FARMERS & MERCHANTS BANCORP INC
Form 10-K
February 27, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2018

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from to

Commission File Number 001-38084

FARMERS & MERCHANTS BANCORP, INC.

OHIO	34-1469491
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
307 North Defiance Street	
Archbold, Ohio	43502
(Address of principal Executive offices)	(Zip Code)

Registrant’s telephone number, including area code (419) 446-2501

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
None	None

Securities registered pursuant to Section 12(g) of the Act:

Common shares without par value

(Title of class)

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

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

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

As of June 30, 2018, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was $373,858,083.

As of February 22, 2019, the Registrant had 12,230,000 shares of common stock issued of which 11,107,063 shares are outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of Form 10-K – Portions of the definitive Proxy Statement for the 2019 Annual Meeting of Shareholders of Farmers & Merchants Bancorp, Inc.

FARMERS & MERCHANTS BANCORP, INC.

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**The following materials from Farmers & Merchants Bancorp, Inc. on Form 10-K for the year ended December 31, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income and Comprehensive Income; (iii) the Consolidated Statements of Cash Flows and (iv) Notes to Consolidated Financial Statements, tagged as blocks of text.

Total Pages:	102

Forward Looking Statements

Statements contained in the Company's Annual Report on Form 10-K may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of such words as "intend," "believe," "expect," "anticipate," "should," "planned," "estimated," and "potential." Such forward-looking statements are based on current expectations but may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the Company and its subsidiaries which include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results could differ from those projected in the forward-looking statements.

PART I

ITEM 1. BUSINESS

General

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

Our executive offices are located at 307 North Defiance Street, Archbold, Ohio 43502, and our telephone number is (419) 446-2501.

For a discussion of the general development of the Company’s business throughout 2018, please see the portion of Management’s Discussion and Analysis of Financial Condition and Results of Operations captioned “2018 in Review.”

Nature of Activities

The Farmers & Merchants State Bank engages in general commercial banking business. Its activities include commercial, agricultural and residential mortgage as well as consumer and credit card lending activities. Because the Bank's offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such things as farm land, farm equipment, livestock and operating loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements and loans for such items as autos, trucks, recreational vehicles and motorcycles. With the expansion into newer market areas, the most recent increases in loan activity have been in commercial real estate, providing operation lines of credit and machinery purchases.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition, Automated Teller Machines (ATMs) or Interactive Teller Machines (ITMs) are provided at most branch locations along with other independent locations in the market area. The Bank has custodial services for Individual Retirement Accounts (IRAs) and Health Savings Accounts (HSAs). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and Automated Clearing House (ACH) file transmittal. In addition, the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Upgrades to our digital products and services continue to occur in both retail and business lines.

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

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

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

All loan requests are reviewed as to credit worthiness and are subject to the Bank's underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on collateral types as set forth in the Bank's Loan Policy. In addition, credit scores of those seeking consumer credit are reviewed and if they do not meet the Bank's Loan Policy guidelines an additional officer approval is required.

Consumer Loans:

- Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect.
- Loans above 100% are generally the result of additional charges for extended warranties and/or insurance coverage for wage or death.
- Boats, campers, motorcycles, RV's and Motor Coaches range from 80%-90% based on age of vehicle.
- 1st or 2nd mortgages on 1-4 family homes range from 75%-90% with "in-house" first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV.
- Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

Commercial/Agriculture/Real Estate:

- Maximum LTVs range from 70%-80% depending on type.
- Accounts Receivable: Up to 80% LTV less retainages and greater than 90 days.

Inventory:

- Agriculture:

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

- Commercial:

Maximum LTV of 50% on raw and finished goods.

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

Equipment:

- New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value.
- Restaurant equipment up to 35% of market value.
- Heavy trucks, titled trailers up to NTE 75% LTV and aircraft up to 75% of appraised value.

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

In December of 2014, the Company became a financial holding company within the meaning of the Bank Holding Company Act of 1956 as amended, in order to provide the flexibility to take advantage of the expanded powers available to a financial holding company under the Act. Our subsidiary bank is in turn regulated and examined by the

Ohio Division of Financial Institutions and the Federal Deposit Insurance Corporation. The activities of our bank subsidiary are also subject to other federal and state laws and regulations. The Company also formed a Captive insurance company in December 2014. The Captive is located in Nevada and regulated by the State of Nevada Division of Insurance.

The Bank's primary market includes communities located in the Ohio counties of Defiance, Fulton, Hancock, Henry, Lucas, Williams, Wood and in the Indiana counties of Adams, Allen, DeKalb, Jay and Steuben. The commercial banking business in this market is highly competitive, with approximately 45 other depository institutions currently doing business in the Bank's primary market. In our banking activities, we compete directly with other commercial banks, credit unions, farm credit services, and savings and loan institutions in each of our operating localities. In a number of our locations, we compete against entities which are much larger than us, including Huntington National Bank, Fifth Third Bank, Wells Fargo Bank, NA, KeyBank NA and JPMorgan Chase Bank, NA. Based on deposit data as of June 30, 2018 from the FDIC and using zip codes in our markets, the Bank ranked 4th with a 12.8% market share in markets served. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of the services provided.

At December 31, 2018, we had 288 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which is contributory. We consider our employee relations to be good.

Supervision and Regulation

General

The Company is a corporation organized under the laws of the State of Ohio. The business in which the Company and its subsidiaries are engaged is subject to extensive supervision, regulation and examination by various bank regulatory authorities. The supervision, regulation and examination to which the Company and its subsidiaries are subject to are intended primarily for the protection of depositors and the deposit insurance funds that insure the deposits of banks, rather than for the protection of shareholders.

Several of the more significant regulatory provisions applicable to banks and bank holding companies to which the Company and its subsidiaries are subject to are discussed below along with certain regulatory matters concerning the Company and its subsidiaries. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statutory provisions. Any change in applicable law or regulation may have a material effect on the business and prospects of the Company and its subsidiaries.

Regulatory Agencies

The Company is a financial holding company and is subject to inspection, examination and supervision by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) pursuant to the Bank Holding Company Act of 1956, as amended. As a financial holding company, the Company is still subject to all the bank holding company regulations.

The Bank is an Ohio chartered commercial bank. It is subject to regulation and examination by both the Ohio Division of Financial Institutions (ODFI) and the Federal Deposit Insurance Corporation (FDIC).

The Captive is an insurance company incorporated in Nevada and regulated by the State of Nevada, Division of Insurance.

Holding Company Activities

As a financial holding company incorporated and doing business within the State of Ohio, the Company is subject to regulation and supervision under the Bank Holding Act of 1956, as amended (the "Act"). The Company is required to file with the Federal Reserve Board on quarterly basis information pursuant to the Act. The Federal Reserve Board may conduct examinations or inspections of the Company and its subsidiaries.

On November 12, 1999, the Gramm-Leach-Bliley Act (the "GLB Act") was enacted into law. The GLB Act made sweeping changes with respect to the permissible financial services which various types of financial institutions may now provide. The Glass-Steagall Act, which had generally prevented banks from affiliation with securities and insurance firms, was repealed. Pursuant to the GLB Act, bank holding companies may elect to become a "financial holding company," provided that all of the depository institution subsidiaries of the bank holding company are “well capitalized” and “well managed” under applicable regulatory standards.

Under the GLB Act, a bank holding company that has elected to become a financial holding company may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. Activities

that are "financial in nature" include securities underwriting, dealing and market-making, sponsoring mutual funds and investment companies, insurance underwriting and agency, merchant banking, and activities that the Federal Reserve Board has determined to be closely related to banking. Federal Reserve Board approval is not required for the Company to acquire a company, other than a bank holding company, bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board. Prior Federal Reserve Board approval is required before the Company may acquire the beneficial ownership or control of more than 5% of the voting shares, or substantially all of the assets, of a bank holding company, bank or savings association. If any subsidiary bank of the Company ceases to be "well capitalized" or "well managed" under applicable regulatory standards, the Federal Reserve Board may, among other actions, order the Company to divest the subsidiary bank. Alternatively, the Company may elect to conform its activities to those permissible for a bank holding company that is not also a financial holding company. If any subsidiary bank of the Company receives a rating under the Community Reinvestment Act of 1977 of less than satisfactory, the Company will be prohibited from engaging in new activities or acquiring companies other than bank holding companies, banks or savings associations.

Affiliate Transactions

Various governmental requirements, including Sections 23A and 23B of the Federal Reserve Act and Regulation W promulgated thereunder limit borrowings by holding companies and non-bank subsidiaries from affiliated insured depository institutions, and also limit various other transactions between holding companies and their non-bank subsidiaries, on the one hand, and their affiliated insured depository institutions on the other. Section 23A of the Federal Reserve Act also generally requires that an insured depository institution's loan to its non-bank affiliates be secured, and Section 23B of the Federal Reserve Act generally requires that an insured depository institution's transactions with its non-bank affiliates be on arms-length terms.

Interstate Banking and Branching

Under the Riegle-Neal Interstate Banking and Branching Efficiency Act ("Riegle-Neal"), subject to certain concentration limits and other requirements, adequately capitalized bank holding companies such as the Company are permitted to acquire banks and bank holding companies located in any state. Any bank that is a subsidiary of a bank holding company is permitted to receive deposits, renew time deposits, close loans, service loans and receive loan payments as an agent for any other bank subsidiary of that bank holding company. Banks are permitted to acquire branch offices outside their home states by merging with out-of-state banks, purchasing branches in other states and establishing de novo branch offices in other states. The Company could from time to time use Riegle-Neal to acquire banks in additional states.

Control Acquisitions

The Change in Bank Control Act prohibits a person or group of persons from acquiring "control" of a bank holding company, unless the Federal Reserve Board has been notified and has not objected to the transaction. Under the rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, such as the Company, would, under the circumstances set forth in the presumption, constitute acquisition of control of the bank holding company. In addition, a company is required to obtain the approval of the Federal Reserve Board under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of any class of outstanding voting stock of a bank holding company, or otherwise obtaining control or a "controlling influence" over that bank holding company.

Liability for Banking Subsidiaries

Under the current Federal Reserve Board policy, a bank holding company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to maintain resources adequate to support each subsidiary bank. This support may be required at times when the bank holding company may not have the resources to provide it. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a U.S. federal bank regulatory agency to maintain the capital of a subsidiary bank would be assumed by the bankruptcy trustee and entitled to priority of payment. Any depository institution insured by the FDIC can be held liable for any loss incurred, or reasonably expected to be incurred, by the FDIC in connection with (1) the "default" of a commonly controlled FDIC-insured depository institution; or (2) any assistance provided by the FDIC to both a commonly controlled FDIC-insured depository institution "in danger of default." The Bank is an FDIC-insured depository institution. If a default occurred with respect to the Bank, any capital loans to the Bank from its parent holding company would be subordinate in right of payment to payment of the Bank's depositors and certain of its other obligations.

Regulatory Capital Requirements

The Company is required by the various regulatory authorities to maintain certain capital levels. Bank holding companies are required to maintain minimum levels of capital in accordance with Federal Reserve Board capital adequacy guidelines. If capital falls below minimum guideline levels, a bank holding company, among other things, may be denied approval to acquire or establish additional banks or non bank businesses. The required capital levels in addition to the Bank's and Company's capital position at December 31, 2018 and 2017 are summarized in the table included in Note 15 to the consolidated financial statements. Beginning in 2018, the consolidated amounts and ratios for the Company are no longer required.

Beginning in 2015, the Company and Bank were required to measure capital adequacy using Basel III accounting. Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. Implementation of the rules will be overseen by the Federal Reserve, the FDIC and the OCC. Reporting under the new rules began with the March 2015 quarterly regulatory filings.

FDICIA

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), and the regulations promulgated under FDICIA, among other things, established five capital categories for insured depository institutions-well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized-and requires U.S. federal bank regulatory agencies to implement systems for "prompt corrective action" for insured depository institutions that do not meet minimum capital requirements based on these categories. Unless a bank is well capitalized, it is subject to restrictions on its ability to offer brokered deposits and on certain other aspects of its operations. An undercapitalized bank must develop a capital restoration plan and its parent bank holding company must guarantee the bank's compliance with the plan up to the lesser of 5% of the bank’s assets at the time it became undercapitalized and the amount needed to comply with the plan. As of December 31, 2018, the Bank was well capitalized pursuant to these prompt corrective action guidelines.

Dividend Restrictions

The ability of the Company to obtain funds for the payment of dividends and for other cash requirements will be largely dependent on the amount of dividends which may be declared by its banking subsidiary, which are limited to the Bank’s retained earnings during the current year and its prior two years. Various U.S. federal statutory provisions limit the amount of dividends the Company's banking subsidiary can pay to the Company without regulatory approval. In 2009, The Board of Governors of the Federal Reserve Division of Banking Supervision and Regulation issued SR09-4 regarding the safe and sound payment of dividends by bank holding companies. See Note 16 to the consolidated financial statements for additional information on applicable dividend restrictions.

Deposit Insurance Assessments

The deposits of the Bank are insured up to the regulatory limits set by the FDIC. The FDIC maintains the Deposit Insurance fund (“DIF”) by assessing depository institutions an insurance premium (assessment). The amount assessed to each institution is based on statutory factors that take into account the degree of risk the institution poses to the DIF. The primary purposes of the DIF are to (1) insure the deposits and protect the depositors of insured depository institutions; and (2) resolve failed banks. The DIF is primarily funded through quarterly assessments on insured depository institutions, but it also earns interest income on its securities. Decreases in the DIF result from loss provisions associated with the resolution of failed banks and FDIC operating expenses.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) revised the statutory authorities governing the FDIC’s management of the DIF. A key requirement from the Dodd-Frank Act resulted in the FDIC’s adoption of new rules in February 2011 regarding Assessments, Dividends, Assessment Base, and Large Bank Pricing. The new rules implemented the following changes: (1) redefined the definition of an institution’s deposit insurance assessment base from one based on domestic deposits to one based on assets now defined as “average consolidated total assets minus average tangible equity”; (2) changed the assessment rate adjustments to better account for risk based on an institution’s funding sources; (3) revised the deposit insurance assessment rate schedule in light of the new assessment base and assessment rate adjustments; (4) implemented Dodd-Frank Act dividend provisions; (5) revised the large insured depository institution assessment system to better differentiate for risk and to take into account losses the FDIC may incur from large institution failures; and (6) provided technical and other changes to the FDIC’s assessment rules. Though deposit insurance assessments maintain a risk-based approach, the FDIC imposed a more extensive risk-based assessment system on large insured depository institutions with at least $10 billion in total assets since they are more complex in nature and could pose greater risk. The rules became effective April 1, 2011 implementing the revised assessment rate schedule for the quarter beginning April 1, 2011. The revised assessment rate schedule was used to calculate the June 30, 2011 assessments which were due September 30, 2011 and subsequent quarterly assessments thereafter.

Due to the changes to the assessment base and assessment rates, as well as the DIF restoration time frame, the impact on the Company’s future deposit insurance assessments has been and should continue to be favorable.

The Dodd-Frank Act permanently raised the standard maximum deposit insurance coverage amount to $250,000.

The FDIC deposit insurance coverage limit applies per depositor, per insured depository institution for each account ownership category.

Depositor Preference Statute

In the "liquidation or other resolution" of an institution by any receiver, U.S. federal legislation provides that deposits and certain claims for administrative expenses and employee compensation against the insured depository institution would be afforded a priority over general unsecured claims against that institution, including federal funds and letters of credit.

Government Monetary Policy

The earnings of the Company are affected primarily by general economic conditions and to a lesser extent by the fiscal and monetary policies of the federal government and its agencies, particularly the Federal Reserve. Its policies influence, to some degree, the volume of bank loans and deposits, and interest rates charged and paid thereon, and thus have an effect on the earnings of the Company's subsidiary Bank.

Additional Regulation

Provisions of the Dodd-Frank Act have resulted in additional rulemaking by the federal regulatory agencies and new rules yet to be issued. Implementing the new and expanded regulations involved extreme diligence to ensure compliance with the complexities of the rules, as well as extensive new disclosure and reporting requirements.

The Dodd-Frank Act created an independent regulatory body, the Bureau of Consumer Financial Protection (“Bureau”), with authority and responsibility to set rules and regulations for most consumer protection laws applicable to all banks – large and small - adds another regulator to scrutinize and police financial activities. Transfer to the Bureau of all consumer financial protection functions for designated laws by the other federal agencies was completed in July 2011. The Bureau was given responsibility for mortgage reform and enforcement, as well as broad new powers over consumer financial activities, including consumer financial products and services and how they are provided.

Significant mortgage rules mandated by the Dodd-Frank Act provisions were enacted in response to the breakdown in the mortgage lending markets and to provide for consumer protections. Final rules issued by the Bureau or jointly with other regulatory agencies implemented requirements under the Dodd-Frank Act regarding mortgage-related matters such as ability-to-repay, qualified mortgage standards, mortgage servicing, mortgage loan originator compensation, escrow requirements for higher-priced mortgage loans, and providing appraisals. These new mortgage rules, effective in January 2014, addressed problems consumers faced in the three major steps in buying a home – shopping for a mortgage, closing on a mortgage, and paying off a mortgage.

Final rules and amendments to the integrated mortgage disclosure rules under the Real Estate Settlement Act (RESPA) and Truth in Lending Act (TILA) became effective in October 2015. The TILA-RESPA Integrated Disclosure rule commonly referred to as TRID combined required disclosures into two single forms: 1) The Loan Estimate which is provided shortly after a mortgage loan application and 2) The Closing Disclosure which is provided prior to loan consummation. In addition, a mandated appraisal notice under the Equal Credit Opportunity Act and the servicing application disclosure under RESPA were also combined into the new integrated disclosures. Process and procedural adjustments were necessary to appropriately implement the new requirements. Implementation to achieve TRID compliance involved extensive collaboration with the Mortgage Loan Origination software vendor, as well as outreach and coordination efforts with real estate agents, attorneys, and closing agents to cultivate preparedness for the new integrated mortgage loan disclosure forms. Amendments to the TRID rules effective in October 2017 with a mandatory compliance in October 2018 were intended to provide further clarity to certain provisions. Due to the complexities of the TRID rules, remaining attentive to these matters will ensure practices and procedures remain compliant and not subject the Bank to unnecessary liability.

Final rules, mostly effective in October 2015, were issued by the Board of Governors of the Federal Reserve System (FRB), the Farm Credit Administration, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC) to implement provisions of the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA) and the Biggert-Waters Flood Insurance Reform Act of 2012 (the Biggert-Waters Act). These provisions amended regulations which apply to loans secured by properties located in special flood hazard areas.

Processes and procedural changes along with the implementation of new forms and notifications resulted. Fines and penalties for compliance with flood insurance requirements promote a continued focus on adherence to the new flood rules and existing requirements.

The Department of Defense (DOD) new rules amending its regulation that implements the Military Lending Act (MLA) became effective in October 2016. The MLA enacted as part of the John Warner National Defense Act of 2007, significantly expanded

the scope of the Act to cover all consumer credit except residential mortgages and purchase money loans. Compliance requirements for credit cards became effective in October 2017. Coverage applies to consumer credit defined as "credit offered or extended for personal, family, or household purpose and that is subject to a finance charge or payable by written agreement in more than four installments." A covered borrower is a consumer who at the time of becoming obligated on a consumer credit transaction or establishing an account for consumer credit, is a covered member or dependent (including a spouse) of a covered member. A covered member is a member of the armed forces serving on active duty or active guard or reserve duty.

Providing a loan to a MLA-covered borrower that exceeds the 36% Military Annual Percentage Rate is prohibited. Any covered loans made without providing proper disclosures or in violation of the MLA is void. Creditors who knowingly or willfully violate the rules could be subject to a fine, imprisonment up to one year or both. Implementation of these new rules involved understanding the impact on the covered consumer credit products offered, collaboration with Loan Origination System vendors for assistance with calculations and required disclosures, and an efficient and effective process for identifying covered borrowers.

Under the TILA Ability to Repay requirements, the Bank meets the criteria to qualify as a small creditor based on the number of first-lien mortgage loans transactions and due to its asset size; however it is not a creditor that operates predominantly in rural or underserved areas as it did not extend more than 50% of its total first-lien covered transactions in rural or underserved areas in calendar year 2018. The Bank focuses on Qualified Mortgage (QM) status for mortgage loans originated as they provide certain presumptions of compliance under the Ability to Repay rules adopted under the Dodd-Frank Act. In satisfying QM requirements, any mortgage lender regardless of their size can make loans which are entitled to the QM presumption of compliance.

Revised Regulation C rules which implement the Home Mortgage Disclosure Act (HMDA) published by the Bureau become effective on January 1, 2018 for reportable loan applications. The Dodd-Frank Act provisions added new data points for HMDA and authorized the Bureau to require additional information. The types of transactions reportable have expanded to include most consumer purpose transactions that are dwelling-secured loans or open-end lines of credit. Reportable data points were significantly expanded to 52 fields which included applicant or borrower age, credit score, automated underwriting system information, property value, application channel, points and fees, borrower-paid origination charges, discount points, lender credits, loan term, prepayment penalty, interest rate, loan originator identifier, as well as other data fields. Ethnicity categories were expanded to include certain subcategories along with a means to capture information on how an applicant's or borrower's ethnicity, race, and sex were collected by the institution. For 2018, a thorough review and validation of data fields to be reported for each application was conducted throughout the year. Year-end submission of 2018 data to be reported will be completed using the web-based tool developed by the Bureau.

Enactment of the Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCPA) on May 24, 2018, resulted in a regulatory reform law deemed to be relief from certain burdensome provisions of the Dodd-Frank Act. The EGRRCPA included provisions with various effective dates, including some that were effective immediately. Matters impacted included access to mortgage credit; access to credit; protections for veterans, consumers, and homeowners; rules for holding companies; capital access; and protections for student borrowers. Though effective immediately, conforming regulations were required for certain provisions such as Reciprocal Deposits, Examination Cycles, and High Volatility Commercial Real Estate (HVCRE). The Protecting Tenants in Foreclosure Act was restored and permanently extended as of June 23, 2018. An interim final rule was jointly issued by the OCC, FRB, and FDIC allowing an extended examination cycle for qualifying insured depository institutions with less than $3 billion in total assets. Effective September 21, 2018, consumers could freeze their credit information and place one-year fraud alerts for free. Additionally, parents can freeze the credit information of their children under age 16 for free. In many instances, regulators still need to issue proposals, provide guidance, and publish final rules. Provisions, including but not limited to the following, still require regulations to become effective;

Residential Mortgage Loans; Mortgage Appraisals; HMDA; Escrow Relief; TRID Revisions; Highly Capitalized Banks; Identity Fraud; and Improving Access to Capital. Though beneficial, there are new requirements mixed in with deregulation. Thus, compliance changes must be monitored and effectively implemented.

