

FARMERS & MERCHANTS BANCORP  
Form 10-Q  
August 08, 2008

---

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, 2008

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  
(State or other jurisdiction  
of incorporation or organization)

94-3327828  
(I.R.S. Employer  
Identification No.)

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

95240  
(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 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)

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

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: Par value \$0.01, authorized 20,000,000 shares; issued and outstanding 794,036 as of July 31, 2008.

---

---

---

## FARMERS &amp; MERCHANTS BANCORP

FORM 10-Q  
TABLE OF CONTENTS

PART I. - <u>FINANCIAL INFORMATION</u>		Page
Item 1 -	<u>Financial Statements</u>	
	<u>Consolidated Balance Sheets as of June 30, 2008 (Unaudited), December 31, 2007 and June 30, 2007 (Unaudited).</u>	
	<u>Consolidated Statements of Income (Unaudited) for the Three Months and Six Months Ended June 30, 2008 and 2007.</u>	4
	<u>Consolidated Statements of Comprehensive Income (Unaudited) for the Three Months and Six Months Ended June 30, 2008 and 2007.</u>	5
	<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) for the Six Months Ended June 30, 2008 and 2007.</u>	6
	<u>Consolidated Statements of Cash Flows (Unaudited) for the Six Months Ended June 30, 2008 and 2007.</u>	7
	<u>Notes to the Unaudited Consolidated Financial Statements (Unaudited)</u>	8
Item 2 -	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	11
Item 3 -	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
Item 4 -	<u>Controls and Procedures</u>	28
PART II. - <u>OTHER INFORMATION</u>		
Item 1 -	<u>Legal Proceedings</u>	28
Item 1A	<u>– Risk Factors</u>	28
Item 2 -	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	29
Item 3 -	<u>Defaults Upon Senior Securities</u>	29
Item 4 -	<u>Submission of Matters to a Vote of Security Holders</u>	29
Item 5 -	<u>Other Information</u>	30
Item 6 -	<u>Exhibits</u>	30

<u>Signatures</u>	31
-------------------	----

<u>Index to Exhibits</u>	31
--------------------------	----

Table of Contents

## PART I. - FINANCIAL INFORMATION

## Item 1 - Financial Statements

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Balance Sheets (Unaudited)

(in thousands)

	June 30, 2008	December 31, 2007	June 30, 2007
<b>Assets</b>			
<b>Cash and Cash Equivalents:</b>			
Cash and Due From Banks	\$ 53,733	\$ 50,240	\$ 45,318
Federal Funds Sold	27,700	1,150	24,000
<b>Total Cash and Cash Equivalents</b>	<b>81,433</b>	<b>51,390</b>	<b>69,318</b>
<b>Investment Securities:</b>			
Available-for-Sale	204,135	142,043	139,137
Held-to-Maturity	106,418	105,594	109,689
<b>Total Investment Securities</b>	<b>310,553</b>	<b>247,637</b>	<b>248,826</b>
<b>Loans</b>			
Loans	1,121,865	1,140,969	1,085,439
Less: Allowance for Loan Losses	18,682	18,483	17,930
<b>Loans, Net</b>	<b>1,103,183</b>	<b>1,122,486</b>	<b>1,067,509</b>
Premises and Equipment, Net	22,101	20,188	19,790
Bank Owned Life Insurance	41,072	40,180	39,295
Interest Receivable and Other Assets	50,454	37,291	37,384
<b>Total Assets</b>	<b>\$ 1,608,796</b>	<b>\$ 1,519,172</b>	<b>\$ 1,482,122</b>
<b>Liabilities</b>			
<b>Deposits:</b>			
Demand	\$ 274,306	\$ 307,299	\$ 279,611
Interest Bearing Transaction	127,295	138,665	126,902
Savings	334,649	301,678	281,358
Time	626,492	563,148	558,325
<b>Total Deposits</b>	<b>1,362,742</b>	<b>1,310,790</b>	<b>1,246,196</b>
Securities Sold Under Agreement to Repurchase	60,000	-	-
Federal Home Loan Bank Advances	729	28,954	63,878
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	28,050	25,700	23,608
<b>Total Liabilities</b>	<b>1,461,831</b>	<b>1,375,754</b>	<b>1,343,992</b>
<b>Shareholders' Equity</b>			
Common Stock	8	8	8
Additional Paid-In Capital	81,642	84,437	89,317
Retained Earnings	65,864	57,990	50,730
Accumulated Other Comprehensive (Loss) Income	(549)	983	(1,925)
<b>Total Shareholders' Equity</b>	<b>146,965</b>	<b>143,418</b>	<b>138,130</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>\$ 1,608,796</b>	<b>\$ 1,519,172</b>	<b>\$ 1,482,122</b>

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



Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Income (Unaudited)

(in thousands except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
<b>Interest Income</b>				
Interest and Fees on Loans	\$ 18,986	\$ 21,178	\$ 39,543	\$ 41,321
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	38	113	44	388
<b>Interest on Investment Securities:</b>				
Taxable	2,892	1,861	5,312	3,769
Tax-Exempt	762	818	1,536	1,631
<b>Total Interest Income</b>	<b>22,678</b>	<b>23,970</b>	<b>46,435</b>	<b>47,109</b>
<b>Interest Expense</b>				
Deposits	5,450	7,551	12,192	14,532
Borrowed Funds	436	339	667	738
Subordinated Debentures	147	214	342	428
<b>Total Interest Expense</b>	<b>6,033</b>	<b>8,104</b>	<b>13,201</b>	<b>15,698</b>
<b>Net Interest Income</b>	<b>16,645</b>	<b>15,866</b>	<b>33,234</b>	<b>31,411</b>
Provision for Loan Losses	4,035	250	4,605	250
<b>Net Interest Income After Provision for Loan Losses</b>	<b>12,610</b>	<b>15,616</b>	<b>28,629</b>	<b>31,161</b>
<b>Non-Interest Income</b>				
Service Charges on Deposit Accounts	1,797	1,893	3,515	3,534
Net Gain (Loss) on Investment Securities	674	(315)	535	(1,083)
Credit Card Merchant Fees	555	557	1,089	1,067
Increase in Cash Surrender Value of Life Insurance	453	438	892	851
ATM Fees	390	349	751	664
Other	3,981	1,209	4,045	2,850
<b>Total Non-Interest Income</b>	<b>7,850</b>	<b>4,131</b>	<b>10,827</b>	<b>7,883</b>
<b>Non-Interest Expense</b>				
Salaries & Employee Benefits	7,117	7,257	13,603	14,647
Occupancy	686	651	1,344	1,301
Equipment	627	642	1,123	1,305
Credit Card Merchant Expense	421	418	828	797
Marketing	167	115	257	224
Other	1,856	1,856	3,485	3,686
<b>Total Non-Interest Expense</b>	<b>10,874</b>	<b>10,939</b>	<b>20,640</b>	<b>21,960</b>
<b>Income Before Income Taxes</b>	<b>9,586</b>	<b>8,808</b>	<b>18,816</b>	<b>17,084</b>
Provision for Income Taxes	3,624	3,142	7,090	5,949
<b>Net Income</b>	<b>\$ 5,962</b>	<b>\$ 5,666</b>	<b>\$ 11,726</b>	<b>\$ 11,135</b>
<b>Earnings Per Share</b>	<b>\$ 7.50</b>	<b>\$ 6.98</b>	<b>\$ 14.71</b>	<b>\$ 13.72</b>

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

Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

Consolidated Statements of Comprehensive Income (Unaudited)  
(in thousands)

