using the cost method as established in ASC 323-740. As an investor, the Company obtains income tax credits and deductions from the operating losses of these tax credit entities. The income tax credits and deductions are allocated to the investors based on their ownership percentages and are recorded as a reduction of income tax expense (or an increase to income tax benefit) and a reduction of federal income taxes payable.



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## Comprehensive Income

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

## Loss Contingencies

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

## 2. Investment Securities

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

|                                                   | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses | Fair/Book<br>Value |
|---------------------------------------------------|-------------------|---------------------------|--------|--------------------|
| June 30, 2016                                     |                   |                           |        |                    |
| Government Agency & Government-Sponsored Entities | \$ 93,139         | \$ 192                    | \$ -   | \$ 93,331          |
| US Treasury Notes                                 | 65,522            | 457                       | -      | 65,979             |
| Mortgage Backed Securities <sup>(1)</sup>         | 195,860           | 6,043                     | -      | 201,903            |
| Other                                             | 1,010             | -                         | -      | 1,010              |
| Total                                             | \$ 355,531        | \$ 6,692                  | \$ -   | \$ 362,223         |

|                                                   | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses   | Fair/Book<br>Value |
|---------------------------------------------------|-------------------|---------------------------|----------|--------------------|
| December 31, 2015                                 |                   |                           |          |                    |
| Government Agency & Government-Sponsored Entities | \$ 33,536         | \$ 134                    | \$ 419   | \$ 33,251          |
| US Treasury Notes                                 | 73,048            | -                         | 164      | 72,884             |
| Mortgage Backed Securities <sup>(1)</sup>         | 261,016           | 2,708                     | 1,231    | 262,493            |
| Other                                             | 509               | -                         | -        | 509                |
| Total                                             | \$ 368,109        | \$ 2,842                  | \$ 1,814 | \$ 369,137         |

|                                                   | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses   | Fair/Book<br>Value |
|---------------------------------------------------|-------------------|---------------------------|----------|--------------------|
| June 30, 2015                                     |                   |                           |          |                    |
| Government Agency & Government-Sponsored Entities | \$ 11,063         | \$ 58                     | \$ -     | \$ 11,121          |
| US Treasury Notes                                 | 80,212            | 85                        | 59       | 80,238             |
| Mortgage Backed Securities <sup>(1)</sup>         | 256,849           | 3,812                     | 1,081    | 259,580            |
| Other                                             | 485               | -                         | -        | 485                |
| Total                                             | \$ 348,609        | \$ 3,955                  | \$ 1,140 | \$ 351,424         |

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



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

|                                                  | Book Value | Gross Unrealized Gains | Losses | Fair Value |
|--------------------------------------------------|------------|------------------------|--------|------------|
| June 30, 2016                                    |            |                        |        |            |
| Obligations of States and Political Subdivisions | \$60,949   | \$ 1,894               | \$ -   | \$62,843   |
| Total                                            | \$60,949   | \$ 1,894               | \$ -   | \$62,843   |

|                                                  | Book Value | Gross Unrealized Gains | Losses | Fair Value |
|--------------------------------------------------|------------|------------------------|--------|------------|
| December 31, 2015                                |            |                        |        |            |
| Obligations of States and Political Subdivisions | \$61,396   | \$ 993                 | \$ 1   | \$62,388   |
| Total                                            | \$61,396   | \$ 993                 | \$ 1   | \$62,388   |

|                                                  | Book Value | Gross Unrealized Gains | Losses | Fair Value |
|--------------------------------------------------|------------|------------------------|--------|------------|
| June 30, 2015                                    |            |                        |        |            |
| Obligations of States and Political Subdivisions | \$65,270   | \$ 278                 | \$ 213 | \$65,335   |
| Other                                            | 2,131      | -                      | -      | 2,131      |
| Total                                            | \$67,401   | \$ 278                 | \$ 213 | \$67,466   |

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.

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

The amortized cost and estimated fair values of investment securities at June 30, 2016 by contractual maturity are shown in the following table (in thousands):

|                                                          | Available-for-Sale |                 | Held-to-Maturity |            |
|----------------------------------------------------------|--------------------|-----------------|------------------|------------|
|                                                          | Amortized Cost     | Fair/Book Value | Book Value       | Fair Value |
| June 30, 2016                                            |                    |                 |                  |            |
| Within one year                                          | \$90,999           | \$ 90,999       | \$719            | \$ 719     |
| After one year through five years                        | 68,672             | 69,321          | 11,275           | 11,325     |
| After five years through ten years                       | -                  | -               | 12,426           | 12,692     |
| After ten years                                          | -                  | -               | 36,529           | 38,107     |
|                                                          | 159,671            | 160,320         | 60,949           | 62,843     |
| Investment securities not due at a single maturity date: |                    |                 |                  |            |
| Mortgage Backed Securities                               | 195,860            | 201,903         | -                | -          |
| Total                                                    | \$355,531          | \$ 362,223      | \$60,949         | \$ 62,843  |

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

There were no available-for-sale or held-to-maturity investments with gross unrealized losses at June 30, 2016.

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The tables below 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 December 31, 2015 and June 30, 2015, (in thousands):

| December 31, 2015 | 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

|                                                   |            |          |          |        |            |          |
|---------------------------------------------------|------------|----------|----------|--------|------------|----------|
| Government Agency & Government-Sponsored Entities | \$ 29,944  | \$ 419   | \$ -     | \$ -   | \$ 29,944  | \$ 419   |
| US Treasury Notes                                 | 44,887     | 164      | -        | -      | 44,887     | 164      |
| Mortgage Backed Securities                        | 78,899     | 1,089    | 7,277    | 142    | 86,176     | 1,231    |
| Total                                             | \$ 153,730 | \$ 1,672 | \$ 7,277 | \$ 142 | \$ 161,007 | \$ 1,814 |

Securities Held-to-Maturity

|                                                  |        |      |      |      |        |      |
|--------------------------------------------------|--------|------|------|------|--------|------|
| Obligations of States and Political Subdivisions | \$ 839 | \$ 1 | \$ - | \$ - | \$ 839 | \$ 1 |
| Total                                            | \$ 839 | \$ 1 | \$ - | \$ - | \$ 839 | \$ 1 |

| June 30, 2015 | 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

|                            |           |          |          |        |           |          |
|----------------------------|-----------|----------|----------|--------|-----------|----------|
| US Treasury Notes          | \$ 35,117 | \$ 59    | \$ -     | \$ -   | \$ 35,117 | \$ 59    |
| Mortgage Backed Securities | 42,839    | 942      | 7,796    | 139    | 50,635    | 1,081    |
| Total                      | \$ 77,956 | \$ 1,001 | \$ 7,796 | \$ 139 | \$ 85,752 | \$ 1,140 |

Securities Held-to-Maturity

|                                                  |           |        |      |      |           |        |
|--------------------------------------------------|-----------|--------|------|------|-----------|--------|
| Obligations of States and Political Subdivisions | \$ 16,083 | \$ 213 | \$ - | \$ - | \$ 16,083 | \$ 213 |
| Total                                            | \$ 16,083 | \$ 213 | \$ - | \$ - | \$ 16,083 | \$ 213 |

As of June 30, 2016, the Company held 237 investment securities none of which were in a loss position. 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 – The unrealized losses on the Company's investment in securities of government agency and government sponsored entities were \$0, \$419,000, and \$0 at June 30, 2016, December 31, 2015 and June 30, 2015, respectively. The unrealized losses were caused by interest rate fluctuations. Repayment of these investments is 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 did not consider these investments to be other-than-temporarily impaired at June 30, 2016, December 31, 2015, and June 30, 2015.

Mortgage Backed Securities – The unrealized losses on the Company's investment in mortgage backed securities were \$0, \$1.2 million, and \$1.1 million at June 30, 2016, December 31, 2015, and June 30, 2015, 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 June 30, 2016, December 31, 2015 and June 30, 2015, respectively.

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Obligations of States and Political Subdivisions - As of June 30, 2016, over ninety-eight percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of the two 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 obligations of states and political subdivisions were \$0, \$1,400, and \$213,000 at June 30, 2016, December 31, 2015 and June 30, 2015, respectively. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were primarily caused by interest rate fluctuations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2016, December 31, 2015 and June 30, 2015, respectively.

US Treasury Notes – The unrealized losses on the Company's investments in US treasury notes were \$0, \$164,000, and \$59,000 at June 30, 2016, December 31, 2015 and June 30, 2015, respectively. The unrealized losses were caused by interest rate fluctuations. 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 did not consider these investments to be other-than-temporarily impaired at June 30, 2016, December 31, 2015 and June 30, 2015, respectively.

Proceeds from sales and calls of securities were as follows:

| (in thousands) | Three Months<br>Ended June 30, |          | Six Months<br>Ended June 30, |          |
|----------------|--------------------------------|----------|------------------------------|----------|
|                | 2016                           | 2015     | 2016                         | 2015     |
| Proceeds       | \$ -                           | \$ 4,060 | \$ 102,895                   | \$ 4,535 |
| Gains          | -                              | 5        | 245                          | 6        |
| Losses         | -                              | -        | 534                          | -        |

Pledged Securities

As of June 30, 2016, securities carried at \$197.0 million were pledged to secure public deposits, Federal Home Loan Bank ("FHLB") borrowings, and other government agency deposits as required by law. This amount was \$189.2 million at December 31, 2015, and \$189.5 million at June 30, 2015.

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3. Loans & Leases and Allowance for Credit Losses

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

| June 30,<br>2016                                   | 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       |
|----------------------------------------------------|---------------------------|-----------------------------|-----------------------------|------------------------------|------------------------------------|--------------|------------|------------------------|----------|-------------|-------------|
| <b>Year-To-Date Allowance for Credit Losses:</b>   |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Beginning</b>                                   |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Balance-</b>                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>January 1,</b>                                  |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| 2016                                               | \$10,063                  | \$6,881                     | \$2,485                     | \$789                        | \$2,146                            | \$6,308      | \$7,836    | \$175                  | \$3,294  | \$1,546     | \$40,558    |
| Charge-Offs                                        | -                         | -                           | -                           | (7)                          | (46)                               | -            | -          | (52)                   | -        | -           | (105)       |
| Recoveries                                         | 2                         | -                           | -                           | 9                            | 33                                 | -            | 29         | 27                     | -        | -           | 101         |
| Provision                                          | 171                       | 2,620                       | (43)                        | 46                           | 16                                 | (85)         | (16)       | 20                     | 148      | (277)       | 2,559       |
| <b>Ending</b>                                      |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Balance-</b>                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>June 30,</b>                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| 2016                                               | \$10,236                  | \$9,501                     | \$2,442                     | \$837                        | \$2,149                            | \$6,223      | \$7,849    | \$170                  | \$3,442  | \$1,269     | \$40,568    |
| <b>Second Quarter Allowance for Credit Losses:</b> |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Beginning</b>                                   |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Balance-</b>                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>April 1,</b>                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| 2016                                               | \$10,099                  | \$9,162                     | \$2,594                     | \$796                        | \$2,064                            | \$5,904      | \$7,725    | \$187                  | \$3,239  | \$2,359     | \$40,530    |
| Charge-Offs                                        | -                         | -                           | -                           | -                            | (27)                               | (7)          | -          | (27)                   | -        | -           | (61)        |
| Recoveries                                         | -                         | -                           | -                           | 3                            | 31                                 | -            | 2          | 14                     | -        | -           | 50          |
| Provision                                          | 137                       | 339                         | (152)                       | 38                           | 81                                 | 326          | 122        | (4)                    | 203      | (1,090)     | -           |
| <b>Ending</b>                                      |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Balance-</b>                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>June 30,</b>                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| 2016                                               | \$10,236                  | \$9,501                     | \$2,442                     | \$837                        | \$2,149                            | \$6,223      | \$7,849    | \$170                  | \$3,442  | \$1,269     | \$40,568    |
| <b>Ending</b>                                      |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Balance</b>                                     |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Individually</b>                                |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Evaluated</b>                                   |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>for</b>                                         |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| Impairment                                         | -                         | -                           | -                           | 66                           | 24                                 | 138          | 756        | 8                      | -        | -           | 992         |
| <b>Ending</b>                                      |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Balance</b>                                     |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Collectively</b>                                |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Evaluated</b>                                   |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>for</b>                                         |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| Impairment                                         | 10,236                    | 9,501                       | 2,442                       | 771                          | 2,125                              | 6,085        | 7,093      | 162                    | 3,442    | 1,269       | 43,973      |
| <b>Loans &amp;</b>                                 |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Leases:</b>                                     |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Ending</b>                                      |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| <b>Balance</b>                                     |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
|                                                    | \$626,498                 | \$454,069                   | \$166,218                   | \$217,176                    | \$32,150                           | \$276,039    | \$220,284  | \$6,830                | \$68,843 | \$-         | \$2,001,197 |

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|                                                                     |           |           |           |           |          |           |           |         |          |     |     |
|---------------------------------------------------------------------|-----------|-----------|-----------|-----------|----------|-----------|-----------|---------|----------|-----|-----|
| Ending<br>Balance<br>Individually<br>Evaluated<br>for<br>Impairment | 3,351     | 485       | -         | 2,018     | 511      | 838       | 4,668     | 14      | -        | -   | 1   |
| Ending<br>Balance<br>Collectively<br>Evaluated<br>for<br>Impairment | \$623,147 | \$453,584 | \$166,218 | \$215,158 | \$31,639 | \$275,201 | \$215,616 | \$6,816 | \$68,843 | \$- | \$2 |

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|                                                                      | 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       |
|----------------------------------------------------------------------|---------------------------|-----------------------------|-----------------------------|------------------------------|------------------------------------|--------------|------------|------------------------|----------|-------------|-------------|
| December 31, 2015                                                    |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| Year-To-Date Allowance for Credit Losses:                            |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |
| Beginning Balance- January 1, 2015                                   | \$7,842                   | \$4,185                     | \$1,669                     | \$1,022                      | \$2,426                            | \$6,104      | \$8,195    | \$218                  | \$2,211  | \$1,529     | \$35,000    |
| Charge-Offs                                                          | -                         | -                           | -                           | -                            | -                                  | -            | (12)       | (84)                   | -        | -           | (96)        |
| Recoveries                                                           | 2,939                     | -                           | 2,225                       | 8                            | 87                                 | 4            | 136        | 69                     | -        | -           | 5,458       |
| Provision                                                            | (718)                     | 2,696                       | (1,409)                     | (241)                        | (367)                              | 200          | (483)      | (28)                   | 1,083    | 17          | 750         |
| Ending Balance- December 31, 2015                                    | \$10,063                  | \$6,881                     | \$2,485                     | \$789                        | \$2,146                            | \$6,308      | \$7,836    | \$175                  | \$3,294  | \$1,546     | \$41,000    |
| Ending Balance Individually Evaluated for Impairment                 | 61                        | -                           | -                           | 69                           | 35                                 | 115          | 905        | 28                     | -        | -           | 1,208       |
| Ending Balance Collectively Evaluated for Impairment                 | 10,002                    | 6,881                       | 2,485                       | 720                          | 2,111                              | 6,193        | 6,931      | 147                    | 3,294    | 1,546       | 40,000      |
| Ending Balance Loans & Leases: Individually Evaluated for Impairment | \$603,650                 | \$424,034                   | \$151,974                   | \$206,405                    | \$33,056                           | \$293,966    | \$210,804  | \$6,592                | \$65,878 | \$-         | \$1,935,000 |
| Ending Balance Collectively Evaluated for Impairment                 | 3,420                     | -                           | -                           | 2,010                        | 1,214                              | 606          | 4,760      | 34                     | -        | -           | 12,000      |
| Ending Balance Loans & Leases: Collectively Evaluated for Impairment | 600,230                   | 424,034                     | 151,974                     | 204,395                      | 31,842                             | 293,360      | 206,044    | 6,558                  | 65,878   | -           | 1,947,000   |
| June 30, 2015                                                        |                           |                             |                             |                              |                                    |              |            |                        |          |             |             |