Unfair or deceptive acts or practices (UDAP) standards originally developed years ago by the Federal Trade Commission focused on unacceptable practices that may not specifically be addressed elsewhere in banking or consumer finance law. Banking regulatory agencies have increasingly used this authority over the last few years to address acts or practices that are deemed harmful, deceptive, or misleading to consumers. The authority of the Federal Trade Commission (FTC) to issue credit practice rules under Section 5 of the Federal Trade Commission Act for financial institutions was repealed as a result of the Dodd-Frank Act. Guidance issued collectively by the FDIC, FRB, the Bureau, NCUA, and OCC in August 2014 clearly indicated certain consumer credit practices were not permissible and remained subject to Section 5 of the Federal Trade Commission Act, as well as Sections 1031 and 1036 of the Dodd-Frank Act. The interagency guidance further noted that the Agencies will continue to have supervisory authority and enforcement authority for unfair or deceptive acts or practices, which could include those

practices previously addressed in the former credit practices rules. Remaining attentive to the UDAP standards, in relation to the offering and marketing of Bank products and services is extremely important.

The Bank is also subject to federal regulation relating to such matters as required reserves, limitation as to the nature and amount of its loans and investments, regulatory approval of any merger or consolidation, issuance or retirement of their own securities, limitations upon the payment of dividends and other aspects of banking operations. In addition, the activities and operations of the Bank are subject to a number of additional detailed, complex and sometimes overlapping laws and regulations. These include state usury and consumer credit laws, state laws relating to fiduciaries, the federal Equal Credit Opportunity Act and Regulation B, the federal Electronic Funds Transfer Act and Regulation E, the federal Fair Credit Reporting Act and Regulation V, the federal Real Estate Settlement Procedures Act (RESPA) and Regulation X, the federal Truth in Lending Act and Regulation Z, the federal Truth in Savings Act and Regulation DD, the Bank Secrecy Act, the federal Community Reinvestment Act, anti-discrimination laws and legislation, and antitrust laws.

Future Legislation

Changes to the laws and regulations, both at the federal and state levels, can affect the operating environment of the Company and its subsidiaries in substantial and unpredictable ways. The Company cannot accurately predict whether those changes in laws and regulations will occur, and, if those changes occur, the ultimate effect they would have upon the financial condition or results of operations of the Company or its subsidiaries. Various provisions and regulations authorized or required by the Dodd-Frank Act have not yet been proposed or implemented by federal regulators. Uncertainty also exists with respect to the Dodd-Frank Act regulations authorized or required that have not yet been proposed or finalized.

Available Information

The Company maintains an Internet web site at the following internet address: www.fm.bank. The Company files reports with the Securities and Exchange Commission (SEC). Because the Company makes its filing with the SEC electronically, you may access such reports at the SEC’s website (www.sec.gov). The Company makes available, free of charge through its internet address, copies of its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to these reports as soon as reasonable practicable after such materials have been filed with or furnished to the SEC. Copies of these documents may also be obtained, either in electronic or paper form, by contacting Barbara J. Britenriker, Chief Financial Officer of the Company at (419) 446-2501.

ITEM 1a. RISK FACTORS

Significant Competition from an Array of Financial Service Providers

Our ability to achieve strong financial performance and a satisfactory return on investment to shareholders will depend in part on our ability to expand our available financial services. In addition to the challenge of attracting and retaining customers for traditional banking services, our competitors now include securities dealers, brokers, mortgage bankers, investment advisors and finance and insurance companies who seek to offer one-stop financial services to their customers that may include services that banks have not been able or allowed to offer to their customers in the past. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems and the accelerating pace of consolidation among financial services providers. If we fail to adequately address each of the competitive pressures in the banking industry, our financial condition and results of operations could be adversely affected.

Credit Risk

The risk of nonpayment of loans is inherent in commercial banking. Such nonpayment could have an adverse effect on the Company's earnings and our overall financial condition as well as the value of our common stock. Management attempts to reduce the Bank's credit exposure by carefully monitoring the concentration of its loans within specific industries and through the loan approval process. However, there can be no assurance that such monitoring and procedures will totally mitigate the risks. Credit losses can cause insolvency and failure of a financial institution and, in such event, its shareholders could lose their entire investment. For more information on the exposure of the Company and the Bank to credit risk, see the section under Part II, Item 7 of this Form 10-K captioned "Loan Portfolio."

Our loan portfolio has a large concentration of real estate loans

Real estate loans, which constitute a large portion of our loan portfolio, include home equity, commercial, construction and residential loans, and such loans are concentrated in the Bank's primary markets in northwest Ohio and Northeast Indiana. The

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market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Adverse developments affecting real estate values in our market could increase the credit risk associated with our loan portfolio. Also, real estate lending typically involves higher loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the control of the borrower could negatively impact the future cash flow and market values of the affected properties.

If the loans that are collateralized by real estate become troubled during a time when market conditions are declining or have declined, then we may not be able to realize the amount of security that we anticipated at the time of originating the loan, which could cause us to increase our provision for loan losses and adversely affect our operating results and financial condition.

Our real estate loans also include construction loans, including land acquisition and development. Construction, land acquisition and development lending involve additional risks because funds are advanced based upon estimates of costs and the estimated value of the completed project. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the completed project and the effects of governmental regulation on real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, commercial construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor to repay principal and interest. If our appraisal of the value of the completed project proves to be overstated, we may have inadequate security for the repayment of the loan upon completion of construction of the project.

Payments on agricultural real estate loans are dependent on the profitable operation or management of the farm property securing the loan. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields (such as hail, drought and floods), loss of livestock due to disease or other factors, declines in market prices for agricultural products (both domestically and internationally) and the impact of government regulations (including changes in price supports, subsidies and environmental regulations). In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower’s ability to repay the loan may be impaired. The primary crops in our market areas are corn, wheat and soybeans. Accordingly, adverse circumstances affecting these crops could have an adverse effect on our agricultural real estate loan portfolio.

Commercial loans make up a significant portion of our loan portfolio

Our commercial loans are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. Repayment of our commercial loans is often dependent on the cash flows of the borrower, which may be unpredictable. Most often, this collateral is accounts receivable, inventory, machinery or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. The other types of collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

We also originate agricultural operating loans. As with agricultural real estate loans, the repayment of operating loans is dependent on the successful operation or management of the farm property. Likewise, agricultural operating loans involve a greater degree of risk than lending on residential properties, particularly in the case of loans that are unsecured or secured by rapidly depreciating assets such as farm equipment or assets such as livestock or crops. The

primary livestock in our market areas is hogs. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The majority of our agricultural customers utilize crop insurance to mitigate the possibility of a large loss within one year on their grain operations. Crop insurance can be structured to be triggered by different factors and claim payment may also be customized, such as based on harvest yields, income generation. Farmers may also use hedging techniques to lock in crop prices, input costs for future production.

Susceptibility to Changes in Regulation

Any changes to state and federal banking laws and regulations may negatively impact our ability to expand services and to increase the value of our business. We are subject to extensive state and federal regulation, supervision, and legislation that govern almost all aspects of our operations. These laws may change from time to time and are primarily intended for the protection of consumers, depositors and the deposit insurance funds. In addition, the Company's earnings are affected by the monetary policies of the Board of Governors of the Federal Reserve. These policies, which include regulating the national supply of bank reserves and bank credit, can have a major effect upon the source and cost of funds and the rates of return earned on loans and investments. The Federal Reserve influences the size and distribution of bank reserves through its open market operations and changes in cash reserve

requirements against member bank deposits. We cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on us, but such changes could be materially adverse to our financial performance. For more information on this subject, see the section under Part I, Item 1 of this Form 10-K captioned "Supervision and Regulation."

Interest Rate Risk

Changes in interest rates affect our operating performance and financial condition in diverse ways. Our profitability depends in substantial part on our "net interest spread," which is the difference between the rates we receive on loans and investments and the rates we pay for deposits and other sources of funds. Our net interest spread will depend on many factors that are partly or entirely outside our control, including competition, federal economic, monetary and fiscal policies, and economic conditions generally. Historically, net interest spreads for other financial institutions have widened and narrowed in response to these and other factors, which are often collectively referred to as "interest rate risk." After many years of a low and flat rate environment, the Federal Reserve began increasing the Federal Funds rate in 2015. The Company did not experience improvement in its asset yield on loans until such time that the rate increases enabled the loan rates to rise above the floors which had been on the majority of the variable rate loans. During 2017, the increasing rates having reached over 100 basis points, triggered rate changes above the floors and the Company experienced improvement in the interest spread. The improvement in the net interest spread during 2016 through 2018 directly correlated to the improvement of the Bank's loan to asset ratio.

The Bank manages interest rate risk within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net interest income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. For more information regarding the Company's exposure to interest rate risk, see Part II, Item 7A of this Form 10-K.

Attraction and Retention of Key Personnel

Our success depends upon the continued service of our senior management team and upon our ability to attract and retain qualified financial services personnel. Competition for qualified employees is intense. In our experience, it can take a significant period of time to identify and hire personnel with the combination of skills and attributes required in carrying out our strategy. If we lose the services of our key personnel or are unable to attract additional qualified personnel, our business, financial condition, results of operations and cash flows could be adversely affected.

A key component of employee retention is providing a fair compensation base combined with the opportunity for additional compensation for above average performance. In this regard, the Company and the Bank use two incentive programs. The Company uses a stock award program to recognize and incentivize officers of the Bank. Under the long-term incentive compensation plan, restricted stock awards may be granted to officers. The amount of shares to be granted each year is determined by the Board Compensation Committee and may vary each year in its amount of shares and the number of recipients. The Compensation Committee determines the number of shares to be awarded overall and to the Chief Executive Officer ("CEO") specifically. The CEO then makes recommendations to the committee as to the recipients of the remaining shares. The full Board of Directors approves the action of the Committee. Since the plan's inception in 2005, all granted stock awards have utilized a three year cliff vesting feature. This is viewed as a retention aid as the awards may be forfeited should an officer leave employment during the vesting period.

A second incentive program of the Bank is based on cash compensation of which almost all employees participate (excluding commission based employees and other employees paid for specific higher paid positions, such as peak

time). A discussion of executive officer pay is incorporated within the proxy and as such, this discussion will pertain to all other employees. Non-officer employees are paid a cash incentive based on the projected overall performance of the Bank in terms of Return of Average Assets (“ROA”). The Compensation Committee determines the target performance levels on which the percentage of pay will be based. The Committee takes into account the five and ten year trend of ROA along with budget forecasted for the next year and the Bank’s past year performance. The Committee also considers the predicted banking environment under which the Bank will be operating. With the formation of the Captive, the ROA goal has been exclusive of the effect of the additional insurance expense at the Bank level. Non-officers receive incentive pay in December of the same year based on the year-to-date base compensation through the last pay received in November.

Officers, other than executive officers, receive incentive pay based on additional criterion. The officers are rewarded based on overall ROA of the Bank along with individual pre-established goals. Officers, therefore, have incentive pay at risk for individual performance. The individualized goals are recommended by each officer’s supervisor and are approved by an incentive committee of the Bank. The goals are designed to improve the performance of the Bank while also limiting the risk of a short-term performance focus. For example, a lending officer may be given two goals of which one is to grow loans within

specific targets and another is tied to a specific level of past dues and charge-offs. The second goal limits the ability to be rewarded for growth at all costs along with the specific target levels within the growth goal itself. Officers in a support department may be given goals which create efficiencies, ensure compliance with procedures, or generate new fee or product opportunities. On average, three to four goals were given to each officer in 2018. Officers are paid cash incentives based on the year-end ROA of the Bank and receive it within the first quarter of the following year. Should the ROA be forecasted to be positive but below the base target set by the Board, the officers are paid an incentive under the same basis and timing as non-officers disclosed above.

The percentages of base pay on which the incentive is calculated graduates higher as does the responsibility level of the employee and their ability to impact the financial performance of the Bank. These percentages are recommended by management to the Compensation Committee and Board for approval. The cash incentive plan along with its targets and goals are subject to modification at the Compensation Committee and Board's discretion throughout each year.

Dividend Payout Restrictions

We currently pay a quarterly dividend on our common shares. However, there is no assurance that we will be able to pay dividends in the future. Dividends are subject to determination and declaration by our Board of Directors, which takes into account many factors. The declaration of dividends by us on our common stock is subject to the discretion of our Board and to applicable state and federal regulatory limitations. The Company may receive dividends from the Bank which is subject to restrictions and limitations in the amount and timing of the dividends it may pay to the Company. The Bank has been declaring additional dividends each quarter to provide this liquidity to the Company. The Captive also upstreams dividends to the Company when reserve levels are adequately provided for and may not exceed the net income of the prior twelve months.

Anti-Takeover Provisions

Provisions of our Articles of Incorporation and Ohio law could have the effect of discouraging takeover attempts which certain stockholders might deem to be in their interest. These anti-takeover provisions may make us a less attractive target for a takeover bid or merger, potentially depriving shareholders of an opportunity to sell their shares of common stock at a premium over prevailing market prices as a result of a takeover bid or merger.

Technological Change

Our industry is susceptible to significant technological changes in the future as there continue to be a high level of new technology driven products and services introduced. Technological advancement aids the Company in providing customer service and increases efficiency. Our national competitors have more resources to invest in technological changes and associated required resources. As a result, they may be able to offer products and services that are more technologically advanced and that may put us at a competitive disadvantage. Our future depends on our ability to analyze technological changes to determine the best course of action for our business, customers and shareholders.

Operational Risks

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

In addition, our operations are dependent on our ability to process financial transactions in a secure manner. Failure in or breach of our operational or security systems or infrastructure, or those of our third party vendors and other service providers could disrupt our businesses or the businesses of our customers, result in the disclosure or misuse of confidential or proprietary information, damage our reputation, increase our costs and cause losses. We must ensure that information is properly protected from a variety of threats such as cyber-attacks, error, fraud, sabotage, terrorism, industrial espionage, privacy violation, service interruption, and natural disaster. The Company, with the assistance of third-party service providers, intends to continue to implement security technology and establish procedures to maintain network security, but there is no assurance that these measures will be successful. As cyber threats continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any information security vulnerabilities. Any activity that jeopardizes our network and the security of the information stored on our network may result in significant cost to the Company and have a significant negative effect on our reputation.

Potential Inadequacy of our allowance for loan losses

Like all financial institutions, we maintain an allowance for loan losses to provide for loan defaults and non-performance. Our allowance for loan losses is based on our historical loss experience as well as an evaluation of the risks associated with our loan

portfolio, including the size and composition of the loan portfolio, current economic conditions and concentrations within the portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed expectations, we will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses may result in a decrease in net income and capital, and may have a material adverse effect on our financial condition and results of operations.

In June 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments," which replaces the current "incurred loss" model for recognizing credit losses with an "expected loss" model referred to as the Current Expected Credit Loss model, or “CECL.” Under the CECL model, we will be required to present certain financial assets carried at amortized cost, such as loans held for investment and held-to-maturity debt securities, at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the "incurred loss" model required under current GAAP, which delays recognition until it is probable a loss has been incurred. Accordingly, we expect that the adoption of the CECL model will materially affect how we determine our allowance for loan losses and could require us to significantly increase our allowance. Moreover, the CECL model may create more volatility in the level of our allowance for loan losses. If we are required to increase our level of allowance for loan losses for any reason, such increase could adversely affect our business, financial condition and results of operations.

The new CECL standard will become effective for us for fiscal years beginning after December 15, 2019 and for interim periods during 2020. We are currently evaluating the impact the CECL model will have on our accounting, but we expect to recognize a one-time cumulative-effect adjustment to our allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective.

Attraction of Deposits and other Short-term Funding

In managing our liquidity, our primary source of short-term funding is customer deposits. Our ability to continue to attract these deposits, and other short-term funding sources, is subject to variability based upon a number of factors, including the relative interest rates we are prepared to pay for these liabilities and the perception of safety of those deposits or short-term obligations relative to alternative short-term investments. The availability and cost of credit in short-term markets depends upon market perceptions of our liquidity and creditworthiness. Our efforts to monitor and manage liquidity risk may not be successful or sufficient to deal with dramatic or unanticipated changes in event-driven reductions in liquidity. In such events, our cost of funds may increase, thereby reducing our net interest revenue, or we may need to dispose of a portion of our investment portfolio, which, depending on market conditions, could result in our realizing a loss or experiencing other adverse consequences

Vendor Relationship Risk

We rely on third-party vendors to provide key components of our business operations such as data processing, recording and monitoring transactions, online and mobile banking interfaces and services, internet connections and network access. While we have performed due diligence procedures in selecting vendors, we do not control their

actions. In the event that one or more of our vendors suffers a bankruptcy or otherwise becomes unable to continue to provide products or services, or fails to protect non-public personal information of our customers or employees, we may suffer operational impairments, reputational damage and financial losses. Replacing these third-party vendors could create significant delay and expense. Accordingly, use of such third parties creates an inherent risk to our business operations.

Limited Trading Market

The Company has its shares of stock listed and traded on the NASDAQ Capital Market. The Company's trading symbol is "FMAO."

ITEM 1b. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal office is located in Archbold, Ohio.

The Bank operates from its principal office located at 307 North Defiance Street, Archbold, Ohio. In addition, the Bank owns the property from 200 to 208 Ditto Street, Archbold, Ohio, which it uses for Bank parking and a community mini-park area. The Bank owns real estate at two locations, 207 Ditto Street and 209 Ditto Street in Archbold, Ohio upon which the bank built a commercial building to be used for storage, and a parking lot for company vehicles and employee parking. The Bank also owns real estate across from the main facilities to provide for parking.

The Bank occupies an Operations Center at 620 S. Clyde's Way in Archbold, Ohio to accommodate our growth over the years. The bank owns a parking lot in downtown Montpelier which is provided for community use.

The Bank owns all of its office locations, with the exception of Angola, Indiana and Bowling Green, Ohio. Both of these office locations are leased.

The Bank currently maintains retail banking offices at the following locations:

Office	Location
Archbold, Ohio	1313 S Defiance Street
Wauseon, Ohio	1130 N Shoop Avenue
	119 N Fulton Street
Stryker, Ohio	300 S Defiance Street
West Unity, Ohio	200 W Jackson Street
Bryan, Ohio	929 E High Street
	1000 S Main Street
Delta, Ohio	101 Main Street
Montpelier, Ohio	1150 E Main Street
Napoleon, Ohio	2255 Scott Street
Swanton, Ohio	7 Turtle Creek Circle
Defiance, Ohio	1175 Hotel Drive
Perrysburg, Ohio	7001 Lighthouse Way
Butler, Indiana	200 S Broadway
Auburn, Indiana	403 Erie Pass
Angola, Indiana	2310 N Wayne Street
Hicksville, Ohio	100 N Main Street
Waterville, Ohio	8720 Waterville-Swanton Road
Custar, Ohio	22973 Defiance Pike
Sylvania, Ohio	5830 Monroe Street
Fort Wayne, Indiana	12106 Lima Road
Bowling Green, Ohio	1072 N. Main Street
Findlay, Ohio	1660 Tiffin Avenue

All but one of the above locations has drive-up service facilities and an ATM. The Captive operates from leased office space at 101 Convention Center Dr., Suite 850, Las Vegas, NV 89109.

On January 1, 2019, the Company acquired Limberlost Bancshares, Inc. and its subsidiary, Bank of Geneva. Six offices located in Indiana, were merged into the Bank as listed below:

Office	Location
Geneva, Indiana	215 East Line Street
Monroe, Indiana	150 W. Washington Street
Berne, Indiana	718 US Highway 27 N
Monroeville, Indiana	103 Main Street
Portland, Indiana	1451 N Meridian Street
Decatur, Indiana	1061 S 13th Street

ITEM 3. LEGAL PROCEEDINGS

There are no material pending legal proceedings, other than ordinary routine proceedings incidental to the business of the Company or its subsidiaries, to which we are a party or of which any of our properties are the subject.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's common stock is listed on the NASDAQ Stock Market LLC under the trading symbol "FMAO."

On August 18, 2017, the Company's Board of Directors authorized a two-for-one stock split payable on September 20, 2017, for shareholders of record on September 5, 2017.

The Company utilizes Computershare as its transfer agent.

As of December 31, 2018, there were 1,776 record holders of our common stock of which 39.46% of the outstanding shares are being held in brokerage accounts or "street name" and only considered as one record holder.

On the following page is a line-graph presentation comparing the cumulative total shareholder returns for the Corporation, an index for NASDAQ Stock Market (U.S. Companies) comprised of all domestic common shares traded on the NASDAQ National Market System and the NASDAQ Bank Index for the five-year period ended December 31, 2018. The chart compares the value of $100 invested in the Corporation and each of the indices and assumes investment on December 31, 2013 with all dividends reinvested.

The Board of Directors recognizes that the market price of stock is influenced by many factors, only one of which is performance. The stock price performance shown on the graph is not necessarily indicative of future performance.

	2013	2014	2015	2016	2017	2018
FMAO	100.00	125.02	129.69	170.53	386.31	370.44
NASDAQ - COMPOSITE	100.00	114.71	122.74	133.34	171.46	167.00
NASDAQ - BANK INDEX	100.00	104.81	113.82	154.63	162.54	138.37

Dividends are declared and paid quarterly. Per share dividends declared for the years ended 2018 and 2017 adjusted for a 2-for-1 stock split on September 20, 2017 are as follows:

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2018	$ 0.13	$ 0.14	$ 0.14	$ 0.15	$0.56
2017	$ 0.12	$ 0.12	$ 0.13	$ 0.13	$0.50

The ability of the Company to pay dividends is impacted by the dividend that the Company receives from the Bank. The Bank may pay as dividends to the Company its retained earnings during the current year and its prior two years. Various U.S. federal statutory provisions also limit the amount of dividends the Company's banking subsidiary can pay to the Company without regulatory approval. In 2009, The Board of Governors of the Federal Reserve Division of Banking Supervision and Regulation issued SR09-4 regarding the safe and sound payment of dividends by

bank holding companies. Currently, such limitation on the payment of dividends from the Bank to the Company does not materially restrict the Company's ability to pay dividends to its shareholders. See Note 16 to the consolidated financial statements for additional information on applicable dividend restrictions.

Dividends declared during 2018 were $0.56 per share totaling $5.14 million, 12% higher than 2017 declared dividends of $0.50 per share. During 2018, the Company awarded 33,000 shares to 80 employees and 2,620 shares were forfeited under its long term incentive plan. At year end, 2018, the Company held 1,114,739 shares in Treasury stock and 93,940 in unearned stock awards.