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2008	2007	2008	2007
Net Income	\$ 5,962	\$ 5,666	\$ 11,726	\$ 11,135
Other Comprehensive Loss -				
Reclassification adjustment for realized gains included in net income, net of related income tax effects of \$0 and \$0 for the quarters ended June 30, 2008 and 2007, respectively, and \$0 and \$1 for the six months ended June 30, 2008 and 2007, respectively.	-	-	-	1
Unrealized Losses on Securities:				
Unrealized holding losses arising during the period, net of income tax benefit of \$(2,017) and \$(1,340) for the quarters ended June 30, 2008 and 2007, respectively, and of \$(887) and \$(1,330) for the six months ended June 30, 2008 and 2007, respectively.	(2,778)	(1,847)	(1,222)	(1,834)
Less: Reclassification adjustment for realized (gains) losses included in net income, net of related income tax effects of \$(283) and \$132 for the quarters ended June 30, 2008 and 2007, respectively, and of \$(225) and \$455 for the six months ended June 30, 2008 and 2007, respectively.	(391)	183	(310)	628
Total Other Comprehensive Loss	(3,169)	(1,664)	(1,532)	(1,205)
Comprehensive Income	\$ 2,793	\$ 4,002	\$ 10,194	\$ 9,930

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



Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

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

(in thousands except share data)

	Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2006	811,933	\$ 8	\$ 89,926	\$ 43,126	\$ (720)	\$ 132,340
Net Income		-	-	11,135	-	11,135
Cash Dividends Declared on Common Stock		-	-	(3,531)	-	(3,531)
Repurchase of Stock	(1,194)	-	(609)	-	-	(609)
Change in Unrealized Gain on Derivative Instruments					1	1
Change in Net Unrealized Loss on Securities Available for Sale		-	-	-	(1,206)	(1,206)
Balance, June 30, 2007	810,739	\$ 8	\$ 89,317	\$ 50,730	\$ (1,925)	\$ 138,130
Balance, December 31, 2007	800,112	\$ 8	\$ 84,437	\$ 57,990	\$ 983	\$ 143,418
Net Income		-	-	11,726	-	11,726
Cash Dividends Declared on Common Stock		-	-	(3,852)	-	(3,852)
Repurchase of Stock	(6,076)	-	(2,795)	-	-	(2,795)
Change in Net Unrealized Loss on Securities Available for Sale		-	-	-	(1,532)	(1,532)
Balance, June 30, 2008	794,036	\$ 8	\$ 81,642	\$ 65,864	\$ (549)	\$ 146,965

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

Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

Consolidated Statements of Cash Flows (Unaudited)  
(in thousands)Six Months Ended  
June 30,  
2008                  June 30,  
2007

## Operating Activities:

Net Income	\$ 11,726	\$ 11,135
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	4,605	250
Depreciation and Amortization	886	1,024
Net Amortization (Accretion) of Investment Security Discounts & Premium	64	(189)
Net (Gain) Loss on Investment Securities	(535)	1,083
Net Gain on Sale of Property & Equipment	(8)	-
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets	(12,943)	(4,753)
Net Increase in Interest Payable and Other Liabilities	2,350	1,085
Net Cash Provided by Operating Activities	6,145	9,635

## Investing Activities:

## Securities Available-for-Sale:

Purchased	(119,742)	(33,014)
Sold, Matured or Called	55,532	23,570

## Securities Held-to-Maturity:

Purchased	(2,500)	(2,165)
Matured or Called	1,621	3,676
Net Loans Originated or Acquired	14,464	(39,093)
Principal Collected on Loans Previously Charged Off	234	147
Net Additions to Premises and Equipment	(2,799)	(318)
Proceeds from Disposition of Property & Equipment	8	-
Net Cash Used by Investing Activities	(53,182)	(47,197)

## Financing Activities:

Net Decrease in Demand, Interest-Bearing Transaction, and Savings Accounts	(11,392)	(11,165)
Increase in Time Deposits	63,344	58,833
Net Increase in Securities Sold Under Agreement to Repurchase	60,000	-
Net (Decrease) Increase in Federal Home Loan Bank Advances	(28,225)	16,346
Cash Dividends	(3,852)	(3,531)
Stock Repurchases	(2,795)	(609)
Net Cash Provided by Financing Activities	77,080	59,874

Increase in Cash and Cash Equivalents	30,043	22,312
---------------------------------------	--------	--------

Cash and Cash Equivalents at Beginning of Year	51,390	47,006
--	--------	--------

Cash and Cash Equivalents as of June 30, 2008 and June 30, 2007	\$ 81,433	\$ 69,318
---	-----------	-----------

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

Table of Contents

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 (GAAP), and was formed for the sole purpose of issuing Trust Preferred Securities. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and prevailing practice within the banking industry.

Basis of Presentation

The accompanying unaudited 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 and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (which consist solely of normal recurring accruals) considered necessary for a fair presentation of the results for the interim periods presented have been included. The Company's interim consolidated financial statements and related notes, including its significant accounting policies, should be read in conjunction with the audited financial statements and related notes contained in the Company's 2007 Annual Report to Shareholders on Form 10-K. There have been no significant changes to our accounting policies since the 2007 10-K except due to adoption of FASB Statement No. 157 (SFAS 157), "Fair Value Measurements" as more fully described in Note 2.

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 results of operations for the six-month period ended June 30, 2008 may not necessarily be indicative of the operating results for the full year 2008.

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

2. Fair Value Measurements

Effective January 1, 2008, the Company adopted SFAS No. 157 (SFAS 157), "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 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, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

8

---

Table of Contents

Level 1 inputs – Unadjusted quoted process 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.

Securities classified as available-for-sale are reported at fair value on a recurring basis utilizing Level 2 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 loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired (see "Financial Condition – Non-Performing Assets) and an allowance for loan losses is established. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, Accounting by Creditors for Impairment of a Loan (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2008, substantially all impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses observable data, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value, or the appraised value contains a significant assumption, and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

Other Real Estate Owned is reported at fair value on a non-recurring basis utilizing Level 2 inputs obtained through appraisals.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

(in thousands)	Fair Value June 30, 2008	Fair Value Measurements At June 30, 2008, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities	\$ 204,135	\$ -	\$ 204,135	\$ -

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Total Assets Measured at Fair Value							
On a Recurring Basis	\$	204,135	\$	-	\$	204,135	\$ -

9

---

Table of Contents

The following table presents information about the Company's assets and liabilities measured 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.

(in thousands)	Fair Value June 30, 2008	Fair Value Measurements At June 30, 2008, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans	\$ 2,729	\$ -	\$ 2,729	\$ -
Other Real Estate Owned	\$ 6,893	\$ -	\$ 6,893	\$ -
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 9,622	\$ -	\$ 9,622	\$ -

Impaired loans, which are measured for impairment using the fair value of the collateral because the loans are considered to be collateral dependent, were \$3.7 million, with an allowance for loan losses of \$923,000.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115." This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company has not elected the fair value option for any financial assets or liabilities at June 30, 2008.

### 3. Accounting for Split-Dollar Life Insurance Arrangements

On January 1, 2008, the Company adopted Emerging Issue Task Force Issue ("EITF") No. 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Agreements, which established recognition of a liability and related compensation costs for endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods. The adoption of EITF 06-4 did not have a material impact on the Company's financial position or results of operations.

### 4. Dividends and Earnings Per 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 6, 2008, the Board of Directors of Farmers & Merchants Bancorp declared a mid-year cash dividend of \$4.85 per share, an 11.5% increase over the \$4.35 per share paid on July 1, 2007. The cash dividend was paid on July 1, 2008, to shareholders of record on June 9, 2008.

Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The table below calculates the earnings per share for the three and six-months ended June

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

30, 2008 and 2007.

(net income in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net Income	\$ 5,962	\$ 5,666	\$ 11,726	\$ 11,135
Average Number of Common Shares Outstanding	795,204	811,552	797,093	811,708
Per Share Amount	\$ 7.50	\$ 6.98	\$ 14.71	\$ 13.72

10

---



## Table of Contents

### 5. Recent Accounting Pronouncements

In May 2008, the FASB issued Statement No. 162, "The Hierarchy of Generally Accepted Accounting Principles" (SFAS No. 162). This standard identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The provisions of SFAS No. 162 did not have a material impact on our financial condition and results of operations.