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Year-To-Date Allowance for Credit Losses:

|                                             |           |           |           |           |          |           |           |         |          |         |         |         |
|---------------------------------------------|-----------|-----------|-----------|-----------|----------|-----------|-----------|---------|----------|---------|---------|---------|
| Beginning                                   |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance-                                    |           |           |           |           |          |           |           |         |          |         |         |         |
| January 1,                                  |           |           |           |           |          |           |           |         |          |         |         |         |
| 2015                                        | \$7,842   | \$4,185   | \$1,669   | \$1,022   | \$2,426  | \$6,104   | \$8,195   | \$218   | \$2,211  | \$1,529 | \$3,146 | \$3,146 |
| Charge-Offs                                 | -         | -         | -         | -         | -        | -         | (12)      | (34)    | -        | -       | (4)     | (4)     |
| Recoveries                                  | 2,939     | -         | -         | 2         | 47       | 3         | 4         | 37      | -        | -       | 3       | 3       |
| Provision                                   | (2,190)   | 3,087     | 508       | (293)     | (400)    | (1,061)   | 691       | (4)     | 321      | (9)     | 6       | 6       |
| Ending                                      |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance-                                    |           |           |           |           |          |           |           |         |          |         |         |         |
| June 30,                                    |           |           |           |           |          |           |           |         |          |         |         |         |
| 2015                                        | \$8,591   | \$7,272   | \$2,177   | \$731     | \$2,073  | \$5,046   | \$8,878   | \$217   | \$2,532  | \$1,520 | \$3,146 | \$3,146 |
| Second Quarter Allowance for Credit Losses: |           |           |           |           |          |           |           |         |          |         |         |         |
| Beginning                                   |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance-                                    |           |           |           |           |          |           |           |         |          |         |         |         |
| April 1,                                    |           |           |           |           |          |           |           |         |          |         |         |         |
| 2015                                        | \$7,954   | \$6,901   | \$1,916   | \$673     | \$2,096  | \$4,602   | \$8,941   | \$212   | \$2,499  | \$3,146 | \$3,146 | \$3,146 |
| Charge-Offs                                 | -         | -         | -         | -         | -        | -         | -         | (17)    | -        | -       | (1)     | (1)     |
| Recoveries                                  | 1         | -         | -         | 2         | 42       | 2         | 2         | 15      | -        | -       | 6       | 6       |
| Provision                                   | 636       | 371       | 261       | 56        | (65)     | 442       | (65)      | 7       | 33       | (1,626) | 5       | 5       |
| Ending                                      |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance-                                    |           |           |           |           |          |           |           |         |          |         |         |         |
| June 30,                                    |           |           |           |           |          |           |           |         |          |         |         |         |
| 2015                                        | \$8,591   | \$7,272   | \$2,177   | \$731     | \$2,073  | \$5,046   | \$8,878   | \$217   | \$2,532  | \$1,520 | \$3,146 | \$3,146 |
| Ending                                      |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance                                     |           |           |           |           |          |           |           |         |          |         |         |         |
| Individually                                |           |           |           |           |          |           |           |         |          |         |         |         |
| Evaluated                                   |           |           |           |           |          |           |           |         |          |         |         |         |
| for                                         |           |           |           |           |          |           |           |         |          |         |         |         |
| Impairment                                  | 61        | -         | -         | 71        | 49       | 129       | 887       | 34      | -        | -       | 1       | 1       |
| Ending                                      |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance                                     |           |           |           |           |          |           |           |         |          |         |         |         |
| Collectively                                |           |           |           |           |          |           |           |         |          |         |         |         |
| Evaluated                                   |           |           |           |           |          |           |           |         |          |         |         |         |
| for                                         |           |           |           |           |          |           |           |         |          |         |         |         |
| Impairment                                  | 8,530     | 7,272     | 2,177     | 660       | 2,024    | 4,917     | 7,991     | 183     | 2,532    | 1,520   | 3       | 3       |
| Loans &                                     |           |           |           |           |          |           |           |         |          |         |         |         |
| Leases:                                     |           |           |           |           |          |           |           |         |          |         |         |         |
| Ending                                      |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance                                     | \$570,173 | \$373,324 | \$116,983 | \$189,039 | \$31,327 | \$225,795 | \$256,386 | \$4,984 | \$50,631 | \$-     | \$1,520 | \$1,520 |
| Ending                                      |           |           |           |           |          |           |           |         |          |         |         |         |
| Balance                                     |           |           |           |           |          |           |           |         |          |         |         |         |
| Individually                                |           |           |           |           |          |           |           |         |          |         |         |         |
| Evaluated                                   |           |           |           |           |          |           |           |         |          |         |         |         |
| for                                         |           |           |           |           |          |           |           |         |          |         |         |         |
| Impairment                                  | 4,163     | -         | 4,335     | 2,055     | 1,541    | 454       | 4,819     | 40      | -        | -       | 1       | 1       |
| Ending                                      | \$566,010 | \$373,324 | \$112,648 | \$186,984 | \$29,786 | \$225,341 | \$251,567 | \$4,944 | \$50,631 | \$-     | \$1,520 | \$1,520 |
| Balance                                     |           |           |           |           |          |           |           |         |          |         |         |         |
| Collectively                                |           |           |           |           |          |           |           |         |          |         |         |         |
| Evaluated                                   |           |           |           |           |          |           |           |         |          |         |         |         |



for  
Impairment

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The ending balance of loans individually evaluated for impairment includes restructured loans in the amount of \$5.1 million at June 30, 2016, \$4.9 million at December 31, 2015 and \$9.6 million at June 30, 2015, which are no longer disclosed or classified as TDR's.

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

| June 30, 2016             | Pass        | Special<br>Mention | Substandard | Total Loans<br>& Leases |
|---------------------------|-------------|--------------------|-------------|-------------------------|
| Loans & Leases:           |             |                    |             |                         |
| Commercial Real Estate    | \$616,297   | \$9,507            | \$ 694      | \$ 626,498              |
| Agricultural Real Estate  | 452,210     | 1,505              | 354         | 454,069                 |
| Real Estate Construction  | 164,694     | 1,524              | -           | 166,218                 |
| Residential 1st Mortgages | 215,681     | 407                | 1,088       | 217,176                 |
| Home Equity Lines & Loans | 32,034      | 69                 | 47          | 32,150                  |
| Agricultural              | 274,920     | 658                | 461         | 276,039                 |
| Commercial                | 209,372     | 8,148              | 2,764       | 220,284                 |
| Consumer & Other          | 6,600       | -                  | 230         | 6,830                   |
| Leases                    | 68,843      | -                  | -           | 68,843                  |
| Total                     | \$2,040,651 | \$21,818           | \$ 5,638    | \$2,068,107             |

| December 31, 2015           | Pass        | Special<br>Mention | Substandard | Total Loans |
|-----------------------------|-------------|--------------------|-------------|-------------|
| Loans & Leases:             |             |                    |             |             |
| Commercial Real Estate      | \$595,011   | \$7,917            | \$ 722      | \$603,650   |
| Agricultural Real Estate    | 424,034     | -                  | -           | 424,034     |
| Real Estate Construction    | 150,379     | 1,595              | -           | 151,974     |
| Residential 1st Mortgages   | 205,135     | 413                | 857         | 206,405     |
| Home Equity Lines and Loans | 32,419      | 75                 | 562         | 33,056      |
| Agricultural                | 293,325     | 9                  | 632         | 293,966     |
| Commercial                  | 199,467     | 8,160              | 3,177       | 210,804     |
| Consumer & Other            | 6,411       | -                  | 181         | 6,592       |
| Leases                      | 65,878      | -                  | -           | 65,878      |
| Total                       | \$1,972,059 | \$18,169           | \$ 6,131    | \$1,996,359 |

| June 30, 2015             | Pass        | Special<br>Mention | Substandard | Total Loans<br>& Leases |
|---------------------------|-------------|--------------------|-------------|-------------------------|
| Loans & Leases:           |             |                    |             |                         |
| Commercial Real Estate    | \$561,370   | \$8,088            | \$ 715      | \$ 570,173              |
| Agricultural Real Estate  | 373,324     | -                  | -           | 373,324                 |
| Real Estate Construction  | 115,320     | 1,663              | -           | 116,983                 |
| Residential 1st Mortgages | 187,663     | 739                | 637         | 189,039                 |
| Home Equity Lines & Loans | 30,637      | 80                 | 610         | 31,327                  |
| Agricultural              | 225,075     | 453                | 267         | 225,795                 |
| Commercial                | 240,190     | 12,680             | 3,516       | 256,386                 |
| Consumer & Other          | 4,737       | -                  | 247         | 4,984                   |
| Leases                    | 50,631      | -                  | -           | 50,631                  |
| Total                     | \$1,788,947 | \$23,703           | \$ 5,992    | \$1,818,642             |

See “Note 1. Significant Accounting Policies - Allowance for Credit Losses” for a description of the internal risk ratings used by the Company. There were no loans or leases outstanding at June 30, 2016, December 31, 2015, and June 30, 2015, rated doubtful or loss.

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

| June 30, 2016            | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days<br>and<br>Still<br>Accruing | Nonaccrual | Total<br>Past<br>Due | Current     | Total<br>Loans & Leases |
|--------------------------|---------------------------|---------------------------|-------------------------------------|------------|----------------------|-------------|-------------------------|
| Loans & Leases:          |                           |                           |                                     |            |                      |             |                         |
| Commercial Real Estate   | \$ 393                    | \$ 605                    | \$ -                                | \$ -       | \$ 998               | \$625,500   | \$ 626,498              |
| Agricultural Real Estate | -                         | -                         | -                                   | 485        | 485                  | 453,584     | 454,069                 |
| Real Estate Construction | -                         | -                         | -                                   | -          | -                    | 166,218     | 166,218                 |
| Residential 1st          |                           |                           |                                     |            |                      |             |                         |
| Mortgages                | -                         | -                         | -                                   | 58         | 58                   | 217,118     | 217,176                 |
| Home Equity Lines &      |                           |                           |                                     |            |                      |             |                         |
| Loans                    | -                         | -                         | -                                   | -          | -                    | 32,150      | 32,150                  |
| Agricultural             | -                         | -                         | -                                   | 234        | 234                  | 275,805     | 276,039                 |
| Commercial               | 3                         | -                         | -                                   | 1,475      | 1,478                | 218,806     | 220,284                 |
| Consumer & Other         | 48                        | -                         | -                                   | 9          | 57                   | 6,773       | 6,830                   |
| Leases                   | -                         | -                         | -                                   | -          | -                    | 68,843      | 68,843                  |
| Total                    | \$ 444                    | \$ 605                    | \$ -                                | \$ 2,261   | \$ 3,310             | \$2,064,797 | \$ 2,068,107            |

| December 31, 2015        | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days<br>and<br>Still<br>Accruing | Nonaccrual | Total<br>Past<br>Due | Current     | Total<br>Loans & Leases |
|--------------------------|---------------------------|---------------------------|-------------------------------------|------------|----------------------|-------------|-------------------------|
| Loans & Leases:          |                           |                           |                                     |            |                      |             |                         |
| Commercial Real Estate   | \$ 705                    | \$ -                      | \$ -                                | \$ 19      | \$ 724               | \$602,926   | \$ 603,650              |
| Agricultural Real Estate | -                         | -                         | -                                   | -          | -                    | 424,034     | 424,034                 |
| Real Estate Construction | -                         | -                         | -                                   | -          | -                    | 151,974     | 151,974                 |
| Residential 1st          |                           |                           |                                     |            |                      |             |                         |
| Mortgages                | 97                        | 194                       | -                                   | 65         | 356                  | 206,049     | 206,405                 |
| Home Equity Lines and    |                           |                           |                                     |            |                      |             |                         |
| Loans                    | -                         | -                         | -                                   | 538        | 538                  | 32,518      | 33,056                  |
| Agricultural             | -                         | -                         | -                                   | -          | -                    | 293,966     | 293,966                 |
| Commercial               | -                         | -                         | -                                   | 1,524      | 1,524                | 209,280     | 210,804                 |
| Consumer & Other         | 7                         | -                         | -                                   | 10         | 17                   | 6,575       | 6,592                   |
| Leases                   | -                         | -                         | -                                   | -          | -                    | 65,878      | 65,878                  |
| Total                    | \$ 809                    | \$ 194                    | \$ -                                | \$ 2,156   | \$ 3,159             | \$1,993,200 | \$ 1,996,359            |

| June 30, 2015            | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days<br>and<br>Still<br>Accruing | Nonaccrual | Total<br>Past<br>Due | Current   | Total<br>Loans & Leases |
|--------------------------|---------------------------|---------------------------|-------------------------------------|------------|----------------------|-----------|-------------------------|
| Loans & Leases:          |                           |                           |                                     |            |                      |           |                         |
| Commercial Real Estate   | \$ -                      | \$ -                      | \$ -                                | \$ 715     | \$ 715               | \$569,458 | \$ 570,173              |
| Agricultural Real Estate | -                         | -                         | -                                   | -          | -                    | 373,324   | 373,324                 |
| Real Estate Construction | -                         | -                         | -                                   | -          | -                    | 116,983   | 116,983                 |
| Residential 1st          |                           |                           |                                     |            |                      |           |                         |
| Mortgages                | -                         | 196                       | -                                   | 72         | 268                  | 188,771   | 189,039                 |
|                          | -                         | -                         | -                                   | 576        | 576                  | 30,751    | 31,327                  |

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Home Equity Lines &  
Loans

|                  |      |        |      |          |          |             |              |
|------------------|------|--------|------|----------|----------|-------------|--------------|
| Agricultural     | -    | -      | -    | 11       | 11       | 225,784     | 225,795      |
| Commercial       | -    | -      | -    | 1,559    | 1,559    | 254,827     | 256,386      |
| Consumer & Other | 8    | -      | -    | 11       | 19       | 4,965       | 4,984        |
| Leases           | -    | -      | -    | -        | -        | 50,631      | 50,631       |
| Total            | \$ 8 | \$ 196 | \$ - | \$ 2,944 | \$ 3,148 | \$1,815,494 | \$ 1,818,642 |

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

| June 30, 2016                       | Recorded Investment | Unpaid Principal Balance | Related Allowance | Three Months Ended June                 | Interest          | Six Months Ended June                   | Interest          |
|-------------------------------------|---------------------|--------------------------|-------------------|-----------------------------------------|-------------------|-----------------------------------------|-------------------|
|                                     |                     |                          |                   | 30, 2016<br>Average Recorded Investment | Income Recognized | 30, 2016<br>Average Recorded Investment | Income Recognized |
| With no related allowance recorded: |                     |                          |                   |                                         |                   |                                         |                   |
| Commercial Real Estate              | \$ 76               | \$ 76                    | \$ -              | \$ 78                                   | \$ 2              | \$ 85                                   | \$ 4              |
| Agricultural Real Estate            | 485                 | 485                      | -                 | 324                                     | -                 | 203                                     | 3                 |
| Residential 1st Mortgages           | 420                 | 471                      | -                 | 375                                     | 2                 | 408                                     | 4                 |
| Home Equity Lines & Loans           | -                   | -                        | -                 | 363                                     | -                 | 508                                     | -                 |
| Agricultural                        | 192                 | 192                      | -                 | 193                                     | 3                 | 193                                     | 3                 |
| Commercial                          | 3,063               | 3,063                    | -                 | 3,073                                   | 34                | 3,083                                   | 67                |
| Consumer & Other                    | 1                   | 1                        | -                 | 1                                       | -                 | -                                       | -                 |
|                                     | \$ 4,237            | \$ 4,288                 | \$ -              | \$ 4,407                                | \$ 41             | \$ 4,480                                | \$ 81             |
| With an allowance recorded:         |                     |                          |                   |                                         |                   |                                         |                   |
| Residential 1st Mortgages           | \$ 240              | \$ 280                   | \$ 12             | 241                                     | \$ 3              | 268                                     | 6                 |
| Home Equity Lines & Loans           | 93                  | 99                       | 5                 | 156                                     | 1                 | 166                                     | 2                 |
| Agricultural                        | 647                 | 647                      | 138               | 530                                     | 6                 | 472                                     | 12                |
| Commercial                          | 1,605               | 1,782                    | 756               | 1,618                                   | 2                 | 1,631                                   | 8                 |
| Consumer & Other                    | 8                   | 14                       | 8                 | 17                                      | -                 | 24                                      | -                 |
|                                     | \$ 2,593            | \$ 2,822                 | \$ 919            | \$ 2,562                                | \$ 12             | \$ 2,561                                | \$ 28             |
| Total                               | \$ 6,830            | \$ 7,110                 | \$ 919            | \$ 6,969                                | \$ 53             | \$ 7,041                                | \$ 109            |

| December 31, 2015                   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average             | Interest          |
|-------------------------------------|---------------------|--------------------------|-------------------|---------------------|-------------------|
|                                     |                     |                          |                   | Recorded Investment | Income Recognized |
| With no related allowance recorded: |                     |                          |                   |                     |                   |
| Commercial Real Estate              | \$ 102              | \$ 104                   | \$ -              | \$ 479              | \$ 7              |
| Residential 1st Mortgages           | 551                 | 618                      | -                 | 560                 | 16                |
| Home Equity Lines and Loans         | 581                 | 646                      | -                 | 620                 | 3                 |
| Agricultural                        | 193                 | 193                      | -                 | 105                 | 3                 |
| Commercial                          | 3,103               | 3,103                    | -                 | 2,349               | 85                |
|                                     | \$ 4,530            | \$ 4,664                 | \$ -              | \$ 4,113            | \$ 114            |
| With an allowance recorded:         |                     |                          |                   |                     |                   |
| Residential 1st Mortgages           | \$ 348              | \$ 420                   | \$ 17             | \$ 354              | \$ 16             |
| Home Equity Lines and Loans         | 134                 | 151                      | 7                 | 136                 | 5                 |
| Agricultural                        | 412                 | 413                      | 115               | 431                 | 28                |
| Commercial                          | 1,657               | 1,798                    | 905               | 2,456               | 31                |
| Consumer & Other                    | 34                  | 40                       | 29                | 39                  | 3                 |
|                                     | \$ 2,585            | \$ 2,822                 | \$ 1,073          | \$ 3,416            | \$ 83             |
| Total                               | \$ 7,115            | \$ 7,486                 | \$ 1,073          | \$ 7,529            | \$ 197            |

