FARMERS & MERCHANTS BANCORP INC
Form 10-K
February 26, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

þ **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2009

or

o **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 0-14492

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 o No þ

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 o No þ

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 þ No o

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

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 þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer , and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicated by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ
As of June 30, 2009, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $96,949,092.00
As of February 24, 2010, the Registrant had 5,200,000 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of Form 10-K Portions of the definitive Proxy Statement for the 2009 Annual Meeting of Shareholders of Farmers & Merchants Bancorp, Inc.

FARMERS & MERCHANTS BANCORP, INC.

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Statements contained in this portion of the Company s annual report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of 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.

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PART 1.

ITEM 1. BUSINESS:

General

Farmers & Merchants Bancorp, Inc. (Company) is a bank holding company incorporated under the laws of Ohio in 1985. Our primary subsidiary, The Farmers & Merchants State Bank (Bank) is a community bank operating in Northwest Ohio since 1897. Our only other subsidiary, Farmers & Merchants Life Insurance Company, a reinsurance company for life, accident and health insurance for the Bank s consumer credits, was formed in 1992. Farmers & Merchants Life Insurance Company was dissolved during 2007. 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 2009, please see the portion of Management s Discussion and Analysis of Financial Condition and Results of Operations captioned 2009 in Review .

Nature Of Activities

The Farmers & Merchants State Bank engages in general commercial banking and savings business. Our activities include commercial, agricultural and residential mortgage, consumer, and credit card lending activities. Because our Bank s offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of our loan portfolio is comprised of loans made to customers in the farming industry for such things as farm land, farm equipment, livestock and general operation loans for seed, fertilizer, feed, etc. Other types of lending activities include loans for home improvements, and loans for such items as autos, trucks, recreational vehicles, motorcycles, etc.

We also provide checking account services, as well as savings and time deposit services such as certificates of deposits. In addition, ATM s (automated teller machines) are also provided at our Ohio offices in Archbold, Wauseon, Stryker, West Unity, Bryan, Delta, Napoleon, Montpelier, Swanton, Defiance, and Perrysburg, along with ones at our Auburn and Angola, Indiana offices. Two ATM s are located at Sauder Woodworking Co., Inc., a major employer in Archbold. Additional locations in Ohio are at Northwest State Community College, Archbold; Community Hospitals of Williams County, Bryan; Fairlawn Haven Wyse Commons, Archbold; R&H Restaurant, Fayette; Delta Eagles, Bryan Eagles; Sauder Village, Archbold; Fulton County Health Center, Wauseon; downtown Defiance; and a mobile trailer ATM. In Indiana, four additional ATM s are located at St. Joe; at Kaiser s Supermarket and Therma-Tru in Butler; and at DeKalb Memorial Hospital in Auburn.

Farmers & Merchants Life Insurance Company was established to provide services to our customers through the issuance of life and disability insurance policies. Our Bank s lending officers were the selling agents of the policies to customers. The activities of Farmers & Merchants Life Insurance Co. were not significant to the consolidated company. The Company dissolved the Farmers & Merchants Life Insurance Company subsidiary as the Bank discontinued offering the credit life, accident and health insurance to its customers. The Bank continues to offer credit insurance related products to our residential real estate customers; however, it is through an unrelated third party vendor.

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.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956. 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 bank is participating in the expanded FDIC limits through all of 2013 and utilizing the additional insurance coverage provided in the Temporary Liquidity Guarantee Program through June 2010. The FDIC increased the insurance level for deposits from $100,000 to $250,000 on interest bearing accounts and unlimited FDIC insurance on non-interest bearing accounts. We believe the cost for this coverage is offset by the benefit to our depositors.

The Bank s primary market includes communities located in the Ohio counties of Defiance, Fulton, Henry, Williams, and Wood. The commercial banking business in this market is highly competitive, with approximately 17 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. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of the services provided. On December 31, 2007, the Bank acquired the Knisely Bank of Indiana, expanding its market with the addition of offices in Butler and Auburn, Indiana, both located in DeKalb County. An additional office was opened in the summer of 2008 in Angola, Indiana, located in Steuben County.

At December 31, 2009, we had 251 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be excellent.

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 subsidiary 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 subsidiary are subject 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 subsidiary are subject are discussed below, along with certain regulatory matters concerning the Company and its subsidiary. 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 subsidiary.

Regulatory Agencies

The Company is a registered bank 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.

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).