In March 2008, the FASB issued Statement No. 161, "Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133" (SFAS No. 161). SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. The provisions of SFAS No. 161 will not have an impact on the Company at the current time.

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations." SFAS No. 141R broadens the guidance of SFAS No. 141, extending its applicability to all transactions and other events in which one entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed, and interests transferred as a result of business combinations. SFAS No. 141R expands on required disclosures to improve the statement users' abilities to evaluate the nature and financial effects of business combinations. SFAS No. 141R is effective for the first annual reporting period beginning on or after December 15, 2008. The provisions of SFAS No. 141R will not have an impact on the Company at the current time.

### 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, 2008. This analysis should be read in conjunction with our 2007 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 the Company's operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risk 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: (i) the effect of changing regional and national economic conditions; (ii) significant changes in interest rates and prepayment speeds; (iii) credit risks of lending and investment activities; (iv) changes in federal and state banking laws or regulations; (v) competitive pressure in the banking industry; (vi) changes in governmental fiscal or monetary policies; (vii) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (viii) other factors discussed in Item 1A. Risk Factors of the Company's 2007 Annual Report on form 10-K.

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

## Table of Contents

### Introduction

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California state-chartered bank formed in 1916. The Bank serves the northern Central Valley of California through twenty-one banking offices and two stand-alone ATM's. The service area includes Sacramento, San Joaquin, Stanislaus and Merced Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock and Hilmar. Substantially all of the Company's business activities are conducted within its market area.

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 Financial Institutions ("DFI") and the Federal Deposit Insurance Corporation ("FDIC").

### Overview

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

For the three and six months ended June 30, 2008, Farmers & Merchants Bancorp reported net income of \$5,962,000 and \$11,726,000, earnings per share of \$7.50 and \$14.71 and return on average assets of 1.54% and 1.54%, respectively. Return on average shareholders' equity was 15.93% and 15.90% for the three and six months ended June 30, 2008.

For the three and six months ended June 30, 2007, Farmers & Merchants Bancorp reported net income of \$5,666,000 and \$11,135,000, earnings per share of \$6.98 and \$13.72 and return on average assets of 1.57% and 1.56%, respectively. Return on average shareholders' equity was 16.24% and 16.27% for the three and six months ended June 30, 2007.

The Company's improved earnings performance during the first six months of 2008 as compared to the same period last year was primarily due to: (1) an increase in average earning assets (see "Net Interest Income/Net Interest Margin"); (2) an increase in non-interest income (see "Non-Interest Income"); partially offset by; (3) an increase in the loan loss provision (see "Provision and Allowance for Loan Losses").

The following is a summary of the financial results for the six-month period ended June 30, 2008 compared to June 30, 2007.

- Net income increased 5.3% to \$11.7 million from \$11.1 million.
- Earnings per share increased 7.2% to \$14.71 from \$13.72.
- Total assets increased 8.5% to \$1.6 billion.
- Total loans increased 3.3% to \$1.1 billion.

- Total deposits increased 9.4% to \$1.4 billion.
- Net interest income increased 5.8% to \$33.2 million from \$31.4 million.

## Table of Contents

### Results of Operations

#### Net Interest Income / Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the three and six month periods ended June 30, 2008 and 2007.

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 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: Market Risk – Interest Rate Risk").

#### 2nd Quarter 2008 vs. 2nd Quarter 2007

Net interest income for the second quarter of 2008 increased 4.9% or \$779,000 to \$16.6 million. On a fully taxable equivalent basis, net interest income increased 4.6% and totaled \$17.0 million for the second quarter of 2008. As more fully discussed below, the increase in net interest income was primarily due to an increase in 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, 2008, the Company's net interest margin was 4.77% compared to 4.89% for the quarter ended June 30, 2007. Recent trends in pricing of both loans and deposits will continue, in management's opinion, to place pressure on the Company's net interest margin in future quarters.

Loans, generally the Company's highest earning assets, increased \$36.4 million as of June 30, 2008 compared to June 30, 2007. See "Financial Condition – Loans" for further discussion on this increase. On an average balance basis, loans increased by \$38.4 million for the quarter ended June 30, 2008. Despite a 325 basis point decrease in the prime rate occurring between September 19, 2007 and May 1, 2008, the yield on the loan portfolio only decreased 105 basis points or 15.5% to a yield of 6.76% for the quarter ended June 30, 2008 compared to a yield of 7.81% for the quarter ended June 30, 2007. Some of the resilience in loan yields is due to pricing floors that the Bank has placed in some of its customer loan agreements. However, these floors typically expire annually and are renegotiated based upon current market conditions. The growth in loan balances during the second quarter partially offset this decrease in yield resulting in interest revenue from loans decreasing only 10.4% to \$19.0 million for the quarter ended June 30, 2008. The Company continues to experience aggressive competitor pricing for loans, which it has responded to in order to retain key customers. This negative pressure could continue to impact future loan yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. The debt securities in the Company's investment portfolio are comprised primarily of Mortgage-backed securities, U.S. Government Agencies and high grade Municipals. All of the Mortgage-backed securities are issued by government-sponsored entities. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans.

Table of Contents

Average investment securities were \$296.6 million for the second quarter of 2008 an increase of \$60.5 million compared to \$236.1 million for the second quarter of 2007. See “Financial Condition – Investment Securities” for further discussion on this increase. Interest income on securities increased \$940,000 to \$4.0 million for the quarter ended June 30, 2008 compared to \$3.1 million for the quarter ended June 30, 2007. The average yield, on a taxable equivalent basis (TE), in the investment portfolio was 5.42% for the second quarter of 2008 compared to 5.22% for the second quarter of 2007. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a taxable equivalent basis (TE), which is higher than net interest income on the Consolidated Statements of Income because of adjustments that relate to income on certain securities that are exempt from federal income taxes.

Average interest-bearing sources of funds increased \$103.7 million or 10.3% during the second quarter of 2008 as compared to the second quarter of 2007. Of that increase, average borrowed funds (primarily FHLB Advances) decreased \$16.6 million; interest-bearing deposits increased \$74.5 million, subordinated debt remained unchanged and securities sold under agreement to repurchase, a new type of borrowing initially used during the first quarter of 2008 to assist in managing the Company’s interest rate risk, increased \$45.8 million.

The increase in average interest-bearing deposits was primarily in time deposits, which grew \$46.9 million, as savings and interest bearing DDA increased by \$27.6 million. Total interest expense on deposit accounts for the second quarter of 2008 was \$5.5 million as compared to \$7.6 million for the second quarter of 2007. The average rate paid on interest-bearing deposits was 2.09% in the second quarter of 2008 and 3.11% in the second quarter of 2007. See “Financial Condition – Deposits” for further discussion.

**Six Months Ending June 30, 2008 vs. Six Months Ending June 30, 2007**

During the first six months of 2008, net interest income increased 5.8% to \$33.2 million, compared to \$31.4 million at June 30, 2007. On a fully taxable equivalent basis, net interest income increased 5.5% and totaled \$33.9 million at June 30, 2008, compared to \$32.2 million at June 30, 2007. The increase in net interest income was primarily due to an increase in earning assets.

For the six months ended June 30, 2008, the Company’s net interest margin was 4.85% compared to 4.92% for the same period in 2007.

Loans, on an average balance basis, increased by \$52.3 million for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The yield on the loan portfolio decreased 73 basis points to 7.08% for the six months ended June 30, 2008 compared to 7.81% for the six months ended June 30, 2007. This decrease in yield, partially offset by an increase in average balances, resulted in interest revenue from loans decreasing 4.3% or \$1.8 million for the first six months of 2008.