Dividends declared during 2017 were $0.50 per share totaling $4.58 million, 8.7% higher than 2016 declared dividends of $0.46 per share. During 2017, the Company awarded 32,000 restricted shares to 74 employees and 1,080 shares were forfeited under its long term incentive plan. At yearend 2017, the Company held 1,134,120 shares in Treasury stock and 92,350 in unearned stock awards.

The Company continues to have a strong capital base.

	2018	2017
Tier I Leverage Ratio	12.81 %	12.02 %
Risk Based Capital Tier I	15.44 %	14.73 %
Total Risk Based Capital	16.21 %	15.52 %
Stockholders' Equity/Total Assets	12.84 %	12.12 %
Capital Conservation Buffer	8.21 %	7.52 %

On January 18, 2019, the Company announced the authorization by its Board of Directors for the Company's repurchase, either on the open market, or in privately negotiated transactions, of up to 500,000 shares of its outstanding common stock commencing January 18, 2019 and ending December 31, 2019.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	Remaining Share Repurchases Authorization
10/1/2018 to 10/31/2018	-	-	-	400,000
11/1/2018 to 11/30/2018	-	-	-	400,000
12/1/2018 to 12/31/2018	-	-	-	400,000
Total	-	-	-	400,000

(1)

From time to time, the Company purchases shares in the market pursuant to a stock repurchase program publicly announced on January 18, 2018. On that date, the Board of Directors authorized the repurchase of 400,000 common shares between January 18, 2018 and December 31, 2018.

ITEM 6. SELECTED FINANCIAL DATA

Reclassification

Certain amounts in the 2017 and 2016 consolidated financial statements have been reclassified to conform with the 2018 presentation.

SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA

Summary of Consolidated Statement of Income - UNAUDITED

	(In Thousands, except share data)				
	2018	2017	2016	2015	2014
Summary of Income:					
Interest income	$46,429	$41,248	$37,727	$33,650	$33,453
Interest expense	6,572	5,127	4,223	3,587	3,716
Net Interest Income	39,857	36,121	33,504	30,063	29,737
Provision for loan losses	324	222	1,121	625	1,191
Net interest income after provision for loan losses	39,533	35,899	32,383	29,438	28,546
Other income (expense), net	(21,357)	(17,996)	(16,063)	(15,279)	(15,029)
Net income before income taxes	18,176	17,903	16,320	14,159	13,517
Income taxes	3,227	5,183	4,656	3,819	3,871
Net income	$14,949	$12,720	$11,664	$10,340	$9,646
Per Share of Common Stock:					
Earnings per common share outstanding *					
Net income[(1)]	$1.61	$1.38	$1.27	$1.12	$1.04
Dividends[(1)]	$0.56	$0.50	$0.46	$0.44	$0.42
Weighted average number of shares outstanding, including participating securities[(1)]	9,272,964	9,250,825	9,224,230	9,234,116	9,256,356

* Based on weighted average number of shares outstanding

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

	(In Thousands)				
	2018	2017	2016	2015	2014
Total assets	$1,116,163	$1,107,009	$1,055,895	$989,068	$941,213
Loans, net	839,599	816,156	751,310	678,573	615,562
Total deposits	928,790	919,340	842,203	771,339	762,560
Stockholders' equity	143,287	134,137	125,577	120,097	114,493
Key Ratios					
Return on average equity	10.86%	9.75%	9.38%	8.80%	8.72%
Return on average assets	1.34%	1.18%	1.14%	1.08%	1.02%
Loans to deposits	90.40%	88.78%	89.45%	88.14%	80.78%
Capital to assets	12.84%	12.12%	11.89%	12.14%	12.16%
Dividend payout	34.40%	36.02%	35.67%	38.54%	40.04%

ITEM 7. MANAGEMENTS DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Critical Accounting Policies and Estimates

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the financial services industry in which it operates. At times the application of these principles requires management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.

All significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the notes to the consolidated financial statements and in the management discussion and analysis of financial condition and results of operations, provide information on how significant assets and liabilities are valued and how those values are determined for the financial statements. Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL) and the valuation of its Mortgage Servicing Rights (MSR) and Other Real Estate Owned (OREO) as the accounting areas that requires the most subjective or complex judgments, and as such could be the most subject to revision as new information becomes available.

OREO, which is comprised of assets acquired by the Bank, through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell.

The ALLL represents management's estimate of credit losses inherent in the Bank's loan portfolio at the report date. The estimate is a composite of a variety of factors including experience, collateral value, and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion. The collection and ultimate recovery of the book value of the collateral, in most cases, is beyond our control.

The Company is also required to estimate the value of its MSR. The Company recognizes as separate assets rights to service fixed rate single-family mortgage loans that it has sold without recourse but services for others for a fee. Mortgage servicing assets are initially recorded at fair value, based upon pricing multiples as determined by the purchaser, when the loans are sold. Mortgage servicing assets are carried at the lower of the initial carrying value, adjusted for amortization, or estimated fair value. Amortization is determined in proportion to and over the period of estimated net servicing income using the level yield method. For purposes of determining impairment, the mortgage servicing assets are stratified into like groups based on loan type, term, new versus seasoned and interest rate. The valuation is completed by an independent third party.

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

The Company’s mortgage servicing rights relating to loans serviced for others represent an asset of the Company. This asset is initially capitalized and included in other assets on the Company’s consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying mortgage servicing rights. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Company, including the estimated prepayment speed of the loan and the discount rate used to present value the servicing right. For example, if the mortgage loan is prepaid, the Company will receive fewer servicing fees, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Company’s balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Company of the mortgage servicing rights, the Company receives a valuation of its mortgage servicing rights from an independent third party. The independent third party’s valuation of the mortgage servicing rights is based on relevant characteristics of the Company’s loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as current national market interest rate levels, market forecasts and other economic conditions. Management, with the advice from its third party valuation firm, review the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter’s analysis related to the mortgage servicing asset. In addition, based upon the independent third party’s valuation of the Company’s mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the

mortgage servicing rights to the Company. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Company's net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on market conditions. The accuracy of these estimates and assumptions by management and its third party can be directly tied back to the fact that management has not been required to record a valuation allowance through its income statement based upon the valuation of each stratum of serving rights.

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

2018 in Review

The Federal Reserve rate hikes in 2018 facilitated both a flattening of the yield curve and an opportunity to widen the net interest margin through asset yield improvement. In the second half of the year, the widening of the net interest margin was pressured by the competition for deposits. The cost of funds rose more quickly in the second half of the year, specifically the fourth quarter. This pressure is expected to continue for 2019 with the added concern of an inverted yield curve throughout the first quarter.

The Company again reports record earnings in total and in earnings per share. This was achieved even with the acquisition costs associated with the merger deal completed January 1, 2019. Earnings per share, with acquisition costs excluded, would have been higher than $1.61 as reported in Note 12. The improvement is credited to a widening of the net interest margin and the change in the effective income tax rate, offset by increases in noninterest expense, primarily attributable to salaries, wages and employee benefits.

Unemployment levels remain low and the economies in the Company's market area are strong. The continuation of reasonable gasoline prices has been a contributor. Strong asset quality enabled loan provision to remain low throughout 2018 and is expected to continue in the foreseeable future as the Bank prepares for the CECL implementation in 2020. Strong asset quality is evidenced by low nonaccruals, watch list and impaired loans along with low net charge-offs. Loan payoffs and paydowns were higher than expected during 2018 and hampered overall loan growth. The Company's asset size grew a modest $9.2 million with net loans accounting for $23.4 million. The difference coming from a decrease in securities and modest growth of $9.5 million in deposits.

During the first quarter of 2018 we opened an office in Findlay, Ohio. This office was our first to utilize ITM equipment, offering traditional service with a self-service option. An ITM completes teller transactions using a debit card for recognition - the self-service option. The traditional service completes the transaction by the customer requesting teller assistance and talking to a remote customer assistance representative on-line. Personal Relationship Bankers (PRBs) welcome our customers to the office and provide exceptional customer service as they can complete a teller transaction, open a new deposit account and complete a consumer loan. Two more existing offices were physically transformed during 2018 with ITMs. Our other offices have begun the personnel transformations with PRBs at each office and Community Relationship Bankers (CRBs) covering specific market areas. CRBs focus on the community and especially small business customers. F&M will serve our customers where they want, and how they want. The Bank will continue the physical transformation with our newest office in 2019 in Decatur, Indiana.

As mentioned previously, the Company acquired Limberlost Bancshares, Inc. on January 1, 2019 and the two subsidiary banks were merged. During 2018, $742.1 thousand of additional expenses attributed to the acquisition were incurred. The acquisition becomes accretive to earnings in 2019 and the foot print of the Company is expanded. Additional products and services are made available to the customers as a strong relationship focused community bank presence is maintained. The Company continues to remain focused on a strategy of expansion as the best use of capital to enhance profitability for our shareholders. For additional information on the projections related to the

acquisition, please see the proforma statements shown in Note 20 as it relates to subsequent events.

A trend of increasing improvement in net income continued from 2016 through 2018. 2018 increased 17.5% over 2017 and 2017 was 9.1% higher than 2016. Dividends declared also increased over the corresponding years. 2018's declared dividends at $0.56 a share was 12.0% higher than 2017's $0.50 per share and 2017 was 8.7% than 2016's $0.46 per share. The Company remains strong, stable and well capitalized and has the capacity to continue to cover the increased costs of doing business. The Company continues to look for new opportunities to generate and protect revenue while providing additional channels through which to serve our customer and maintain our high level of customer satisfaction. The Company plans to continue our strategy of expansion into new markets, whether by acquisition or the establishment of new branch office locations.

Material Changes in Results of Operations

Net Interest Income

The discussion now centers on the individual line items of the consolidated statement of income and their effect on net income. This section will focus on the most traditional source of revenue contributing to the profitability of the Company which is net interest income.

Net interest income is the difference between interest income earned on interest earning assets, such as loans and securities, and interest expense paid on interest bearing liabilities used to fund those assets, such as interest bearing deposits and other borrowings. Net interest income is affected by changes in both interest rates and the amount and composition of earning assets and liabilities. The change in net interest income is most often measured by two statistics – interest spread and net interest margin. The difference between the yields earned on earning assets and the rates paid for interest bearing liabilities represents the interest spread. The net interest margin is the difference of funds (interest expense) between the yield on earning assets and

the cost as a percentage of earning assets. Because noninterest bearing sources of funds such as demand deposits and stockholders' equity also support earning assets, the net interest margin exceeds the net interest spread.

As mentioned previously, the largest factor of the record earnings for 2018 was the $3.7 million improvement in net interest income as compared to 2017. In 2017, net interest income increased $2.6 million as compared to 2016. Interest and fee income from loans were responsible for the improvement. Interest income from loans, including fees, increased $5.1 million in 2018 as compared to 2017. This was preceded by an increase in 2017 of $3.5 million as compared to 2016. The underlying factors for the reason of the increase differed between the two time periods; however, both years were aided by prime rate increases which drove the effective interest rates on the Bank's variable loans over their floor rates. 2018's improvement was almost equally impacted by the increased volume and the increased rates. As a comparison to 2017, the volume of loan growth was the largest contributing factor to the improved profitability over 2016. Given that securities were sold or matured and proceeds used to fund the loan growth, interest income from that balance sheet component has declined each of the last three years. Overall, total interest income was $5.2 million higher for 2018 than 2017 and was $3.5 million higher for 2017 than 2016.

Interest expense increased from all interest bearing funding sources with the exception of other borrowed money over the time periods shown of 2016 through 2018. This reversed a previous trend of declining interest expense that occurred in 2014 and 2015. Overall, the funding goal the last three years has been to grow core deposits. Two strategies have been employed through the years, one of allowing expensive time deposits to run off until needed for funding and secondly to offer new non-interest bearing deposit products. Both of these strategies were to assist in controlling interest expense in a rising rate environment. During 2018, interest expense from deposits increased by $1.5 million over 2017 and 2017 increased $866 thousand over 2016. The majority, approximately 94.3%, of the increased expense of 2018 was influenced by increased rates rather than due to additional cost associated with deposit growth.

Total interest expense (which includes deposit, federal funds purchased, securities sold under agreement to repurchase, and borrowed funds) totaled $6.6, $5.1 and $4.2 million for 2018, 2017 and 2016 respectively. The increased expense is almost entirely attributable to the rising interest rate environment in 2018 as compared to 2017 as well as the 2017 to 2016 comparison. Borrowed fund balances increased in December of 2015, which impacted 2016, 2017 and 2018. All of 2015's borrowings have since matured in December of 2017 and December of 2018.

The success in improving net interest income confirmed that management's long term strategy of repositioning the balance sheet and increasing loan balances was the correct approach. Funding loan growth with internal funds, whether from the liquidation of investment securities or core deposits, was a beneficial move.

The dollar amount of improvement has been shown. Now the discussion moves on to the percentages and the change in the net interest margin and spread.

Overall, we have seen increased improvement in the net interest margin and spread since 2016. Looking at the components behind the change in net interest margin for 2018 as compared to 2017, increased average balances in loans of $48.5 million stands out. The additional revenue of almost $5.1 million that those balances were responsible for was the largest contributor to the improved net yield on loans of 33 basis points. Beginning in 2017, loan revenue was positively impacted by the change in the interest rate. The majority of variable loans with floor rates attained the point where rate increases caused the rate to go above the floor. The Bank had expected 100 basis points of change was needed for this to occur which was reached with the June 2017 Fed Funds rate hike. The next hike did not occur until December of 2017, too late to largely impact 2017 though it benefitted 2018. 2018 saw four additional rate hikes of 25 basis points. The large revenue gain in loan interest was offset by the decrease earnings in securities which were used to fund the loan growth. However, the overall asset yield in 2018 still improved by 30 basis points over 2017, as loans earn at a higher rate than the securities.

Increased interest expense correlated to the higher rate environment in which the deposits needed to be garnered. The Bank experienced pressure to offer higher rates to public funds in Ohio due to competition. In the area where the strategic plan was to gather core deposits, the average balance in savings grew by $32.2 million during 2018 as compared to 2017's average balance. The other average balance increase for core deposits would be the change in non-interest bearing demand deposits. 2018's average balance in this portfolio was $14.4 million higher than 2017's average balance. Overall, cost of funds increased 18 basis points for 2018 over 2017. The reason behind the increase was due to rate increases not the volume increases.

The net interest margin for 2018 was 3.83% compared to 2017 which was 3.65%. The 0.18% increase for 2018 was an important factor in the improved profitability for 2018. Net interest spread was 3.60% for 2018 compared to 2017's 3.48%, creating an 12 basis point difference in the spread. Variable and new loans will reprice higher if the Federal Reserve continues with their stated monetary policy and the challenge will be to control the rate of increase on the deposits. The goal is, as always, to improve the net interest margin and spread and thereby improve profitability.

In comparing 2017 to 2016, loan volume was primarily responsible for the improvement in interest income as the yield on the overall loan portfolio increased 9 basis points during 2017. The only category of asset yield to decrease was the investment securities which were used to fund growth. Overall, asset yield increased 18 basis points in 2017 as compared to 2016.

The net interest margin also climbed up in 2017, ending 10 basis points over 2016. Asset yield raised 18 basis points and the cost of funds increased only 9 basis points. The yields on the individual segments did cause the overall improvement as all increased. The improvement in the asset yield was primarily a result of the change in volume. In addition, loans as a percentage of earning assets increased to 77.8% in 2017 compared to 75.0% in 2016. Loans to assets also increased to 72.8% for 2017 compared to 2016's 70.7%. Overall yield improves when the balances of the highest yield asset increases, which is loans.

With respect to the cost of funds, the Bank's goal is to grow the least expensive category of funding sources. The largest average balance increase for 2017 was $72.6 million in savings deposits over 2016's average balances. This helped to keep the increase in funding expense to just 9 basis points when comparing 2017 to 2016.

The Company will always prefer to see improvement in real dollars over percentages. The strategy for increasing core deposits, in order to mitigate the higher interest rates and interest expense and to continue to establish the opportunity for fee dollars from services provided, remains for 2019.

Total assets of the Company increased overall as did the earning assets in both average and year end during 2018 and 2017. This matched the movement in interest dollars and in yields. The percentage of average earning assets to total average assets reflects the best utilization of funds. For 2018, the percentage at 94.23% was slightly higher than 2017 at 93.47%. The addition of offices in 2016, 2017 and 2018 increased the non-earning assets with cash balances held at the new offices and also the investment in the capital assets of their building and furniture. What made 2018 more profitable was the percentage of average loans to total assets. For 2018 the average balance of loans to total average assets was 74.77%, for 2017, 72.76%, for 2016, 70.69%. Loans are the highest yielding asset for the Company.

Net interest spread is the difference between what the Company earns on its assets and what it pays on its liabilities. It is generally from this spread that the Company must fund its operations and generate profit. When the asset yield decreases so must funding costs in order to maintain profitability. It becomes increasingly challenging as the asset yield gets closer to the prime lending rate, or the break-even point, of operations. The challenge began to change in 2016 as rates increased in December 2015. In a rising rate environment, the challenge is to hold the cost steady while allowing time for the asset portfolio to rise. Floors and ceilings on variable products also impact the level of increase in either scenario. The 25 basis point prime rate increase of 2015 did little to increase the rate on the variable loans because of the floors in place and the spread of rate to prime. The floors provided yield protection in the previous lower rate environment and the rising rates wouldn't benefit the asset yield until the spread plus prime is higher than the floor. The challenge is to increase the spread during renewals and on new loans. After the December 2015 rate increase, it was another year before the next rate hike in December of 2016. These two rate hikes had little effect on the profitability as the majority of loans were still below the floors. It wasn't until the third and fourth rate hikes of March and June 2017, that the majority of loans were now either equal to or over the floors. This helped the asset yield in 2017. In December 2017 along with March, June and September of 2018, there were rate hikes which contributed to the increased asset yield for 2018. The most recent rate hike in December of 2018 will help increase the asset yield for 2019.

In terms of interest expense, 2018's increase as compared to 2017 was due to the increase in rates. 2017's increase was also due to an increase in rates as compared to 2016.

The impact of the change in the portfolio mix was a factor in the liabilities as it was in the assets. In comparing to 2017, 2018 had movements as average balances decreased in all categories other than savings deposits and non-interest bearing liabilities. Other time deposits continued to run off and $5 million of other borrowed money was paid off in December that had been originally borrowed in December 2015 to fund loan growth. Time deposits and saving deposits increased in interest expense for 2017 as compared to 2016. Fed Funds purchased and securities sold under agreement to repurchase increased for 2017 and was due to increased balance and rate.

The following tables present net interest income, interest spread and net interest margin for the three years 2016 through 2018, comparing average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and expense. The tables show the corresponding average rates of interest earned and paid. The tax-exempt asset yields have been tax adjusted to reflect a marginal corporate tax rate of 34% for 2016 and 2017 and a marginal corporate tax rate of 21% for 2018. Average outstanding loan balances include non-performing loans and mortgage loans held for sale. Average outstanding security balances are computed based on carrying values including unrealized gains and losses on available-for-sale securities. The average cost of funds for 2018 was 0.86%, 18 basis points higher than 2017's 0.68% for interest bearing liabilities.

The yield on Tax-Exempt investment securities shown in the following charts were computed on a tax equivalent basis. The yield on Loans has been tax adjusted for the portion of tax-exempt IDB loans included in the total. Total Interest Earning Assets is therefore also reflecting a tax equivalent yield in both line items, also with the Net Interest Spread and Margin. The adjustments were based on a 34% tax rate for 2016 and 2017 and a 21% tax rate for 2018 and 27 basis points higher than 2016's 0.59%.

	2018 (In Thousands)			
	Average Balance	Interest/ Dividends	Yield/Rate	
ASSETS				
Interest Earning Assets:				
Loans	$831,614	$ 42,303	5.09	%
Taxable investment securities	147,186	2,863	1.95	%
Tax-exempt investment securities	48,059	930	2.45	%
Federal funds sold & other	21,218	333	1.57	%
Total Interest Earning Assets	1,048,077	$ 46,429	4.46	%
Non-Interest Earning Assets:				
Cash and cash equivalents	35,486			
Other assets	28,650			
Total Assets	$1,112,213			
LIABILITIES AND SHAREHOLDERS' EQUITY				
Interest Bearing Liabilities:				
Savings deposits	$551,746	$ 3,453	0.63	%
Other time deposits	183,512	2,536	138.00	%
Other borrowed money	4,946	80	1.62	%
Federal funds purchased and securities sold under agreement to repurchase	26,252	503	1.92	%
Total Interest Bearing Liabilities	766,456	$ 6,572	0.86	%
Non-Interest Bearing Liabilities:				
Non-interest bearing demand deposits	194,548			
Other	13,570			
Total Liabilities	974,574			
Shareholders' Equity	137,639			
Total Liabilities and Shareholders' Equity	$1,112,213			
Interest/Dividend income/yield		$ 46,429	4.46	%
Interest Expense/cost		6,572	0.86	%
Net Interest Spread		$ 39,857	3.60	%
Net Interest Margin			3.83	%

	2017 (In Thousands)			
	Average Balance	Interest/ Dividends	Yield/Rate	
ASSETS				
Interest Earning Assets:				
Loans	$783,140	$ 37,195	4.76	%
Taxable investment securities	154,081	2,815	1.83	%
Tax-exempt investment securities	52,192	1,045	3.03	%
Federal funds sold & other	16,597	193	1.16	%
Total Interest Earning Assets	1,006,010	$ 41,248	4.16	%
Non-Interest Earning Assets:				
Cash and cash equivalents	33,411			
Other assets	36,913			
Total Assets	$1,076,334			
LIABILITIES AND SHAREHOLDERS' EQUITY				
Interest Bearing Liabilities:				
Savings deposits	$519,580	$ 2,302	0.44	%
Other time deposits	188,443	2,181	1.16	%
Other borrowed money	9,960	147	1.48	%
Federal funds purchased and securities sold under agreement to repurchase	32,173	497	1.54	%
Total Interest Bearing Liabilities	750,156	$ 5,127	0.68	%
Non-Interest Bearing Liabilities:				
Non-interest bearing demand deposits	180,129			
Other	15,624			
Total Liabilities	945,909			
Shareholders' Equity	130,425			
Total Liabilities and Shareholders' Equity	$1,076,334			
Interest/Dividend income/yield		$ 41,248	4.16	%
Interest Expense/cost		5,127	0.68	%
Net Interest Spread		$ 36,121	3.48	%
Net Interest Margin			3.65	%

	2016 (In Thousands)			
	Average Balance	Interest/ Dividends	Yield/Rate	
ASSETS				
Interest Earning Assets:				
Loans	$724,076	$ 33,703	4.67	%
Taxable investment securities	172,647	2,730	1.58	%
Tax-exempt investment securities	55,395	1,229	3.36	%
Federal funds sold & interest bearing deposits	13,004	65	0.50	%
Total Interest Earning Assets	965,122	$ 37,727	3.98	%
Non-Interest Earning Assets:				
Cash and cash equivalents	27,348			
Other assets	31,848			
Total Assets	$1,024,318			
LIABILITIES AND SHAREHOLDERS' EQUITY				
Interest Bearing Liabilities:				
Savings deposits	$446,996	$ 1,690	0.38	%
Other time deposits	194,753	1,927	0.99	%
Other borrowed money	10,000	148	1.48	%
Federal funds purchased and securities sold under agreement to repurchase	64,825	458	0.71	%
Total Interest Bearing Liabilities	716,574	$ 4,223	0.59	%
Non-Interest Bearing Liabilities:				
Non-interest bearing demand deposits	169,510			
Other	13,896			
Total Liabilities	899,980			
Shareholders' Equity	124,338			
Total Liabilities and Shareholders' Equity	$1,024,318			
Interest/Dividend income/yield		$ 37,727	3.98	%
Interest Expense/cost		4,223	0.59	%
Net Interest Spread		$ 33,504	3.39	%
Net Interest Margin			3.55	%

The following tables show changes in interest income, interest expense and net interest resulting from changes in volume and rate variances for major categories of earnings assets and interest bearing liabilities.