Holding Company Activities

As a bank 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 a quarterly basis information pursuant to the Act. The Federal Reserve Board may conduct examinations or inspections of the Company and its subsidiary.

The Company is required to obtain prior approval from the Federal Reserve Board for the acquisition of more than five percent of the voting shares or substantially all of the assets of any bank or bank holding company. In addition, the Company is generally prohibited by the Act from acquiring direct or indirect ownership or control of more than five percent of the voting shares of any company which is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks or furnishing services to its subsidiaries. The Company may, however, subject to the prior approval of the Federal Reserve Board, engage in, or acquire shares of companies engaged in activities which are deemed by the Federal Reserve Board by order or by regulation to be so closely related to banking or managing and controlling a bank as to be a proper activity.

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. No Federal Reserve Board approval is 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. The Company has not elected to become a financial holding company and has no current intention of making such an election.

Affiliate Transactions

Various governmental requirements, including Sections 23A and 23B of the Federal Reserve Act, 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.

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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 ability of banks to acquire branch offices is contingent, however, on the host state having adopted legislation opting in to those provisions of Riegle-Neal. In addition, the ability of a bank to merge with a bank located in another state is contingent on the host state not having adopted legislation opting out of that provision of Riegle-Neal. 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 Company s subsidiary 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 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 and the Company s capital position at December 31, 2009 are summarized in the table included in Note 14 to the consolidated financial statements.

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 banks or thrift s assets at the time it became undercapitalized and the amount needed to comply with the plan. As of December 31, 2009, the Company s banking subsidiary 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. Various U.S. federal statutory provisions limit the amount of dividends the Company s banking subsidiaries can pay to the Company without regulatory approval. Dividend payments by the Bank are limited to its retained earnings during the current year and its prior two years. See Note 15 to the consolidated financial statements for the actual amount.

Deposit Insurance Assessments

The deposits of the Company s banking subsidiary are insured up to regulatory limits by the FDIC, and, accordingly, are subject to deposit insurance assessments based on the Federal Deposit Insurance Reform Act of 2005, as adopted and took effect on April 21, 2006.

The Emergency Economic Stabilization Act of 2008 provided a temporary increase in deposit insurance coverage from $100,000 to $250,000 per depositor. This legislation was effective immediately upon the President s signature on October 3, 2008. The basic deposit insurance limit was set to return to $100,000 on January 1, 2010, however, at this time, the date has been extended to December 31, 2013.

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.

Capital Purchase Program

In response to the financial crisis affecting the banking system and financial markets, the Emergency Economic Stabilization Act of 2008 (the EESA) was signed into law on October 3, 2008 creating the Troubled Assets Relief Program (TARP). As part of TARP, the U.S. Treasury established the Capital Purchase Program to provide up to $700 billion of funding to eligible financial institutions through the purchase of capital stock and other financial institutions for the purpose of stabilizing and providing liquidity to the United States financial markets. The Company did not participate in the TARP Capital Purchase Program. In connection with the EESA, there have been numerous actions by the Federal Reserve Board, the United States Congress, the U.S. Treasury, the FDIC, the SEC and others to further the economic and banking industry stabilization efforts under the EESA. It remains unclear at this time what further legislative and regulatory measures will be implemented under the EESA that affect the Company.

Additional Regulation

The Bank is also subject to federal regulation as 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 Truth-in-Lending Act and Regulation Z, the Federal Equal Credit Opportunity Act and Regulation B, the Fair Credit Reporting Act, the Electronic Funds Transfer Act and Regulation E, the Truth in Savings Act and Regulation DD, the Bank Secrecy Act, the Community Reinvestment Act, HUD s RESPA regulations, 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 subsidiary 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 subsidiary.

Available Information:

The Company maintains an Internet web site at the following internet address: www.fm-bank.com. The Company files reports with the Securities and Exchange Commission (SEC). Copies of all filings made with the SEC may be read and copied at the SEC s Public Reference Room, 450 Fifth Street, Washington, DC, 20549. You may obtain information about the SEC s Public Reference Room by calling (800/SEC-0330). 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.

Please see the Consolidated Financial Statements provided under Part II, Item 8 of this Form 10-K for information regarding the Company s revenues from external customers, profits, and total assets for and as of, respectively, the fiscal year ended December 31, 2009.

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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 loan application and approval procedures. However, there can be no assurance that such monitoring and procedures will reduce such lending 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.