Table of Contents

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

Assets	Three Months Ended June 30, 2008			Three Months Ended June 30, 2007		
	Balance	Interest	Rate	Balance	Interest	Rate
Federal Funds Sold and Securities Purchased Under Agreements to Resell	\$ 7,360	\$ 38	2.07%	\$ 8,574	\$ 113	5.29%
Investment Securities						
Available-for-Sale						
Municipals - Non-Taxable	8,451	160	7.57%	11,726	204	6.97%
Mortgage Backed Securities	180,190	2,425	5.38%	107,773	1,397	5.18%
Other	3,335	79	9.48%	6,562	55	3.35%
Total Investment Securities						
Available-for-Sale	191,976	2,664	5.55%	126,061	1,656	5.26%
Investment Securities						
Held-to-Maturity						
U.S. Agencies	30,399	317	4.17%	30,502	319	4.18%
Municipals - Non-Taxable	66,096	967	5.85%	69,458	1,015	5.84%
Mortgage Backed Securities	6,123	59	3.85%	7,961	75	3.77%
Other	1,992	13	2.61%	2,110	15	2.84%
Total Investment Securities						
Held-to-Maturity	104,610	1,356	5.18%	110,031	1,424	5.17%
Loans						
Real Estate	664,933	11,004	6.64%	626,265	11,499	7.36%
Home Equity	66,719	1,070	6.43%	65,990	1,304	7.93%
Agricultural	177,357	3,178	7.19%	199,861	4,219	8.47%
Commercial	198,748	3,332	6.72%	175,944	3,708	8.45%
Consumer	12,669	272	8.61%	13,755	313	9.13%
Credit Card	5,192	127	9.81%	5,348	131	9.82%
Municipal	1,168	3	1.03%	1,168	4	1.37%
Total Loans	1,126,786	18,986	6.76%	1,088,331	21,178	7.81%
Total Earning Assets	1,430,732	\$ 23,044	6.46%	1,332,997	\$ 24,371	7.33%
Unrealized Gain/(Loss) on Securities						
Available-for-Sale	3,018			(1,038)		
Allowance for Loan Losses	(19,217)			(18,064)		
Cash and Due From Banks	36,703			37,308		
All Other Assets	101,527			91,230		
Total Assets	\$ 1,552,763			\$ 1,442,433		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits						



Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Interest Bearing DDA	\$ 129,699	\$ 31	0.10%	\$ 129,851	\$ 24	0.07%
Savings	318,553	761	0.96%	290,779	1,108	1.53%
Time Deposits	598,741	4,658	3.12%	551,841	6,419	4.67%
Total Interest Bearing Deposits	1,046,993	5,450	2.09%	972,471	7,551	3.11%
Securities Sold Under Agreement to Repurchase	45,778	378	3.31%	-	-	0.00%
Other Borrowed Funds	9,158	58	2.54%	25,715	339	5.29%
Subordinated Debentures	10,310	147	5.72%	10,310	214	8.33%
Total Interest Bearing Liabilities	1,112,239	\$ 6,033	2.18%	1,008,496	\$ 8,104	3.22%
Interest Rate Spread			4.28%			4.11%
Demand Deposits (Non-Interest Bearing)	263,102			272,504		
All Other Liabilities	27,696			21,862		
Total Liabilities	1,403,037			1,302,862		
Shareholders' Equity	149,726			139,571		
Total Liabilities & Shareholders' Equity	\$ 1,552,763			\$ 1,442,433		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.48%			0.78%
Net Interest Income and Margin on Total Earning Assets		17,011	4.77%		16,267	4.89%
Tax Equivalent Adjustment		(366)			(401)	
Net Interest Income		\$ 16,645	4.67%		\$ 15,866	4.77%

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 \$490,000 and \$625,000 for the quarters ended June 30, 2008 and 2007, respectively. Yields on securities available-for-sale are based on historical cost.

Table of Contents

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

Assets	Six Months Ended June 30, 2008			Six Months Ended June 30, 2007		
	Balance	Interest	Rate	Balance	Interest	Rate
Federal Funds Sold and Securities Purchased Under Agreements to Resell	\$ 4,060	\$ 44	2.17%	\$ 14,695	\$ 388	5.32%
Investment Securities						
Available-for-Sale						
Municipals - Non-Taxable	8,956	336	7.50%	11,462	402	7.02%
Mortgage Backed Securities	163,405	4,377	5.36%	108,347	2,790	5.15%
Other	3,546	152	8.57%	7,522	156	4.15%
Total Investment Securities						
Available-for-Sale	175,907	4,865	5.53%	127,331	3,348	5.26%
Investment Securities						
Held-to-Maturity						
U.S. Agencies	30,412	635	4.18%	30,516	636	4.17%
Municipals - Non-Taxable	66,096	1,937	5.86%	69,696	2,029	5.82%
Mortgage Backed Securities	6,334	122	3.85%	8,211	156	3.80%
Other	2,002	26	2.60%	2,111	31	2.94%
Total Investment Securities						
Held-to-Maturity	104,844	2,720	5.19%	110,534	2,852	5.16%
Loans						
Real Estate	658,119	22,859	6.97%	621,418	22,671	7.36%
Home Equity	64,929	2,223	6.87%	66,068	2,609	7.96%
Agricultural	180,728	6,756	7.50%	190,852	8,036	8.49%
Commercial	196,851	6,901	7.03%	168,822	7,120	8.50%
Consumer	12,657	533	8.45%	13,780	607	8.88%
Credit Card	5,273	264	10.04%	5,416	270	10.05%
Municipal	1,102	7	1.27%	1,042	8	1.55%
Total Loans	1,119,659	39,543	7.08%	1,067,398	41,321	7.81%
Total Earning Assets	1,404,470	\$ 47,172	6.74%	1,319,958	\$ 47,909	7.32%
Unrealized Gain/(Loss) on Securities Available-for-Sale	2,646			(1,131)		
Allowance for Loan Losses	(18,931)			(18,069)		
Cash and Due From Banks	37,122			38,464		
All Other Assets	98,186			90,199		
Total Assets	\$ 1,523,493			\$ 1,429,421		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits						
Interest Bearing DDA	\$ 129,962	\$ 57	0.09%	\$ 130,262	\$ 46	0.07%

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Savings	316,052	1,837	1.17%	289,654	2,043	1.42%
Time Deposits	584,226	10,298	3.54%	541,526	12,443	4.63%
Total Interest Bearing Deposits	1,030,240	12,192	2.37%	961,442	14,532	3.05%
Securities Sold Under Agreement to Repurchase	27,033	446	3.31%	-	-	0.00%
Other Borrowed Funds	15,328	221	2.89%	28,342	738	5.25%
Subordinated Debentures	10,310	342	6.65%	10,310	428	8.37%
Total Interest Bearing Liabilities	1,082,911	\$ 13,201	2.44%	1,000,094	\$ 15,698	3.17%
Interest Rate Spread			4.29%			4.15%
Demand Deposits (Non-Interest Bearing)	268,082			271,362		
All Other Liabilities	25,047			21,061		
Total Liabilities	1,376,040			1,292,517		
Shareholders' Equity	147,453			136,904		
Total Liabilities & Shareholders' Equity	\$ 1,523,493			\$ 1,429,421		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.56%			0.77%
Net Interest Income and Margin on Total Earning Assets		33,971	4.85%		32,211	4.92%
Tax Equivalent Adjustment		(737)			(800)	
Net Interest Income		\$ 33,234	4.75%		\$ 31,411	4.80%

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 \$1.3 million and \$1.1 million for the six months ended June 30, 2008 and 2007, respectively. Yields on securities available-for-sale are based on historical cost.