Three Months Ended June 30, 2015      Six Months Ended June 30, 2015

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| June 30, 2015                       | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
|-------------------------------------|---------------------|--------------------------|-------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|
| With no related allowance recorded: |                     |                          |                   |                             |                            |                             |                            |
| Commercial Real Estate              | \$ 802              | \$ 802                   | \$ -              | \$ 497                      | \$ 2                       | \$ 297                      | \$ 4                       |
| Residential 1st Mortgages           | 564                 | 628                      | -                 | 567                         | 4                          | 426                         | 8                          |
| Home Equity Lines & Loans           | 620                 | 660                      | -                 | 641                         | -                          | 486                         | 1                          |
| Agricultural                        | 11                  | 24                       | -                 | 13                          | -                          | 10                          | -                          |
| Commercial                          | 3,125               | 3,125                    | -                 | 1,587                       | 27                         | 806                         | 28                         |
|                                     | \$ 5,122            | \$ 5,239                 | \$ -              | \$ 3,305                    | \$ 33                      | \$ 2,025                    | \$ 41                      |
| With an allowance recorded:         |                     |                          |                   |                             |                            |                             |                            |
| Residential 1st Mortgages           | \$ 355              | \$ 426                   | \$ 18             | 357                         | \$ 4                       | 503                         | 8                          |
| Home Equity Lines & Loans           | 137                 | 155                      | 7                 | 138                         | 1                          | 342                         | 2                          |
| Agricultural                        | 443                 | 443                      | 129               | 443                         | 7                          | 448                         | 14                         |
| Commercial                          | 1,694               | 1,804                    | 887               | 3,244                       | 2                          | 4,006                       | 27                         |
| Consumer & Other                    | 40                  | 46                       | 34                | 42                          | 1                          | 44                          | 2                          |
|                                     | \$ 2,669            | \$ 2,874                 | \$ 1,075          | \$ 4,224                    | \$ 15                      | \$ 5,343                    | \$ 53                      |
| Total                               | \$ 7,791            | \$ 8,113                 | \$ 1,075          | \$ 7,529                    | \$ 48                      | \$ 7,368                    | \$ 94                      |

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

At June 30, 2016, the Company allocated \$896,000 of specific reserves to \$6.1 million of troubled debt restructured loans & leases, of which \$4.6 million were performing. The Company had no commitments at June 30, 2016 to lend additional amounts to customers with outstanding loans or leases that are classified as troubled debt restructurings.

During the three month period ending June 30, 2016, there was one loan modified as a troubled debt restructuring. During the six month period ending June 30, 2016, the terms of certain loans & leases were modified as troubled debt restructurings. The modification of the terms of such loans & leases can include one or a combination of the following: a reduction of the stated interest rate; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate were for 5 years. Modifications involving an extension of the maturity date were for 10 years.

The following table presents loans or leases by class modified as troubled debt restructured loans or leases during the three and six-month periods ended June 30, 2016 (in thousands):

|                              | Three Months Ended June 30, 2016 |                                                  |                                                   | Six Months Ended June 30, 2016 |                                                  |                                                   |
|------------------------------|----------------------------------|--------------------------------------------------|---------------------------------------------------|--------------------------------|--------------------------------------------------|---------------------------------------------------|
|                              | Number of Loans                  | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Loans                | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Troubled Debt Restructurings |                                  |                                                  |                                                   |                                |                                                  |                                                   |
| Residential 1st Mortgages    | 1                                | \$ 97                                            | \$ 89                                             | 1                              | \$ 97                                            | \$ 89                                             |
| Home Equity Lines & Loans    | -                                | -                                                | -                                                 | 2                              | 305                                              | 286                                               |
| Total                        | 1                                | \$ 97                                            | \$ 89                                             | 3                              | \$ 402                                           | \$ 375                                            |

The TDRs described above had no impact on the allowance for credit losses for the three and six-month periods ending June 30, 2016, and resulted in charge-offs of \$7,000 and \$27,000 for the three and six-month periods ended June 30, 2016.

During the three and six-months ended June 30, 2016, there were no payment defaults on loans or leases modified as troubled debt restructurings within twelve months following the modification. The Company considers a loan or lease to be in payment default once it is greater than 90 days contractually past due under the modified terms.

At December 31, 2015, the Company allocated \$1.1 million of specific reserves to \$6.6 million of troubled debt restructured loans, of which \$5.0 million were performing. The Company had no commitments at December 31, 2015 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the period ending December 31, 2015, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.



Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 4 to 30 years.  
Modifications involving an extension of the maturity date were for periods ranging from 6 months to 30 years.

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The following table presents loans or leases by class modified as TDRs for the period ended December 31, 2015 (in thousands):

|                              | December 31, 2015                                  |                                                            |
|------------------------------|----------------------------------------------------|------------------------------------------------------------|
|                              | Pre-Modification<br>Number<br>of Recorded<br>Loans | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Troubled Debt Restructurings |                                                    |                                                            |
| Agricultural                 | 1 \$ 194                                           | \$ 194                                                     |
| Commercial                   | 1 131                                              | 119                                                        |
| Total                        | 2 \$ 325                                           | \$ 313                                                     |

The troubled debt restructurings described above increased the allowance for credit losses by \$70,000 and resulted in charge-offs of \$12,000 for the twelve months ended December 31, 2015.

During the period ended December 31, 2015, there were no payment defaults on loans modified as troubled debt restructurings within twelve months following the modification. The Company considers a loan to be in payment default once it is greater than 90 days contractually past due under the modified terms.

At June 30, 2015, the Company allocated \$1.1 million of specific reserves to \$6.5 million of troubled debt restructured loans & leases, of which \$4.8 million were performing. The Company had no commitments at June 30, 2015 to lend additional amounts to customers with outstanding loans or leases that are classified as troubled debt restructurings.

During the three month period ending June 30, 2015, there were no loans & leases modified as a troubled debt restructuring. During the six month period ending June 30, 2015, the terms of certain loans & leases were modified as troubled debt restructurings. The modification of the terms of such loans & leases can include one or a combination of the following: a reduction of the stated interest rate; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate were for 10 years. Modifications involving an extension of the maturity date were for 10 years.

The following table presents loans or leases by class modified as troubled debt restructured loans or leases during the three and six-month periods ended June 30, 2015 (in thousands):

|                              | Three Months Ended June 30, 2015 |                                                           |                                                            | Six Months Ended June 30, 2015 |                                                           |                                                            |
|------------------------------|----------------------------------|-----------------------------------------------------------|------------------------------------------------------------|--------------------------------|-----------------------------------------------------------|------------------------------------------------------------|
|                              | Number<br>of<br>Loans            | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Number<br>of<br>Loans          | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Troubled Debt Restructurings |                                  |                                                           |                                                            |                                |                                                           |                                                            |
| Commercial                   | -                                | \$ -                                                      | \$ -                                                       | 1                              | \$ 131                                                    | \$ 119                                                     |
| Total                        | -                                | \$ -                                                      | \$ -                                                       | 1                              | \$ 131                                                    | \$ 119                                                     |

The TDR described above increased the allowance for credit losses by \$0 and \$114,000 for the three and six-month periods ending June 30, 2015, and resulted in charge-offs of \$0 and \$12,000 for the three and six-month periods ended June 30, 2015.

During the three and six-months ended June 30, 2015, there were no payment defaults on loans or leases modified as troubled debt restructurings within twelve months following the modification. The Company considers a loan or lease

to be in payment default once it is greater than 90 days contractually past due under the modified terms.

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4. Fair Value Measurements

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

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

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

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

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

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

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

The Company does not record all loans & leases at fair value on a recurring basis. However, from time to time, a loan or lease is considered impaired and an allowance for credit losses is established. Once a loan or lease is identified as individually impaired, management measures impairment in accordance with the “Receivable” topic of the FASB ASC. The fair value of impaired loans or leases is estimated using one of several methods, including collateral value when the loan 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 into 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 into 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 ORE is primarily the sales comparison approach less selling costs of 10%.

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At June 30, 2016, formal foreclosure proceedings were in process for \$163,000 of consumer mortgage loans secured by residential real estate properties.

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

|                                                          |                     | Fair Value Measurements<br>At June 30, 2016, 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)                                           | Fair Value<br>Total |                                                                                           |                                            |                                                    |
| Available-for-Sale Securities:                           |                     |                                                                                           |                                            |                                                    |
| Government Agency & Government-Sponsored Entities        | \$ 93,331           | \$-                                                                                       | \$ 93,331                                  | \$ -                                               |
| US Treasury Notes                                        | 65,979              | 65,979                                                                                    | -                                          | -                                                  |
| Mortgage Backed Securities                               | 201,903             | -                                                                                         | 201,903                                    | -                                                  |
| Other                                                    | 1,010               | 200                                                                                       | 310                                        | 500                                                |
| Total Assets Measured at Fair Value On a Recurring Basis | \$ 362,223          | \$ 66,179                                                                                 | \$ 295,544                                 | \$ 500                                             |

|                                                          |                     | Fair Value Measurements<br>At December 31, 2015, Using                              |                                            |                                                    |
|----------------------------------------------------------|---------------------|-------------------------------------------------------------------------------------|--------------------------------------------|----------------------------------------------------|
|                                                          |                     | 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) |
| (in thousands)                                           | Fair Value<br>Total |                                                                                     |                                            |                                                    |
| Available-for-Sale Securities:                           |                     |                                                                                     |                                            |                                                    |
| Government Agency & Government-Sponsored Entities        | \$ 33,251           | \$ -                                                                                | \$ 33,251                                  | \$ -                                               |
| US Treasury Notes                                        | 72,884              | 72,884                                                                              | -                                          | -                                                  |
| Mortgage Backed Securities                               | 262,493             | -                                                                                   | 262,493                                    | -                                                  |
| Other                                                    | 509                 | 199                                                                                 | 310                                        | -                                                  |
| Total Assets Measured at Fair Value On a Recurring Basis | \$ 369,137          | \$ 73,083                                                                           | \$ 296,054                                 | \$ -                                               |

|                |                     | Fair Value Measurements<br>At June 30, 2015, Using |                                            |                                                    |
|----------------|---------------------|----------------------------------------------------|--------------------------------------------|----------------------------------------------------|
|                |                     | Quoted<br>Prices<br>in<br>Active<br>Markets        | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands) | Fair Value<br>Total |                                                    |                                            |                                                    |

|                                                          |            |        | for<br>Identical<br>Assets<br>(Level<br>1) |    |   |
|----------------------------------------------------------|------------|--------|--------------------------------------------|----|---|
| Available-for-Sale Securities:                           |            |        |                                            |    |   |
| Government Agency & Government-Sponsored Entities        | \$ 11,121  | \$ -   | \$ 11,121                                  | \$ | - |
| US Treasury Notes                                        | 80,238     | -      | 80,238                                     |    | - |
| Mortgage Backed Securities                               | 259,580    | -      | 259,580                                    |    | - |
| Other                                                    | 485        | 175    | 310                                        |    | - |
| Total Assets Measured at Fair Value On a Recurring Basis | \$ 351,424 | \$ 175 | \$ 351,249                                 | \$ | - |

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Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the three and six-months ended June 30, 2016 and 2015, there were no transfers in or out of level 1, 2, or 3.

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

| (in thousands)                                               | Fair Value<br>Total | Fair Value Measurements<br>At June 30, 2016, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for |                                            |                                                    |
|--------------------------------------------------------------|---------------------|----------------------------------------------------------------------------------------------------------|--------------------------------------------|----------------------------------------------------|
|                                                              |                     | Identical<br>Assets<br>(Level 1)                                                                         | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Impaired Loans                                               |                     |                                                                                                          |                                            |                                                    |
| Residential 1st Mortgage                                     | \$ 317              | \$ -                                                                                                     | \$ -                                       | \$ 317                                             |
| Home Equity Lines and Loans                                  | 85                  | -                                                                                                        | -                                          | 85                                                 |
| Agricultural                                                 | 509                 | -                                                                                                        | -                                          | 509                                                |
| Commercial                                                   | 849                 | -                                                                                                        | -                                          | 849                                                |
| Total Impaired Loans                                         | 1,760               | -                                                                                                        | -                                          | 1,760                                              |
| Other Real Estate                                            |                     |                                                                                                          |                                            |                                                    |
| Home Equity Lines and Loans                                  | 779                 | -                                                                                                        | -                                          | 779                                                |
| Total Other Real Estate                                      | 779                 | -                                                                                                        | -                                          | 779                                                |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$ 2,539            | \$ -                                                                                                     | \$ -                                       | \$ 2,539                                           |



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| (in thousands)                                               | Fair Value<br>Total | Fair Value Measurements<br>At December 31, 2015, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for |                                            |                                                    |
|--------------------------------------------------------------|---------------------|--------------------------------------------------------------------------------------------------------------|--------------------------------------------|----------------------------------------------------|
|                                                              |                     | Identical<br>Assets<br>(Level<br>1)                                                                          | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Impaired Loans:                                              |                     |                                                                                                              |                                            |                                                    |
| Residential 1st Mortgage                                     | \$ 329              | \$ -                                                                                                         | \$ -                                       | \$ 329                                             |
| Home Equity Lines and Loans                                  | 125                 | -                                                                                                            | -                                          | 125                                                |
| Agricultural                                                 | 298                 | -                                                                                                            | -                                          | 298                                                |
| Commercial                                                   | 752                 | -                                                                                                            | -                                          | 752                                                |
| Consumer                                                     | 5                   | -                                                                                                            | -                                          | 5                                                  |
| Total Impaired Loans                                         | 1,509               | -                                                                                                            | -                                          | 1,509                                              |
| Other Real Estate:                                           |                     |                                                                                                              |                                            |                                                    |
| Real Estate Construction                                     | 2,441               | -                                                                                                            | -                                          | 2,441                                              |
| Total Other Real Estate                                      | 2,441               | -                                                                                                            | -                                          | 2,441                                              |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$ 3,950            | \$ -                                                                                                         | \$ -                                       | \$ 3,950                                           |

| (in thousands)                                               | Fair Value<br>Total | Fair Value Measurements<br>At June 30, 2015, Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for |                                            |                                                    |
|--------------------------------------------------------------|---------------------|----------------------------------------------------------------------------------------------------------|--------------------------------------------|----------------------------------------------------|
|                                                              |                     | Identical<br>Assets<br>(Level<br>1)                                                                      | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Impaired Loans                                               |                     |                                                                                                          |                                            |                                                    |
| Residential 1st Mortgage                                     | \$ 337              | \$ -                                                                                                     | \$ -                                       | \$ 337                                             |
| Home Equity Lines and Loans                                  | 128                 | -                                                                                                        | -                                          | 128                                                |
| Agricultural                                                 | 313                 | -                                                                                                        | -                                          | 313                                                |
| Commercial                                                   | 807                 | -                                                                                                        | -                                          | 807                                                |
| Consumer                                                     | 6                   | -                                                                                                        | -                                          | 6                                                  |
| Total Impaired Loans                                         | 1,591               | -                                                                                                        | -                                          | 1,591                                              |
| Other Real Estate                                            |                     |                                                                                                          |                                            |                                                    |
| Real Estate Construction                                     | 2,441               | -                                                                                                        | -                                          | 2,441                                              |
| Total Other Real Estate                                      | 2,441               | -                                                                                                        | -                                          | 2,441                                              |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$ 4,032            | \$ -                                                                                                     | \$ -                                       | \$ 4,032                                           |

The Company's property appraisals are primarily based on the sales comparison approach and the income approach methodologies, which consider recent sales of comparable properties, including their income generating

characteristics, and then make adjustments to reflect the general assumptions that a market participant would make when analyzing the property for purchase. These adjustments may increase or decrease an appraised value and can vary significantly depending on the location, physical characteristics and income producing potential of each property. Additionally, the quality and volume of market information available at the time of the appraisal can vary from period to period and cause significant changes to the nature and magnitude of comparable sale adjustments.