	2018 vs 2017 (In Thousands)		
	Net	Due to change in	
	Change	Volume	Rate
Interest Earning Assets:			
Loans	$5,108	$ 2,308	$2,800
Taxable investment securities	48	(126)	174
Tax-exempt investment securities	(115)	(125)	10
Federal funds sold & other	140	54	86
Total Interest Earning Assets	$5,181	$ 2,111	$3,070
Interest Bearing Liabilities:			
Savings deposits	$1,151	$ 143	$1,008
Other time deposits	355	(57)	412
Other borrowed money	(67)	(74)	7
Federal funds purchased and securities sold under agreement to repurchase	6	(91)	97
Total Interest Bearing Liabilities	$1,445	$ (79)	$1,524

	2017 vs 2016 (In Thousands)		
	Net	Due to change in	
	Change	Volume	Rate
Interest Earning Assets:			
Loans	$3,492	$ 2,757	$735
Taxable investment securities	85	(294)	379
Tax-exempt investment securities	(184)	(108)	(76)
Federal funds sold & interest bearing deposits	128	18	110
Total Interest Earning Assets	$3,521	$ 2,373	$1,148
Interest Bearing Liabilities:			
Savings deposits	$612	$ 274	$338
Other time deposits	254	(62)	316
Other borrowed money	(1)	(1)	-
Federal funds purchased and securities sold under agreement to repurchase	39	(231)	270
Total Interest Bearing Liabilities	$904	$ (20)	$924

Non-Interest Income

The discussion now focuses on the non-interest income and expense generated from the Company. Non-interest income increased overall in 2018 as compared to 2017. This followed a year of decrease in 2017 as compared to 2016. 2018 did not reach the level of 2016's non-interest income, lower by $504 thousand.

Components of non-interest income which improved over 2017 and 2016 were service charge revenue from both the business accounts and consumer accounts. 2018 service charge revenue was $53.1 thousand higher than 2017, mainly due to the increased number of accounts that had service charges attached to them. During the second quarter 2017, new business checking products were announced and existing business accounts were converted to one of three new products, Business Essential, Edge or Elite. The new products provided customers with new options to bundle services and for the Bank to utilize the full relationship to determine pricing. This was a continuation of the Bank's "earn to free" strategic initiative. It also aided the increase of $292.7 thousand in service charge revenue in 2017 as compared to 2016. Upgrades to our digital products and services continue to occur

in both retail and business lines. Increases in the number of accounts and the number of services being utilized by our customers accounted for the increase in fees over the last two years.

The Bank has long promoted the use of debit cards by its customers and continues to build on that philosophy with the introduction of new products. During 2018 the Bank collected interchange revenue, combined with fees collected on foreign ATM fees (noncustomers utilizing our ATMs), of $2.9 million which was $167.5 thousand higher than 2017 and $340.0 thousand higher than 2016. While this revenue stream continues to improve with more depositors using electronic methods for purchasing, the expense attributable to card fraud has offset a portion of the revenue gain. Further discussion can be found in the non-interest section regarding the net effect of debit card activity.

Noninterest income form net gain on sales of loans was the highest in 2016 of the three year periods shown. The change may be related to the increase in rates after the long duration of the flat interest rate environment. The net gain on sale of loans is derived from sales of real estate loans into the secondary market. Of these loan types, the Bank sells 100% of the residential loans and 90% of the agricultural loans. 66.5% of the gains are attributed to the residential loans in 2018, 80% in 2017 and 77% in 2016. In conjunction with these sales, the Bank maintains servicing rights and those income amounts during all three years are included in the customer service fee income line item and accounted for $449 thousand in 2018, $460 thousand in 2017 and $555.3 thousand in revenue for 2016.

The last item in the non-interest income section is the net gain of sale of investments. The Bank has sold securities over the last three years for two main purposes: to provide funds for loan growth and to take advantage of the position of the yield curve when a gain can be recognized on sales without extending the duration of the portfolio longer than wanted. 2018 had limited sales for gain recognition due to the flatness of the yield curve which began to occur in second half 2017. The Bank will not increase short-terms gains at the sacrifice of long-term profitability. The available for sale security portfolio switched from an unrealized gain position into an unrealized loss position in 2017. Sales in 2017 were made early in the first quarter before the additional Federal Reserve rate hike in March and again in May before the June rate hike. These sales recognized much lower gains than in prior years. The Bank recognized gains of $9.8 thousand in 2018, $47 thousand for 2017 and $588 thousand for 2016. This line item was largely responsible for the lower non-interest income of 2017 as compared to 2016. The Company also recognized a loss on sale of securities from the holding company. These proceeds were used to provide cash for the acquisition with the losses totaling $19.2 thousand. The net effect of the consolidated number is what shows on the line item of net loss of $9 thousand for 2018.

Non-Interest Expense

Noninterest expense increased 12.2% in 2018 as compared to 2017 and was preceded by a 4.7% increase in 2017 as compared to 2016. Represented in dollars, 2018 was $3.5 million higher than 2017 and 2017 was $1.3 million higher than 2016. The largest factor behind the increase in both years was the expense of employee salaries and wages. During 2018, an additional $1.1 million was spent over 2017 which correlates to an 9.1% increase. When making the same analysis for 2017 as compared to 2016, 2017's costs increased $993 thousand or 8.6%. Three main components flow into salaries and wages: base salary, deferred costs, and incentives composed of the expense of restricted stock awards and performance incentives. Base pay has increased with the addition of the four offices of Findlay, Huntertown, Bowling Green and Sylvania, as well as from the operations of the Captive and through normal yearly increases to the remainder of the employees. Base pay was up $768.3 thousand for 2018 over the previous year and 2017 was up $731.2 thousand over 2016. The full time equivalent number of employees at each yearend increased to 288 for 2018, to 275 for 2017 compared to 2016's 273. The Company had also chosen to invest a portion of the tax

savings dollars of 2018 to increase the base pay of our lowest paid employees.

Incentive pay as it related to performance was up $181.7 thousand in 2018 over 2017 and up $234.2 thousand in 2017 over 2016. Measurements used for award incentive pay had improved in 2018 and 2017 and employees benefited accordingly. The measurements used for 2018 were increased to negate the paying of incentive for the benefit of the lower tax rate. The effect of acquisition costs incurred in 2018 were also removed. The expense for the restricted stock awards has also increased each of the last three years as more shares have been granted to a larger number of employees and the market value of the shares has increased. The market value of the Company's stock increased significantly with the listing on NASDAQ and being included in the Russell 3000 Index during the second quarter of 2017. 700 more shares were awarded in 2018 and with a higher value as compared to 2017. An equivalent number of restricted shares were awarded as compared to 2016 though the value of these rewards was higher; therefore, the expense for 2018 was higher by $237.7 thousand as compared to 2017 and will likely be higher in 2019 due to the value of the 2018 awards. 2017's cost for this program was $105.3 thousand higher than 2016. The awards incorporate a three year vesting period so the increase of any one year carries forward through the next two years. This expense should continue to increase as the Company continues its expansion strategy. For further discussion in incentive pay and restricted stock awards, see Note 11 of the consolidated financial statements.

Along with the salary and wage increase was an increase in employee benefits in 2018 as compared to 2017. Employee group insurance accounted for the largest portion of the cost, which was an increase of $293.3 thousand over 2017. This was due to an increase in the cost to provide to a larger number of employees along with a higher level of medical claims. The cost of the 401-K retirement plan also increased $79.7 thousand for 2018 as compared to 2017. Due to the increased profitability achieved in 2018 over 2017, the contribution portion relating to the discretionary profit-sharing percentage was raised from 5.5% to 6% for 2018. Overall, employee benefits increased $480.0 thousand or 13.2% from 2017.

Along with the salary and wage increase was an increase in employee benefits in 2017 as compared to 2016. Employee group insurance accounted for the largest portion of the cost, which was an increase of $181.9 thousand over 2016. This was due to an increase in the cost to provide to a larger number of employees along with a higher level of medical claims. The cost of the 401-K retirement plan also increased $72.7 thousand for 2017 as compared to 2016. Overall, employee benefits increased $312 thousand or 9.4% from 2016.

Net occupancy expense typically increases as the Company expands, which is what has occurred for 2018 and 2017. One factor that can offset occupancy expense is the receipt by the Company of building rent as it is netted out of occupancy expense. The greatest contributor to building rent comes from the division of FM Investments within the Bank. This division experienced a weaker 2018; however, the department was short staffed most of 2018 and 2017. For 2018, building rent as generated from FM Investments was lower by $151.2 thousand due to staff turnover. Rent is received in lieu of commissions. This loss of revenue contributed to the increased net occupancy expense of $268 thousand for 2018 as compared to 2017. The improved performance of $85.9 thousand in 2017 assisted in keeping the overall increase to net occupancy to $30 thousand in 2017 as compared to 2016.

The 1-4 family mortgage refinancing activity has been slow over the last three years though increasing slightly each year. A correlating expense to that activity is the amortization of mortgage servicing rights. The amortization is the expense that offsets the income recognized when the loan is first made. Income is recorded when the mortgage loan is first sold with servicing retained and is therefore recognized within one year. The amortization, however, is calculated over the life of the loan and accelerated as loans are paid off early. An increase in this expense can be driven by two activities: an increase in the number of sold loans and/or by the acceleration of the expense from payoff and refinance activity. The best picture of the bottom line impact is achieved by netting the income with the expense each year. The net income for 2018 was $86 thousand; 2017 had net income of $107 thousand and was preceded by net income of $136 thousand for 2016. Of course, the value (or income) of the mortgage servicing right when sold also impacts the net position. As of December 31, 2018, 3,588 loans are being serviced with corresponding balances of $289.2 million. 2017 had 3,636 loans serviced with corresponding balances of $288.6 million. As of December 2016, 3,599 loans were being serviced with balances of $280.4 million.

The impact of mortgage servicing rights to both noninterest income and expense is shown in the following table:

	(In Thousands)		
	2018	2017	2016
Beginning Year	$2,299	$2,192	$2,056
Capitalized Additions	450	460	555
Amortization	(364)	(353)	(419)
Valuation Allowance	-	-	-
End of Year	$2,385	$2,299	$2,192

Furniture and equipment steadily increases as we continue to add facilities and invest in technology. Annual maintenance costs continue to grow and become a greater piece of the overall cost. As new services are provided to our customers, the backroom cost to supply them continues to rise. The Company accepts it is an expected cost of doing business and keeping our services relevant to the industry.

Data processing costs were actually lower in 2017 as compared to 2016 by $196 thousand. Two reasons for the improvement was the negotiation of an extended contract with our core processor and 2016 had the additional cost of upgrading Bank customer debit cards to incorporate EMV chip card technology. Both already better align with our future strategies while controlling costs. Data processing expense increased $105 thousand during 2018 as compared to 2017. As we continue to expand this line item is expected to also increase.

As the pricing on many services, however, is based on number of accounts and the Bank fully expects those to increase with the growth from the newer offices and overall Bank growth. Overall, data processing expense for 2019 will be higher than 2018 with the addition of the six Indiana offices.

The FDIC assessment has a decreasing cost trend over the years shown. This line item speaks to the health of the Bank and the financial industry. The assessment for 2018 was down only $4 thousand from 2017 and the assessment for 2017 was down $77 thousand from 2016.

The last line items with significant variation in noninterest expense to discuss is “consulting fees” and “other general and administrative.” Two main events are behind the increase of $865 thousand in 2018 as compared to 2017 in this line item. Both events incurred one-time costs which required the use of outside consultants. First related to the use of an executive recruiter firm to conduct a search for a CEO due to an upcoming retirement. The second related to the costs of researching, analyzing and negotiating possible mergers and acquisition opportunities. The consulting fees were beneficial in both instances as a new CEO was hired and a merger was closed on January 1, 2019. Consulting fees increased by $551.2 thousand in 2018 over 2017. Acquisition costs incurred in 2018 total $742.1 thousand with expenses being recorded in multiple line items. Though 2017 did not increase by as large an amount as 2016 had when compared to 2015, it was still an increase of $207 thousand. The two main reasons behind the increase in 2017 were the costs associated with listing on the NASDAQ stock market and the cost of offering the Insured Cash Sweep product. Both of these costs have been previously explained along with the benefits that have been provided by incurring said costs. Advertising and public relations increased also in 2018 by $129.9 thousand following an increase of $113 thousand in 2017. With the addition of new offices in both years behind the increases, 2019 is also expected to increase due to additional offices being added. The Bank also celebrates the anniversary of office openings with a special event in each community.

Allowance for Credit Losses

Provision expense increased by $102 thousand for 2018 as compared to 2017 to account for the net charge-off activity of 2018. Provision expense decreased by $899 thousand for 2017 due to the consistent strong asset quality of the Bank’s loan portfolio as evidenced by low levels of both net charge-offs and delinquencies. Sustained strong asset quality kept the provision expense lower than the growth alone would have warranted. Provision expense increased by $496 thousand for 2016 in response to the significant growth for the period. Net charge-offs were $417, $138 and $394 thousand for 2018, 2017 and $2016, respectively. The consumer portfolios had the highest levels of charge-off activity in 2018, 2017 and 2016 at $359, $263 and $310 thousand respectively. Net charge offs in the consumer portfolio was $245, $161 and $223 thousand for 2018, 2017 and 2016 respectively.

The Company segregates its Allowance for Credit Losses (ACL) into two reserves: The ACL and the Allowance for Unfunded Loan Commitments and Letters of Credit (AULC). When combined, these reserves constitute the total ACL. The AUCL is included in other liabilities on the consolidated balance sheets.

The Bank’s ALLL methodology captures trends in leading, current, and lagging indicators which will directly affect the Bank’s allocation amount. The Bank monitors trends in such leading indicators as delinquency, unemployment changes in the Bank’s service area, experience and ability of staff, regulatory trends, and credit concentrations. A current indicator such as the total watch list loan amount to Capital, and a lagging indicator such as the charge off amount are referenced as well. A matrix formed by loan type from these indicators is used in making ALLL adjustments.

Watch list loan balances are comprised of loans graded 5-8. At yearend December 31, 2018 these loans totaled $7.9 million and were $13.3 million lower than December 31, 2017. Grade 5 decreased $6.6 million in 2018 as compared to 2017 and Grade 6 decreased by $7.3 million in the same comparison. Much of the decrease is represented by the payoff of two loan relationships in the Bank’s commercial real estate portfolio. During 2018, one commercial real estate loan relationship was upgraded from a risk category of 6 to a risk category of 4 while one new commercial real estate loan relationship was added to the risk category 5. Those associated loans are adequately secured by collateral. These loan balances increased $800 thousand as of December 31, 2017 as compared to same date 2016.

The largest increases occurring in the risk grade of 6. The loan grades of 5, which have the least likelihood of default decreased for 2017.

At December 31, 2018, 47.5% of the watch list was classified as special mention, with an additional 41.4% classified as substandard. A small 11.1% or $886 thousand of the $7.9 million watch list was classified as doubtful. At yearend 2017, 49.0% of the watch list was comprised of loans classified as special mention, with an additional 50.1% classified as substandard and the remaining 0.9% classified as doubtful. The large decreases in special mention and substandard were mainly driven by two loan relationships in the Bank’s commercial real estate portfolio.

Of the aggregate watch list loan balances, as of December 31, 2016, special mention accounted for 59.7% with substandard comprising 39.0% and doubtful accounting for the final 1.3%.

In response to these fluctuations and loan growth during 2016 through 2018, the Bank’s ALLL to outstanding loan coverage percentage changed to 0.80% as of December 31, 2018, 0.83% as of December 31, 2017, and 0.89% as of December 31, 2016.

The above indicators impacting ALLL are reviewed quarterly. Some of the indicators are quantifiable and, as such, will automatically adjust the ALLL once calculated. These indicators include the ratio of past due loans to total loans, loans past due greater than 30 days, and the ratio of watch list loans to capital, with the watch list made up of loans graded 5, 6 or 7 on a scale of 1 (best) to 7 (worst). Other indicators consist of more subjective data used to evaluate the potential for inherent losses in the Bank's loan portfolio. For example, the economic indicator uses the unemployment statistics from the communities in our market area to help determine whether the ALLL should be adjusted. At the end of each of 2016, 2017 and 2018, improvements were noted in unemployment figures.

All aggregate commercial and agricultural credits including real estate loans of $250,000 and over are reviewed annually by both credit committees and internal loan review to look for early signs of deterioration.

To establish the specific reserve allocation for real estate, a discount to the market value is established to account for liquidation expenses. The discounting percentage used for real estate mirrors the discounting of real estate as provided for in the Bank's Loan Policy. However, unique or unusual circumstances may be present which will affect the real estate value and, when appropriately identified, can adjust the discounting percentage at the discretion of management.

The ACL decreased $46 thousand during 2018 while increased $94 thousand and $736 thousand during 2017 and 2016 respectively. The large increase in 2016 directly correlates to the large increase in loan balances and related unfunded commitments. With the improved asset quality, the metrics upon which the ACL is calculated did not support a larger increase in 2017 even though loan growth occurred. The percentage of ACL to the total loan portfolio was 0.92% as of December 31, 2016 and 0.86% as of December 31, 2017, and 0.83% as of December 31, 2018. December 31, 2018 had the lowest loans past due 30+ day percentage at 0.09% in the last ten years. December 31, 2016 and 2017 were still at respectable lows of 0.23% and 0.13%.

Please see Note 4 in the consolidated financial statement for additional tables regarding the composition of the ACL.

Federal Income Taxes

Federal income tax expense was approximately $2.0 million less for 2018 than 2017 as result of tax reform legislation under the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017 and became effective for the Company's 2018 fiscal year. Effective tax rates were 17.75%, 28.95% and 28.53%, for 2018, 2017 and 2016 respectively. The effect of tax-exempt interest from holding tax-exempt securities and Industrial Development Bonds (IDBs) was $229, $413 and $468 thousand for 2018, 2017, and 2016, respectively. 2016 and 2017 included an increase into a higher tax bracket for income over $10 million. 2018 had a flat corporate tax rate of 21%. One of the benefits from the establishment of the Captive subsidiary was a lower effective tax rate.

Material Changes in Financial Condition

The shifts in the balance sheet during 2018 and 2017 have positioned the Company for continued improvement in profitability. On the asset side, interest income increased primarily from loan growth with funding for the increase provided by a decrease in the investment portfolio, growth in core deposits and growth in other borrowings generated in 2015 which had laddered maturities, that were then paid off in the following years. $5 million of other borrowings were paid off in December of 2017 and 2018. Other assets increased $9.2 million in 2018 with $8.5 prefunded for the pending acquisition. The cost of funds has been impacted by the increase of both interest bearing liabilities and the pressure on rates from competition for funds. Increased balances in non-interest bearing deposits aided in profitability also. Loan growth and a widened net interest margin contributed to improved profitability in 2018 and 2017, and the Company expects continued improvement through 2019.

Average earning assets increased in balances throughout 2018 and 2017. Newer offices have contributed the most towards new loan production. Loan growth in both years was the main factor. 2016 had two offices open, one in each half of the year and operating fully throughout 2017. An additional office opened in early 2018.

Securities

The investment portfolio is primarily used to provide overall liquidity for the Bank. It is also used to provide required collateral for pledging to the Bank's Ohio public depositors for amounts on deposit in excess of the FDIC coverage limits. It may also be used to pledge for additional borrowings from third parties. Investments are made with the above criteria in mind while still seeking a fair market rate of return and looking for maturities that fall within the projected overall strategy of the Bank. The possible need to fund future loan growth is also a consideration.

During 2016, the Bank began to utilize Promontory's ICS, product to replace pledged securities; thereby increasing liquidity. ICS utilizes a nation-wide bank network to provide FDIC insurance coverage to the Bank's depositors. The Bank is using the product to replace pledged securities to the Bank's Ohio public customers and for commercial sweep customers previously utilizing daily repurchase agreements to protect balances over $250 thousand. The majority of the commercial accounts converted in 2017 and is evidenced by the movement of funds out of repurchase agreements into interest bearing deposits.

All of the Bank's security portfolio is categorized as available for sale and as such is recorded at market value.

Security balances as of December 31 are summarized below:

	(In Thousands)		
	2018	2017	2016
U.S. Treasury	$22,830	$20,978	$24,775
U.S. Government agencies	69,327	80,466	82,474
Mortgage-backed securities	36,262	39,510	48,461
State and local governments	40,028	55,444	62,817
	$168,447	$196,398	$218,527

The following table sets forth the maturities of investment securities as of December 31, 2018 and the weighted average yields of such securities calculated on the basis of cost and effective yields weighted for the scheduled maturity of each security. Tax-equivalent adjustments, using a twenty-one percent rate, have been made in yields on obligations of state and political subdivisions. Stocks of domestic corporations have not been included. Maturities of mortgage-backed securities are based on the stated maturity date of the security. Due to prepayments, actual maturities may be different.

	Maturities (Amounts in Thousands)			
	Within One Year		After One Year Within Five Years	
	Amount	Yield	Amount	Yield
U.S. Treasury	$12,914	1.20 %	$9,916	1.73 %
U.S. Government agencies	12,179	1.30 %	40,333	1.98 %
Mortgage-backed securities	-	0.00 %	1,382	2.53 %
State and local governments	3,051	2.14 %	13,570	2.07 %
Taxable state and local governments	1,091	1.74 %	1,936	2.44 %

	After Five Years Within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield

U.S. Treasury	$-	0.00 %	$-	0.00 %
U.S. Government agencies	16,815	2.12 %	-	0.00 %
Mortgage-backed securities	3,347	2.12 %	31,533	2.27 %
State and local governments	16,612	1.85 %	1,195	1.65 %
Taxable state and local governments	2,573	4.05 %	-	0.00 %

As of December 31, 2018, the Bank did not hold a large block of any one investment security in excess of 10% of stockholders' equity. The largest segment of holdings is in U.S. Government agencies. The Bank also holds stock in the Federal Home Loan Bank of Cincinnati at a cost of $3.7 million. This is required in order to obtain Federal Home Loan Bank loans.