Table of Contents

## Farmers &amp; Merchants Bancorp

## Volume and Rate Analysis of Net Interest Revenue

(Rates on a Taxable Equivalent Basis)

(in thousands)

Interest Earning Assets	Three Months Ended			Six Months Ended		
	June 30, 2008	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2008	June 30, 2007
	Volume	Rate	Net Chg.	Volume	Rate	Net Chg.
Federal Funds Sold	\$ (5)	\$ (70)	\$ (75)	\$ (189)	\$ (155)	\$ (344)
Investment Securities						
Available for Sale						
Municipals -						
Non-Taxable	(60)	16	(44)	(93)	27	(66)
Mortgage Backed						
Securities	974	54	1,028	1,471	116	1,587
Other	(37)	61	24	(111)	107	(4)
Total Investment						
Securities Available for						
Sale	877	131	1,008	1,267	250	1,517
Investment Securities						
Held to Maturity						
U.S. Agencies	(1)	(1)	(2)	(2)	1	(1)
Municipals -						
Non-Taxable	(49)	1	(48)	(106)	14	(92)
Mortgage Backed						
Securities	(17)	1	(16)	(36)	2	(34)
Other	(1)	(1)	(2)	(2)	(3)	(5)
Total Investment						
Securities Held to						
Maturity	(68)	0	(68)	(146)	14	(132)
Loans:						
Real Estate	686	(1,181)	(495)	1,378	(1,190)	188
Home Equity	15	(249)	(234)	(43)	(343)	(386)
Agricultural	(444)	(597)	(1,041)	(399)	(881)	(1,280)
Commercial	447	(823)	(376)	1,111	(1,330)	(219)
Consumer	(24)	(17)	(41)	(46)	(28)	(74)
Credit Card	(4)	-	(4)	(7)	1	(6)
Other	-	(1)	(1)	-	(1)	(1)
Total Loans	676	(2,868)	(2,192)	1,994	(3,772)	(1,778)
Total Earning Assets	1,480	(2,807)	(1,327)	2,926	(3,663)	(737)
Interest Bearing						
Liabilities						
Interest Bearing						
Deposits:						
Transaction	-	7	7	-	11	11
Savings	97	(444)	(347)	181	(387)	(206)
Time Deposits	517	(2,278)	(1,761)	949	(3,094)	(2,145)
	614	(2,715)	(2,101)	1,130	(3,470)	(2,340)

Total Interest Bearing Deposits						
Securities Sold Under Agreement to Repurchase	378	-	378	446	-	446
Other Borrowed Funds	(171)	(110)	(281)	(262)	(255)	(517)
Subordinated Debentures	-	(67)	(67)	-	(86)	(86)
Total Interest Bearing Liabilities	821	(2,892)	(2,071)	1,314	(3,811)	(2,497)
Total Change	\$ 659	\$ 85	\$ 744	\$ 1,612	\$ 148	\$ 1,760

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

## Table of Contents

Average investment securities were \$280.7 million for the six months ended June 30, 2008 compared to \$237.8 million for the same period in 2007. The average yield (TE) for the six months ended June 30, 2008 was 5.40% compared to 5.21% for the six months ended June 30, 2007, primarily due to an increase in the mix of higher yielding mortgage backed securities. The increase in the yield on investment securities, in addition to the increase in volume, resulted in an increase in interest income of \$1.4 million or 22.3%, for the six months ended June 30, 2008.

Average interest-bearing sources of funds increased \$82.8 million or 8.3% during the six months ended June 30, 2008. Of that increase, average borrowed funds (primarily FHLB Advances) decreased \$13.0 million; interest-bearing deposits increased \$68.8 million, subordinated debt remained unchanged and securities sold under agreement to repurchase, a new type of borrowing added during the first quarter of 2008 to manage the Company's interest rate risk, increased \$27.0 million.

The increase in average interest-bearing deposits was primarily in time deposits, which grew \$42.7 million, as lower cost savings and interest bearing DDA increased by \$26.1 million. Total interest expense on deposit accounts for the first six months of 2008 was \$12.2 million as compared to \$14.5 million for the first six months of 2007. The average rate paid on interest-bearing deposits was 2.37% in the first six months of 2008 and 3.05% in the first six months of 2007.

### Provision and Allowance for Loan 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 allowance for loan losses is established to absorb losses inherent in the loan portfolio. The allowance for loan losses is maintained at a level considered by management to be adequate to provide for risks inherent in the loan portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. In determining the adequacy of the allowance for loan losses, management takes into consideration examinations by the Company's supervisory authorities, results of internal credit reviews, financial condition of borrowers, loan concentrations, prior loan loss experience, and general economic conditions. The allowance is based on estimates and ultimate losses may vary from the current estimates. Management reviews these estimates periodically and, when adjustments are necessary, they are reported in the period in which they become known.

The Company has established credit management policies and procedures that govern both the approval of new loans and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans to one borrower and by restricting loans made primarily to its principal market area where management believes it is better 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 portfolio and regularly conducts credit reviews of individual loans. Loans that are performing but have shown some signs of weakness are subjected to more stringent reporting and oversight.

The provision for loan losses during the first half of 2008 was \$4.6 million, and \$250,000 for the first half of 2007. Changes in the provision between the first half of 2008 and 2007 were the result of management's evaluation of the adequacy of the allowance for loan losses relative to factors such as the credit quality of the loan portfolio, loan growth, current loan losses and the prevailing economic climate and its effect on borrowers' ability to repay loans in accordance with the terms of the notes. During the second quarter of 2008, resolution of a problem loan to one of the Bank's customers resulted in \$3.9 million of principal being charged against the allowance for loan losses. See "Note 1. Significant Accounting Policies – Allowance for Loan Losses" in the Company's 2007 Annual Report on Form 10-K and "Item 3. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk" and "Part II Item 1a. Risk Factors" of this report.

The allowance for loan losses was \$18.7 million or 1.66% of total loan balances at June 30, 2008 and \$17.9 million or 1.65% of total loan balances at June 30, 2007. As of December 31, 2007, the allowance for loan losses was \$18.5 million, which represented 1.62% of the total loan balance. After reviewing all factors above, management concluded that the allowance for loan losses as of June 30, 2008 was adequate. See the table below for allowance for loan loss activity for the periods indicated.

18

---

Table of Contents

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2008	2007	2008	2007
Balance at Beginning of Period	\$ 19,032	\$ 18,060	\$ 18,483	\$ 18,099
Provision Charged to Expense	4,035	250	4,605	250
Recoveries of Loans Previously Charged Off	142	53	234	147
Loans Charged Off	(4,527)	(433)	(4,640)	(566)
Balance at End of Period	\$ 18,682	\$ 17,930	\$ 18,682	\$ 17,930

## Non-Interest Income

Non-interest income includes: (1) service charges and fees from deposit accounts; (2) net gains and losses from investment securities; (3) credit card merchant fees; (4) ATM fees; (5) investment gains and losses on non-qualified deferred compensation plans; (6) increases in the cash surrender value of bank owned life insurance; (7) gains and losses on the sale of loans and/or other business assets; and (8) fees from other miscellaneous business services.

## 2nd Quarter 2008 vs. 2nd Quarter 2007

Overall, non-interest income increased \$3.7 million for the three months ended June 30, 2008 compared to the same period of 2007. This increase was due to two main events as outlined below.

Gain (Loss) on investment securities was a gain of \$674,000 for the second quarter of 2008 compared to a loss of \$315,000 for the second quarter of 2007. In April of 2008 the Company sold \$38.9 million of available-for-sale mortgage-backed securities resulting in a gain. During the first quarter of 2007 the Company took a \$768,000 impairment loss on one of its investment securities whose drop in market value was determined to be "other than temporary". An additional impairment loss of \$315,000 was recorded during the second quarter of 2007 to adjust the same security to its June 30, 2007 market value. During the first quarter of 2008 the Company disposed of its remaining interest in this investment (see "Investment Securities") recording a loss of \$215,000.

Other non-interest income increased \$2.8 million for the three months ended June 30, 2008 compared to the same period of 2007. During the second quarter of 2008 the Company determined that providing credit card and merchant processing services through third party strategic partners would result in a stronger, more competitive, set of products with the potential for increased growth in future earnings. The sale of the credit card portfolio resulted in a gain of \$1.0 million and the merchant portfolio \$1.9 million.

## Six Months Ending June 30, 2008 vs. Six Months Ending June 30, 2007

Non-interest income increased \$2.9 million for the six-months ended June 30, 2008 compared to the same period of 2007 (see discussion above).

Gain (Loss) on investment securities was a gain of \$535,000 for the first six months of 2008 compared to a loss of \$1.1 million for the first six months of 2007 (see discussion above).