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. The Gramm-Leach-Bliley Act regarding financial modernization that became effective in November, 1999 removed many of the barriers to the integration of the banking, securities and insurance industries and is likely to increase the competitive pressures upon the Bank. We cannot predict what effect such Act and 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. Over the last few years, the Bank, along with most other financial institutions, has experienced a margin squeeze as drastic interest rate fluctuations have made it difficult to maintain a more favorable net interest spread. During 2009, the Bank was able to improve its margin and spread slightly as the rate environment remained low and flat. Maturities of higher rate deposits aided the decrease in cost of funds.

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 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 materially 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 incent 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). 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 vested 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. 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, 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

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department may be given goals which create efficiencies, ensure compliance with procedures, or generate new fee or product opportunities. An average of four goals were given to each officer in 2009. 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 s ability to pay dividends on its common stock depends on its receipt of dividends from the Bank. The Bank is subject to restrictions and limitations in the amount and timing of the dividends it may pay to the Company.

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.

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.

Limited Trading Market

Our common stock is not listed on any exchange or The NASDAQ Stock Market. Our stock is currently quoted in the over-the-counter markets.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal office is located in Archbold, Ohio.

The Bank operates from the facilities at 307 North Defiance Street. 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 622 Clydes Way in Archbold, Ohio to accommodate our growth over the years. The bank owns a parking lot in downtown Montpelier which had been provided for customer use. The bank owns a property at 204 Washington Street, St Joe, Indiana at which an ATM is located.

The Bank owns all of its office locations, with the exception of Angola, Indiana. The Angola office location is leased.

Current locations of retail banking services are:

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

All but one of of the above locations have drive-up service facilities and an ATM.

ITEM 3. LEGAL PROCEEDINGS

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

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PART II.

ITEM 4. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is not listed on the NASDAQ stock market or any other stock exchange. While there is no established public trading market for our common stock, our shares are currently dually-quoted by various market makers on the Pink Sheets and the Over the Counter Bulletin Board, which are both over-the-counter quotation services for participant broker-dealers.

There are market makers that set a price for our stock; however, private sales continue to occur. The high and low sale prices were from sales of which we have been made aware by researching daily on Bloomberg.com. The high and low sale prices known to our management are as follows:

		Stock Prices	
2009 - quarter	Quarter	Low	High
	1st	$17.60	$20.00
	2nd	17.55	20.50
	3rd	19.25	20.99
	4th	15.20	19.00

2008 - quarter	Quarter	Low	High
	1st	$18.00	$20.25
	2nd	19.05	22.80
	3rd	20.05	22.25
	4th	19.00	21.35

The Company utilizes Registrar and Transfer Company as its transfer agent.

As of January 27, 2010 there were 2,052 record holders of our common stock.

Below 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, 2009. The chart compares the value of $100 invested in the Corporation and each of the indices and assumes investment on December 31, 2004 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.

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Year 2004 as the Base

	2004	2005	2006	2007	2008	2009
FMAO	$ 100.00	$ 80.00	$ 81.65	$ 76.40	$ 77.90	$ 67.60
NASDAQ-COMPOSITE	$ 100.00	$ 102.09	$ 112.64	$ 124.61	$ 75.02	$ 108.82
NASDAQ-BANK INDEX	$ 100.00	$ 98.02	$ 111.40	$ 89.54	$ 70.55	$ 58.97

Dividends are declared and paid quarterly. Per share dividends declared for the years ended 2009 and 2008 are as follows:

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2009	$.18	$.18	$.18	$.18	$.72
2008	$.16	$.16	$.18	$.18	$.68

The ability of the Company to pay dividends is limited 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. 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.

Dividends declared during 2009 were $0.72 per share totaling $3.41 million, 5.88 percent higher than 2008 declared dividends of $0.68 per share. During 2009, the Company purchased 28,907 shares and awarded 10,000 restricted shares to 49 employees under its long term incentive plan. 350 shares were forfeited during 2009. At year end 2009, the Company held 437,551 shares in Treasury stock and 27,775 in unearned stock awards. The Company purchased 171,889 shares throughout 2008. 10,000 shares were awarded to 51 employees in 2008. 245 restricted shares were forfeited during 2008. At December 31, 2008, the Company held 418,294 shares in Treasury stock and 23,575 in unearned stock awards. The Company continues to have a strong capital base and to maintain regulatory capital ratios that are significantly above the defined regulatory capital ratios. On December 18, 2009, 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 200,000 shares of its outstanding common stock commencing January 1, 2010 and ending December 31, 2010.