Loan Portfolio

The Bank's various loan portfolios are subject to varying levels of credit risk. Management mitigates these risks through portfolio diversification and through standardization of lending policies and procedures.

Risks are mitigated through an adherence to the Bank's loan policies, with any exception being recorded and approved by senior management or committees comprised of senior management. The Bank's loan policies define parameters to essential underwriting guidelines such as loan-to-value ratio, cash flow and debt-to-income ratio, loan requirements and covenants, financial information tracking, collection practice and others. The maximum loan amount to any one borrower is limited by the

Bank's legal lending limits and is stated in policy. On a broader basis, the Bank restricts total aggregate funding in comparison to Bank capital to any one business or agricultural sector by an approved sector percentage to capital limitation.

The following table shows the Bank's loan portfolio by category of loan as of December 31st of each year, excluding loans held for sale:

	(In Thousands)				
Loans:	2018	2017	2016	2015	2014
Consumer Real Estate	$80,766	$83,620	$86,234	$88,189	$97,426
Agricultural Real Estate	68,609	64,073	62,375	57,277	50,560
Agricultural	108,495	95,111	84,563	82,654	74,611
Commercial Real Estate	419,784	410,520	377,481	322,762	270,188
Commercial and Industrial	121,793	126,275	109,256	100,125	100,126
Consumer	41,953	37,757	33,179	27,770	24,277
Industrial Development Bonds	5,889	6,415	5,732	6,491	4,698
	$847,289	$823,771	$758,820	$685,268	$621,886

The following table shows the maturity of loans as of December 31, 2018:

	(In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	$4,226	$16,495	$60,045
Agricultural Real Estate	615	4,818	63,176
Agricultural	70,505	28,073	9,917
Commercial Real Estate	16,339	160,783	242,662
Commercial and Industrial	61,382	52,678	7,733
Consumer	5,211	27,369	9,373
Industrial Development Bonds	600	270	5,019
	$158,878	$290,486	$397,925

The following table presents the total of loans due after one year which has either 1) predetermined interest rates (fixed) or 2) floating or adjustable interest rates (variable):

(In Thousands)	
Fixed	Variable

	Rate	Rate	Total
Consumer Real Estate	70,990	5,550	76,540
Agricultural Real Estate	55,357	12,637	67,994
Agricultural	37,164	826	37,990
Commercial Real Estate	283,622	119,823	403,445
Commercial and Industrial	54,218	6,193	60,411
Consumer	36,724	18	36,742
Industrial Development Bonds	5,289	-	5,289
	543,364	145,047	688,411

The following table summarizes the Company's nonaccrual, past due 90 days or more and still accruing loans, and accruing troubled debt restructurings as of December 31 for each of the last five years:

	(In Thousands)				
	2018	2017	2016	2015	2014
Non-accrual loans	$542	$1,003	$1,384	$2,041	$1,705
Accruing loans past due 90 days or more	-	-	-	-	-
Troubled Debt Restructurings, not included above	104	534	559	878	471
Total	$646	$1,537	$1,943	$2,919	$2,176

Although loans may be classified as non-performing, some pay on a regular basis, and many continue to pay interest irregularly or at less than original contractual rates. Interest income that would have been recorded under the original terms of these loans would have aggregated $99 thousand for 2018, $205.4 for 2017 and $116.1 thousand for 2016. Any collections of interest on nonaccrual loans are included in interest income when collected unless it is on an impaired loan with a specific allocation. A collection of interest on an impaired loan with a specific allocation is applied to the loan balance to decrease the allocation. Total interest collections, whether on an accrued or cash basis, amounted to $69 thousand for 2018, $57 thousand for 2017 and $64 thousand for 2016.

Loans are placed on nonaccrual status in the event that the loan is in past due status for more than 90 days or payment in full of principal and interest is not expected. The Bank had nonaccrual loan balances of $542 thousand at December 31, 2018 compared to balances of $1.0 and $1.4 million as of year-end 2017 and 2016. All of the balances of nonaccrual loans for the past three years were collaterally secured.

As of December 31, 2018, the Bank had $7.9 million of loans which it considers to be "potential problem loans" in that the borrowers are experiencing financial difficulties. At December 31, 2017, the Bank had $21.2 million of these loans. The decrease is largely attributed to the payoff of one relationship. At December 31, 2016, the Bank had $20.4 million of these loans. These loans are subject to constant management attention and are reviewed at least monthly. The amount of the potential problem loans was considered in management's review of the loan loss reserve at December 31, 2018 and 2017.

In extending credit to families, businesses and governments, banks accept a measure of risk against which an allowance for possible loan loss is established by way of expense charges to earnings. This expense is determined by management based on a detailed monthly review of the risk factors affecting the loan portfolio, including general economic conditions, changes in the portfolio mix, past due loan-loss experience and the financial condition of the bank's borrowers.

As of December 31, 2018, the Bank had loans outstanding to individuals and firms engaged in the various fields of agriculture in the amount of $108.5 million with an additional $68.6 million in agricultural real estate loans these compared to $95.1 and $64.1 million respectively as of December 31, 2017. The ratio of this segment of loans to the total loan portfolio is not considered unusual for a bank engaged in and servicing rural communities.

Interest rate modification to reflect a decrease in market interest rates or maintain a relationship with the debtor, where the debtor is not experiencing financial difficulty and can obtain funding from other sources, is not considered a troubled debt restructuring. As of December 31, 2018, the Bank had $178.1 thousand of its loans that were classified as troubled debt restructurings, of which $74.4 thousand are included in non-accrual loans. This compares to $0.7 million as of same date 2017 and 2016.

Updated appraisals are required on all collateral dependent loans once they are deemed impaired. The Bank may also require an updated appraisal of a watch list loan which the Bank monitors under their loan policy. On a quarterly basis, Bank management reviews properties supporting asset dependent loans to consider market events that may indicate a change in value has occurred.

To determine observable market value, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the existing collateral value used.

Performing “non-watch list” loans secured in whole or in part by real estate, do not require an updated appraisal unless the loan is rewritten and additional funds advanced. Watch List loans secured in whole or in part by real estate require updated appraisals every two years. All loans are subject to loan to values as found in the Bank’s loan policies irrespective of their grade. The Bank’s watch list is reviewed on a quarterly basis by management and any questions to value are addressed at that time.

The majority of the Bank's loans are made in the market by lenders who live and work in the market. Thus, their evaluation of the independent valuation is also valuable and serves as a double check.

On extremely rare occasions, the Bank will make adjustments to the recorded values of collateral securing commercial real estate loans without acquiring an updated appraisal for the subject property. The Bank has no formalized policy for determining when collateral value adjustments between regularly scheduled appraisals are necessary, nor does it use any specific methodology for applying such adjustments. However, on a quarterly basis as part of its normal operations, the Bank's senior management and the Loan Review Committee will meet to review all commercial credits either deemed to be impaired or on the Bank's watch list. In addition to analyzing the recent performance of these loans, management and the Enterprise Risk Management Committee will also consider any general market conditions that might warrant adjustments to the value of particular real estate collateralizing commercial loans. In addition, management conducts annual reviews of all commercial loans exceeding certain outstanding balance thresholds. In each of these situations, any information available to management regarding market conditions impacting a specific property or other relevant factors are considered, and lenders familiar with a particular commercial real estate loan and the underlying collateral may be present to provide their opinion on such factors. If the available information leads management to conclude a valuation adjustment is warranted, such an adjustment may be applied on the basis of the information available. If management concludes that an adjustment is warranted but lacks the specific information needed to reasonably quantify the adjustment, management will order a new appraisal on the subject property even though one may not be required under the Bank's general policies for updating appraisal.

Note 4 of the Consolidated Financial Statements may also be reviewed for additional tables dealing with the Bank's loans and ALLL.

ALLL is evaluated based on an assessment of the losses inherent in the loan portfolio. This assessment results in an allowance consisting of two components, allocated and unallocated.

Management considers several different risk assessments in determining ALLL. The allocated component of ALLL reflects expected losses resulting from an analysis of individual loans, developed through specific credit allocations for individual loans and historical loss experience for each loan category. For those loans where the internal credit rating is at or below a predetermined classification and management can reasonably estimate the loss that will be sustained based upon collateral, the borrowers operating activity and economic conditions in which the borrower operates, a specific allocation is made. For those borrowers that are not currently behind in their payment, but for which management believes, based on economic conditions and operating activities of the borrower, the possibility exists for future collection problems, a reserve is established. The amount of reserve allocated to each loan portfolio is based on past loss experiences and the different levels of risk within each loan portfolio. The historical loan loss portion is determined using a historical loss analysis by loan category.

The unallocated portion of the reserve for loan losses is determined based on management's assessment of general economic conditions as well as specific economic factors in the Bank's marketing area. This assessment inherently involves a higher degree of uncertainty. It represents estimated inherent but undetected losses within the portfolio that are probable due to uncertainties in economic conditions, delays in obtaining information, including unfavorable information about a borrower's financial condition and other current risk factors that may not have yet manifested themselves in the Bank's historical loss factors used to determine the allocated component of the allowance.

Actual charge-off of loan balances is based upon periodic evaluations of the loan portfolio by management. These evaluations consider several factors, including, but not limited to, general economic conditions, financial condition of the borrower, and collateral.

As presented in the table on the next page, charge-offs increased to $580 thousand for 2018. 61.9% of the charge-offs stemmed from the consumer related portfolios. Charge-offs were $288 thousand for 2017, $550 thousand for 2016, preceded by $1.0 million for 2015 and $778 thousand for 2014. Recoveries were $163 thousand in 2018 compared to $150, $156, $557, and $298 thousand for 2017, 2016, 2015 and 2014, respectively. The net charge-offs for the last five years were all under $1 million. 2017 was the lowest at $138 thousand.

Higher provision expense was used to fund the ALLL for loan growth in 2014 and 2016. For 2015 and 2017, the provision was used to replenish the balance decreased by the net charge-off activity. Overall, the ALLL increased from $5.9 million at yearend 2014 to $6.8 million at yearend 2018. After adding the allowance for unfunded loan commitments, the ACL ended 2018 just over $7.0 million. As the ratios on the bottom of the following table show, the trends for each have continually improved over the five years shown. Asset quality and the ACL are both strong and emphasize the level of credit quality.

In reviewing the bigger picture of the allowance for credit loss, the years with the higher percentage of ACL to total nonperforming loans ratio account for the lower level of nonaccrual and watch list loans. This demonstrates the extended time period with which it has taken to achieve resolution and/or collection of these loans. 2014's significant and continued loan growth since fourth quarter 2013 was the reason behind 2014's higher balances as asset quality remained strong. The ratio of ACL to nonperforming loans increased significantly in 2014 which is why provision loan expense was lower in 2015 in comparison. The ACL to nonperforming loans for 2015 remained more than adequate and emphasizes the existing strong level of credit quality. 2018 did not warrant a large provision as the asset quality continued to strengthen. Loan growth occurred, though not at the double-digit percentage increases of 2015 and 2016.

The following table presents a reconciliation of the allowance for credit losses for the years ended December 31, 2018, 2017, 2016, 2015 and 2014:

	(In Thousands)				
	2018	2017	2016	2015	2014
Loans	$846,374	$823,024	$758,094	$684,630	$621,467
Daily average of outstanding loans	$831,614	$783,140	$724,076	$627,194	$581,483
Allowance for Loan Losses - Jan 1	$6,868	$6,784	$6,057	$5,905	$5,194
Loans Charged off:					
Consumer Real Estate	63	4	106	38	168
Agricultural Real Estate	-	-	-	-	-
Agricultural	-	-	21	-	-
Commercial Real Estate	16	21	93	143	229
Commercial and Industrial	142	-	20	536	-
Consumer	359	263	310	313	381
	580	288	550	1,030	778
Loan Recoveries:					
Consumer Real Estate	18	13	28	41	34
Agricultural Real Estate	-	-	-	-	-
Agricultural	8	8	10	64	44
Commercial Real Estate	10	15	20	204	4
Commercial and Industrial	13	12	11	91	20
Consumer	114	102	87	157	196
	163	150	156	557	298
Net Charge Offs	417	138	394	473	480
Provision for loan loss	324	222	1,121	625	1,191
Acquisition provision for loan loss	-	-	-	-	-
Allowance for Loan & Lease Losses - Dec 31	6,775	6,868	6,784	6,057	5,905
Allowance for Unfunded Loan Commitments & Letters of Credit - Dec 31	274	227	217	208	207
Total Allowance for Credit Losses - Dec 31	$7,049	$7,095	$7,001	$6,265	$6,112
Ratio of net charge-offs to average Loans outstanding	0.05 %	0.02 %	0.05 %	0.08 %	0.08 %
Ratio of the Allowance for Loan Loss to Nonperforming Loans	1249.57 %	684.83 %	490.39 %	293.75 %	346.30 %

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

Allocation of ALLL per Loan Category in terms of dollars and percentage of loans in each category to total loans is as follows:

	2018 Amount (000's)	%	2017 Amount (000's)	%	2016 Amount (000's)	%	2015 Amount (000's)	%	2014 Amount (000's)	%
Balance at End of Period Applicable To:										
Consumer Real Estate	$247	9.48	$343	10.11	$316	11.33	$338	12.85	$537	15.68
Agricultural Real Estate	250	8.10	244	7.78	241	8.22	211	8.35	184	8.13
Agricultural	768	12.83	667	11.57	616	11.17	582	12.09	547	12.00
Commercial Real Estate	3,217	49.52	3,149	49.81	3,250	49.72	2,516	47.07	2,367	43.48
Commercial and Industrial	1,305	15.10	1,546	16.14	1,318	15.18	1,229	15.58	1,421	16.87
Consumer	484	4.97	441	4.59	394	4.38	337	4.06	323	3.84
Unallocated	504	0.00	478	0.00	649	0.00	844	0.00	526	0.00
Allowance for Loan & Lease Losses	$6,775	100.00	$6,868	100.00	$6,784	100.00	$6,057	100.00	$5,905	100.00
Off Balance Sheet Commitments	274		227		217		208		207	
Total Allowance for Credit Losses	$7,049		$7,095		$7,001		$6,265		$6,112	

Deposits

The amount of outstanding time certificates of deposits and other time deposits in amounts of $100,000 or more by maturity as of December 31, 2018 are as follows:

	(In Thousands)			
	Under Three Months	Over Three Months Less than Six Months	Over Six Months Less Than One Year	Over One Year
Time Deposits	$8,002	$ 10,987	$ 26,168	$49,065

The following table presents the average amount of and average rate paid on each deposit category:

	(In Thousands)			
	Non-Interest DDAs	Interest DDAs	Savings Accounts	Time Accounts
December 31, 2018:				
Average balance	$194,548	$313,785	$237,961	$183,512
Average rate	0.00 %	1.05 %	0.15 %	1.38 %
December 31, 2017:				
Average balance	$180,129	$286,912	$232,668	$188,443
Average rate	0.00 %	0.76 %	0.14 %	1.16 %
December 31, 2016:				
Average balance	$169,510	$207,057	$239,939	$194,753
Average rate	0.00 %	0.61 %	0.18 %	0.99 %

Liquidity

Liquidity remains adequate though down from prior years as the Bank has decreased the investment portfolio to fund loans. The Bank has access to $69 million of unsecured borrowings through correspondent banks and $73.7 million of unpledged securities which may be sold or used as collateral. The amount of unpledged securities decreased almost $20.9 million as compared to 2017. This was accomplished with utilizing Promontory's ICS product to protect Ohio public fund depositors and commercial sweep customers with FDIC coverage rather than pledged securities. For the Bank, an additional $9.0 million is also available

from the Federal Home Loan Bank based on current collateral pledging with up to $119.0 million available provided adequate collateral is pledged.

Maintaining sufficient funds to meet depositor and borrower needs on a daily basis continues to be among management's top priorities. This is accomplished not only by immediate liquid resources of cash, due from banks and federal funds sold, but also by the Bank's available for sale securities portfolio. The average aggregate balance of these assets was $195.2 for 2018, $206.3 for 2017 and $228.0 million for 2016. This represented 17.6%, 19.2% and 22.3% of total average assets, respectively. Of the almost $155.5 million of debt securities in the Bank's portfolio as of December 31, 2018, $29.0 million, or 18.6% of the portfolio, is expected to receive payments or mature in 2019. This liquidity provides the opportunity to fund loan growth by analysis of the lowest cost and source of funds whether by increasing deposits, sales or runoff of investments or utilizing debt.

In addition to the Bank's investment portfolio, the Company has $13.0 million held in the holding company's investment portfolio. $260 thousand of those investments will mature or receive payments in the next twelve months. These funds provide liquidity to the Company. The Bank has been declaring additional dividends each quarter to provide this liquidity to the Company. The Captive has also upstreamed dividends to the Company and is expected to continue annually as long as reserve levels are adequately provided for. This provides additional liquidity for Company activities. The company sold securities in December 2018 to provide $8.5 million in cash for the preparation of the acquisition on January 1, 2019.

Historically, the primary source of liquidity has been core deposits that include noninterest bearing and interest bearing demand deposits, savings, money market accounts and time deposits of individuals. Core deposit balances increased in noninterest bearing deposits but decreased in all other categories as of December 31, 2018 compared to same date 2017. Average total savings balances increased $32.2 million in 2018 as compared to 2017. Core deposit balances as of year-end 2017 increased in all categories with the exception of time deposits. Overall deposits increased an average of $76.9 million in 2017 and $47.1 million in 2016. The Bank also utilized Federal Funds purchased at times during 2016 through 2018. The average balance for 2018 was $1.4 million, for 2017 and 2016 was $2.2 million and $1.9 million respectively. During 2016, it was used heavily in the third quarter. The Bank is comfortable accessing these funds on a regular basis.

Historically, the primary use of new funds is placing the funds back into the community through loans for the acquisition of new homes, consumer products and for business development. The use of new funds for loans is measured by the loan to deposit ratio. The Bank's average loan to deposit ratio was 89.4% for 2018, 88.2% for 2017, and 87.9% for 2016. The Bank's goal is for this ratio to be higher in the 80-90 percent range with loan growth being the driver. The Bank ended the year 2018 at a 91.2% loan to deposit ratio.

Short-term debt such as federal funds purchased and securities sold under agreement to repurchase also provides the Company with liquidity. Short-term debt for both federal funds purchased and securities sold under agreement to repurchase amounted to $32.2 million at December 31, 2018, $39.5 million at December 31, 2017, and $70.3 million at the end of 2016. These accounts are used to provide a sweep product to the Bank's commercial customers and for some term deposits. As ICS was implemented, the sweep balances moved into interest bearing deposits and for yearend 2017 and 2018 the repurchase agreements are for term deposits only.

"Other borrowings" are also a source of funds. Other borrowings consist of loans from the Federal Home Loan Bank of Cincinnati. These funds are then used to provide loans in our community. The Bank utilized this funding source in December 2015 by borrowing $10 million. These remained consistent borrowings during 2016 and in December of 2017 and 2018 $5 million matured and was paid off each year. At yearend 2018, all borrowings were paid off and this has increased the availability from this source of funds.

Asset/Liability Management

The primary functions of asset/liability management are to assure adequate liquidity and maintain an appropriate balance between interest earning assets and interest bearing liabilities. It involves the management of the balance sheet mix, maturities, re-pricing characteristics and pricing components to provide an adequate and stable net interest margin with an acceptable level of risk. Interest rate sensitivity management seeks to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates.

Changes in net income, other than those related to volume arise when interest rates on assets re-price in a time frame or interest rate environment that is different from that of the re-pricing period for liabilities. Changes in net interest income also arise from changes in the mix of interest-earning assets and interest-bearing liabilities.

Historically, the Bank has maintained liquidity through cash flows generated in the normal course of business, loan repayments, maturing earning assets, the acquisition of new deposits, and borrowings. The Bank's asset and liability management program is designed to maximize net interest income over the long term while taking into consideration both credit and interest rate risk. Interest rate sensitivity varies with different types of interest-earning assets and interest-bearing liabilities. Overnight federal funds on which rates change daily and loans that are tied to the market rate differ considerably from long-term investment securities and fixed rate loans. Similarly, time deposits over $100,000 and money market certificates are much more interest rate sensitive than passbook savings accounts. The Bank utilizes shock analysis to examine the amount of exposure an instant rate change of 100, 200, 300 and 400 basis points in both increasing and decreasing directions would have on the financials. Acceptable ranges of earnings and equity at risk are established and decisions are made to maintain those levels based on the shock results.

Impact of Inflation and Changing Prices

The consolidated financial statements and notes thereto presented herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Company’s operations. Unlike most industrial companies, nearly all the assets and liabilities of the Company are monetary in nature. As a result, interest rates have a greater impact on the Company’s performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and service.

Contractual Obligations

Contractual Obligations of the Company totaled $213.6 million as of December 31, 2018. Excluded from the chart is Federal Funds Purchased of $6.5 million which are immediately payable the next business day. Time deposits represent contractual agreements for certificates of deposits held by its customers. Long term debt represents the borrowings with the Federal Home Loan Bank and is further defined in Note 9 of the Consolidated Financial Statements.

	Payment Due by Period (In Thousands)				
Contractual Obligations	Total	Less than 1 year	1-3 Years	3-5 Years	More than 5 years
Securities sold under agreement to repurchase	$25,695	$22,135	$3,560	$-	$-
Time Deposits	187,413	88,388	72,497	25,974	554
Dividends Payable	-	-	-	-	-
Building Leases	531	90	183	164	94
Long Term Debt	-	-		-	-
Total	$213,639	$110,613	$76,240	$26,138	$648

Capital Resources

Stockholders’ equity was $143.3 million as of December 31, 2018 compared to $134.1 million at December 31, 2017. Dividends declared during 2018 were $0.56 per share totaling $5.1 million and dividends declared during 2017 were $0.50 per share totaling $4.6 million. Throughout 2018, the Company awarded 33,000 shares of restricted stock

awards to 80 employees. During 2017, the Company awarded 32,000 shares of restricted stock to 74 employees. For a summary of activity as it relates to the Company's restricted stock awards, please refer to Note 11: Employee Benefit Plans in the consolidated financial statements. On December 31, 2018 the Company held 1,114,739 shares in Treasury Stock and 93,940 unvested shares of restricted stock. At yearend 2017, the Company held 1,134,120 shares in Treasury stock and 92,350 unvested shares of restricted stock. On January 18, 2019 the Company announced the authorization by its Board of Directors for the Company's repurchase, either on the open market, or in privately negotiated transactions, of up to 500,000 shares of its outstanding common stock commencing January 18, 2019 and ending December 31, 2019. The Company has a history of approving a similar resolution to be in effect each year for at least the last five years.