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Given these variations, comparable sale adjustments are generally not a reliable indicator for how fair value will increase or decrease from period to period. Under certain circumstances, management discounts are applied based on specific characteristics of an individual property.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at June 30, 2016:

| (in thousands)              | Fair Value | Valuation Technique       | Unobservable Inputs                                | Range, Weighted Avg. |
|-----------------------------|------------|---------------------------|----------------------------------------------------|----------------------|
| Impaired Loans              |            |                           |                                                    |                      |
| Residential 1st Mortgage    | \$ 317     | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 0% -4%, 2%           |
| Home Equity Lines and Loans | \$ 85      | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 1% - 2%, 2%          |
| Agricultural                | \$ 298     | Income Approach           | Capitalization Rate                                | 16% - 16%, 16%       |
| Agricultural                | \$ 211     | Collateral Approach       | Collateral Value                                   | 10% - 10%, 10%       |
| Commercial                  | \$ 849     | Income Approach           | Capitalization Rate                                | 16% - 16%, 16%       |
| Other Real Estate           |            |                           |                                                    |                      |
| Home Equity Lines and Loans | \$ 779     | Sales Comparison Approach | Adjustment for Difference Between Comparable Sales | 10% - 10%, 10%       |

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## 5. Fair Value of Financial Instruments

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

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

| June 30, 2016<br>(in thousands)                                      | Carrying<br>Amount | Fair Value of Financial Instruments Using                                        |                                            |                                                    |                                  |
|----------------------------------------------------------------------|--------------------|----------------------------------------------------------------------------------|--------------------------------------------|----------------------------------------------------|----------------------------------|
|                                                                      |                    | Quoted<br>Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Estimated<br>Fair Value |
| <b>Assets:</b>                                                       |                    |                                                                                  |                                            |                                                    |                                  |
| Cash and Cash Equivalents                                            | \$69,756           | \$69,756                                                                         | \$-                                        | \$-                                                | \$69,756                         |
| <b>Investment Securities Available-for-Sale:</b>                     |                    |                                                                                  |                                            |                                                    |                                  |
| Government Agency &<br>Government-Sponsored Entities                 | 93,331             | -                                                                                | 93,331                                     | -                                                  | 93,331                           |
| U.S. Treasury Notes                                                  | 65,979             | 65,979                                                                           | -                                          | -                                                  | 65,979                           |
| Mortgage Backed Securities                                           | 201,903            | -                                                                                | 201,903                                    | -                                                  | 201,903                          |
| Other                                                                | 1,010              | 200                                                                              | 310                                        | 500                                                | 1,010                            |
| Total Investment Securities Available-for-Sale                       | 362,223            | 66,179                                                                           | 295,544                                    | 500                                                | 362,223                          |
| <b>Investment Securities Held-to-Maturity:</b>                       |                    |                                                                                  |                                            |                                                    |                                  |
| Obligations of States and Political<br>Subdivisions                  | 60,949             | -                                                                                | 45,083                                     | 17,760                                             | 62,843                           |
| Total Investment Securities Held-to-Maturity                         | 60,949             | -                                                                                | 45,083                                     | 17,760                                             | 62,843                           |
| FHLB Stock                                                           | 8,872              | N/A                                                                              | N/A                                        | N/A                                                | N/A                              |
| <b>Loans &amp; Leases, Net of Deferred Fees &amp;<br/>Allowance:</b> |                    |                                                                                  |                                            |                                                    |                                  |
| Commercial Real Estate                                               | 616,262            | -                                                                                | -                                          | 622,090                                            | 622,090                          |
| Agricultural Real Estate                                             | 444,568            | -                                                                                | -                                          | 435,848                                            | 435,848                          |
| Real Estate Construction                                             | 163,776            | -                                                                                | -                                          | 163,826                                            | 163,826                          |
| Residential 1st Mortgages                                            | 216,339            | -                                                                                | -                                          | 220,349                                            | 220,349                          |
| Home Equity Lines and Loans                                          | 30,001             | -                                                                                | -                                          | 31,192                                             | 31,192                           |
| Agricultural                                                         | 269,816            | -                                                                                | -                                          | 268,535                                            | 268,535                          |
| Commercial                                                           | 212,435            | -                                                                                | -                                          | 212,018                                            | 212,018                          |
| Consumer & Other                                                     | 6,660              | -                                                                                | -                                          | 6,722                                              | 6,722                            |
| Leases                                                               | 65,401             | -                                                                                | -                                          | 66,526                                             | 66,526                           |
| Unallocated Allowance                                                | (1,269 )           | -                                                                                | -                                          | (1,269 )                                           | (1,269 )                         |

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|                                                        |           |   |       |           |           |
|--------------------------------------------------------|-----------|---|-------|-----------|-----------|
| Total Loans & Leases, Net of Deferred Fees & Allowance | 2,023,989 | - | -     | 2,025,837 | 2,025,837 |
| Accrued Interest Receivable                            | 9,929     | - | 9,929 | -         | 9,929     |

Liabilities:

Deposits:

|                              |           |           |         |   |           |
|------------------------------|-----------|-----------|---------|---|-----------|
| Demand                       | 646,408   | 646,408   | -       | - | 646,408   |
| Interest Bearing Transaction | 452,758   | 452,758   | -       | - | 452,758   |
| Savings and Money Market     | 726,580   | 726,579   | -       | - | 726,579   |
| Time                         | 502,200   | -         | 502,098 | - | 502,098   |
| Total Deposits               | 2,327,946 | 1,825,745 | 502,098 | - | 2,327,843 |
| Subordinated Debentures      | 10,310    | -         | 6,443   | - | 6,443     |
| Accrued Interest Payable     | 569       | -         | 569     | - | 569       |

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| December 31, 2015<br>(in thousands)                       | Carrying<br>Amount | Fair Value of Financial Instruments Using<br>Quoted<br>Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) |                                                    |           |           | Total<br>Estimated<br>Fair Value |
|-----------------------------------------------------------|--------------------|-------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------|-----------|-----------|----------------------------------|
|                                                           |                    | Other<br>Observable<br>Inputs<br>(Level 2)                                                                                    | Significant<br>Unobservable<br>Inputs<br>(Level 3) |           |           |                                  |
| Assets:                                                   |                    |                                                                                                                               |                                                    |           |           |                                  |
| Cash and Cash Equivalents                                 | \$59,446           | \$ 59,446                                                                                                                     | \$ -                                               | \$ -      | \$59,446  |                                  |
| Investment Securities Available-for-Sale:                 |                    |                                                                                                                               |                                                    |           |           |                                  |
| Government Agency &<br>Government-Sponsored Entities      | 33,251             | -                                                                                                                             | 33,251                                             | -         | 33,251    |                                  |
| U.S. Treasury Notes                                       | 72,884             | 72,884                                                                                                                        | -                                                  | -         | 72,884    |                                  |
| Mortgage Backed Securities                                | 262,493            | -                                                                                                                             | 262,493                                            | -         | 262,493   |                                  |
| Other                                                     | 509                | 199                                                                                                                           | 310                                                | -         | 509       |                                  |
| Total Investment Securities Available-for-Sale            | 369,137            | 73,083                                                                                                                        | 296,054                                            | -         | 369,137   |                                  |
| Investment Securities Held-to-Maturity:                   |                    |                                                                                                                               |                                                    |           |           |                                  |
| Obligations of States and Political<br>Subdivisions       | 61,396             | -                                                                                                                             | 44,675                                             | 17,713    | 62,388    |                                  |
| Total Investment Securities Held-to-Maturity              | 61,396             | -                                                                                                                             | 44,675                                             | 17,713    | 62,388    |                                  |
| FHLB Stock                                                | 7,795              | N/A                                                                                                                           | N/A                                                | N/A       | N/A       |                                  |
| Loans & Leases, Net of Deferred Fees &<br>Allowance:      |                    |                                                                                                                               |                                                    |           |           |                                  |
| Commercial Real Estate                                    | 593,587            | -                                                                                                                             | -                                                  | 591,271   | 591,271   |                                  |
| Agricultural Real Estate                                  | 417,153            | -                                                                                                                             | -                                                  | 405,295   | 405,295   |                                  |
| Real Estate Construction                                  | 149,489            | -                                                                                                                             | -                                                  | 149,371   | 149,371   |                                  |
| Residential 1st Mortgages                                 | 205,616            | -                                                                                                                             | -                                                  | 207,431   | 207,431   |                                  |
| Home Equity Lines and Loans                               | 30,910             | -                                                                                                                             | -                                                  | 32,360    | 32,360    |                                  |
| Agricultural                                              | 287,658            | -                                                                                                                             | -                                                  | 285,733   | 285,733   |                                  |
| Commercial                                                | 202,968            | -                                                                                                                             | -                                                  | 201,105   | 201,105   |                                  |
| Consumer & Other                                          | 6,417              | -                                                                                                                             | -                                                  | 6,416     | 6,416     |                                  |
| Leases                                                    | 62,584             | -                                                                                                                             | -                                                  | 62,139    | 62,139    |                                  |
| Unallocated Allowance                                     | (1,546 )           | -                                                                                                                             | -                                                  | (1,546 )  | (1,546 )  |                                  |
| Total Loans & Leases, Net of Deferred Fees &<br>Allowance | 1,954,836          | -                                                                                                                             | -                                                  | 1,939,575 | 1,939,575 |                                  |
| Accrued Interest Receivable                               | 9,240              | -                                                                                                                             | 9,240                                              | -         | 9,240     |                                  |
| Liabilities:                                              |                    |                                                                                                                               |                                                    |           |           |                                  |
| Deposits:                                                 |                    |                                                                                                                               |                                                    |           |           |                                  |
| Demand                                                    | 711,029            | 711,029                                                                                                                       | -                                                  | -         | 711,029   |                                  |
| Interest Bearing Transaction                              | 377,594            | 377,594                                                                                                                       | -                                                  | -         | 377,594   |                                  |
| Savings and Money Market                                  | 707,885            | 707,885                                                                                                                       | -                                                  | -         | 707,885   |                                  |
| Time                                                      | 481,024            | -                                                                                                                             | 480,334                                            | -         | 480,334   |                                  |
| Total Deposits                                            | 2,277,532          | 1,796,508                                                                                                                     | 480,334                                            | -         | 2,276,842 |                                  |
| Subordinated Debentures                                   | 10,310             | -                                                                                                                             | 6,424                                              | -         | 6,424     |                                  |
| Accrued Interest Payable                                  | 513                | -                                                                                                                             | 513                                                | -         | 513       |                                  |



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| June 30, 2015<br>(in thousands)                                      | Carrying<br>Amount | Fair Value of Financial Instruments Using<br>Quoted<br>Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) |         |           | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Estimated<br>Fair Value |
|----------------------------------------------------------------------|--------------------|-------------------------------------------------------------------------------------------------------------------------------|---------|-----------|--------------------------------------------|----------------------------------------------------|----------------------------------|
|                                                                      |                    |                                                                                                                               |         |           |                                            |                                                    |                                  |
| <b>Assets:</b>                                                       |                    |                                                                                                                               |         |           |                                            |                                                    |                                  |
| Cash and Cash Equivalents                                            | \$91,339           | \$ 91,339                                                                                                                     | \$ -    | \$ -      | \$ -                                       | \$ -                                               | \$91,339                         |
| <b>Investment Securities Available-for-Sale:</b>                     |                    |                                                                                                                               |         |           |                                            |                                                    |                                  |
| Government Agency &<br>Government-Sponsored Entities                 | 11,121             | -                                                                                                                             | 11,121  | -         | -                                          | -                                                  | 11,121                           |
| U.S. Treasury Notes                                                  | 80,238             | -                                                                                                                             | 80,238  | -         | -                                          | -                                                  | 80,238                           |
| Mortgage Backed Securities                                           | 259,580            | -                                                                                                                             | 259,580 | -         | -                                          | -                                                  | 259,580                          |
| Other                                                                | 485                | 175                                                                                                                           | 310     | -         | -                                          | -                                                  | 485                              |
| Total Investment Securities Available-for-Sale                       | 351,424            | 175                                                                                                                           | 351,249 | -         | -                                          | -                                                  | 351,424                          |
| <b>Investment Securities Held-to-Maturity:</b>                       |                    |                                                                                                                               |         |           |                                            |                                                    |                                  |
| Obligations of States and Political<br>Subdivisions                  | 65,270             | -                                                                                                                             | 47,321  | 18,014    | -                                          | -                                                  | 65,335                           |
| Other                                                                | 2,131              | -                                                                                                                             | 2,131   | -         | -                                          | -                                                  | 2,131                            |
| Total Investment Securities Held-to-Maturity                         | 67,401             | -                                                                                                                             | 49,452  | 18,014    | -                                          | -                                                  | 67,466                           |
| FHLB Stock                                                           | 7,795              | N/A                                                                                                                           | N/A     | N/A       | N/A                                        | N/A                                                | N/A                              |
| <b>Loans &amp; Leases, Net of Deferred Fees &amp;<br/>Allowance:</b> |                    |                                                                                                                               |         |           |                                            |                                                    |                                  |
| Commercial Real Estate                                               | 561,582            | -                                                                                                                             | -       | 559,550   | -                                          | -                                                  | 559,550                          |
| Agricultural Real Estate                                             | 366,052            | -                                                                                                                             | -       | 362,035   | -                                          | -                                                  | 362,035                          |
| Real Estate Construction                                             | 114,806            | -                                                                                                                             | -       | 114,984   | -                                          | -                                                  | 114,984                          |
| Residential 1st Mortgages                                            | 188,308            | -                                                                                                                             | -       | 191,266   | -                                          | -                                                  | 191,266                          |
| Home Equity Lines and Loans                                          | 29,254             | -                                                                                                                             | -       | 31,021    | -                                          | -                                                  | 31,021                           |
| Agricultural                                                         | 220,749            | -                                                                                                                             | -       | 219,967   | -                                          | -                                                  | 219,967                          |
| Commercial                                                           | 247,508            | -                                                                                                                             | -       | 245,825   | -                                          | -                                                  | 245,825                          |
| Consumer & Other                                                     | 4,767              | -                                                                                                                             | -       | 4,803     | -                                          | -                                                  | 4,803                            |
| Leases                                                               | 48,099             | -                                                                                                                             | -       | 47,595    | -                                          | -                                                  | 47,595                           |
| Unallocated Allowance                                                | (1,520 )           | -                                                                                                                             | -       | (1,520 )  | -                                          | -                                                  | (1,520 )                         |
| Total Loans & Leases, Net of Deferred Fees &<br>Allowance            | 1,779,605          | -                                                                                                                             | -       | 1,775,526 | -                                          | -                                                  | 1,775,526                        |
| Accrued Interest Receivable                                          | 9,024              | -                                                                                                                             | 9,024   | -         | -                                          | -                                                  | 9,024                            |
| <b>Liabilities:</b>                                                  |                    |                                                                                                                               |         |           |                                            |                                                    |                                  |
| <b>Deposits:</b>                                                     |                    |                                                                                                                               |         |           |                                            |                                                    |                                  |
| Demand                                                               | 613,042            | 613,041                                                                                                                       | -       | -         | -                                          | -                                                  | 613,041                          |
| Interest Bearing Transaction                                         | 349,404            | 349,404                                                                                                                       | -       | -         | -                                          | -                                                  | 349,404                          |
| Savings and Money Market                                             | 706,121            | 706,122                                                                                                                       | -       | -         | -                                          | -                                                  | 706,122                          |
| Time                                                                 | 494,569            | -                                                                                                                             | 494,724 | -         | -                                          | -                                                  | 494,724                          |
| Total Deposits                                                       | 2,163,136          | 1,668,567                                                                                                                     | 494,724 | -         | -                                          | -                                                  | 2,163,291                        |
| Subordinated Debentures                                              | 10,310             | -                                                                                                                             | 6,252   | -         | -                                          | -                                                  | 6,252                            |



|                          |     |   |     |   |     |
|--------------------------|-----|---|-----|---|-----|
| Accrued Interest Payable | 556 | - | 556 | - | 556 |
|--------------------------|-----|---|-----|---|-----|

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Fair value estimates presented herein are based on pertinent information available to management as of June 30, 2016, December 31, 2015, and June 30, 2015. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purpose of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above. The methods and assumptions used to estimate the fair value of each class of financial instrument listed in the table above are explained below.