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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 Programs	Remaining Share Repurchase Authorization
10/1/2009 to 10/31/2009				196,093
11/1/2009 to 11/30/2009				196,093
12/1/2009 to 12/31/2009				196,093
Total				196,093

(1) On January 16, 2009, 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 225,000 shares of its outstanding common stock commencing on January 16, 2009 and ending December 31, 2009.

Reclassification

Certain amounts in the 2008 and 2007 consolidated financial statements have been reclassified to conform with the 2009 presentation.

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ITEM 5. SELECTED FINANCIAL DATA

SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA

Summary of Consolidated Statement of Income UNAUDITED

	(In Thousands, except share data) 2009	2008	2007	2006	2005
Summary of Income:					
Interest income	$ 41,114	$ 43,824	$ 45,424	$ 42,269	$ 38,101
Interest expense	13,220	18,101	21,722	18,535	13,539
Net Interest Income	27,894	25,723	23,702	23,734	24,562
Provision for loan loss	3,558	1,787	871	525	(425)
Net interest income after provision for loan loss	24,336	23,936	22,831	23,209	24,987
Other income (expense), net	(15,256)	(14,763)	(12,269)	(11,966)	(13,209)
Net income before income taxes	9,080	9,173	10,562	11,243	11,778
Income taxes	2,475	2,450	2,828	3,107	3,202
Net income	$ 6,605	$ 6,723	$ 7,734	$ 8,136	$ 8,576
Per Share of Common Stock:					
Earnings per common share outstanding *					
Net income	$ 1.39	$ 1.39	$ 1.52	$ 1.57	$ 1.65
Dividends	$ 0.720	$ 0.680	$ 0.640	$ 0.575	$ 0.500
Weighted average number of shares outstanding	4,741,392	4,846,310	5,097,636	5,186,329	5,198,728

* Based on weighted average number of shares outstanding

	(In Thousands) 2009	2008	2007	2006	2005
Total assets	$ 853,860	$ 805,729	$ 803,974	$ 737,096	$ 720,945
Loans	563,911	562,336	523,474	498,580	458,704
Total Deposits	676,444	615,732	634,593	585,409	576,297
Stockholders equity	93,584	90,547	89,375	87,732	82,588

Key Ratios					
Return on average equity	7.19%	7.51%	8.71%	9.64%	10.62%
Return on average assets	0.80%	0.84%	1.06%	1.14%	1.22%
Loans to deposits	83.36%	91.33%	82.49%	85.17%	79.65%
Capital to assets	10.96%	11.24%	11.12%	11.90%	11.46%
Dividend payout	51.66%	48.77%	42.00%	36.63%	30.31%

ITEM 6. MANAGEMENTS DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Critical Accounting Policy 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 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.

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 past 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 Mortgage Servicing Rights. 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 cost, 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.

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.

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2009 in Review

2009 proved to be a tough year in which businesses had to operate. This was especially true in banking as negative press continued throughout the year and all banks were painted with the same brush. Increased FDIC assessments along with a special mid-year assessment impacted the bottom line with over $1.2 million additional expense recorded for 2009 as compared to 2008. This increased level of cost is forecasted to continue as the Bank has prepaid over $3.5 million for the next three years. While funds were available for the prepayment, it still represents a cost in terms of lost opportunity for earnings on the $3.5 million.

The Bank was not hit with the cost of failures in just our own industry, but rather from almost all industries as charge-offs and watch list loans increased also. Much of our lenders time was spent working delinquencies and the one bright spot of the low rate environment, refinancing mortgages. Fortunately, many of our customers were able to refinance their mortgages to lower rates and payments even though their house values had declined. The financial impact of both these scenarios will be further discussed in the material changes in operations to follow.

The Bank launched a new product offering in March 2008: Reward Checking. The product is a free checking account which pays a high rate of interest to customers who agree to three qualifications each statement cycle. The three qualifications enable the Bank to deliver the high interest rate as they create efficiencies or increase non-interest revenue to the Bank. As will be shown later, the success of this product grew throughout 2009 and is the reason for the increase in interest bearing liabilities. It has been extremely well received by customers and embraced by the Bank s employees. It has exceeded expectations at this point and continues to be the product of choice for a new checking customer. At year end 2009, it had the highest balance at over $49 million within the business and consumer checking portfolio. The Bank looks forward to further development of the product line in 2010 with the introduction of KASASA . KASASA is the first national brand of the most innovative checking accounts available today. KASASA is a new word that was created to capture consumers attention and awaken them to a new way of banking. These accounts are designed to be the first and only accounts that actually take an interest in their accountholders by paying them to use their account with what interests them most. More discussion will be focused on this product with the tables to follow.