The Company continues to have a strong capital base and maintains regulatory capital ratios that are above the defined regulatory capital ratios. At December 31, 2018, the Bank had total risk-based capital ratio of 13.45%. Core capital to risk-based asset ratio of 12.67% for the Bank, is well in excess of regulatory guidelines. The Bank's leverage ratio of 10.54% is also substantially in excess of regulatory guidelines. Under Basel III, the common equity Tier 1 Capital to risk-weighted assets ratio is also well above the required 4.50% and the 6.50% well capitalized levels with the Bank at 12.67%. As a result of the passage of the Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCPA) in 2018, the Company is no longer subject to regulatory

capital ratio requirements as long as its total consolidating assets are less than $3.0 billion. For further discussion and analysis of regulatory capital requirements, refer to Note 15 of the Audited Financial Statements.

The Company's subsidiaries are restricted by regulations from making dividend distributions in excess of certain prescribed amounts. Upon prior regulatory approval, the Bank may be allowed to pay above the prescribed amount.

ITEM 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

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

Interest rate risk is managed within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.

The shocks presented below assume an immediate change of rate in the percentages and directions shown:

Interest Rate Shock on Net Interest Margin				Interest Rate Shock on Net Interest Income	
Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate changes by	Cumulative Total ($000)	% Change to Flat Rate
4.39%	9.50%	Rising	3.00%	45,237	9.56%
4.21%	4.97%	Rising	2.00%	43,351	4.99%
4.03%	0.44%	Rising	1.00%	41,469	0.43%
4.01%	0.00%	Flat	0.00%	41,290	0.00%
3.78%	-5.59%	Falling	-1.00%	38,977	-5.60%
3.65%	-8.95%	Falling	-2.00%	37,588	-8.97%
3.49%	-12.98%	Falling	-3.00%	35,921	-13.00%

The shock chart currently shows a widening in net interest margin over the next twelve months in an increasing rate environment and a tightening in a falling rate environment. Due to nine rate increases since December 2015, the model predicts an expansion in a rising rate environment. The 200 and 300 basis rising rates scenarios are predicted to

expand the net interest margin and produce higher levels of net interest income. This would indicate that the assets yield is predicted to increase faster than the cost of funds will rise. The Bank continues to enhance its use of the software model and performs additional stress tests whose results management and the director's review. The Bank also monitors and adjusts the assumptions for decay rates and key rate ties on certain deposit accounts and continues to review and modify those rates as the index rates change. Both directional changes are well within risk exposure guidelines. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

ITEM 8. FINANCIAL STATEMENTS

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Reports of Independent Registered Public Accounting Firm.

Consolidated Balance Sheets at December 31, 2018 and 2017.

Consolidated Statements of Income for the years ended December 31, 2018, 2017 and 2016.

Consolidated Statements of Comprehensive Income for the years ended December 31, 2018, 2017 and 2016.

Consolidated Statements of Changes to Shareholders' Equity for the years ended December 31, 2018, 2017 and 2016.

Consolidated Statements of Cash Flow for the years ended December 31, 2018, 2017 and 2016.

Notes to Consolidated Financial Statements.

Report of Independent Registered Public Accounting Firm

To the Shareholders, Board of Directors and Audit Committee

Farmers & Merchants Bancorp, Inc.

Archbold, Ohio

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Farmers & Merchants Bancorp, Inc. (Company) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes to stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2018, and the related notes (collectively referred to as the financial statements). In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the three-year period ended
December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of
December 31, 2018, based on established in 2013 Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2019, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits.

We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities

and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

BKD, LLP

We have served as the Company's auditor since 2014.

Fort Wayne, Indiana

February 27, 2019

Report of Independent Registered Public Accounting Firm

To the Shareholders, Board of Directors and Audit Committee

Farmers & Merchants Bancorp, Inc.

Archbold, Ohio

Opinion on Internal Control Over Financial Reporting

We have audited Farmers & Merchants Bancorp, Inc.'s (Company) internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework: (2013) issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated financial statements of the Company and our report dated February 27, 2019, expressed an unqualified opinion.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definitions and Limitations of Internal Control Over Financial Reporting

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

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

BKD, LLP

Fort Wayne, Indiana

February 27, 2019

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheets

December 31, 2018 and 2017

(000's Omitted, Except Share Data)

	2018	2017
Assets		
Assets		
Cash and due from banks	$37,492	$33,480
Federal funds sold	873	987
Total cash and cash equivalents	38,365	34,467
Interest-bearing time deposits	4,019	4,018
Securities - available-for-sale	168,447	196,398
Other securities, at cost	3,679	3,679
Loans held for sale	495	1,221
Loans, net	839,599	816,156
Premises and equipment	22,612	21,617
Construction in progress	3	109
Goodwill	4,074	4,074
Mortgage servicing rights	2,385	2,299
Other real estate owned	600	674
Bank owned life insurance	14,884	14,523
Other assets	17,001	7,774
Total Assets	$1,116,163	$1,107,009
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing	$215,422	$199,114
Interest-bearing		
NOW accounts	298,254	298,711
Savings	227,701	233,949
Time	187,413	187,566
Total deposits	928,790	919,340
Federal funds purchased and securities sold under agreement to repurchase	32,181	39,495
Federal Home Loan Bank (FHLB) advances	-	5,000
Dividend payable	1,379	1,193
Accrued expenses and other liabilities	10,526	7,844
Total liabilities	972,876	972,872
Commitments and Contingencies		
Stockholders' Equity		
Common stock - No par value 20,000,000 shares authorized; issued and	10,823	11,546

outstanding 10,400,000 shares 12/31/18 and 12/31/17		
Treasury stock - 1,114,739 shares 12/31/18, 1,134,120 shares 12/31/17	(12,409)	(12,160)
Retained earnings	147,887	136,577
Accumulated other comprehensive loss	(3,014)	(1,826)
Total stockholders' equity	143,287	134,137
Total Liabilities and Stockholders' Equity	$1,116,163	$1,107,009

See Notes to Consolidated Financial Statements

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Consolidated Statements of Income

Years Ended December 31, 2018, 2017 and 2016

(000's Omitted, Except Per Share Data)

	2018	2017	2016
Interest Income			
Loans, including fees	$42,303	$37,195	$33,703
Debt securities:			
U.S. Treasury and government agencies	2,478	2,480	2,373
Municipalities	1,095	1,193	1,437
Dividends	220	187	149
Federal funds sold and other	333	193	65
Total interest income	46,429	41,248	37,727
Interest Expense			
Deposits	5,989	4,483	3,617
Federal funds purchased and securities sold under agreements to repurchase	503	497	458
Borrowed funds	80	147	148
Total interest expense	6,572	5,127	4,223
Net Interest Income Before Provision for Loan Losses	39,857	36,121	33,504
Provision for Loan Losses	324	222	1,121
Net Interest Income After Provision for Loan Losses	39,533	35,899	32,383
Noninterest Income			
Customer service fees	5,935	5,609	6,118
Other service charges and fees	4,181	4,268	3,774
Net gain on sale of loans	757	811	888
Net gain (loss) on sale of available-for-sale securities	(9)	47	588
Total noninterest income	10,864	10,735	11,368
Noninterest Expense			
Salaries and wages	13,760	12,613	11,620
Employee benefits	4,115	3,635	3,323
Net occupancy expense	1,757	1,489	1,459
Furniture and equipment	2,110	1,858	1,724
Data processing	1,318	1,213	1,409
Franchise taxes	954	902	878
ATM expense	1,340	1,173	1,210
Advertising	887	757	727
Net loss on sale of other assets owned	44	27	81

FDIC assessment	326	330	407
Mortgage servicing rights amortization	364	353	419
Consulting fees	928	377	336
Other general and administrative	4,318	4,004	3,838
Total noninterest expense	32,221	28,731	27,431
Income Before Income Taxes	18,176	17,903	16,320
Income Taxes	3,227	5,183	4,656
Net Income	$14,949	$12,720	$11,664
Basic and Diluted Earnings Per Share	$1.61	$1.38	$1.27
Dividends Declared	$0.56	$0.50	$0.46

See Notes to Consolidated Financial Statements

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2018, 2017 and 2016

(000's Omitted)

	2018	2017	2016
Net Income	$14,949	$12,720	$11,664
Other Comprehensive Income (Loss) (Net of Tax):			
Net unrealized gain (loss) on available-for-sale securities	(1,058)	267	(2,721)
Reclassification adjustment for (gain) loss on sale of available-for-sale securities	9	(47)	(588)
Net unrealized gain (loss) on available-for-sale securities	(1,049)	220	(3,309)
Tax expense (benefit)	(220)	74	(1,125)
Other comprehensive income (loss)	(829)	146	(2,184)
Comprehensive Income	$14,120	$12,866	$9,480

See Notes to Consolidated Financial Statements

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Consolidated Statements of Changes to Stockholder's Equity

For the Years Ended December 31, 2018, 2017 and 2016

(000's Omitted, Except Per Share Data)

	Shares of Common Stock	Common Stock	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance - January 1, 2016	9,225,068	$ 12,086	$ (12,389)	$ 120,188	$ 212	$ 120,097
Net income				11,664		11,664
Other comprehensive loss					(2,184)	(2,184)
Purchase of Treasury stock	(14,000)		(194)			(194)
Issuance of 32,300 shares of restricted stock (Net of Forfeitures - 1,546 Repurchases - 72)	30,682	(541)	316	178		(47)
Stock-based compensation expense		402				402
Cash dividends declared - $0.46 per share				(4,161)		(4,161)
Balance - December 31, 2016	9,241,750	$ 11,947	$ (12,267)	$ 127,869	$ (1,972)	$ 125,577
Net income				12,720		12,720
Other comprehensive income					146	146
Purchase of Treasury stock	(6,790)		(196)			(196)
Issuance of 32,000 shares of restricted stock (Net of Forfeitures - 1,080)	30,920	(908)	303	570		(35)
Stock-based compensation expense		507				507
Cash dividends declared - $0.50 per share				(4,582)		(4,582)
Balance - December 31, 2017	9,265,880	$ 11,546	$ (12,160)	$ 136,577	$ (1,826)	$ 134,137
Adoption of ASU 2017-08, cumulative effect				(30)		(30)
Balance - December 31, 2017, adjusted	9,265,880	11,546	(12,160)	136,547	(1,826)	134,107
Net income				14,949		14,949
Other comprehensive loss					(829)	(829)
Adoption of ASU 2018-02				359	(359)	-
Purchase of Treasury stock	(10,999)		(490)			(490)
	30,380	(1,468)	241	1,174		(53)

Issuance of 33,000 shares of restricted stock (Net of Forfeitures - 2,620)						
Stock-based compensation expense		745				745
Cash dividends declared - $0.56 per share				(5,142)		(5,142)
Balance - December 31, 2018	9,285,261	$ 10,823	$ (12,409)	$ 147,887	$ (3,014)	$ 143,287

See Notes to Consolidated Financial Statements

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Farmers & Merchants Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Years Ended December 31, 2018, 2017 and 2016

(000's Omitted)

	2018	2017	2016
Cash Flows from Operating Activities			
Net income	$14,949	$12,720	$11,664
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation	1,717	1,613	1,464
Amortization of available-for-sale securities, net	957	1,106	1,146
Amortization of servicing rights	364	353	419
Amortization of core deposit intangible	167	245	323
Stock-based compensation expense	745	507	402
Deferred income taxes	472	21	55
Provision for loan loss	324	222	1,121
Gain on sale of loans held for sale	(757)	(811)	(888)
Originations of loans held for sale	(51,807)	(57,391)	(66,014)
Proceeds from sale of loans held for sale	51,381	59,520	63,988
Loss on sale of other assets owned	44	27	81
(Gain) loss on sales of available-for-sale securities	9	(47)	(588)
Change in other assets and other liabilities, net	(6,423)	1,173	(743)
Net cash provided by operating activities	12,142	19,258	12,430
Cash Flows from Investing Activities			
Activity in available-for-sale securities:			
Maturities, prepayments and calls	29,691	23,064	41,825
Sales	10,081	13,562	85,723
Purchases	(13,866)	(15,335)	(114,819)
Change in interest-bearing time deposits	1	(2,103)	(1,915)
Proceeds from sales of other assets owned	112	21	41
Additions to premises and equipment	(2,612)	(1,794)	(2,406)
Loan originations and principal collections, net	(23,341)	(67,197)	(72,639)
Net cash provided by (used in) investing activities	66	(49,782)	(64,190)
Cash Flows from Financing Activities			
Net change in deposits	9,450	77,137	70,864
Net change in federal funds purchased and securities sold under agreements to repurchase	(7,314)	(30,829)	(8,491)
Repayment of FHLB advances	(5,000)	(5,000)	-
Purchase of Treasury stock	(490)	(196)	(194)

Cash dividends paid on common stock	(4,956)	(4,443)	(4,115)
Net cash provided by (used in) financing activities	(8,310)	36,669	58,064
Net Increase in Cash and Cash Equivalents	3,898	6,145	6,304
Cash and Cash Equivalents - Beginning of Year	34,467	28,322	22,018
Cash and Cash Equivalents - End of Year	$38,365	$34,467	$28,322
Supplemental Information			
Cash paid during the year for:			
Interest	$6,472	$5,064	$4,151
Income taxes	$3,107	$5,102	$5,012
Noncash investing activities:			
Transfer of loans to other real estate owned	$68	$59	$419

See Notes to Consolidated Financial Statements

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2018, 2017, 2016

Note 1 - Summary of Significant Accounting Policies

Nature of Operations

The Farmers & Merchants Bancorp, Inc. (the Company) through its bank subsidiary, The Farmers & Merchants State Bank (the Bank) provides a variety of financial services to individuals and small businesses through its offices in Northwest Ohio and Northeast Indiana.

Consolidation Policy

The consolidated financial statements include the accounts of Farmers & Merchants Bancorp, Inc. and its wholly-owned subsidiaries, The Farmers & Merchants State Bank (the Bank), a commercial banking institution and Farmers & Merchants Risk Management, Inc. (the Captive), a Captive insurance company. All significant inter-company balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of mortgage servicing rights. Actual results could differ from those estimates.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral.

The Bank’s loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Bank has a diversified loan portfolio, a substantial portion of its debtors’ ability to honor their contracts is dependent on local economic conditions in the agricultural industry.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Cash and Cash Equivalents

For purposes of the consolidated statement of cash flows, the Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. This includes cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are purchased for one day periods.

Restrictions on Cash and Amounts Due from Banks

The Bank is required to maintain average balances on hand with the Federal Reserve Bank. The aggregate reserve was $12.6 million for December 31, 2018 and it was $11.4 million for December 31, 2017. The Company and its subsidiaries maintain cash balances with high quality credit institutions. At times such balances may be in excess of the federally insured limits.

Note 1 – Summary of Significant Accounting Policies (Continued)

Securities

Debt securities are classified as available-for-sale. Securities available-for-sale are carried at fair value with unrealized gains and losses reported in other comprehensive income (loss). Net realized gains and losses on securities available for sale are included in noninterest income and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income (loss). Gains and losses on sales of securities are determined on the specific-identification method.

Declines in the fair value of securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The related write-downs are included in earnings as realized losses.

Other Securities

Other Securities is the Federal Home Loan Bank of Cincinnati stock which is held to enable the Bank to conduct business with the entity. The Federal Home Loan Bank sells and purchases their stock at par. The Federal Home Loan Bank of Cincinnati stock is carried at cost and held as collateral security for all indebtedness of the Bank to the Federal Home Loan Bank. The Federal Home Loan Bank of Cincinnati is evaluated for impairment as conditions warrant.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at the amount of unpaid principal, reduced by unearned discounts and deferred loan fees and costs, as well as, by the allowance for loan losses. Interest income is accrued on a daily basis based on the principal outstanding.

Generally, a loan is classified as nonaccrual and the accrual of interest income is generally discontinued when a loan becomes ninety days past due as to principal or interest and these loans are placed on a "cash basis" for purposes of income recognition. Management may elect to continue the accrual of interest when the estimated net realizable value of collateral is sufficient to cover the principal and accrued interest, and the loan is in the process of collection. When a loan is placed on nonaccrual status, all previously accrued and unpaid interest receivable is charged against income.

Loan origination and commitment fees and certain direct loan origination costs are deferred and amortized as a net adjustment to the related loan's yield. The Bank is generally amortizing these costs over the contractual life of such loans.

Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses charged to income. Loans deemed to be uncollectable and changes in the allowance relating to loans are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based on management's periodic review of the collectability of the loans in light of historical experiences, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are subject to revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss

Note 1 – Summary of Significant Accounting Policies (Continued)

experience adjusted for qualitative factors. The unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and agricultural loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

At 90 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency.

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

Large groups of homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer loans for impairment, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

For more information regarding the actual composition and classification of loans involved in the establishment of the allowance for loan loss, please see Note 4 provided here with the notes to consolidated financial statements.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses, if any, are recognized in a valuation allowance by charges to income.

Servicing Assets

Servicing assets are recognized as separate assets when rights are acquired through purchase or sale of financial assets. Capitalized servicing rights are amortized into noninterest expense in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights

by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum. Fees received for servicing loans owned by investors are based on a percentage of the outstanding monthly principal balance of such loans and are included in operating income as loan payments are received. Costs of servicing loans are charged to expense as incurred.

Goodwill and Other Intangible Assets

Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually. If

Note 1 – Summary of Significant Accounting Policies (Continued)

possible impairment is likely, the Bank will utilize the assistance of an independent third party for impairment and any such impairment is recognized in the period identified. Periodically the Bank will have an independent third party assess the possibility of impairment of Goodwill. Such an assessment was performed as of September 30, 2017. The goodwill impairment analysis consisted of a first step goodwill impairment test which was used to identify potential impairment by comparing the fair value of the relevant reporting unity with its carrying value, including goodwill. The analysis was performed under guidance of FASB ASC 350. The engagement would have expanded to the second step goodwill impairment valuation if necessary; however, the findings showed the second step was not warranted. The analysis confirmed no impairment was likely. In quantitative testing done in 2018, the excess fair value of capital was $58.5 million or 51.1% over the carrying value and was over fourteen times the value of the goodwill being carried Therefore, the Bank concluded it is unlikely impairment of Goodwill has occurred from the goodwill established from the Bank's acquisition which occurred on December 31, 2007.

Other intangible assets consist of core deposit intangible assets arising from business acquisitions. They are initially measured at fair value and then are amortized on a straight line method over their estimated useful lives and evaluated for impairment. These assets are included in other assets on the consolidated balance sheets.

Off Balance Sheet Instruments

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Foreclosed Real Estate

Foreclosed real estate held for sale is carried at the lower of fair value minus estimated costs to sell, or cost. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and an allowance is established by a charge to non-interest expense if the carrying value exceeds the fair value minus the estimated costs to sell. Foreclosed real estate is classified as other real estate owned. The net loss from operations of foreclosed real estate held for sale is reported in non-interest expense. At December 31, the Bank's holding of other real estate owned totaled $600 thousand and approximately $674 thousand for 2018 and 2017, respectively.

Bank Premises and Equipment

Land is carried at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is based on the estimated useful lives of the various properties and is computed using straight line and accelerated methods. Costs for maintenance and repairs are charged to operations as incurred. Gains and losses on dispositions are included in current operations.

Revenue Recognition

Accounting Standards Codification 606, "Revenue from Contracts with Customer" (ASC 606) provides that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Revenue

generated from financial instruments, including loans and investment securities, are not included within the scope of ASC 606. The adoption of ASC 606 did not result in a change to the accounting for any of the Company's revenue streams that

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Note 1 – Summary of Significant Accounting Policies (Continued)

are within scope of the amendments. Revenue-generating activities that are within the scope of ASC 606 that are presented as non-interest income in the Company's consolidated statements of income include:

- Customer service fees – these include miscellaneous service fees and transaction-based fees charged for certain services, such as debit card or credit card. Revenue is recognized when the performance obligation is completed, which is generally after a transaction is completed or monthly for account maintenance services.
- Other service charges and fees – these include service fees charged for deposit account maintenance and activity along with transaction-based fees charged for certain services, such as overdraft activities, returned check charges and wire transfers. Revenue is recognized when the performance obligation is completed, which is generally after a transaction is completed or monthly for account maintenance services.

Federal Income Tax

The Company's income tax expense consists of the following components: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Company recognizes interest and penalties, if any, related to unrecognized tax benefits in tax expense. Based on management's analysis, the Company did not have any uncertain tax positions as of December 31, 2018 and 2017. With a few exceptions, the Company is no longer subject to U.S. Federal, state or local examinations by tax authorities for years before 2015.

Earnings Per Share

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. On August 18, 2017, the Company's Board of Directors authorized a two-for-one stock split payable on September 20, 2017, for shareholders of record on September 5, 2017. See Note 12 for additional information.

Stock-Based Compensation

The fair value of restricted common stock is their fair market value on the date of grant. The fair value of restricted stock is amortized as compensation expense on a straight-line basis over the vesting period of the grants. Compensation expense recognized is included in salaries and wages in the consolidated statements of income.

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2018, 2017, 2016

Note 1 – Summary of Significant Accounting Policies (Continued)

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Treasury Stock

Common stock shares repurchased are recorded at market value on date of purchase.

Other Comprehensive Income (Loss)

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of other comprehensive income (loss).

The company adopted ASU 2018-02 on January 1, 2018 and elected to reclassify the income tax effects of the Tax Cuts and Job Act from AOCI to retained earnings. The reclassification increased retained earnings and decreased AOCI by $359 thousand, with zero net effect on total stockholder's equity.

The components of other comprehensive income (loss) and related tax effects are as follows:

	(In Thousands)		
	2018	2017	2016
Net unrealized gain (loss) on available-for-sale securities	$(1,058)	$267	$(2,721)
Reclassification adjustment for (gain) loss on sale of available-for-sale securities	9	(47)	(588)
Net unrealized gain (loss) on available-for-sale securities	(1,049)	220	(3,309)
Tax expense (benefit)	(220)	74	(1,125)
Other comprehensive income (loss)	$(829)	$146	$(2,184)

Reclassification

Certain amounts in the 2017 and 2016 consolidated financial statements have been reclassified to conform with the 2018 presentation. These reclassifications had no effect on net income.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09 “Revenue from Contracts with Customers (Topic 606)” ASU 2014-09 requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. On July 9, 2015, the FASB approved amendments deferring the effective date by one year. ASU 2014-09 is now effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. The amendments can be applied retrospectively to each prior reporting period or retrospectively with

Note 1 – Summary of Significant Accounting Policies (Continued)

the cumulative effect of initially applying this Update recognized at the date of initial application. Early application was permitted but not before the original public entity effective date, i.e., annual periods beginning after December 15, 2016. The Company has adopted ASU 2014-09 on January 1, 2018 and ASU did not have a significant impact on its financial statements. Several of the Company's revenue streams were reviewed as a result of the standard.