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

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

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

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

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

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

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

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

### 6. Dividends and Basic Earnings Per Common Share

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. On May 12, 2016, the Board of Directors of Farmers & Merchants Bancorp

announced a mid-year cash dividend of \$6.55 per share, a 2.3% increase over the \$6.40 per share paid on July 1, 2015. The cash dividend was paid on July 1, 2016, to shareholders of record on June 10, 2016.

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Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the basic earnings per common share for the three and six months ended June 30, 2016 and 2015.

| (net income in thousands)                            | Three Months   |         | Six Months     |          |
|------------------------------------------------------|----------------|---------|----------------|----------|
|                                                      | Ended June 30, |         | Ended June 30, |          |
|                                                      | 2016           | 2015    | 2016           | 2015     |
| Net Income                                           | \$7,332        | \$6,749 | \$14,504       | \$13,152 |
| Weighted Average Number of Common Shares Outstanding | 792,387        | 785,782 | 792,141        | 785,575  |
| Basic Earnings Per Common Share Amount               | \$9.25         | \$8.59  | \$18.31        | \$16.74  |

## 7. Shareholders' Equity

On January 29, 2016, the Company issued 1,600 shares of common stock to the Bank's non-qualified defined contribution retirement plans. These shares were issued at a price of \$525 per share based upon a valuation completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, the regulations promulgated thereunder. The proceeds were contributed to the Bank as equity capital.

## 8. Pending Acquisition of Delta National Bancorp

On June 8, 2016, Farmers & Merchants Bancorp and Delta National Bancorp announced that a definitive agreement had been signed by both parties. Under the terms of the agreement, Delta National Bancorp will merge into Farmers & Merchants Bancorp. The transaction is subject to customary closing conditions, including regulatory approvals and Delta National Bancorp's shareholder approval, and is expected to close in the fourth quarter of 2016.

Delta National Bancorp, headquartered in Manteca, California, is the parent holding company for Delta Bank N.A., a locally owned and operated community bank established in 1973. As of June 30, 2016, Delta National Bancorp had approximately \$109.1 million in assets and four branch locations in the communities of Manteca, Riverbank, Modesto and Turlock. Delta National Bancorp will be merged with and into Farmers & Merchants Bancorp and Delta National Bancorp's banking subsidiary Delta Bank, N.A. will be merged with and into Farmers & Merchants Bancorp's banking subsidiary Farmers & Merchants Bank of Central California. The names of the combined entities will remain Farmers & Merchants Bancorp and Farmers & Merchants Bank of Central California.

Delta National Bancorp common shareholders will be entitled to receive 12,074 shares of Farmers & Merchants Bancorp common stock, subject to certain adjustments described in the definitive merger agreement. Based on the 20 day daily volume weighted average price of Farmers & Merchants Bancorp as of June 6, 2016, the transaction would have a value of \$6.6 million, or \$17.30 per Delta National Bancorp common share. However, the deal value for the common shareholders will fluctuate with changes in Farmers & Merchants Bancorp's stock price. Delta National Bancorp's preferred shareholders will receive \$19.827 per share in cash.

For additional information about the proposed acquisition of Delta Bank, N.A., see the Company's Current Report on Form 8-K filed with the SEC on June 10, 2016 and the Agreement and Plan of Reorganization which is filed as an exhibit to the Current Report on Form 8-K.

## 9. Recent Accounting Pronouncements

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU will require the earlier recognition of credit losses on loans and other financial instruments based on an expected loss model, replacing the incurred loss model that is currently in use.

Under the new guidance, an entity will measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts. The expected loss model will apply to loans and leases, unfunded lending commitments, held-to-maturity debt securities and other debt instruments measured at amortized cost. The impairment model for available-for-sale debt securities will require the recognition of credit losses through a valuation allowance when fair value is less than amortized cost, regardless of whether the impairment is considered to be other-than-temporary. The new guidance is effective on January 1, 2020, with early adoption permitted on January 1, 2019. The Company is currently evaluating the effects of ASU 2016-13 on its financial statements and disclosures.

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In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The new standard is being issued to increase the transparency and comparability around lease obligations. Previously unrecorded off-balance sheet obligations will now be brought more prominently to light by presenting lease liabilities on the face of the balance sheet, accompanied by enhanced qualitative and quantitative disclosures in the notes to the financial statements. The Update is generally effective for public business entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the effects of ASU 2016-02 on its financial statements and disclosures.

In August 2015, the FASB issued ASU 2015-14 which deferred the effective date of ASU 2014-09, Revenue from Contracts with Customers (Topic 606). As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reporting periods beginning after December 15, 2017. The Update modifies the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. The Company is currently evaluating the effects of ASU 2014-09 on its financial statements and disclosures.

### Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three and six months ended June 30, 2016. This analysis should be read in conjunction with our 2015 Annual Report to Shareholders on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

#### Forward-Looking Statements

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

Such factors include the following: (1) continuing economic sluggishness in the Central Valley of California; (2) significant changes in interest rates and prepayment speeds; (3) credit risks of lending and investment activities; (4) changes in federal and state banking laws or regulations; (5) competitive pressure in the banking industry; (6) changes in governmental fiscal or monetary policies; (7) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; (8) ongoing drought conditions in California and the resulting impact on the Company's agricultural customers; (9) expansion into new geographic markets and new lines of business; (10) integration of Delta National Bancorp with and into the Company pursuant to the merger; and (11) other factors discussed in Item 1A. Risk Factors located in the Company's 2015 Annual Report on Form 10-K and in Part II. Other Information, Item 1A. Risk Factors of this Form 10-Q.

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.

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### Introduction

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California state-chartered bank formed in 1916. Banking services are provided in twenty-four locations in the Company's service area. The service area includes Sacramento, San Joaquin, Stanislaus, Merced and Contra Costa Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock, Hilmar, Merced, Walnut Creek and Concord.

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

On June 8, 2016, Farmers & Merchants Bancorp and Delta National Bancorp announced that a definitive agreement had been signed by both parties. Under the terms of the agreement, Delta National Bancorp will merge into Farmers & Merchants Bancorp. The transaction is subject to customary closing conditions, including regulatory approvals and Delta National Bancorp's shareholder approval, and is expected to close in the fourth quarter of 2016. (See "Part I, Item 1 – Note 8 to the Financial Statements")

Delta National Bancorp, headquartered in Manteca, California, is the parent holding company for Delta Bank N.A., a locally owned and operated community bank established in 1973. As of June 30, 2016, the Bank had approximately \$109 million in assets and four branch locations in the communities of Manteca, Riverbank, Modesto and Turlock. Delta National Bancorp will be merged with and into Farmers & Merchants Bancorp and Delta National Bancorp's banking subsidiary Delta Bank, N.A. will be merged with and into Farmers & Merchants Bancorp's banking subsidiary Farmers & Merchants Bank of Central California. The names of the combined entities will remain Farmers & Merchants Bancorp and Farmers & Merchants Bank of Central California.

Delta National Bancorp common shareholders will be entitled to receive 12,074 shares of Farmers & Merchants Bancorp common stock, subject to certain adjustments described in the definitive merger agreement. Based on the 20 day daily volume weighted average price of Farmers & Merchants Bancorp as of June 6, 2016, the transaction would have a value of \$6.6 million, or \$17.30 per Delta National Bancorp common share. However, the deal value for the common shareholders will fluctuate with changes in Farmers & Merchants Bancorp's stock price. Delta National Bancorp's preferred shareholders will receive \$19.827 per share in cash.

For additional information about the proposed acquisition of Delta Bank, N.A., see the Company's Current Reports on Form 8-K filed with the SEC on June 9 and June 10, 2016 and the Agreement and Plan of Reorganization which is filed as an exhibit to the June 10<sup>th</sup> Current Report on Form 8-K. See also "Part II. Other Information, Item 1a, Risk Factors."

### Overview

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

The state of California has experienced drought conditions since 2013. These conditions did not have a material impact on the Company's credit quality during the 2015 growing season. Although rain and snow levels in early 2016 increased significantly relative to prior years, they were not sufficient to completely relieve the drought conditions that had built up over the prior three years. Accordingly, management believes that current conditions will continue to have an adverse impact on some of the Company's agricultural customers' operating costs in 2016, but at the current time we cannot tell what the ultimate impact will be on 2016 crop yields and crop quality. The longer the drought continues, the more significant is its impact, particularly if ground water levels begin to significantly deteriorate or riparian rights are curtailed. See Item 1A. Risk Factors located in the Company's 2015 Annual Report on Form 10-K" for additional information.



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For the three and six months ended June 30, 2016, Farmers & Merchants Bancorp reported net income of \$7,332,000 and \$14,504,000, earnings per share of \$9.25 and \$18.31 and return on average assets of 1.14% and 1.12%, respectively. Return on average shareholders' equity was 11.14% and 11.13% for the three and six months ended June 30, 2016.

For the three and six months ended June 30, 2015, Farmers & Merchants Bancorp reported net income of \$6,749,000 and \$13,152,000, earnings per share of \$8.59 and \$16.74 and return on average assets of 1.12% and 1.10%, respectively. Return on average shareholders' equity was 11.11% and 10.94% for the three and six months ended June 30, 2015.

The following is a summary of the financial results for the six-month period ended June 30, 2016 compared to June 30, 2015.

Net income increased 10.3% to \$14.5 million from \$13.2 million.

Earnings per share increased 9.4% to \$18.31 from \$16.74.

Total assets increased 9.5% to \$2.7 billion from \$2.5 billion.

Total loans & leases increased 13.7% to \$2.1 billion from \$1.8 billion.

Total deposits increased 7.6% to \$2.3 billion from \$2.2 billion.

The primary reasons for the Company's \$1.4 million or 6.7% increase in pre-tax income in the first half of 2016 as compared to the same period of 2015 were:

A \$5.05 million increase in net interest income primarily related to the growth in earning assets.

A \$5.64 million increase in gain on sale of ORE related to the disposition of two of the Company's foreclosed properties.

These positive impacts were partially offset by:

A \$2.00 million increase in the provision for credit losses and a \$100,000 increase in the provision for unused commitments, resulting from: (1) management's assessment of the risks related to the continuing sluggish economy in our primary service area, and increasing concerns regarding the level of future growth in the U.S. economy in general; (2) a decline in key agricultural commodity prices; (3) continuing drought conditions in California; and (4) the overall growth in the loan portfolio, measured by both commitments and outstanding balances.

A \$295,000 increase in loss on sale of investment securities as the Company took advantage of a decline in market interest rates to sell certain lower yielding investment securities.

A \$1.89 million decrease in non-interest income primarily related to a \$1.10 million non-recurring financing fee earned in the first quarter of 2015.

\$700,000 in merger related expenses related to the proposed acquisition of Delta National Bancorp.

A \$4.62 million increase in other (i.e., non merger related) non-interest expenses primarily related to:

Salaries and employee benefits of new staff added for branch expansion and the Company's equipment leasing activities, bank wide raises, and increased contributions to employee retirement and other benefit plans.

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- Legal and other professional services resulting from management's assessment of the Company's future corporate structure, branding and overall strategic direction.
- Recruiting and training of new staff as the company expands its geographic footprint and business activities.
- Amortization expense related to an increase in CRA qualifying low income housing tax credit investments.
- Occupancy, equipment and marketing expenses from branch expansion and remodeling, ATM upgrades, introduction of a new logo and celebration of the Bank's 100th anniversary.

### Results of Operations

#### Net Interest Income / Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analyses for the three and six-month periods ended June 30, 2016 and 2015.

The average yields on earning assets and average rates paid on interest-bearing liabilities have been computed on an annualized basis for purposes of comparability with full year data. Average balance amounts for assets and liabilities are the computed average of daily balances.

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

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

The Company's earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix. See "Item 3. Quantitative and Qualitative Disclosures about Market Risk – Interest Rate Risk."

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Farmers & Merchants Bancorp  
 Quarterly Average Balances and Interest Rates  
 (Interest and Rates on a Taxable Equivalent Basis)  
 (in thousands)

|                                                                   | Three Months Ended June 30,<br>2016 |          |        | Three Months Ended June 30,<br>2015 |           |        |
|-------------------------------------------------------------------|-------------------------------------|----------|--------|-------------------------------------|-----------|--------|
|                                                                   | Balance                             | Interest | Rate   | Balance                             | Interest  | Rate   |
| Assets                                                            |                                     |          |        |                                     |           |        |
| Interest Bearing Deposits with Banks                              | \$28,395                            | \$36     | 0.51 % | \$ 103,093                          | \$ 65     | 0.25 % |
| Investment Securities:                                            |                                     |          |        |                                     |           |        |
| U.S. Treasuries                                                   | 65,552                              | 155      | 0.95 % | 42,026                              | 141       | 1.34 % |
| Government Agency & Government-Sponsored<br>Entities              | 16,397                              | 28       | 0.68 % | 18,559                              | 16        | 0.34 % |
| Obligations of States and Political Subdivisions -<br>Non-Taxable | 61,385                              | 744      | 4.85 % | 59,982                              | 772       | 5.15 % |
| Mortgage Backed Securities                                        | 202,494                             | 1,115    | 2.20 % | 265,064                             | 1,418     | 2.14 % |
| Other                                                             | 515                                 | 3        | 2.33 % | 2,621                               | 7         | 1.07 % |
| Total Investment Securities                                       | 346,343                             | 2,045    | 2.36 % | 388,252                             | 2,354     | 2.43 % |
| Loans & Leases:                                                   |                                     |          |        |                                     |           |        |
| Real Estate                                                       | 1,443,510                           | 16,463   | 4.59 % | 1,200,131                           | 14,007    | 4.68 % |
| Home Equity Lines & Loans                                         | 31,415                              | 391      | 5.01 % | 31,411                              | 430       | 5.49 % |
| Agricultural                                                      | 260,242                             | 2,640    | 4.08 % | 211,841                             | 2,138     | 4.05 % |
| Commercial                                                        | 222,044                             | 2,238    | 4.05 % | 243,995                             | 2,450     | 4.03 % |
| Consumer                                                          | 5,080                               | 69       | 5.46 % | 4,934                               | 59        | 4.80 % |
| Other                                                             | 1,968                               | 11       | 2.25 % | -                                   | -         | 0.00 % |
| Leases                                                            | 65,096                              | 680      | 4.20 % | 50,759                              | 522       | 4.12 % |
| Total Loans & Leases                                              | 2,029,355                           | 22,492   | 4.46 % | 1,743,071                           | 19,606    | 4.51 % |
| Total Earning Assets                                              | 2,404,093                           | \$24,573 | 4.11 % | 2,234,416                           | \$ 22,025 | 3.95 % |
| Unrealized Gain on Securities Available-for-Sale                  | 5,628                               |          |        | 5,525                               |           |        |
| Allowance for Credit Losses                                       | (44,126 )                           |          |        | (38,958 )                           |           |        |
| Cash and Due From Banks                                           | 43,185                              |          |        | 37,033                              |           |        |
| All Other Assets                                                  | 171,778                             |          |        | 176,543                             |           |        |
| Total Assets                                                      | \$2,580,558                         |          |        | \$ 2,414,559                        |           |        |
| Liabilities & Shareholders' Equity                                |                                     |          |        |                                     |           |        |
| Interest Bearing Deposits:                                        |                                     |          |        |                                     |           |        |
| Interest Bearing DDA                                              | \$414,876                           | 128      | 0.12 % | \$ 342,327                          | \$ 46     | 0.05 % |
| Savings and Money Market                                          | 718,077                             | 262      | 0.15 % | 693,071                             | 300       | 0.17 % |
| Time Deposits                                                     | 487,861                             | 469      | 0.39 % | 496,736                             | 408       | 0.33 % |
| Total Interest Bearing Deposits                                   | 1,620,814                           | 859      | 0.21 % | 1,532,134                           | 754       | 0.20 % |
| Federal Home Loan Bank Advances                                   | 393                                 | -        | 0.00 % | -                                   | -         | 0.00 % |
| Subordinated Debentures                                           | 10,310                              | 92       | 3.59 % | 10,310                              | 81        | 3.15 % |
| Total Interest Bearing Liabilities                                | 1,631,517                           | \$951    | 0.23 % | 1,542,444                           | \$ 835    | 0.22 % |
| Interest Rate Spread                                              |                                     |          | 3.88 % |                                     |           | 3.74 % |
| Demand Deposits (Non-Interest Bearing)                            | 633,394                             |          |        | 574,265                             |           |        |
| All Other Liabilities                                             | 52,321                              |          |        | 54,756                              |           |        |
| Total Liabilities                                                 | 2,317,232                           |          |        | 2,171,465                           |           |        |
| Shareholders' Equity                                              | 263,326                             |          |        | 243,094                             |           |        |

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|                                                               |             |        |             |        |
|---------------------------------------------------------------|-------------|--------|-------------|--------|
| Total Liabilities & Shareholders' Equity                      | \$2,580,558 |        | \$2,414,559 |        |
| Impact of Non-Interest Bearing Deposits and Other Liabilities |             | 0.08 % |             | 0.08 % |
| Net Interest Income and Margin on Total Earning Assets        | 23,622      | 3.95 % | 21,190      | 3.81 % |
| Tax Equivalent Adjustment                                     | (259 )      |        | (269 )      |        |
| Net Interest Income                                           | \$23,363    | 3.91 % | \$20,921    | 3.77 % |

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 \$1.2 million and \$1.3 million for the quarters ended June 30, 2016 and 2015, respectively. Yields on securities available-for-sale are based on historical cost.