Other non-interest income increased \$1.2 million. As previously discussed, this was due to the sale of the Company's credit card portfolio and merchant portfolio.

## Non-Interest Expense

Non-interest expense for the Company includes expenses for salaries and employee benefits, occupancy, equipment, supplies, legal fees, professional services, data processing, marketing, deposit insurance, merchant bankcard operations, and other miscellaneous expenses.

## 2nd Quarter 2008 vs. 2nd Quarter 2007



Non-interest expense remained relatively unchanged with a decrease of only \$65,000 or 0.6% from the second quarter of 2007 primarily as a result of: (1) decreases in salary and employee benefits; and (2) increases in marketing expenses related to newspaper advertisements for IRA's, CD's, Bank image and automobile loans.

## Table of Contents

### Six Months Ending June 30, 2008 vs. Six Months Ending June 30, 2007

Non-interest expense for the six months ended June 30, 2008 decreased \$1.3 million or 6.0% from the same period in 2007. The primary factors affecting non-interest expense were: (1) reduced contributions to bonus and retirement plans primarily as a result of a reduction in the number of certain key individuals eligible to participate in the plans; (2) reductions in non-qualified deferred compensation plan balances; (3) decreased equipment expenses; and (4) decreased legal and consulting fees.

### Income Taxes

The provision for income taxes increased 15.3% to \$3.6 million for the second quarter of 2008. The Company's effective tax rate increased for the second quarter of 2008 and was 37.8% compared to 35.7% for the same period in 2007.

The provision for income taxes increased 5.3% to \$7.1 million for the first six months of 2008. The Company's effective tax rate increased for the first six months of 2008 and was 37.7% compared to 34.8% for the same period in 2007.

The Company's effective tax rate can change somewhat from quarter to quarter due primarily to changes in the mix of taxable and tax-exempt earning sources. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance, California enterprise zone interest income exclusion and tax-exempt interest income on municipal securities and loans.

### Financial Condition

This section discusses material changes in the Company's balance sheet for the six-month period ending June 30, 2008 as compared to the year ended December 31, 2007 and to the six-month period ending June 30, 2007. As previously discussed (see "Overview") the Company's financial condition is influenced by the seasonal banking needs of its agricultural customers.

### Investment Securities

The investment portfolio provides the Company with an income alternative to loans. The Company's investment portfolio at June 30, 2008 was \$310.6 million compared to \$247.6 million at the end of 2007, an increase of \$62.9 million or 25.4%. At June 30, 2007, the investment portfolio totaled \$248.8 million. The Company grew the available-for-sale portion of its investment portfolio during the first half of 2008 as part of a leveraging strategy implemented to manage the Company's interest rate risk. This increase in the investment portfolio was funded primarily through Repurchase Agreements.

The Company's total investment portfolio currently represents 19.3% of the Company's total assets as compared to 16.3% at December 31, 2007 and 16.8% at June 30, 2007. Not included in the investment portfolio are overnight investments in Federal Funds Sold. Average Federal Funds Sold for the six-months ended June 30, 2008 was \$4.1 million compared to \$10.4 million for the twelve-months ended December 31, 2007 and \$14.7 million for the six-months ended June 30, 2007.

The Company classifies its investments as held-to-maturity, trading or available-for-sale. Securities are classified as held-to-maturity and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of June 30, 2008, December 31, 2007 and June 30, 2007 there were no securities in the trading portfolio. Securities classified as available-for-sale include securities which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from

income and included as a separate component of shareholders' equity, net of related income taxes. See "Note 2. Fair Value Measurements" for further discussion.

The debt securities in the Company's investment portfolio are comprised primarily of Mortgage-backed securities, U.S. Government Agencies and high grade municipals. All of the Mortgage-backed securities are issued by federal government-sponsored entities.

Table of Contents

## Loans

The Company's loan portfolio at June 30, 2008 decreased \$19.1 million or 1.7% from December 31, 2007, primarily as a result of: (1) seasonal paydowns of loans made to the Company's dairy customers in the fourth quarter of 2007; and (2) the resolution of a problem loan to one of the Bank's customers. Compared to June 30, 2007, loans have increased \$36.4 million or 3.4%. Most of the current year's growth occurred in Commercial Real Estate and in Real Estate Secured by Farmland loans, market segments where the Company believes that current market rates and/or credit risks are more reasonable than in the areas of Consumer, Home Equity and Real Estate Construction loans.

Beginning in late 2006 and continuing into 2007 the Company purposely reduced its exposure to Residential Real Estate Construction Loans (which averaged \$105 million during the first quarter of 2006) as the residential housing market softened. Additionally, the Company's Residential 1st Mortgage portfolio is comprised primarily of 15 and 20 year mortgages to local customers. The Company does not originate sub-prime residential mortgage loans, nor does it hold any in its loan portfolio.

On an average balance basis, loans have increased \$52.3 million or 4.9% since June 30, 2007. The table following sets forth the distribution of the loan portfolio by type and percent as of the periods indicated.

## Loan Portfolio As Of:

(in thousands)	June 30, 2008	Dec. 31, 2007	June 30, 2007
Commercial Real Estate	\$ 255,457	\$ 245,925	\$ 246,921
Real Estate Secured by Farmland	219,614	207,890	187,271
Real Estate Construction	72,310	80,651	73,634
Residential 1st Mortgages	108,650	109,764	107,459
Home Equity Lines and Loans	64,499	65,953	66,641
Agricultural	184,073	215,798	207,357
Commercial	205,900	197,108	178,525
Consumer	13,460	20,061	20,138
Gross Loans	1,123,963	1,143,150	1,087,946
Less:			
Unearned Income	2,098	2,181	2,507
Allowance for Loan Losses	18,682	18,483	17,930
Net Loans	\$ 1,103,183	\$ 1,122,486	\$ 1,067,509

## Non-Performing Assets

Loans on which the accrual of interest has been discontinued are designated as non-performing loans. Accrual of interest on loans is generally discontinued either when: (1) a loan becomes contractually past due by 90 days or more with respect to interest or principal; or (2) the loan is considered by management to be impaired because it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When loans 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 is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. The Company reported \$3.8 million of Non-Performing Loans at June 30, 2008, \$69,000 at December 31, 2007, and \$501,000 at June 30, 2007. These balances are reported net of guarantees of the U.S. Government, including its agencies and its government-sponsored agencies, in the amounts of \$731,000, \$134,000 and \$138,000, respectively. Non-Performing Loans as a percentage of Total Loans were 0.33% at June 30, 2008, 0.01% at December 31, 2007, and 0.05% at June 30, 2007. The Allowance for Loan Losses as a percentage of Non-Performing Loans was 495.0% at June 30, 2008, 26,786.9% at December 31, 2007, and 3,578.8% at June 30, 2007.



## Table of Contents

Interest income on non-accrual loans, which would have been recognized during the period, if all such loans had been current in accordance with their original terms, totaled \$200,000 at June 30, 2008, \$31,000 at December 31, 2007, and \$57,000 at June 30, 2007.

Repossessed collateral that is real property is classified as other real estate owned ("OREO") or, if the collateral is personal property, the collateral is classified as other assets on the Company's financial statements. The Company reported \$6.9 million of OREO at June 30, 2008, \$251,000 at December 31, 2007, and none at June 30, 2007. During the second quarter of 2008 the increase in OREO was a result of the Company resolving a problem loan to one of the Bank's customers.

Except for non-performing loans discussed above, the Company's management is not aware of any loans as of June 30, 2008 for which known credit problems of the borrower would cause serious doubts as to the ability of these borrowers to comply with their present loan repayment terms, or any known events that would result in the loan being designated as non-performing at some future date. The Company's management cannot, however, predict the extent to which the following or other factors may affect a borrower's ability to pay: (1) deterioration in general economic conditions, real estate values or agricultural commodity prices; (2) changes in market interest rates; or (3) changes in the overall financial condition or business of a borrower. Real estate values in the Company's markets have been declining significantly and this situation remains volatile. See "Part II, Item 1a. Risk Factors".