In January 2016, the FASB issued ASU No. 2016-01 "Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities." ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in a accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company adopted ASU 2016-01 on January 1, 2018 and it did not have a material impact on the consolidated financial statement. The Bank's equity securities are membership stocks in the Federal Home Loan Bank and are thereby excluded from fair value pricing. For exit pricing on loans, the company used recent Merger and Acquisition Transaction Metrics compiled by S&P Global Market Intelligence for the second half of 2017. This provided the credit mark to be used along with the fair value adjustment based on the yield metrics of the portfolio.

In February 2016, the FASB issued ASU No. 2016-02 "Leases (Topic 842)." ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. Based on an initial analysis, the Company expects to record a right of use asset and corresponding liability in the amount of approximately $500 thousand.

In June 2016, FASB issued ASU No. 2016-13 "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform

their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration.

The ASU is effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). Early application will be permitted for all

Note 1 – Summary of Significant Accounting Policies (Continued)

organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company has contracted with an external advisor and has formed a committee to determine the methodology to be used. Most importantly, the Company is gathering as much data as possible to enable review scenarios and determine which calculations will produce the most reliable results. The Company is in the early stages of CECL conversion analysis with use of a third party service provider.

In November 2016, the FASB issued ASU No. 2016-18 "Statement of Cash Flows (Topic 230) – Restricted Cash." ASU-2016-18 provides amendments to cash flow statement classification and presentation to explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and should be applied using a retrospective transition method to each period presented. Early adoption is permitted including adoption in an interim period. The Company has adopted ASU 2016-18 on January 1, 2018 and does not currently have restricted cash or restricted cash equivalents. In the future, restricted cash or restricted cash equivalents will be presented in accordance with the guidance.

In January 2017, the FASB issued ASU No. 2017-01 "Business Combinations (Topic 805) – Clarifying the Definition of a Business." ASU 2017-01 provides amendments to clarify the definition of a business and affect all companies and other reporting organizations that must determine whether they have acquired or sold a business. The amendments are intended to help companies and other organizations evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and adoption is permitted under certain circumstances. The company has adopted ASU 2017-01 on January 1, 2018 and going forward will account for business combinations accordingly.

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

In March 2017, the FASB issued ASU No. 2017-08 "Receivables – Nonrefundable Fees and Other Cost (Subtopic 310-20), Premium Amortization on Purchased Callable Debit Securities." These amendments shorten the amortization period for certain callable debit securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company adopted this standard January 1, 2018. The impact of just over

$30 thousand of accelerated amortization expense was recorded as an adjustment to beginning retained earnings. This will not alter the Bank or Company's well capitalized status. The Bank's Municipal Tax-Exempt category of securities was the only category affected by the adoption.

In February 2018, the FASB issued ASU No. 2018-02 "Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." The amendments allow for the reclassification of stranded tax effects in accumulated other comprehensive income (AOCI) an option rather than a requirement; however, disclosure is required if not elected. The reclassification from accumulated other comprehensive income to retained earnings results from the newly enacted federal corporate income tax rate resulting from the Tax Cuts and Job Acts signed by President Trump in December 2017. The amount of the reclassification is the difference between the historical corporate income tax rate and the newly enacted corporate income tax rate of

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
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Note 1 – Summary of Significant Accounting Policies (Continued)

21%. Entities will have an option to adopt the standard retrospectively or in the period of adoption. The Company has adopted this standard on January 1, 2018 and reclassified approximately $359 thousand into retained earnings.

In March 2018, the FASB issued No. ASU 2018-05 "Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin (SAB) No. 118." These amendments add SEC guidance to the FASB Accounting Standards Codification regarding the Tax Cuts and Jobs Act pursuant to the issuance of SAB 118. The amendments were effective upon addition to the FASB Codification. The adoption did not have an impact on the Company.

In June 2018, the FASB issued ASU No. 2018-07 "Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting." These amendments expand the scope of Topic 718, Compensation – Stock Compensation (which currently only includes share-based payments to employees) to include share-based payments issued to nonemployees for goods or services. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially aligned. The ASU supersedes Subtopic 505-50, Equity – Equity-Based Payments to Non-Employees. The guidance is effective for public companies for fiscal years, and interim fiscal periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, but no earlier than a company's adoption date of Topic 606, Revenue from Contracts with Customers. At this time, the Company has adopted as of December 31, 2018 and does not recognize the existence of any non-employee relationships involving share-based payments.

In August 2018, the FASB issued ASU No. 2018-13 "Fair Value Measurement (Topic 820) - Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement." ASU 2018-13 modifies the disclosure requirements on fair value measurements in Topic 820. The amendments in this update remove disclosures that no longer are considered cost beneficial, modify/clarify the specific requirements of certain disclosures, and add disclosure requirements identified as relevant. ASU 2018-13 will be effective until years beginning after December 15, 2019, with early adoption permitted. The Company is in the process of evaluating and does not expect ASU 2018-13 to have a material impact on its accounting disclosures.

Note 2 – Business Combination & Asset Purchase

The Company recognized core deposit intangible assets of $1.17 million with the purchase of the Custar office on December 13, 2013. This is being amortized over an estimated remaining economic useful life of the deposits of 7 years on a straight line basis. The core deposit intangible is included in other assets on the consolidated balance sheets.

The amortization expense for the years ended December 31, 2018, 2017 and 2016 was $167, $245, and $323 thousand, respectively.

Amortization expense of the core deposit intangible assets remaining is as follows:

	Custar
2019	$ 167
2020	161

Total	$ 328

Note 3 - Securities

The amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

(In Thousands) 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
Available-for-Sale:				
U.S. Treasury	$23,078	$ 6	$ (254)	$22,830
U.S. Government agencies	71,235	2	(1,910)	69,327
Mortgage-backed securities	37,342	62	(1,142)	36,262
State and local governments	40,608	225	(805)	40,028
Total available-for-sale securities	$172,263	$ 295	$ (4,111)	$168,447

(In Thousands) 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
Available-for-Sale:				
U.S. Treasury	$21,219	$ -	$ (241)	$20,978
U.S. Government agencies	82,198	-	(1,732)	80,466
Mortgage-backed securities	40,236	64	(790)	39,510
State and local governments	55,512	437	(505)	55,444
Total available-for-sale securities	$199,165	$ 501	$ (3,268)	$196,398

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Note 3 – Securities (Continued)

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

1. The fair value of the security has significantly declined from book value.
2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB – by Standard and Poors.)
3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.
4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.
5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

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

Information pertaining to securities with gross unrealized losses at December 31, 2018 and 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

	2018 (In Thousands)		(In Thousands)	
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$-	$-	$(254)	$20,861
U.S. Government agencies	-	-	(1,910)	64,727
Mortgage-backed securities	(4)	697	(1,138)	30,347
State and local governments	(22)	3,254	(783)	29,413
Total available-for-sales securities	$(26)	$3,951	$(4,085)	$145,348

2017
(In Thousands) (In Thousands)

	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$(36)	$6,924	$(205)	$14,054
U.S. Government agencies	(314)	27,328	(1,418)	53,139
Mortgage-backed securities	(70)	7,149	(720)	28,080
State and local governments	(205)	24,999	(300)	11,567
Total available-for-sales securities	$(625)	$66,400	$(2,643)	$106,840

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Notes to Consolidated Financial Statements
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Note 3 – Securities (Continued)

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

Sales of $10.1, $13.6, and $85.7 million for 2018, 2017, and 2016 respectively, generated gross realized gains and losses for the years ended December 31, as presented below:

	(In Thousands)		
	2018	2017	2016
Gross realized gains	$51	$58	$598
Gross realized losses	(60)	(11)	(10)
Net realized gains (losses)	$(9)	$47	$588
Tax expense (benefit) related to net realized gains (losses)	$(2)	$16	$200

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

The amortized cost and fair value of debt securities at December 31, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(In Thousands)	
	Amortized Cost	Fair Value
One year or less	$29,477	$29,235
After one year through five years	67,009	65,755
After five years through ten years	37,154	36,000
After ten years	1,281	1,195
Total	$134,921	$132,185
Mortgage-backed securities	37,342	36,262
Total	$172,263	$168,447

Investments with a carrying value and fair value of $81.8 million at December 31, 2018 and $82.9 million at December 31, 2017 were pledged to secure public deposits and securities sold under repurchase agreements.

Other securities include Federal Home Loan Bank of Cincinnati stock as of December 31, 2018 and 2017.

Note 4 - Loans

The Company had $495 thousand in loans held for sale at December 31, 2018 as compared to $1.2 million in loans held for sale at December 31, 2017.

Loans at December 31 are summarized below:

	(In Thousands)	
Loans:	2018	2017
Consumer Real Estate	$80,766	$83,620
Agricultural Real Estate	68,609	64,073
Agricultural	108,495	95,111
Commercial Real Estate	419,784	410,520
Commercial and Industrial	121,793	126,275
Consumer	41,953	37,757
Industrial Development Bonds	5,889	6,415
	$847,289	$823,771
Less: Net deferred loan fees and costs	(915)	(747)
	846,374	823,024
Less: Allowance for loan losses	(6,775)	(6,868)
Loans - Net	$839,599	$816,156

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

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

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

Agricultural: Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re-finance of capital assets such as machinery and equipment and livestock. The production of crops and livestock is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmer’s ability to hedge their position by the use of the future contracts. The risk related to weather is often mitigated by requiring crop insurance.

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

before granting loan approval.

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

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

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

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Note 4 – Loans (Continued)

The following is a maturity schedule by major category of loans at December 31, 2018:

	(In Thousands)			
	Within One Year	After One Year Within Five Years	After Five Years	Total
Consumer Real Estate	$4,226	$16,495	$60,045	$80,766
Agricultural Real Estate	615	4,818	63,176	68,609
Agricultural	70,505	28,073	9,917	108,495
Commercial Real Estate	16,339	160,783	242,662	419,784
Commercial and Industrial	61,382	52,678	7,733	121,793
Consumer	5,211	27,369	9,373	41,953
Industrial Development Bonds	600	270	5,019	5,889
	$158,878	$290,486	$397,925	$847,289

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of December 31, 2018:

	(In Thousands)	
	Fixed Rate	Variable Rate
Consumer Real Estate	$35,174	$45,592
Agricultural Real Estate	49,717	18,892
Agricultural	37,053	71,442
Commercial Real Estate	265,197	154,587
Commercial and Industrial	45,934	75,859
Consumer	37,487	4,466
Industrial Development Bonds	5,889	-

Industrial Development Bonds are included in the commercial and industrial category for the remainder of the tables in this Note 4, unless specifically noted separately.

The following table represents the contractual aging of the recorded investment in past due loans by portfolio classification of loans as of December 31, 2018 and 2017, net of deferred loan fees and costs:

December 31, 2018	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Consumer Real Estate	$ 342	$ 24	$ 254	$ 620	$ 79,612	$ 80,232	$ -
Agricultural Real Estate	-	-	-	-	68,588	68,588	-
Agricultural	-	-	-	-	108,616	108,616	-
Commercial Real Estate	-	-	-	-	419,131	419,131	-
Commercial and Industrial	-	-	-	-	127,752	127,752	-
Consumer	85	24	8	117	41,938	42,055	-
Total	$ 427	$ 48	$ 262	$ 737	$ 845,637	$ 846,374	$ -

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2018, 2017, 2016

Note 4 – Loans (Continued)

December 31, 2017	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Consumer Real Estate	$ 565	$ 212	$ 113	$ 890	$ 82,310	$ 83,200	$ -
Agricultural Real Estate	-	-	101	101	63,943	64,044	-
Agricultural	-	-	-	-	95,238	95,238	-
Commercial Real Estate	-	-	38	38	409,915	409,953	-
Commercial and Industrial	-	42	-	42	132,745	132,787	-
Consumer	34	2	7	43	37,759	37,802	-
Total	$ 599	$ 256	$ 259	$ 1,114	$ 821,910	$ 823,024	$ -

The following table presents the recorded investment in nonaccrual loans by portfolio class of loans as of December 31, 2018 and December 31, 2017:

	(In Thousands)	
	2018	2017
Consumer Real Estate	$ 462	$ 708
Agricultural Real Estate	-	101
Agriculture	-	-
Commercial Real Estate	-	38
Commercial and Industrial	72	149
Consumer	8	7
Total	$ 542	$ 1,003

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

The risk ratings are described as follows.

1. Zero (0) Unclassified. Any loan which has not been assigned a classification.
2. One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of Risk Management Association ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No

credit or collateral exceptions exist and the loan adheres to the Bank's loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.

3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50, and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.
4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk – having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage

Note 4 – Loans (Continued)

position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans are meeting the terms of repayment.

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

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

a. At inception, the loan was secured with collateral possessing a loan-to-value adequate to protect the Bank from loss;
b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;
c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of these credit weaknesses are observed, a lower risk grade is warranted.

5. Four (4) Satisfactory / Monitored. A "4" (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines so long as the loan is given management supervision.
6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserve close attention but do not yet warrant substandard classification. Such loans pose unwarranted financial risk that if not corrected could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered "potential" versus "defined" impairments to the primary source of loan repayment and collateral.
7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:

a. Loans which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source and are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.
c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
e. Unusual courses of action are needed to maintain a high probability of repayment.
f. The borrower is not generating enough cash flow to repay loan principal but continues to make interest payments.
g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.
h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.

Farmers & Merchants Bancorp, Inc. and Subsidiaries

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Note 4 – Loans (Continued)

i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan
j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:
a. Loans have all of the weaknesses of those classified as Substandard. Additionally, these weaknesses make collection or liquidation in full based on existing conditions improbable.
b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.
c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.

9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

The following table represents the risk category of loans by portfolio class, net of deferred fees, based on the most recent analysis performed as of the time periods shown of December 31, 2018 and December 31, 2017.

(In Thousands)	Agricultural Real Estate		Agricultural		Commercial Real Estate		Commercial and Industrial		Industrial Development Bonds	
	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017
1-2	$4,442	$4,143	$5,753	$6,558	$4,698	$1,244	$3,199	$9,205	$-	$-
3	14,118	15,244	38,852	37,267	64,341	32,498	16,284	15,277	3,135	3,489
4	49,596	43,416	63,380	51,312	346,072	359,600	100,644	99,581	2,754	2,926
5	422	1,125	631	101	2,171	7,758	308	1,381	-	-
6	10	116	-	-	1,849	8,853	542	817	-	-
7	-	-	-	-	-	-	886	111	-	-
8	-	-	-	-	-	-	-	-	-	-
Total	$68,588	$64,044	$108,616	$95,238	$419,131	$409,953	$121,863	$126,372	$5,889	$6,415

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, which was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of December 31, 2018 and December 31, 2017.

(In Thousands)
Consumer Real Estate

	2018	2017
Grade		
Pass	$79,121	$82,300
Special mention (5)	232	-
Substandard (6)	879	820
Doubtful (7)	-	80
Total	$80,232	$83,200

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Farmers & Merchants Bancorp, Inc. and Subsidiaries

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Note 4 – Loans (Continued)

	(In Thousands)			
	Consumer - Credit Card		Consumer - Other	
	2018	2017	2018	2017
Performing	$3,909	$4,108	$38,073	$33,666
Nonperforming	19	-	54	28
Total	$3,928	$4,108	$38,127	$33,694

Information about impaired loans as of and for the years ended December 31, 2018 and 2017 are as follows:

	(In Thousands)	
	2018	2017
Impaired loans without a valuation allowance	$1,808	$1,131
Impaired loans with a valuation allowance	246	614
Total impaired loans	$2,054	$1,745
Valuation allowance related to impaired loans	$31	$106
Total non-accrual loans	$542	$1,003
Total loans past-due ninety days or more and still accruing	$-	$-

	(In Thousands)		
	2018	2017	2016
Average investment in impaired loans	$1,958	$1,885	$1,802
Interest income recognized on impaired loans	$69	$57	$64
Interest income recognized on a cash basis on impaired loans	$17	$23	$27

Additional funds of $7 thousand are committed to be advanced in connection with impaired loans.

The Bank had approximately $178 thousand and $0.7 million of its impaired loans classified as troubled debt restructured as of December 31, 2018 and December 31, 2017.

Farmers & Merchants Bancorp, Inc. and Subsidiaries

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Note 4 – Loans (Continued)

The following table represents the years ended December 31, 2018 and 2017.

December 31, 2018		(In thousands)		December 31, 2017		(In thousands)	
Troubled Debt Restructurings	Number of Contracts Modified in the Last 12 Months	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Troubled Debt Restructurings	Number of Contracts Modified in the Last 12 Months	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and Industrial	-	-	-	Commercial and Industrial	1	38	38

For the years ended December 31, 2018 and 2017, there were no TDR's that subsequently defaulted after modification.

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

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

Note 4 – Loans (Continued)

The following tables present loans individually evaluated for impairment by portfolio class of loans as of December 31, 2018 and 2017:

2018	(In Thousands) Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
With no related allowance recorded:						
Consumer Real Estate	$583	$ 583	$ -	$ 562	$ 31	$ 17
Agricultural Real Estate	-	-	-	17	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	194	194	-	198	11	-
Commercial and Industrial	1,031	1,031	-	438	25	-
Consumer	-	-	-	-	-	-
With a specific allowance recorded:						
Consumer Real Estate	174	174	26	158	-	-
Agricultural Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	-	-	-	140	-	-
Commercial and Industrial	72	72	5	445	2	-
Consumer	-	-	-	-	-	-
Totals:						
Consumer Real Estate	$757	$ 757	$ 26	$ 720	$ 31	$ 17
Agricultural Real Estate	$-	$ -	$ -	$ 17	$ -	$ -
Agricultural	$-	$ -	$ -	$ -	$ -	$ -
Commercial Real Estate	$194	$ 194	$ -	$ 338	$ 11	$ -
Commercial and Industrial	$1,103	$ 1,103	$ 5	$ 883	$ 27	$ -
Consumer	$-	$ -	$ -	$ -	$ -	$ -

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2018, 2017, 2016

Note 4 – Loans (Continued)

(In Thousands)

2017	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
With no related allowance recorded:						
Consumer Real Estate	$495	$ 495	$ -	$ 911	$ 30	$ 21
Agricultural Real Estate	101	101	-	123	-	-
Agricultural	-	-	-	27	-	-
Commercial Real Estate	202	202	-	51	1	-
Commercial and Industrial	333	333	-	85	2	-
Consumer	-	-	-	-	-	-
With a specific allowance recorded:						
Consumer Real Estate	80	80	21	88	-	-
Agricultural Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	423	423	46	486	24	2
Commercial and Industrial	111	111	39	114	-	-
Consumer	-	-	-	-	-	-
Totals:						
Consumer Real Estate	$575	$ 575	$ 21	$ 999	$ 30	$ 21
Agricultural Real Estate	$101	$ 101	$ -	$ 123	$ -	$ -
Agricultural	$-	$ -	$ -	$ 27	$ -	$ -
Commercial Real Estate	$625	$ 625	$ 46	$ 537	$ 25	$ 2
Commercial and Industrial	$444	$ 444	$ 39	$ 199	$ 2	$ -
Consumer	$-	$ -	$ -	$ -	$ -	$ -

As of December 31, 2018 the Company had $61 thousand of foreclosed residential real estate property obtained by physical possession and $278 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions. This compares to the Company having $25 thousand of foreclosed residential real estate property obtained by physical possession and $55 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions as of December 31, 2017.

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

The following is an analysis of the allowance for credit losses for the years ended December 31:

(In Thousands)

	2018	2017	2016
Allowance for Loan Losses			
Balance at beginning of year	$6,868	$6,784	$6,057
Provision for loan loss	324	222	1,121
Loans charged off	(580)	(288)	(550)
Recoveries	163	150	156
Balance at ending of year	$6,775	$6,868	$6,784
Allowance for Unfunded Loan Commitments & Letters of Credit	$274	$227	$217
Total Allowance for Credit Losses	$7,049	$7,095	$7,001

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Note 4 – Loans (Continued)

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

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

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

Note 4 – Loans (Continued)

Additional analysis related to the allowance for credit losses as of December 31, 2018 and 2017 is as follows:

(In Thousands)

2018	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	$343	$244	$667	$3,149	$1,546	$441	$227	$478	$7,095
Charge Offs	(63)	-	-	(16)	(142)	(359)	-	-	(580)
Recoveries	18	-	8	10	13	114	-	-	163
Provision (Credit)	(51)	6	93	74	(112)	288	-	26	324
Other Non-interest expense related to unfunded	-	-	-	-	-	-	47	-	47
Ending Balance	$247	$250	$768	$3,217	$1,305	$484	$274	$504	$7,049
Ending balance: individually evaluated for impairment	$26	$-	$-	$-	$5	$-	$-	$-	$31
Ending balance: collectively evaluated for impairment	$221	$250	$768	$3,217	$1,300	$484	$274	$504	$7,018
Ending balance: loans acquired with deteriorated credit quality	$-	$-	$-	$-	$-	$-	$-	$-	$-
FINANCING RECEIVABLES:									
Ending balance	$80,232	$68,588	$108,616	$419,131	$127,752	$42,055	$-	$-	$846,374

Ending balance: individually evaluated for impairment	$757	$-	$-	$194	$1,103	$-	$-	$-	$2,054
Ending balance: collectively evaluated for impairment	$79,475	$68,588	$108,616	$418,937	$126,649	$42,055	$-	$-	$844,320

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Farmers & Merchants Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2018, 2017, 2016

Note 4 – Loans (Continued)

(In Thousands)

2017	Consumer Real Estate	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Consumer	Unfunded Loan Commitment & Letters of Credit	Unallocated	Total
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	$316	$241	$616	$3,250	$1,318	$394	$ 217	$ 649	$7,001
Charge Offs	(4)	-	-	(21)	-	(263)	-	-	(288)
Recoveries	13	-	8	15	12	102	-	-	150
Provision (Credit)	18	3	43	(95)	216	208	-	(171)	222
Other Non-interest expense related to unfunded	-	-	-	-	-	-	10	-	10
Ending Balance	$343	$244	$667	$3,149	$1,546	$441	$ 227	$ 478	$7,095
Ending balance: individually evaluated for impairment	$21	$-	$-	$46	$39	$-	$ -	$ -	$106
Ending balance: collectively evaluated for impairment	$322	$244	$667	$3,103	$1,507	$441	$ 227	$ 478	$6,989
Ending balance: loans acquired with deteriorated credit quality	$-	$-	$-	$-	$-	$-	$ -	$ -	$-
FINANCING RECEIVABLES:									
Ending balance	$83,200	$64,044	$95,238	$409,953	$132,787	$37,802	$ -	$ -	$823,024
Ending balance: individually	$575	$101	$-	$625	$444	$-	$ -	$ -	$1,745

evaluated for impairment									
Ending balance: collectively evaluated for impairment	$82,625	$63,943	$95,238	$409,328	$132,343	$37,802	$ -	$ -	$821,279

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Note 5 - Premises and Equipment

The major categories of banking premises and equipment and accumulated depreciation at December 31 are summarized below:

	(In Thousands)	
	2018	2017
Land	$5,917	$5,892
Buildings (useful life 15-39 years)	24,489	23,977
Furnishings (useful life 3-15 years)	15,203	13,351
	45,609	43,220
Less: Accumulated depreciation	(22,997)	(21,603)
Premises and Equipment (Net)	$22,612	$21,617

Depreciation expense for the years ended December 31, 2018, 2017 and 2016 amounted to $1.7, $1.6, and $1.5 million, respectively.