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

|                                                                   | Six Months Ended June 30,<br>2016 |          |       | Six Months Ended June 30,<br>2015 |          |       |
|-------------------------------------------------------------------|-----------------------------------|----------|-------|-----------------------------------|----------|-------|
|                                                                   | Balance                           | Interest | Rate  | Balance                           | Interest | Rate  |
| Assets                                                            |                                   |          |       |                                   |          |       |
| Interest Bearing Deposits with Banks                              | \$32,674                          | \$82     | 0.50% | \$98,300                          | \$123    | 0.25% |
| Investment Securities:                                            |                                   |          |       |                                   |          |       |
| U.S. Treasuries                                                   | 48,856                            | 227      | 0.93% | 24,085                            | 160      | 1.33% |
| Government Agency & Government-Sponsored<br>Entities              | 25,172                            | 133      | 1.06% | 47,259                            | 55       | 0.23% |
| Obligations of States and Political Subdivisions -<br>Non-Taxable | 61,404                            | 1,487    | 4.84% | 60,771                            | 1,573    | 5.18% |
| Mortgage Backed Securities                                        | 228,613                           | 2,537    | 2.22% | 271,564                           | 2,940    | 2.17% |
| Other                                                             | 512                               | 6        | 2.34% | 2,625                             | 13       | 0.99% |
| Total Investment Securities                                       | 364,557                           | 4,390    | 2.41% | 406,304                           | 4,741    | 2.33% |
| Loans & Leases:                                                   |                                   |          |       |                                   |          |       |
| Real Estate                                                       | 1,427,211                         | 32,429   | 4.57% | 1,165,452                         | 27,529   | 4.76% |
| Home Equity Lines & Loans                                         | 31,862                            | 780      | 4.92% | 31,740                            | 852      | 5.41% |
| Agricultural                                                      | 260,072                           | 5,254    | 4.06% | 219,828                           | 4,356    | 4.00% |
| Commercial                                                        | 219,253                           | 4,395    | 4.03% | 237,604                           | 4,846    | 4.11% |
| Consumer                                                          | 4,987                             | 147      | 5.93% | 4,887                             | 131      | 5.41% |
| Other                                                             | 1,968                             | 22       | 0.00% | -                                 | -        | 0.00% |
| Leases                                                            | 65,389                            | 1,359    | 4.18% | 48,982                            | 1,019    | 4.20% |
| Total Loans & Leases                                              | 2,010,742                         | 44,386   | 4.44% | 1,708,493                         | 38,733   | 4.57% |
| Total Earning Assets                                              | 2,407,973                         | \$48,858 | 4.08% | 2,213,097                         | \$43,597 | 3.97% |
| Unrealized Gain on Securities Available-for-Sale                  | 4,833                             |          |       | 5,535                             |          |       |
| Allowance for Credit Losses                                       | (42,865 )                         |          |       | (37,212 )                         |          |       |
| Cash and Due From Banks                                           | 42,115                            |          |       | 36,890                            |          |       |
| All Other Assets                                                  | 170,060                           |          |       | 175,024                           |          |       |
| Total Assets                                                      | \$2,582,116                       |          |       | \$2,393,334                       |          |       |
| Liabilities & Shareholders' Equity                                |                                   |          |       |                                   |          |       |
| Interest Bearing Deposits:                                        |                                   |          |       |                                   |          |       |
| Interest Bearing DDA                                              | \$403,697                         | \$236    | 0.12% | \$341,686                         | \$92     | 0.05% |
| Savings and Money Market                                          | 727,970                           | 542      | 0.15% | 685,996                           | 590      | 0.17% |
| Time Deposits                                                     | 485,358                           | 909      | 0.38% | 488,388                           | 784      | 0.32% |
| Total Interest Bearing Deposits                                   | 1,617,025                         | 1,687    | 0.21% | 1,516,070                         | 1,466    | 0.19% |
| Federal Home Loan Bank Advances                                   | 1,910                             | 4        | 0.42% | 2                                 | -        | 0.00% |
| Subordinated Debentures                                           | 10,310                            | 180      | 3.51% | 10,310                            | 161      | 3.15% |
| Total Interest Bearing Liabilities                                | 1,629,245                         | \$1,871  | 0.23% | 1,526,382                         | \$1,627  | 0.21% |
| Interest Rate Spread                                              |                                   |          | 3.85% |                                   |          | 3.76% |
| Demand Deposits (Non-Interest Bearing)                            | 642,354                           |          |       | 575,242                           |          |       |
| All Other Liabilities                                             | 49,802                            |          |       | 51,167                            |          |       |
| Total Liabilities                                                 | 2,321,401                         |          |       | 2,152,791                         |          |       |
| Shareholders' Equity                                              | 260,715                           |          |       | 240,543                           |          |       |

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|                                                               |             |       |             |       |
|---------------------------------------------------------------|-------------|-------|-------------|-------|
| Total Liabilities & Shareholders' Equity                      | \$2,582,116 |       | \$2,393,334 |       |
| Impact of Non-Interest Bearing Deposits and Other Liabilities |             | 0.07% |             | 0.07% |
| Net Interest Income and Margin on Total Earning Assets        | 46,987      | 3.92% | 41,970      | 3.82% |
| Tax Equivalent Adjustment                                     | (518 )      |       | (548 )      |       |
| Net Interest Income                                           | \$46,469    | 3.88% | \$41,422    | 3.77% |

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 \$2.2 million and \$2.6 million for the six months ended June 30, 2016 and 2015, respectively. Yields on securities available-for-sale are based on historical cost.

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Volume and Rate Analysis of Net Interest Revenue  
(in thousands)

|                                                                | Three Months Ended                      |           |          | Six Months Ended                        |             |          |
|----------------------------------------------------------------|-----------------------------------------|-----------|----------|-----------------------------------------|-------------|----------|
|                                                                | June 30, 2016 compared to June 30, 2015 |           |          | June 30, 2016 compared to June 30, 2015 |             |          |
|                                                                | Volume                                  | Rate      | Net Chg. | Volume                                  | Rate        | Net Chg. |
| Interest Earning Assets                                        |                                         |           |          |                                         |             |          |
| Interest Bearing Deposits with Banks                           | \$ (68 )                                | \$ 39     | \$ (29 ) | \$ (116 )                               | \$ 75       | \$ (41 ) |
| Investment Securities:                                         |                                         |           |          |                                         |             |          |
| U.S. Treasuries                                                | 64                                      | (50 )     | 14       | 127                                     | (60 )       | 67       |
| Government Agency & Government-Sponsored Entities              | (2 )                                    | 14        | 12       | (37 )                                   | 115         | 78       |
| Obligations of States and Political Subdivisions - Non-Taxable | 18                                      | (46 )     | (28 )    | 16                                      | (102 )      | (86 )    |
| Mortgage Backed Securities                                     | (344 )                                  | 41        | (303 )   | (475 )                                  | 72          | (403 )   |
| Other                                                          | (8 )                                    | 4         | (4 )     | (15 )                                   | 8           | (7 )     |
| Total Investment Securities                                    | (272 )                                  | (37 )     | (309 )   | (384 )                                  | 33          | (351 )   |
| Loans & Leases:                                                |                                         |           |          |                                         |             |          |
| Real Estate                                                    | 2,749                                   | (293 )    | 2,456    | 6,061                                   | (1,161 )    | 4,900    |
| Home Equity Lines & Loans                                      | -                                       | (39 )     | (39 )    | 3                                       | (75 )       | (72 )    |
| Agricultural                                                   | 485                                     | 17        | 502      | 823                                     | 75          | 898      |
| Commercial                                                     | (228 )                                  | 16        | (212 )   | (358 )                                  | (93 )       | (451 )   |
| Consumer                                                       | 2                                       | 8         | 10       | 3                                       | 13          | 16       |
| Other                                                          | 11                                      | -         | 11       | 22                                      | -           | 22       |
| Leases                                                         | 148                                     | 10        | 158      | 344                                     | (4 )        | 340      |
| Total Loans & Leases                                           | 3,167                                   | (281 )    | 2,886    | 6,898                                   | (1,245 )    | 5,653    |
| Total Earning Assets                                           | 2,827                                   | (279 )    | 2,548    | 6,398                                   | (1,137 )    | 5,261    |
| Interest Bearing Liabilities                                   |                                         |           |          |                                         |             |          |
| Interest Bearing Deposits:                                     |                                         |           |          |                                         |             |          |
| Transaction                                                    | 12                                      | 70        | 82       | 20                                      | 124         | 144      |
| Savings and Money Market                                       | 11                                      | (49 )     | (38 )    | 35                                      | (83 )       | (48 )    |
| Time                                                           | (7 )                                    | 68        | 61       | (5 )                                    | 130         | 125      |
| Total Interest Bearing Deposits                                | 16                                      | 89        | 105      | 50                                      | 171         | 221      |
| Other Borrowed Funds                                           | -                                       | -         | -        | 4                                       | -           | 4        |
| Subordinated Debentures                                        | -                                       | 11        | 11       | -                                       | 19          | 19       |
| Total Interest Bearing Liabilities                             | 16                                      | 100       | 116      | 54                                      | 190         | 244      |
| Total Change on a Tax Equivalent Basis                         | \$ 2,811                                | \$ (379 ) | \$ 2,432 | \$ 6,344                                | \$ (1,327 ) | \$ 5,017 |

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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Second Quarter 2016 vs. Second Quarter 2015

Net interest income for the second quarter of 2016 increased 11.7% or \$2.4 million to \$23.4 million. On a fully taxable equivalent basis, net interest income increased 11.5% and totaled \$23.6 million for the second quarter of 2016. As more fully discussed below, the increase in net interest income was primarily due to a \$170.0 million increase in average earning assets.

Net interest income on a taxable equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For the quarter ended June 30, 2016, the Company's net interest margin was 3.95% compared to 3.81% for the quarter ended June 30, 2015. This increase in net interest margin was due primarily to an increase in earning asset yields.

Average loans & leases totaled \$2.0 billion for the quarter ended June 30, 2016; an increase of \$286.3 million compared to the average balance for the quarter ended June 30, 2015. Loans & leases increased from 78.0% of average earning assets at June 30, 2015 to 84.4% at June 30, 2016. As a result of the continuing impact of the sustained low rate environment since late 2008, the annualized yield on the Company's loan & lease portfolio declined to 4.46% for the quarter ended June 30, 2016, compared to 4.51% for the quarter ended June 30, 2015. Overall, the positive impact on interest revenue from the increase in loan & lease balances resulted in interest revenue from loans & leases increasing 14.7% to \$22.5 million for quarter ended June 30, 2015. The Company has been experiencing aggressive competitor pricing for loans & leases to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan & lease yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Since the risk factor for investments is typically lower than that of loans & leases, the yield earned on investments is generally less than that of loans & leases. Average investment securities totaled \$346.3 million for the quarter ended June 30, 2016; a decrease of \$41.9 million compared to the average balance for the quarter ended June 30, 2015. Tax equivalent interest income on securities decreased \$309,000 to \$2.0 million for the quarter ended June 30, 2016, compared to \$2.4 million for the quarter ended June 30, 2015. The average investment portfolio yield, on a tax equivalent basis, was 2.36% for the quarter ended June 30, 2016, compared to 2.43% for the quarter ended June 30, 2015. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2016. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statement of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Average interest bearing deposits with banks consisted of FRB deposits. Deposits with the FRB earn interest at the Fed Funds rate, which had been 0.25% since December 2008, but increased to 0.50% in December 2015. Average interest bearing deposits with banks for the quarter ended June 30, 2016, were \$28.7 million, a decrease of \$74.4 million compared to the average balance for the quarter ended June 30, 2015. Interest income on interest bearing deposits with banks for the quarter ended June 30, 2016, decreased \$29,000 to \$36,000 compared to the quarter ended June 30, 2015.

Average interest-bearing liabilities increased \$89.1 million or 5.8% during the second quarter of 2016. Of that increase: (1) interest-bearing transaction deposits increased \$72.5 million; (2) savings and money market deposits increased \$25.0 million; (3) time deposits decreased \$8.9 million; (4) Federal Home Loan Bank ("FHLB") Advances increased \$393,000 (see "Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings"); and (5) subordinated debt remained unchanged (see "Financial Condition – Subordinated Debentures").

Total interest expense on interest bearing deposits was \$859,000 for the second quarter of 2016 as compared to \$754,000 for the second quarter of 2015. The average rate paid on interest-bearing deposits was 0.21% for the second quarter of 2016 compared to 0.20% for the second quarter of 2015.





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### Six Months Ending June 30, 2016 vs. Six Months Ending June 30, 2015

During the first six months of 2016, net interest income increased 12.2% to \$46.5 million, compared to \$41.4 million at June 30, 2015. On a fully taxable equivalent basis, net interest income increased 11.9% and totaled \$47.0 million at June 30, 2016, compared to \$42.0 million at June 30, 2015. The increase in net interest income was primarily due to a \$194.9 million increase in average earning assets.

For the six months ended June 30, 2016, the Company's net interest margin was 3.92% compared to 3.82% for the same period in 2015. This increase in net interest margin was due primarily to an increase in earning asset yields.

The average balance of loans & leases increased by \$302.2 million for the six months ended June 30, 2016 compared to the six months ended June 30, 2015. The yield on the loan & lease portfolio decreased 13 basis points to 4.44% for the six months ended June 30, 2016 compared to 4.57% for the six months ended June 30, 2015. This decrease in yield was offset by growth of average balance of loans resulting in interest income from loans & leases increasing 14.6% or \$5.7 million for the first six months of 2016.

Average investment securities were \$364.6 million for the six months ended June 30, 2016 compared to \$406.3 million for the same period in 2015. The average tax equivalent yield for the six months ended June 30, 2016 was 2.41% compared to 2.33% for the six months ended June 30, 2015. Despite this increase in yield, because of the decrease in balances, interest income decreased \$351,000 or 7.4%, for the six months ended June 30, 2016.

Average interest bearing deposits with banks consisted of FRB deposits. Deposits with the FRB earn interest at the Fed Funds rate, which had been 0.25% since December 2008, but increased to 0.50% in December 2015. Average interest bearing deposits with banks for the six-months ended June 30, 2016, was \$32.7 million, a decrease of \$65.6 million compared to the average balance for the six-months ended June 30, 2015. Interest income on interest bearing deposits with banks for the six-months ended June 30, 2016, decreased \$41,000 to \$82,000 compared to the six-months ended June 30, 2015.

Average interest-bearing liabilities increased \$102.9 million or 6.7% during the six months ended June 30, 2016 as compared to the six months ended June 30, 2015. Of that increase: (1) interest-bearing deposits increased \$101.0 million; (2) FHLB advances increased \$1.9 million; and (3) subordinated debentures remained unchanged.

Total interest expense on interest bearing deposits was \$1.7 million for the first six months of 2016 as compared to \$1.5 million for the first six months of 2015. The average rate paid on interest-bearing deposits was 0.21% in the first six months of 2016 and 0.19% in the first six months of 2015.