### Deposits

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

The Company's deposit balances at June 30, 2008 increased \$51.9 million or 3.9% from December 31, 2007, and have increased \$116.5 million or 9.4% compared to June 30, 2007. Core deposits (exclusive of Public Time Deposits) increased \$40.0 million or 3.4% from December 31, 2007 and \$94.3 million or 8.5% since June 30, 2007. Public Time Deposits have increased \$11.9 million since December 31, 2007, and \$22.2 million since June 30, 2007 primarily because of the Company's decision to increase its use of public time deposits for short-term funding needs instead of using FHLB Advances (see "Federal Home Loan Bank Advances").

Demand and Interest-Bearing transaction accounts decreased \$44.4 million or 9.9% since December 31, 2007 and 1.2% since June 30, 2007 while savings and time deposit accounts have increased \$96.3 million or 11.1% since December 31, 2007 and \$121.4 million or 14.5% since June 30, 2007. Demand and Interest bearing transaction accounts have declined as customers have transferred funds to higher yielding savings and time deposit accounts with the Bank.

### Securities Sold Under Agreement to Repurchase

On March 13, 2008, the Company entered into a \$40 million medium term repurchase agreement with Citigroup as part of a leveraging strategy (see "Investment Securities"). The repurchase agreement pricing rate is 3.20% with an embedded 3 year cap tied to 3 month Libor with a strike price of 3.3675%. The repurchase agreement matures March 13, 2013, putable only on March 13, 2011, and is secured by investments in Agency pass through securities.

On May 30, 2008, the Company entered into a \$20 million medium term repurchase agreement with Citigroup as part of a leveraging strategy (see "Investment Securities"). The repurchase agreement pricing rate is 4.19% with an embedded 3 year cap tied to 3 month Libor with a strike price of 3.17%. The repurchase agreement matures June 5, 2013, putable only on June 5, 2011, and is secured by investments in Agency pass through securities.

### Federal Home Loan Bank Advances

Advances from the Federal Home Loan Bank are another key source of funds to support earning assets (see “Item 3. Quantitative and Qualitative Disclosures about Market Risk and Liquidity Risk”). These advances are also used to manage the Company’s interest rate risk exposure, and as opportunities exist, to borrow and invest the proceeds at a positive spread through the investment portfolio. FHLB Advances as of June 30, 2008 were \$729,000 compared to \$28.9 million at December 31, 2007 and \$63.9 million at June 30, 2007. The decrease of \$28.2 million since December 31, 2007 and \$63.1 million since June 30, 2007, is a result of the Company’s increased use of public time deposits and repurchase agreements as opposed to FHLB advances.

Table of Contents

## Long-term Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities. Although this amount is reflected as subordinated debt on the Company's balance sheet, under applicable regulatory guidelines, trust preferred securities qualify as regulatory capital (see "Capital"). These securities accrue interest at a variable rate based upon 3-month Libor plus 2.85%. Interest rates reset quarterly and were 5.66% as of June 30, 2008, 7.84% at December 31, 2007 and 8.21% at June 30, 2007.

## 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 \$146.9 million at June 30, 2008, \$143.4 million at December 31, 2007, and \$138.1 million at June 30, 2007.

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios set forth in the table below of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all terms as defined in the regulations). Management believes, as of June 30, 2008, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

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

(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, 2008						
Total Capital to Risk Weighted Assets	\$ 174,771,353	12.67%	\$ 110,317,417	8.0%	N/A	N/A
Tier 1 Capital to Risk Weighted Assets	\$ 157,514,670	11.42%	\$ 55,158,708	4.0%	N/A	N/A
Tier 1 Capital to Average Assets	\$ 157,514,670	10.20%	\$ 61,746,644	4.0%	N/A	N/A



Table of Contents

(in thousands) The Bank: As of June 30, 2008	Actual		Regulatory Capital Requirements		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital to Risk Weighted Assets	\$ 169,655,873	12.35%	\$ 109,913,859	8.0%	\$ 137,392,324	10.0%
Tier 1 Capital to Risk Weighted Assets	\$ 152,461,468	11.10%	\$ 54,956,929	4.0%	\$ 82,435,394	6.0%
Tier 1 Capital to Average Assets	\$ 152,461,468	9.92%	\$ 61,493,570	4.0%	\$ 76,866,963	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. The quantitative limitation concerning goodwill will not be effective until June 30, 2009. Since the Company has no goodwill on its balance sheet, this rule will have no impact. 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.

In accordance with the provisions of Financial Accounting Standard Board Interpretation No. 46, “Consolidation of Variable Interest Entities” (“FIN 46”), the Company does not consolidate the subsidiary trust which has issued the trust-preferred securities.

In 1998, the Board approved the Company’s first stock repurchase program which expired on May 1, 2001. During the second quarter of 2004, the Board approved a second stock repurchase program because it concluded that the Company continued to have more capital than it needed to meet present and anticipated regulatory guidelines for the Bank to be classified as “well capitalized.” On April 4, 2006, the Board unanimously approved expanding the Repurchase Program to allow the repurchase of up to \$15 million of stock between May 1, 2006 and April 30, 2009.

Repurchases under the program will continue to be made on the open market or through private transactions. The repurchase program also requires that no purchases may be made if the Bank would not remain “well-capitalized” after the repurchase. All shares repurchased under the repurchase program will be retired. See the Company’s 2007 Form 10-K, Part II, “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.”

During the second quarter of 2008, the Company repurchased 2,654 shares at an average share price of \$460 per share. During the second quarter of 2007, the Company repurchased 1,000 shares at an average share price of \$510. Since the second share repurchase program was expanded in 2006, the Company has repurchased over 26,000 shares for total consideration of \$12.5 million. (See Part II, Item 2. Unregistered Sales of Equity Securities and Use of Proceeds).

#### 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 loan 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 Annual Report to Shareholders on Form 10-K for the year ended December 31, 2007.

## Table of Contents

### Off Balance Sheet Arrangements

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

In the ordinary course of business, the Company enters into commitments to extend credit to its customers. As of June 30, 2008, the Company had entered into commitments with certain customers amounting to \$365.6 million compared to \$440.3 million at December 31, 2007 and \$382.9 million at June 30, 2007. Letters of credit at June 30, 2008, December 31, 2007 and June 30, 2007, were \$7.5 million, \$8.4 million and \$11.0 million, respectively. These commitments are not reflected in the accompanying consolidated financial statements and do not significantly impact operating results.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### Risk Management

The Company has adopted a Risk Management Plan, which aims to ensure the proper control and management of all risk factors inherent in the operation of the Company. Specifically, credit risk, interest rate risk, liquidity risk, compliance risk, strategic risk, reputation risk and price risk can all affect the market risk of the Company. These specific 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.

Credit risk in the loan portfolio is controlled by limits on industry concentration, aggregate customer borrowings and geographic boundaries. Standards on loan quality also are designed to reduce loan credit risk. Senior Management, Directors' Committees, and the Board of Directors are regularly provided with information intended to identify, measure, control and monitor the credit risk of the Company.

The Company's methodology for assessing the appropriateness of the allowance is applied on a regular basis and considers all loans. The systematic methodology consists of two major elements. The first major element includes a detailed analysis of the loan portfolio in two phases. The first phase is conducted in accordance with SFAS No. 114, "Accounting by Creditors for the Impairment of a Loan" as amended by SFAS No. 118, "Accounting by Creditors for Impairment of a Loan — Income Recognition and Disclosures." Individual loans are reviewed to identify loans for impairment. A loan is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan. Impairment is measured as either the expected future cash flows discounted at each loan's effective interest rate, the fair value of the loan's collateral if the loan is collateral dependent, or an observable market price of the loan (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 and the Company's credit risk management is its loan risk rating system. The originating credit officer assigns borrowers an initial risk rating, which is based primarily on a thorough analysis of each borrower's financial position in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior credit administration personnel. Credits are monitored by credit administration personnel for deterioration in a borrower's financial condition, which would impact the ability of the borrower to perform under the contract. Risk ratings are adjusted as necessary.