Construction in progress of $3 thousand as of December 31, 2018 related to environmental and foundation study expenses incurred for new construction in Fort Wayne, Indiana to be opened in 2019. Construction in progress of $109 thousand as of December 31, 2017 represented remodeling expenses incurred for the Findlay office opened in first quarter 2018.

Note 6 - Servicing

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of loans serviced for others were $289.2 and $288.6 million at December 31, 2018 and 2017, respectively.

The balance of capitalized servicing rights included in other assets at December 31, 2018 and 2017, was $2.4 and $2.3 million, respectively. The capitalized addition of servicing rights is included in net gain on sale of loans on the consolidated statement of income.

The fair market value of the capitalized servicing rights as of December 31, 2018 and 2017 was $3.3 million and $3.1 million, respectively. The valuations were completed by stratifying the loans into like groups based on loan type and term. Impairment was measured by estimating the fair value of each stratum, taking into consideration an estimated level of prepayment based upon current market conditions. An average constant prepayment rate of 8.9% and 10.4% were utilized for 2018 and 2017, respectively. All stratums showed positive values compared to carrying value using a discount yield of 6.60% for 2018 and 6.07% for 2017.

The following summarizes mortgage servicing rights capitalized and amortized during each year:

(In Thousands)

	2018	2017
Beginning Year	$2,299	$2,192
Capitalized Additions	450	460
Amortization	(364)	(353)
Valuation Allowance	-	-
End of Year	$2,385	$2,299

Note 7 - Deposits

Time deposits as of December 31 consist of the following:

	(In Thousands)	
	2018	2017
Time deposits under $250,000	$165,528	$165,866
Time deposits of $250,000 or more	21,885	21,700
	$187,413	$187,566

At December 31, 2018 the scheduled maturities for time deposits are as follows:

	(In Thousands)
2019	$ 88,388
2020	44,517
2021	27,980
2022	16,070
2023	9,904
Thereafter	554
	$ 187,413

Note 8 – Federal Funds Purchased and Securities Sold Under Agreement to Repurchase

The Bank’s policy requires qualifying securities to be used as collateral for the underlying repurchase agreements. As of December 31, 2018 and 2017 securities with a market value of $34.9 million and $35.9 million, respectively, were pledged to secure the repurchase agreements. The table below presents the daily securities sold under agreement to repurchase and the term repurchase agreements. It does not include the Bank’s Federal Funds purchased.

Daily Securities Sold Under Agreement to Repurchase

	Amount Outstanding at End of Period (000's)	Weighted Average Rate End of Period	Maximum Amount Borrowings Outstanding Month End (000's)	Approximate Average Outstanding in Period (000's)	Approximate Weighted Average Interest Rate For the Period
2018	$806	1.04 %	$ 819	$ 1,026	1.12 %
2017	$6,145	1.19 %	$ 14,929	$ 10,253	0.96 %

Term CD's Sold Under Agreement to Repurchase

	Amount Outstanding at End of Period (000's)	Weighted Average Rate End of Period	Maximum Amount Borrowings Outstanding Month End (000's)	Approximate Average Outstanding in Period (000's)	Approximate Weighted Average Interest Rate For the Period
2018	$24,889	2.00 %	$ 24,889	$ 23,793	1.87 %
2017	$22,925	1.97 %	$ 22,925	$ 21,172	1.81 %

Note 8 – Federal Funds Purchased and Securities Sold Under Agreement to Repurchase (Continued)

The Company had $6.5 and $10.4 million of Federal Funds Purchased as of December 31, 2018 and December 31, 2017 respectively. The $25.7 million in Securities Sold Under Agreements to Repurchase were comprised of U.S. Treasuries and government agency securities. The table below shows the remaining contractual maturity in the repurchase agreements and the collateral pledged as of December 31, 2018.

	December 31, 2018				
	Remaining Contractual Maturity of the Agreements				
	Overnight & Continuous	Up to 30 days	30-90 days	Greater Than 90 days	Total
Federal funds purchased	$6,486				$6,486
Repurchase agreements					
US Treasury & agency securities	806			24,889	25,695
Total	$7,292	$ -	$ -	$ 24,889	$32,181

Note 9 - Federal Home Loan Bank Advances

Long term debit consists of various loans from the Federal Home Loan Bank. Repayment structures vary, ranging from monthly installments, annual payments or upon maturity. Interest payments are due monthly. Total borrowings were $0.0 million and $5.0 million for December 31, 2018 and 2017, respectively. The advances were secured by $14.9 and $17.3 million of mortgage loans as of December 31, 2018 and 2017, respectively under a blanket collateral agreement.

The advances are subject to pre-payment penalties and the provisions and conditions of the credit policy of the Federal Home Loan Bank.

The Bank had access to $69 million unsecured borrowings through correspondent banks as of both December 31, 2018 and December 31, 2017. $73.7 million and $94.6 million at the end of the same time periods, respectively, were unpledged securities which could be sold or used as collateral. An additional $9.0 million at December 31, 2018, and $5.7 million at December 31, 2017, were available from the Federal Home Loan Bank based on current pledging, with up to $119.0 million and $116.8 million, respectively, available provided adequate collateral is pledged.

Note 10 - Federal Income Taxes

The Tax Cuts and Jobs Act was enacted on December 22, 2017. Among other things, the new law (i) establishes a new, flat corporate federal statutory income tax rate of 21%, (ii) eliminates the corporate alternative minimum tax and allows the use of any such carryforwards to offset regular tax liability for any taxable year, (iii) limits the deduction for net interest expense incurred by U.S. corporations, (iv) allows businesses to immediately expense, for tax purposes, the cost of new investments in certain qualified depreciable assets, (v) eliminates or reduces certain deductions related to meals and entertainment expenses, (vi) modifies the limitation on excessive employee

remuneration to eliminate the exception for performance-based compensation and clarifies the definition of a covered employee and (vii) limits the deductibility of deposit insurance premiums. The Tax Cuts and Jobs Act also significantly changes U.S. tax law related to foreign operations, however, such changes do not currently impact us.

As stated above, as a result of the enactment of the Tax Cuts and Jobs Act on December 22, 2017, we remeasured our deferred tax assets and liabilities based upon the newly enacted U.S. statutory federal income tax rate of 21%, which is the tax rate at which these assets and liabilities are expected to reverse in the future. We recognized a net tax benefit related to the remeasurement of our deferred tax assets and liabilities totaling $8 thousand in 2017.

Note 10 – Federal Income Taxes (Continued)

The components of income tax expense (benefit) for the years ended December 31 are as follows:

	(In Thousands)		
	2018	2017	2016
Current:			
Federal	$2,755	$5,162	$4,601
Deferred:			
Federal	472	29	55
Federal - impact of enacted changes in tax law	-	(8)	-
	$3,227	$5,183	$4,656

The following is a reconciliation of the statutory federal income tax rate to the effective tax rate:

	(In Thousands)		
	2018	2017	2016
Income tax at statutory rates	$3,758	$6,045	$5,521
Decrease resulting from:			
Tax exempt interest	(220)	(413)	(468)
Adjustment of deferred taxes for enacted changes in tax law	-	(8)	-
Section 831 deduction	(236)	(318)	(351)
Change in other	(75)	(123)	(46)
	$3,227	$5,183	$4,656

Deferred tax assets and liabilities at December 31 are comprised of the following:

	(In Thousands)	
	2018	2017
Deferred Tax Assets:		
Allowance for loan losses	$1,444	$1,464
Other	505	399
Net unrealized loss on available-for-sale securities	802	581
Total deferred tax assets	2,751	2,444
Deferred Tax Liabilities:		
Accreted discounts on bonds	29	55
FHLB stock dividends	462	462

Mortgage servicing rights	508	490
Other	1,751	1,185
Total deferred tax liabilities	2,750	2,192
Net Deferred Tax Asset	$1	$252

Note 11 - Employee Benefit Plans

The Bank has established a 401(k) profit sharing plan, which allows eligible employees to save at a minimum one percent of eligible compensation on a pre-tax basis, subject to certain Internal Revenue Service limitations. The Bank will match 50% of employee 401(k) contributions up to four percent of total eligible compensation. In addition, the Bank may make a discretionary contribution from time to time. A participant is 100% vested in the participant's deferral contributions and employer matching contributions. A six-year vesting schedule applies to employer discretionary contributions. Contributions expensed for the 401(k) profit sharing plan for both the employer matching contribution and the discretionary contribution were $1.1 million, $972 thousand and $877 thousand for 2018, 2017 and 2016, respectively.

Note 11 – Employee Benefit Plans (Continued)

Restricted Stock Awards

The Company has a Long-Term Stock Incentive Plan under which 33,000 shares of restricted stock were issued to 80 employees during 2018, 32,000 shares of restricted stock were issued to 74 employees during 2017 and 32,300 shares of restricted stock were issued to 74 employees during 2016. Under the plan, the shares vest 100% in three years. During the 3 year vesting period, the employees receive dividends or dividend equivalent compensation on the shares. Due to employee termination, there were 2,620, 1,080, and 1,546 forfeited during 2018, 2017 and 2016, respectively. During 2017, one employee retired and received 640 shares from the shares awarded in 2014, 2015 and 2016. During 2016, due to retirement, four employees received 2,394 shares from awards granted in 2013, 2014 and 2015. During 2018, 28,790 shares awarded in 2015 were 100% vested and 56 employees received the stock. During 2017, 24,230 shares awarded in 2014, were vested 100% and 52 employees received the stock. During 2016, 20,050 shares awarded in 2013, were vested 100% and 45 employees received the stock. Compensation expense applicable to the restricted stock awards totaled $745 thousand, $507 thousand and $402 thousand for the years ending December 31, 2018, 2017 and 2016, respectively.

The table below summarizes the details of the restricted shares issued, vested, and forfeited for the years ending December 31, 2018, 2017 and 2016.

	Year Ended December 31,					
	2018		2017		2016	
	Number of Shares	Number of Employees	Number of Shares	Number of Employees	Number of Shares	Number of Employees
Restricted shares issued	33,000	80	32,000	74	32,300	74
Restricted shares vested	28,790	56	24,230	52	20,050	45
Restricted shares awarded due to retirement	-	-	640	1	2,394	4
Restricted shares forfeited	2,620	5	1,080	2	1,546	2

The following table summarizes the activity of restricted stock awards as of December 31:

	Year Ended December 31,					
	2018		2017		2016	
	Number of Shares	Weighted average fair value per award	Number of Shares	Weighted average fair value per award	Number of Shares	Weighted average fair value per award
Beginning of period	92,350	19.17	86,300	14.10	77,990	12.46

Granted	33,000	44.63	32,000	27.79	32,300	16.01
Vested	(28,790)	13.18	(24,870)	12.81	(22,444)	11.16
Forfeited	(2,620)	44.04	(1,080)	37.06	(1,546)	15.77
Nonvested, end of period	93,940	29.87	92,350	19.17	86,300	14.10

As of December 31, 2018, there was $1.9 million of unrecognized compensation cost related to the nonvested portion of restricted stock awards under the plan.

Note 12 – Earnings Per Share

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

The table below presents basic and diluted earnings per share for the years ended December 31, 2018, 2017, and 2016.

	Year Ended December 31, 2018	December 31, 2017	December 31, 2016
Earnings per share			
Net income	$14,949	$ 12,720	$ 11,664
Less: distributed earnings allocated to participating securities	(52)	(45)	(37)
Less: undistributed earnings allocated to participating securities	(98)	(77)	(64)
Net earnings available to common shareholders	$14,799	$ 12,598	$ 11,563
Weighted average common shares outstanding including participating securities	9,272,964	9,250,825	9,224,230
Less: average unvested restricted shares	(93,000)	(88,664)	(79,964)
Weighted average common shares outstanding	9,179,964	9,162,161	9,144,266
Basic and diluted earnings per share	$1.61	$ 1.38	$ 1.27

Note 13 – Related Party Transactions

In the ordinary course of business, the Bank has granted loans to senior officers and directors and their affiliated companies amounting to $1.5 million and $1.5 million at December 31, 2018 and 2017, respectively. Two new loans were approved during 2018 of which no additional borrowings were utilized. During 2018, subsequent advances

totaled $9.4 million and payments of $9.5 million were received. The difference in related borrowings amounted to $45 thousand, net decrease. Deposits of directors, executive officers and companies in which they have a direct or indirect ownership as of December 31, 2018 and 2017, amounted to $26.1 million and $23.4 million, respectively.

Note 14 - Off Balance Sheet Activities

Credit Related Financial Instruments

The Bank is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing need of its customers. These financial instruments include commitments to extend credit, Standby Letters of Credit, and Commercial Letters of Credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

Note 14 – Off Balance Sheet Activities (Continued)

The Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policies in making commitments as it does for on-balance-sheet instruments. The allowance for credit losses as it relates to unfunded loan commitments (AULC) is included under other liabilities. The AULC as of December 31, 2018 and 2017 was $274 thousand and $227 thousand, respectively.

At December 31, 2018 and 2017, the following financial instruments were outstanding whose contract amounts represent credit risk:

	(In Thousands)	
	2018	2017
Commitments to extend credit	$267,166	$237,774
Credit card arrangements	20,993	20,184
Standby letters of credit	691	791

Commitments to extend credit, credit card arrangements and Standby Letters of Credit all include exposure to some credit loss in the event of nonperformance of the customer. The Bank's credit policies and procedures for credit commitments and financial guarantees are the same as those for extensions of credit that are recorded in the financial statements. Due to the fact that these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they generally do not present any significant liquidity risk to the Bank.

Collateral Requirements

To reduce credit risk related to the use of credit-related financial instruments, the Bank might deem it necessary to obtain collateral. The amount and nature of the collateral obtained is based on the Bank's credit evaluation of the customer. Collateral held varies but may include cash, securities, accounts receivable, inventory, property, plant, and real estate.

Legal Contingencies

Various legal claims also arise from time to time in the normal course of business, which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

Note 15 - Minimum Regulatory Capital Requirements

The Company (on a consolidated basis) 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 additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and 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 their assets, liabilities and certain off balance-sheet items as calculated under regulatory accounting practices.

The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

The Basel III Capital Rules, a new comprehensive capital framework for U.S. banking organizations, became effective for on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of Common Equity Tier 1 capital, Tier 1 capital and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

In connection with the adoption of the Basel III Capital Rules, we elected to opt-out of the requirement to include most components of accumulated other comprehensive income in Common Equity Tier 1.

Common Equity Tier 1 is reduced by, goodwill and other intangible assets, net of associated deferred tax liabilities, and subject to transition provisions.

Note 15 – Minimum Regulatory Capital Requirements (Continued)

The Common Equity Tier 1 (beginning in 2015), Tier 1 and Total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, with certain exclusions, allocated by risk weight category, and certain off-balance-sheet items, among other things. The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets, among other things.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The capital conservation buffer was 1.875% at December 31, 2018. The Basel III Capital Rules also provide for a “countercyclical capital buffer” that is applicable to only certain covered institutions and does not have any current applicability to the Company or Bank. The capital conservation buffer is designed to absorb losses during periods of economic stress and, as detailed above, effectively increases the minimum required risk-weighted capital ratios. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets below the effective minimum (4.5% plus the capital conservation buffer and, if applicable, the countercyclical capital buffer) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

Management believes, as of December 31, 2018, that the Bank meets all the capital adequacy requirements to which it is subject.

As of December 31, 2018 the most recent notification from the FDIC indicated the Bank was categorized as well capitalized under the regulatory framework for prompt corrective action. To remain categorized as well capitalized, the Bank will have to maintain minimum total risk-based, Tier I risk-based, Common Tier 1 and Tier I leverage ratios as disclosed in the table to follow. There are no conditions or events since the most recent notification that management believes have changed the Bank’s prompt corrective action category.

The following tables present actual and required capital ratios as of December 31, 2018 and December 31, 2017 under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2018 and December 31, 2017. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

Note 15 – Minimum Regulatory Capital Requirements (Continued)

The Company and the Bank's actual and required capital amounts and ratios as of December 31, 2018 are as follows:

As of December 31, 2018	Actual (000's) Amount	Ratio	Minimum Capital Required (000's) Amount	Ratio	Required to be Considered Well-Capitalized (000's) Amount	Ratio
Common Equity Tier 1 Capital (to Risk Weighted Assets) Consolidated	N/A	N/A	N/A	N/A	N/A	N/A
Farmers & Merchants State Bank	114,978	12.67 %	40,834	4.50 %	58,983	6.50 %
Total Risk-Based Capital (to Risk Weighted Assets) Consolidated	N/A	N/A	N/A	N/A	N/A	N/A
Farmers & Merchants State Bank	122,027	13.45 %	72,594	8.00 %	90,743	10.00 %
Tier 1 Capital (to Risk Weighted Assets) Consolidated	N/A	N/A	N/A	N/A	N/A	N/A
Farmers & Merchants State Bank	114,978	12.67 %	54,446	6.00 %	72,594	8.00 %
Tier 1 Leverage Capital (to Adjusted Total Assets) Consolidated	N/A	N/A	N/A	N/A	N/A	N/A
Farmers & Merchants State Bank	114,978	10.54 %	43,644	4.00 %	54,555	5.00 %

With the enactment of the Economic Growth, Regulatory Relief and Consumer Protection Act on May 24, 2018, the Company is no longer required to file the FR Y-9C consolidated financial statements for holding companies but will file the FR Y-9SP parent company only financial statements for small holding companies. As a result, the consolidated amounts and ratios are no longer required beginning in 2018.

The following table presents the Company and the Bank's actual and required capital amounts and ratios as of December 31, 2017.

Actual

As of December 31, 2017	(000's) Amount	Ratio	Minimum Capital Required (000's) Amount	Ratio	Required to be Considered Well-Capitalized (000's) Amount	Ratio
Common Equity Tier 1 Capital (to Risk Weighted Assets) Consolidated	$131,493	14.73 %	$40,177	4.50 %	N/A	N/A
Farmers & Merchants State Bank	107,006	12.04 %	39,992	4.50 %	$ 57,767	6.50 %
Total Risk-Based Capital (to Risk Weighted Assets) Consolidated	138,588	15.52 %	71,426	8.00 %	N/A	N/A
Farmers & Merchants State Bank	114,101	12.84 %	71,098	8.00 %	88,872	10.00 %
Tier 1 Capital (to Risk Weighted Assets) Consolidated	131,493	14.73 %	53,569	6.00 %	N/A	N/A
Farmers & Merchants State Bank	107,006	12.04 %	53,323	6.00 %	71,098	8.00 %
Tier 1 Leverage Capital (to Adjusted Total Assets) Consolidated	131,493	12.02 %	43,765	4.00 %	N/A	N/A
Farmers & Merchants State Bank	107,006	9.92 %	43,148	4.00 %	53,935	5.00 %

The above tables exclude the capital conservation buffer requirements.

Note 16 - Restrictions of Dividends & Inter-company Borrowings

The Bank is restricted as to the amount of dividends that can be paid. Dividends declared by the Bank that exceed the net income for the current year plus retained income for the preceding two years must be approved by federal and state regulatory agencies. Under this formula dividends of $18.3 million may be paid without prior regulatory approval. Regardless of formal regulatory restrictions, the Bank may not pay dividends that would result in its capital levels being reduced below the minimum requirements shown above. Under current Federal Reserve regulations, the Bank is limited as to the amount and type of loans it may make to the Company. These loans are subject to qualifying collateral requirements on which the amount of the loan may be based.

Note 17 - Fair Value of Financial Instruments

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

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

Cash and Cash Equivalents

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

Interest Bearing Time Deposits

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

Securities – Available-for-sale

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

Other Securities

The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

Loans Held for Sale

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

Loans, net

For 2018, the fair values of the loans are estimated using a credit mark adjustment along with discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality. The credit mark adjustment was estimated using merger and acquisition analysis of nationwide bank and thrift deals.

For 2017, the fair values used for net variable-rate loans that reprice frequently, and with no significant change in credit risk, fair values are based on carrying values. The fair values of the fixed rate and all other loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality.

Deposits

The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair value at the reporting date. Fair value for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Federal Funds Purchased and Securities Sold Under Agreement to Repurchase

The carrying value of Federal Funds purchased and securities sold under agreement to repurchase approximates fair values.

FHLB Advances

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

Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate fair values.

Off Balance Sheet Financial Instruments

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

Farmers & Merchants Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements
December 31, 2018, 2017, 2016

Note 17 – Fair Value of Financial Instruments (Continued)

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of December 31, 2018 and 2017, are reflected below. The aggregate fair values in the table below do not represent the total market value of the Bank's assets and liabilities. The table excludes the following: Bank Premises and Equipment, Goodwill, Mortgage Servicing Rights, Other Real Estate Owned, Other Assets, Other Liabilities and Accrued Expenses.

	(In Thousands) December 31, 2018					December 31, 2017				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial Assets:										
Cash and cash equivalents	$38,365	$38,365	$38,365	$-	$-	$34,467	$34,467	$34,467	$-	$-
Interest-bearing time deposits	4,019	3,954	-	3,954	-	4,018	4,009	-	4,009	-
Securities - available-for-sale	168,447	168,447	36,935	130,085	1,427	196,398	196,398	20,978	173,992	1,428
Other securities	3,679	3,679	-	-	3,679	3,679	3,679	-	-	3,679
Loans held for sale	495	495	-	-	495	1,221	1,221	-	-	1,221
Loans, net	839,599	823,914	-	-	823,914	816,156	819,193	-	-	819,193
Interest receivable	4,542	4,542	-	-	4,542	4,276	4,276	-	-	4,276
Financial Liabilities:										