### Provision and Allowance for Credit Losses

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

### Allowance for Credit Losses

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

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

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

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

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

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

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

Special Mention – A special mention loan or lease has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or

lease position at some future date. Special mention loans & leases are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

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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 Bank will estimate its probable loss and immediately charge-off some or all of the balance.

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

**Commercial Real Estate** – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

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

**Commercial** – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

**Agricultural Real Estate and Agricultural** – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

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

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

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

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

### Provision for Credit Losses

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

The Central Valley of California was one of the hardest hit areas in the country during the recession. In many areas, housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has stabilized throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country. While, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of June 30, 2016, compare very favorably to our peers at the present time, carefully managing credit risk remains a key focus of the Company.

The state of California has experienced drought conditions since 2013. These conditions did not have a material impact on the Company's credit quality during the 2015 growing season. Although rain and snow levels in early 2016 increased significantly relative to prior years, they were not sufficient to completely relieve the drought conditions that had built up over the prior three years. Accordingly, management believes that current conditions will continue to have an adverse impact on some of the Company's agricultural customers' operating costs in 2016, but at the current time we cannot tell what the ultimate impact will be on 2016 crop yields and crop quality. The longer the drought continues, the more significant is its impact, particularly if ground water levels begin to significantly deteriorate or riparian rights are curtailed. See "Part II. Other Information, Item 1A. Risk Factors" for additional information.

The Company made a \$2.6 million provision for credit losses during the first half of 2016 compared to \$650,000 provision during the first half of 2015. Net charge-offs during the first half of 2016 were \$5,000 compared to net recoveries of \$3.0 million in the first half of 2015. During the first half of 2015 the Company was able to fully recover \$2.9 million that was charged-off during 2010 on a restructured commercial real estate loan. In addition to the full recovery of the charged off principal, this transaction also resulted in the recovery of \$353,000 in interest income and the client's payment of a financing fee of \$1.1 million. See "Overview – Looking Forward: 2016 and Beyond", "Critical Accounting Policies and Estimates – Allowance for Credit Losses" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk" located in the Company's 2015 Annual Report on Form 10-K.



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After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of June 30, 2016, was adequate.

| (in thousands)                 | Three Months Ended |           | Six Months Ended |           |
|--------------------------------|--------------------|-----------|------------------|-----------|
|                                | June 30, 2016      | 2015      | June 30, 2016    | 2015      |
| Balance at Beginning of Period | \$ 44,129          | \$ 38,940 | \$ 41,523        | \$ 35,401 |
| Charge-Offs                    | (61 )              | (17 )     | (105 )           | (46 )     |
| Recoveries                     | 50                 | 64        | 100              | 3,032     |
| Provision                      | -                  | 50        | 2,600            | 650       |
| Balance at End of Period       | \$ 44,118          | \$ 39,037 | \$ 44,118        | \$ 39,037 |

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

| June 30, 2016                               | Commercial Real Estate | Agricultural Real Estate | Real Estate Construction | Residential Mortgages | Home Equity Loans & Lines | Agricultural | Commercial | Consumer & Other Leases | Unallocated | Total    |           |
|---------------------------------------------|------------------------|--------------------------|--------------------------|-----------------------|---------------------------|--------------|------------|-------------------------|-------------|----------|-----------|
| Year-To-Date Allowance for Credit Losses:   |                        |                          |                          |                       |                           |              |            |                         |             |          |           |
| Beginning Balance- January 1, 2016          |                        |                          |                          |                       |                           |              |            |                         |             |          |           |
|                                             | \$ 10,063              | \$ 6,881                 | \$ 2,485                 | \$ 789                | \$ 2,146                  | \$ 6,308     | \$ 7,836   | \$ 175                  | \$ 3,294    | \$ 1,546 | \$ 41,523 |
| Charge-Offs                                 | -                      | -                        | -                        | (7 )                  | (46 )                     | -            | -          | (52 )                   | -           | -        | (105 )    |
| Recoveries                                  | 2                      | -                        | -                        | 9                     | 33                        | -            | 29         | 27                      | -           | -        | 100       |
| Provision                                   | 171                    | 2,620                    | (43 )                    | 46                    | 16                        | (85 )        | (16 )      | 20                      | 148         | (277 )   | 2,600     |
| Ending Balance- June 30, 2016               |                        |                          |                          |                       |                           |              |            |                         |             |          |           |
|                                             | \$ 10,236              | \$ 9,501                 | \$ 2,442                 | \$ 837                | \$ 2,149                  | \$ 6,223     | \$ 7,849   | \$ 170                  | \$ 3,442    | \$ 1,269 | \$ 44,118 |
| Second Quarter Allowance for Credit Losses: |                        |                          |                          |                       |                           |              |            |                         |             |          |           |
| Beginning Balance- April 1, 2016            |                        |                          |                          |                       |                           |              |            |                         |             |          |           |
|                                             | \$ 10,099              | \$ 9,162                 | \$ 2,594                 | \$ 796                | \$ 2,064                  | \$ 5,904     | \$ 7,725   | \$ 187                  | \$ 3,239    | \$ 2,359 | \$ 44,129 |
| Charge-Offs                                 | -                      | -                        | -                        | -                     | (27 )                     | (7 )         | -          | (27 )                   | -           | -        | (61 )     |
| Recoveries                                  | -                      | -                        | -                        | 3                     | 31                        | -            | 2          | 14                      | -           | -        | 50        |
| Provision                                   | 137                    | 339                      | (152 )                   | 38                    | 81                        | 326          | 122        | (4 )                    | 203         | (1,090 ) | -         |
| Ending Balance- June 30, 2016               |                        |                          |                          |                       |                           |              |            |                         |             |          |           |
|                                             | \$ 10,236              | \$ 9,501                 | \$ 2,442                 | \$ 837                | \$ 2,149                  | \$ 6,223     | \$ 7,849   | \$ 170                  | \$ 3,442    | \$ 1,269 | \$ 44,118 |

The Allowance for Credit Losses at June 30, 2016 increased \$2.6 million from December 31, 2015. The allowance allocated to the following portfolio segment changed materially during the first half of 2016:

Agricultural Real Estate allowance balances increased \$2.6 million primarily due to increased qualitative factors in the Company's allowance calculation related to: (1) the longer-term impact of continuing drought conditions in

California; and (2) declines in prices for certain commodities that will impact agricultural real estate prices as cash flow is reduced.

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

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

#### Non-Interest Income

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

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Second Quarter 2016 vs. Second Quarter 2015

Non-interest income increased \$49,000 or 1.7% for the three months ended June 30, 2016, compared to the same period of 2015. This increase was primarily due to a \$264,000 increase in the net gain on deferred compensation investments for the second quarter of 2016 compared to the same period in 2015. This increase was partially offset by a \$220,000 decrease in other non-interest income, primarily comprised of a one-time special FHLB dividend that was received in 2015.

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.

Six Months Ending June 30, 2016 vs. Six Months Ending June 30, 2015

Non-interest income decreased \$1.9 million or 25.3% for the six months ended June 30, 2016 compared to the same period of 2015. This decrease was primarily due to: (1) a \$123,000 decrease in service charges on deposit accounts related to the Company's overdraft privilege service; (2) a \$295,000 decrease in the net gain on the sale of investment securities; (3) a \$210,000 decrease in the net gain on deferred compensation investments; and (4) a \$1.1 million non-recurring financing fee related to the full recovery of a loan previously charged off that took place in 2015. (see "Provision for Credit Losses").

Non-Interest Expense

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

Second Quarter 2016 vs. Second Quarter 2015

Overall, non-interest expense increased \$2.0 million or 15.5% for the three months ended June 30, 2016, compared to the same period in 2015. This increase was primarily comprised: (1) a \$517,000 increase in salaries and employee benefits primarily related to : (a) new staff added for the branches in Walnut Creek and Concord and the Company's leasing activities; (b) increased contributions to retirement and profit sharing plans; and (c) bank wide raises that occurred in mid-2015; (2) a \$264,000 increase in the net gain on deferred compensation investments; (3) a \$243,000 increase in equipment and marketing expenses related to branch expansion and remodeling, ATM upgrades, introduction of a new logo and celebration of the Bank's 100<sup>th</sup> anniversary; (4) a \$119,000 increase in CRA qualified contributions; (5) a \$173,000 increase in legal services related to management's assessment of the Company's future corporate structure, branding and overall strategic direction; (5) a \$287,000 increase in amortization expense related to an increase in CRA qualifying low income housing tax credit investments (See "Income Taxes" for the offsetting credits related to these investments); and (6) merger related expenses totaling \$250,000 related to the pending acquisition of Delta National Bancorp which is scheduled to close in the fourth quarter of 2016. These expenses consisted primarily of professional fees (including legal, accounting, consulting and investment banker fees) and data processing costs.

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.

Six Months Ending June 30, 2016 vs. Six Months Ending June 30, 2015

Non-interest expense decreased \$223,000 or 0.8% for the six months ended June 30, 2016, compared to the same period of 2015. This decrease was primarily comprised of: (1) a \$5.6 million gain on the sale of ORE property; and (2) a \$210,000 decrease in the net gain on deferred compensation investments. These decreases were partially offset by:

(1) a \$2.1 million increase in salaries and employee benefits primarily related to: (a) new staff added for the branches in Walnut Creek and Concord and the Company's leasing activities; (b) increased contributions to retirement and profit sharing plans; and (c) bank wide raises that occurred in mid-2015; (2) a \$600,000 increase in occupancy, equipment and marketing expenses related to branch expansion and remodeling, ATM upgrades, introduction of a new logo and celebration of the Bank's 100<sup>th</sup> anniversary; (3) a \$750,000 increase in legal and other professional services related to management's assessment of the Company's future corporate structure, branding and overall strategic direction; (4) a \$614,000 increase in amortization expense related to an increase in CRA qualifying low income housing tax credit investments (See "Income Taxes" for the offsetting credits related to these investments); (5) a \$200,000 increase in recruiting and training expense related to the addition of new staff as the Company expands its geographic footprint and business activities; (6) a \$131,000 increase in CRA qualified contributions; (7) a \$100,000 increase in the provision for unused commitments; and (8) merger related expenses totaling \$700,000 related to the pending acquisition of Delta National Bancorp which is scheduled to close in the fourth quarter of 2016. These expenses consisted primarily of professional fees (including legal, accounting, consulting and investment banker fees) and data processing costs.

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### Income Taxes

The provision for income taxes decreased 0.4% to \$4.2 million for the second quarter of 2016. The Company's effective tax rate was 36.2% for the second quarter of 2016 and 38.3% for the second quarter of 2015.

The provision for income taxes increased 0.9% to \$8.2 million for the first six months of 2016. The Company's effective tax rate for the first six months of 2016 was 36.1% compared to 38.2% for the same period in 2015.

The Company's effective tax rate fluctuates from quarter to quarter due primarily to changes in the mix of taxable and tax-exempt earning sources. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance; credits associated with low income housing tax credit investments (LIHTC); and tax-exempt interest income on municipal securities and loans.

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

### Financial Condition

This section discusses material changes in the Company's balance sheet at June 30, 2016, as compared to December 31, 2015 and to June 30, 2015. As previously discussed (see "Overview") the Company's financial condition can be influenced by the seasonal banking needs of its agricultural customers.

### Investment Securities and Federal Funds Sold

The investment portfolio provides the Company with an income alternative to loans & leases. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by US Treasury, government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2012, when loan demand lagged deposit growth resulting in significant liquidity, the Company began to selectively add investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities. This portfolio of corporate securities was sold during the 3<sup>rd</sup> quarter of 2014 in order to fund the Company's increase in loan balances.

The Company's investment portfolio at June 30, 2016 was \$423.2 million compared to \$430.5 million at the end of 2015, a decrease of \$7.4 million or 1.7%. At June 30, 2015, the investment portfolio totaled \$418.8 million. The mix of the investment portfolio has changed over the past three to five years. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company has invested most of its available funds in either shorter term US Treasury, government agency & government-sponsored entity securities or shorter term (10, 15, and 20 year) mortgage-backed securities.

The Company's total investment portfolio currently represents 15.7% of the Company's total assets as compared to 16.5% at December 31, 2015, and 17.0% at June 30, 2015.

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As of June 30, 2016 the Company held \$60.9 million of municipal investments, of which \$43.2 million were bank-qualified municipal bonds, all classified as HTM. In order to comply with Section 939A of the Dodd-Frank Act, the Company: (1) only invests in bonds rated AA or better; and (2) performs its own credit analysis on new purchases of municipal bonds. As of June 30, 2016, ninety-eight percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of all municipal investments with particular attention paid to the approximately two percent (\$539,000) of the portfolio that is not rated, and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Interest bearing deposits with banks consisted of FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. Interest bearing deposits with banks totaled \$23.2 million at June 30, 2016, \$9.5 million at December 31, 2015 and \$46.3 million at June 30, 2015.

The Company classifies its investments as HTM, trading, or AFS. Securities are classified as HTM 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 June 30, 2016, December 31, 2015 and June 30, 2015, there were no securities in the trading portfolio. Securities classified as AFS include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes.

### Loans & Leases

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

**Commercial and Agricultural Real Estate** - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties generally 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 or LIBOR 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.”

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

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

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

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

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

The Company accounts for leases with Investment Tax Credits (ITC) under the deferred method as established in ASC 740-10. ITC are viewed and accounted for as a reduction of the cost of the related assets and presented as deferred income on the Company's financial statement.

See "Item 3. 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.

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

Overall, the Company's loan & lease portfolio at June 30, 2016 totaled \$2.1 billion, an increase of \$249.5 million or 13.7% over June 30, 2015. This increase has occurred despite the continuing sluggish economic conditions in the Central Valley of California and is a result of: (1) the Company's intensified business development efforts directed toward credit-qualified borrowers; (2) entry into the equipment leasing business; and (3) expansion of our service area into Walnut Creek and Concord. No assurances can be made that this growth in the loan & lease portfolio will continue.

Loans & leases at June 30, 2016 increased \$71.7 million from December 31, 2015, primarily as a result of strong growth in real estate segments offset to some extent by normal seasonal pay downs of loans made to the Company's agricultural customers.

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

| Loan & Lease Portfolio<br>(in thousands) | June 30, 2016 |         | December 31, 2015 |         | June 30, 2015 |         |
|------------------------------------------|---------------|---------|-------------------|---------|---------------|---------|
|                                          | \$            | %       | \$                | %       | \$            | %       |
| Commercial Real Estate                   | \$632,275     | 30.4 %  | \$609,602         | 30.4 %  | \$575,355     | 31.5 %  |
| Agricultural Real Estate                 | 454,069       | 21.9 %  | 424,034           | 21.2 %  | 373,324       | 20.5 %  |
| Real Estate Construction                 | 166,218       | 8.0 %   | 151,974           | 7.6 %   | 116,983       | 6.4 %   |
| Residential 1st Mortgages                | 217,176       | 10.5 %  | 206,405           | 10.3 %  | 189,039       | 10.4 %  |
| Home Equity Lines and Loans              | 32,150        | 1.6 %   | 33,056            | 1.7 %   | 31,327        | 1.7 %   |
| Agricultural                             | 276,039       | 13.3 %  | 293,966           | 14.7 %  | 225,795       | 12.4 %  |
| Commercial                               | 220,284       | 10.6 %  | 210,804           | 10.5 %  | 256,386       | 14.1 %  |
| Consumer & Other                         | 6,830         | 0.3 %   | 6,592             | 0.3 %   | 4,984         | 0.3 %   |
| Leases                                   | 68,068        | 3.3 %   | 65,054            | 3.3 %   | 49,791        | 2.7 %   |
| Total Gross Loans & Leases               | 2,073,109     | 100.0 % | 2,001,487         | 100.0 % | 1,822,984     | 100.0 % |
| Less: Unearned Income                    | 5,002         |         | 5,128             |         | 4,342         |         |
| Subtotal                                 | 2,068,107     |         | 1,996,359         |         | 1,818,642     |         |
| Less: Allowance for Credit Losses        | 44,118        |         | 41,523            |         | 39,037        |         |
| Net Loans & Leases                       | \$2,023,989   |         | \$1,954,836       |         | \$1,779,605   |         |

Classified Loans & Leases and Non-Performing Assets

All loans & leases are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See "Results of Operations - Provision and Allowance for Credit Losses" for more detail on risk grades. The Company utilizes the services of a third-party independent loan review firm to perform evaluations of individual loans & leases and review the credit risk grades the Company places on loans & leases. Loans & leases that are judged to exhibit a higher risk profile are referred to as "classified loans & leases," and these loans & leases receive increased management attention. As of June 30, 2016, classified loans totaled \$5.6 million compared to \$6.1 million at December 31, 2015 and \$6.0 million at June 30, 2015.