Table of Contents

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 the possibility of loss. Management performs a detailed analysis of these loans, 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.

The second phase is conducted by segmenting the loan portfolio by risk rating and into groups of loans with similar characteristics in accordance with SFAS No. 5, "Accounting for Contingencies." In this second phase, groups of loans with similar characteristics are reviewed and applied the appropriate allowance factor based on the five-year average charge-off rate for each particular group of loans.

The second major element of the analysis, which considers qualitative internal and external factors that may affect a loan's collectibility, 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:

- § then-existing general economic and business conditions affecting the key lending areas of the Company;
- § credit quality trends (including trends in non-performing loans expected to result from existing conditions);
- § collateral values;
- § loan volumes and concentrations;
- § seasoning of the loan portfolio;
- § specific industry conditions within portfolio segments;
- § recent loss experience within portfolio segments;
- § duration of the current business cycle;
- § bank regulatory examination results; and
- § findings of the Company's internal credit examiners.

Management reviews 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 problem 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 problem 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 major element of the allowance.

Implicit in lending activities is the risk that losses will and do occur and that the amount of such losses will vary over time. Consequently, the Company maintains an allowance for loan losses by charging a provision for loan losses to earnings. Loans determined to be losses are charged against the allowance for loan losses. The Company's allowance for loan losses is maintained at a level considered by management to be adequate to provide for estimated losses inherent in the existing portfolio.

Management believes that the allowance for loan losses at June 30, 2008 was adequate to provide for both recognized probable losses and estimated inherent losses in the portfolio. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans or net loan charge-offs that would increase the provision for loan losses and thereby adversely affect the results of operations.

Market Risk - Interest Rate Risk

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

## Table of Contents

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: analysis of asset and liability mismatches (GAP analysis), the utilization of a simulation model and limits on maturities of investment, loan and deposit products which reduces the market volatility of those instruments.

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

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

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

The simulation model estimates the impact of changing interest rates on interest income from all interest earning assets and the interest expense paid on all interest bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 200 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, 2008, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was a decrease in net interest income of 0.88% if rates increase by 200 basis points and an increase in net interest income of 0.45% if rates decline 100 basis points. Comparatively, at December 31, 2007, the Company's estimated net interest income sensitivity was a decrease in net interest income of 0.40% if rates increase by 200 basis points and an increase in net interest income of 0.90% if rates decrease 200 basis points. All results are within the Company's policy limits.

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 and securities; pricing strategies on loans and deposits; replacement of asset and liability cashflows; 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 principal sources of liquidity include credit facilities from correspondent banks, brokerage firms and the Federal Home Loan Bank, as well as interest and principal payments on loans and investments, proceeds from the maturity or sale of investments, and growth in deposits.



## Table of Contents

In general, liquidity risk is managed by controlling the level of borrowings and the use of funds provided by the cash flow from the investment portfolio. At June 30, 2008, the Company maintained Federal Funds borrowing lines of \$99 million with major banks subject to the customary terms and conditions for such arrangements and \$150 million in repurchase lines with major brokers. In addition, the Company has additional borrowing capacity of \$206.8 million from the Federal Home Loan Bank.

At June 30, 2008, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities of approximately \$81.4 million, which represents 5.1% of total assets.

### ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures designed to ensure that information is recorded and reported in all filings of financial reports. Such information is reported to the Company's management, including its Chief Executive Officer and its Chief Financial Officer to allow timely and accurate disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e). In designing these controls and procedures, management recognizes that they can only provide reasonable assurance of achieving the desired control objectives. Management also evaluates the cost-benefit relationship of possible controls and procedures.

As of the end of the period covered by this report, the Company carried out an evaluation of the effectiveness of Company's disclosure controls and procedures under the supervision and with the participation of the Chief Executive Officer, the Chief Financial Officer and other senior management of the Company. The evaluation was based, in part, upon reports and affidavits provided by a number of executives. Based on the foregoing, the Company's Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

There have been no significant changes in the Company's internal controls over financial reporting or in other factors that could significantly affect the internal controls over financial reporting during the second quarter of 2008.

## 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 2007 Annual Report to Shareholders on Form 10-K. In management's opinion, although there have been no material changes in risk factors since the filing of the 2007 Form 10-K, the overall decline in real estate values in California, and more specifically the Central Valley, has continued during the first half of 2008, and shows no signs of abating in the near future. While the Company has not been as adversely impacted by this trend as some other banks, continuing real estate price declines will have a negative impact on overall economic conditions in the Company's markets and may result in: (1) increased non-performing loans, credit losses, and OREO (see "Financial Condition – Non-Performing Assets"); and/or (2) reduced opportunities for profitable

growth.

28

---

Table of Contents

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

The following table indicates the number of shares repurchased by Farmers & Merchants Bancorp during the second quarter of 2008.

Second Quarter 2008	Number of Shares	Average Price per Share	Number of Shares Purchased as Part of a Publicly Announced Plan or Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan or Program
04/01/2008 - 04/30/2008	-	-	-	\$ 3,754,294
05/01/2008 - 05/31/2008	2,503	460.00	2,503	2,602,914
06/01/2008 - 06/30/2008	151	460.00	151	2,533,454
Total	2,654	\$ 460.00	2,654	\$ 2,533,454

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

## ITEM 3. Defaults Upon Senior Securities

Not applicable

## ITEM 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Shareholders of Farmers & Merchants Bancorp was held on May 19, 2008. There were 560,233 shares represented in person and by proxy. At this meeting, the Company's shareholders considered and voted on the following matters:

## 1. ELECTION OF DIRECTORS

Directors	For	%	Withheld	%
S. ADAMS	553,718	98.8%	6,515	1.2%
R. BURLINGTON	553,711	98.8%	6,522	1.2%
E. CORUM, JR	553,740	98.8%	6,493	1.2%
O. METTLER	548,127	97.8%	12,106	2.2%
J. PODESTA	553,711	98.8%	6,522	1.2%
K. SANGUINETTI	553,711	98.8%	6,522	1.2%
K. STEINWERT	548,002	97.8%	12,231	2.2%
C. SUESS	553,671	98.8%	6,562	1.2%

C. WISHEK, JR.	553,711	98.8%	6,522	1.2%
----------------	---------	-------	-------	------

29

---

Table of Contents

ITEM 5. Other Information

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 (see Exhibit No. 4.1 to this Form 10-Q) dated August 5, 2008 with Registrar and Transfer Company, as Rights Agent, and the Company declared a dividend of a right to acquire one preferred share purchase right (a “Right”) for each outstanding share of the Company’s Common Stock, \$0.01 par value per share, to stockholders of record at the close of business on August 15, 2008. Generally, the Rights only are triggered and become exercisable if a person or group (the “Acquiring Person”) acquires beneficial ownership of 10 percent or more of the Company’s common stock or announces a tender offer for 10 percent or more of the Company’s common stock.

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

ITEM 6. Exhibits

See Exhibit Index on Page 31.

Table of Contents

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 7, 2008

/s/ Kent A. Steinwert  
Kent A. Steinwert  
President and  
Chief Executive Officer  
(Principal Executive Officer)

Date: August 7, 2008

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

Index to Exhibits

Exhibit No.	Description
3.3	Certificate of Designation for the Series A Junior Participating Preferred Stock (included as Exhibit A to the Rights Agreement between Farmers & Merchants Bancorp and Registrar and Transfer Company, dated as of August 5, 2008, filed as Exhibit 4.1 below).
<u>4.1</u>	Rights Agreement between Farmers & Merchants Bancorp and Registrar and Transfer Company, dated as of August 5, 2008, including Form of Right Certificate attached thereto as Exhibit B.
<u>31(a)</u>	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>31(b)</u>	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>32</u>	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.