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).

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**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 June 30, 2016 non-accrual loans & leases totaled \$2.3 million. At December 31, 2015 and June 30, 2016, non-accrual loans totaled \$2.2 million and \$2.9 million, respectively.

**Restructured Loans & Leases** - A restructuring of a loan or lease constitutes a 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 June 30, 2016, restructured loans & leases on accrual totaled \$4.6 million as compared to \$5.0 million at December 31, 2015. Restructured loans on accrual at June 30, 2015 were \$4.8 million.

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

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

Non-Performing Assets

| (in thousands)                                               | June 30, 2016 | Dec. 31, 2015 | June 30, 2015 |
|--------------------------------------------------------------|---------------|---------------|---------------|
| Non-Performing Loans & Leases                                | \$ 2,260      | \$ 2,156      | \$ 2,944      |
| Other Real Estate                                            | 779           | 2,441         | 2,441         |
| Total Non-Performing Assets                                  | \$ 3,039      | \$ 4,597      | \$ 5,385      |
| Non-Performing Loans & Leases as a % of Total Loans & Leases | 0.11          | % 0.11        | % 0.16        |
| Restructured Loans & Leases (Performing)                     | \$ 4,565      | \$ 4,953      | \$ 4,843      |

Although management believes that non-performing loans & leases are generally well-secured and that potential losses are provided for in the Company's allowance for credit losses, there can be no assurance that future deterioration in economic conditions and/or collateral values will not result in future credit losses. Specific reserves of \$657,000, \$782,000 and \$763,000 have been established for non-performing loans & leases at June 30, 2016, December 31, 2015 and June 30, 2015, respectively.

Foregone interest income on non-accrual loans & leases which would have been recognized during the period, if all such loans & leases had been current in accordance with their original terms, totaled \$51,000 for the six months ended June 30, 2016, \$109,000 for the year ended December 31, 2015, and \$55,000 for the six months ended June 30, 2015.



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The Company reported \$779,000 of ORE at June 30, 2016, and \$2.4 million at both December 31, 2015 and June 30, 2015. The June 30, 2016 value has no reserve for ORE valuation allowance. The December 31, 2015 and June 30, 2015 values are both net of a \$3.7 million reserve for ORE valuation allowance

Except for those classified and non-performing loans & leases discussed above, the Company's management is not aware of any loans & leases as of June 30, 2016, for which known financial problems of the borrower would cause serious doubts as to the ability of these borrowers to materially comply with their present loan or lease repayment terms, or any known events that would result in the loan or lease being designated as non-performing at some future date. However:

The Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has stabilized throughout most of the Central Valley, housing prices for the most part have not fully recovered and unemployment levels remain above those in other areas of the state and country.

The state of California has experienced drought conditions since 2013. These conditions did not have a material impact on the Company's credit quality during the 2015 growing season. Although rain and snow levels in early 2016 increased significantly relative to prior years, they were not sufficient to completely relieve the drought conditions that had built up over the prior three years. Accordingly, management believes that current conditions will continue to have an adverse impact on some of the Company's agricultural customers' operating costs in 2016, but at the current time we cannot tell what the ultimate impact will be on 2016 crop yields and crop quality. The longer the drought continues, the more significant is its impact, particularly if ground water levels begin to significantly deteriorate or riparian rights are curtailed. See "Part II. Other Information, Item 1A. Risk Factors" for additional information.

In addition to the other information set forth in this report, readers should carefully consider the factors discussed in "Part I, Item 1A. Risk Factors" in the Company's 2015 Annual Report on Form 10-K.

### Deposits

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

The Company's deposit balances at June 30, 2016 have increased \$164.8 million or 7.6% compared to June 30, 2015. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) the Federal government's decision to permanently increase FDIC deposit insurance limits from \$100,000 to \$250,000 per depositor; and (2) the Company's strong financial results and position and F&M Bank's reputation as one of the most safe and sound banks in its market territory. The Company expects that, at some point, deposit customers may begin to diversify how they invest their money (e.g., move funds back into the stock market or other investments) and this could impact future deposit growth.

Although total deposits have increased 7.6% since June 30, 2015, the Company continues to focus on increasing low cost transaction and savings accounts:

Demand and interest-bearing transaction accounts increased \$136.7 million or 14.2% since June 30, 2015.

Savings and money market accounts have increased \$20.5 million or 2.9% since June 30, 2015.

Time deposit accounts have increased \$7.6 million or 1.5% since June 30, 2015.

The Company's deposit balances at June 30, 2016 have increased \$50.4 million or 2.2% compared to December 31, 2015. Savings and money market deposits increased 2.6% or \$18.7 million while demand and interest-bearing transaction accounts increased by \$10.5 million or 1.0% and time deposit accounts increased by \$21.2 million or 4.4%. Deposit trends in the first half of the year can be impacted by the seasonal needs of our agricultural customers.

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

Lines of credit with the Federal Reserve Bank and the Federal Home Loan Bank are other key sources of funds to support earning assets. These sources of funds are also used to manage the Company's interest rate risk exposure, and as opportunities arise, to borrow and invest the proceeds at a positive spread through the investment portfolio. There were no FHLB Advances at June 30, 2016, December 31, 2015, or June 30, 2015. There were no Federal Funds purchased or advances from the FRB at June 30, 2016, December 31, 2015 or June 30, 2015.

As of June 30, 2016 the Company has additional borrowing capacity of \$349.0 million with the Federal Home Loan Bank and \$340.6 million with the Federal Reserve Bank. Borrowings under these lines are collateralized with loans or securities that have been accepted for pledging at the FHLB and FRB.

### Long-Term Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities ("TPS"). See Note 13 located in "Item 8. Financial Statements and Supplementary Data" of the Company's 2015 Annual Report on Form 10-K. Although this amount is reflected as subordinated debt on the Company's balance sheet, under current regulatory guidelines, our TPS will continue to qualify as regulatory capital. These securities accrue interest at a variable rate based upon 3-month LIBOR plus 2.85%. Interest rates reset quarterly and were 3.51% at June 30, 2016, 3.38% at December 31, 2015 and 3.13% at June 30, 2015. The average rate paid for these securities for the first half of 2016 was 3.51% compared to 3.15% for the first half of 2015. 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 \$265.3 million at June 30, 2016, \$251.8 million at December 31, 2015, and \$241.2 million at June 30, 2015.

The Company and the Bank are subject to various federal regulatory capital requirements under the Basel III Capital Rules. 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.

The implementation of Basel III requirements will increase the required capital levels that the Company and the Bank must maintain. 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 issued in 2003 to continue to be counted as Tier 1 capital.



The final rules became effective as applied to the Company and the Bank on January 1, 2015, with a phase in period through January 1, 2019. 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.

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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 Capital Requirements |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|------------------------------------|-----------|--------|---------------------------------|-------|------------------------------------------------------------------|-------|
|                                    | Amount    | Ratio  | Amount                          | Ratio | Amount                                                           | Ratio |
| The Company:                       |           |        |                                 |       |                                                                  |       |
| As of June 30, 2016                |           |        |                                 |       |                                                                  |       |
| Total Capital Ratio                | \$301,740 | 12.50% | \$193,092                       | 8.0 % | N/A                                                              | N/A   |
| Common Equity Tier 1 Capital Ratio | \$261,394 | 10.83% | \$108,614                       | 4.5 % | N/A                                                              | N/A   |
| Tier 1 Capital Ratio               | \$271,394 | 11.24% | \$144,819                       | 6.0 % | N/A                                                              | N/A   |
| Tier 1 Leverage Ratio              | \$271,394 | 10.52% | \$103,155                       | 4.0 % | N/A                                                              | N/A   |

| (in thousands)                     | Actual    |        | Regulatory Capital Requirements |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|------------------------------------|-----------|--------|---------------------------------|-------|------------------------------------------------------------------|--------|
|                                    | Amount    | Ratio  | Amount                          | Ratio | Amount                                                           | Ratio  |
| The Bank:                          |           |        |                                 |       |                                                                  |        |
| As of June 30, 2016                |           |        |                                 |       |                                                                  |        |
| Total Capital Ratio                | \$301,321 | 12.49% | \$193,064                       | 8.0 % | \$241,330                                                        | 10.0 % |
| Common Equity Tier 1 Capital Ratio | \$270,979 | 11.23% | \$108,599                       | 4.5 % | \$158,865                                                        | 6.5 %  |
| Tier 1 Capital Ratio               | \$270,979 | 11.23% | \$144,798                       | 6.0 % | \$193,064                                                        | 8.0 %  |
| Tier 1 Leverage Ratio              | \$270,979 | 10.52% | \$103,008                       | 4.0 % | \$128,760                                                        | 5.0 %  |

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

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

In 1998, the Board approved the Company’s first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on August 11, 2015, the Board of Directors approved an extension of the \$20 million stock repurchase program over the three-year period ending September 30, 2018. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2015 Annual Report on Form 10-K for additional information.

There were no stock repurchases during the first half of 2016 or 2015. The remaining dollar value of shares that may yet be purchased under the Company's Common Stock Repurchase Plan is approximately \$20 million.

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On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Computershare (formerly Registrar and Transfer Company), as Rights Agent. The Rights Plan was set to expire on August 5, 2018. On November 19, 2015, the Board of Directors approved a seven-year extension of the term of the Rights Plan. Pursuant to an Amendment to the Rights Agreement dated February 18, 2016, the term of the Rights Plan was extended from August 5, 2018 to August 5, 2025. The extension of the term of the Rights Plan was intended as a means to continue to guard against abusive takeover tactics and was not in response to any particular proposal. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2015 Annual Report on Form 10-K for further explanation.

On January 28, 2016, the Company issued 1,600 shares of common stock to the Bank’s non-qualified defined contribution retirement plans. These shares were issued at a price of \$525 per share based upon a valuation completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds from this issuance were contributed to the Bank as equity capital.

Critical Accounting Policies and Estimates

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

For a full discussion of the Company’s critical accounting policies and estimates see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” in the Company’s 2015 Annual Report on Form 10-K.

Off Balance Sheet Commitments

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

| (in thousands)                                                                                                              | June 30,<br>2016 | December 31,<br>2015 | June 30,<br>2015 |
|-----------------------------------------------------------------------------------------------------------------------------|------------------|----------------------|------------------|
| Commitments to Extend Credit                                                                                                | \$ 612,309       | \$ 708,122           | \$ 638,190       |
| Letters of Credit                                                                                                           | 14,326           | 14,745               | 12,136           |
| Performance Guarantees Under Interest Rate Swap Contracts<br>Entered Into Between Our Borrowing Customers and Third Parties | 5,995            | 2,758                | 1,511            |

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

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. Most standby letters of credit are issued for 18 months or less. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Additionally, the Company

maintains a reserve for off balance sheet commitments which totaled \$267,000 at June 30, 2016, \$167,000 at December 31, 2015, and \$142,000 at June 30, 2015. We do not anticipate any material losses as a result of these transactions.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Risk Management

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

Credit Risk

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

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

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

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

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

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

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

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

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

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

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

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

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

Management believes, that based upon the preceding methodology, and using information currently available, the allowance for credit losses at June 30, 2016 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 bearing assets and liabilities results in uncertainty in the Company’s earnings and economic value and is referred to as interest rate risk. The Company does not attempt to predict interest rates and positions the balance sheet in a manner, which seeks to minimize, to the extent possible, the effects of changing interest rates.

The Company measures interest rate risk in terms of potential impact on both its economic value and earnings. The methods for governing the amount of interest rate risk include: (1) analysis of asset and liability mismatches (Gap analysis); (2) the utilization of a simulation model; and (3) limits on maturities of investment, loan & lease, and deposit and borrowing 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 interest bearing liabilities 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 interest bearing liabilities. 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 June 30, 2016, 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 4.54% if rates increase by 200 basis points and a decrease in net interest income of 1.79% if rates decline 100 basis points. Comparatively, at December 31, 2015, 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 3.88% if rates increase by 200 basis points and a decrease in net interest income of 1.67% if rates decline 100 basis points.

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

### Liquidity Risk

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

The Company's principal operating sources of liquidity include (see "Item 8. Financial Statements and Supplementary Data – Consolidated Statements of Cash Flows" of the Company's 2015 Annual Report on Form 10-K) cash and cash equivalents, cash provided by operating activities, principal payments on loans & leases, proceeds from the maturity or sale of investments, and growth in deposits. To supplement these operating sources of funds the Company maintains Federal Funds credit lines of \$75.0 million and repurchase lines of \$130.0 million with major banks. As of June 30, 2016 the Company has additional borrowing capacity of \$349.0 million with the FHLB and \$340.6 million with the FRB. Borrowings under these lines are collateralized with loans or securities that have been accepted for pledging at the FHLB and FRB.

At June 30, 2016, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities AFS of approximately \$277.0 million, which represents 10.24% of total assets.



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ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is communicated to the Company’s management, including its Chief Executive Officer and its Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

As of the end of the period covered by this report, the Company carried out an evaluation of the effectiveness of Company’s disclosure controls and procedures under the supervision and with the participation of the Chief Executive Officer, the Chief Financial Officer and other senior management of the Company. Based on this evaluation, the Company’s Chief Executive Officer and the Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective.

During the quarter ended June 30, 2016, there were no changes in the Company’s internal controls or in other factors that have materially affected or are reasonably likely to materially affect the Company’s internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

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

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

ITEM 1A. Risk Factors

See “Item 1A. Risk Factors” in the Company’s 2015 Annual Report to Shareholders on Form 10-K. In management’s opinion, except as provided below, there have been no material changes in risk factors since the filing of the 2015 Form 10-K.

In connection with the merger of Delta National Bancorp with and into the Company (See “Item 1 – Note 8 to the Financial Statements”), Company stockholders should be aware of the following risks:

The Company May Fail To Realize The Anticipated Benefits Of The Merger - The success of the merger will depend on, among other things, the Company’s ability to realize the anticipated revenue enhancements and efficiencies and to combine the businesses of the Company and Delta National Bancorp in a manner that does not materially disrupt the existing customer relationships of Delta National Bancorp or result in decreased revenues resulting from any loss of customers and that permits growth opportunities to occur. If the Company is not able to successfully achieve these objectives or if there are unanticipated losses at Delta National Bancorp, the anticipated benefits of the merger may not be realized fully or at all or may take longer to realize than expected.

The Company and Delta National Bancorp have operated and, until the completion of the merger, will continue to operate, independently. It is possible that the integration process could result in the loss of key employees, the

disruption of each company's ongoing businesses or inconsistencies in standards, controls, procedures and policies that adversely affect the Company's ability to maintain relationships with clients, customers, depositors and employees or to achieve the anticipated benefits of the merger. Integration efforts between the two companies could also divert management attention and resources. These integration matters could have an adverse effect on each of the Company and Delta National Bancorp during the transition period and on the combined company following completion of the merger.

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The Market Price Of The Company's Common Stock After The Merger May Be Affected By Factors Different From Those Affecting The Shares Of Delta National Bancorp Or The Company Currently - Upon completion of the merger, holders of Delta National Bancorp common stock will become holders of the Company's common stock. The Company's business differs from that of Delta National Bancorp, and, accordingly, the financial condition and results of operations of the combined company and the market price of the Company's common stock after the completion of the merger may be affected by factors different from those currently affecting the financial condition and results of operations of Delta National Bancorp.

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

There were no shares repurchased by Farmers & Merchants Bancorp during the first six months of 2016. The remaining dollar value of shares that may yet be purchased under the Company's Stock Repurchase Plan is approximately \$20.0 million.

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

In January, 2016, the Company issued 1,600 shares of common stock to the Bank's non-qualified defined contribution retirement plans. These shares were issued at a price of \$525 per share based upon a valuation completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds were contributed to the Bank as equity capital.

ITEM 3. Defaults Upon Senior Securities

Not applicable

ITEM 4. Mine Safety Disclosures

Not applicable

ITEM 5. Other Information

None

ITEM 6. Exhibits

See "Index to Exhibits"

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SIGNATURES

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

FARMERS & MERCHANTS BANCORP

Date: August 8, 2016 /s/ Kent A. Steinwert

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

FARMERS & MERCHANTS BANCORP

Date: August 8, 2016 /s/ Stephen W. Haley

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

Index to Exhibits

Exhibit No. Description

- 31(a) Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  
31(b) Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  
32 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  
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