The Company is proud of its results for 2009. Increased regulatory demands and high unemployment in the communities we serve impacted the level of profitability; however, the Company has remained in the black throughout the year. Using the Bank Holding Company and Uniform Bank Performance Report compiled by the Federal Reserve system as a reference, the Company was seven times more profitable than its national peer and the Bank twice its peers as of end of third quarter 2009.

Material Changes in Results of Operations

The discussion now turns to more financial based results and trends as a result of 2009 operations. In comparing line items of the consolidated statement of income for years ended 2007 through 2009, it is easily seen where the Company has been spending its time and the impact of the recession. Decreasing interest income and expense are obvious large factors on the profitability of the Company for 2009; however, that discussion can be found in the net interest income section. This discussion will focus on the significant non-interest items that impacted the operations of the Company.

Looking at the positive items first; overall, non-interest income shows a trend of improvement. A modest improvement of $94 thousand in 2008 over 2007 was followed by a more significant gain of over $1.3 million in 2009 as compared to 2008. Accounting for over $1 million of the gain was the revenue generated from mortgage loan activity through establishing mortgage servicing rights and gain on the sale of loans into the secondary market. As mentioned earlier, our loan officers and supporting departments were very busy in 2009 handling refinance activity for mortgages. It was a much needed, but unexpected source of increased revenue.

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The second largest increase to non-interest income was derived from increased debit card usage. As the Bank receives interchange revenue from each swipe of the card, usage increased thereby increasing revenue over $126.5 thousand in 2009 over 2008. 2008 s increase was $218.5 thousand over 2007. Both increases are attributed to the growth and popularity of the Bank s Reward checking product. One of the criteria for the payment of high interest on the account is utilizing the debit card at least twelve times per statement cycle. The Bank s Reward Checking customers average 25 transactions per statement, surpassing the 9 transactions average of our Free Checking customers. The additional revenue from debit card usage offsets the interest expense, creating a win-win situation for the customers and the Bank. In 2010, this revenue stream will be further enhanced with the addition of KASASA. All of the KASASA products will have a debit card usage qualification; however, interest income will not be the customer win for all accounts. Customers may choose to receive credit towards iTunes downloads or donate earnings to charity.

One additional non-interest income item to mention is overdraft and return check fee income. This revenue source decreased 6.5%, or $176 thousand, during 2009 even though the number of checking accounts increased 4.16% and the portfolio year end balance was $23.6 million higher in 2009 than 2008. Overdraft fees had been higher in 2008 than in 2007; however 2008 s income fee was lower than in 2007. 2008 was higher due to the volume of checking accounts added from the Knisely acquisition. The average overdraft fee paid per account was $6.77 less in 2008 than in 2007. This revenue source is under intense regulatory review and proposed changes are predicted to decrease this line item by as much as 30% in 2010.

Service charge income remained virtually unchanged from 2008 even with the increase in accounts. Most of the new accounts added either don t have service fee charges and/or the balances are high enough to offset any charges. Both the OD and return check and service charge income from checking accounts are included in the customer service fees line item on the income statement.

Lastly, the Bank was able to take advantage of the ability to book some gains on the sale of securities. This opportunity presented itself in the first and last quarter of 2009. The Bank did not sacrifice long term profitability for short term gains as the yields of the portfolio were not negatively impacted by the sales. The discussion on causes for changes to yields follows in the interest section. The Bank did recognize a loss of just over $50 thousand on an equity security of a Banker s Bank. The entity had been taken over by the FDIC with its assets and deposits being bought by another financial institution.

Overall, non-interest expense increased 8.6% or $1.8 million in 2009 over 2008. This has proved to be an increasing trend as 2008 was 13.9% over 2007, or $2.6 million higher. The causes behind the increases; however, are different. The largest factor behind the 2009 increase was FDIC assessment, which was broken out as its own line item on the statement of income due to its significance. Of the $1.8 million increase in 2009 non-interest expense, $1.2 million is attributed to the cost of FDIC insurance.

Also mentioned previously was the mortgage refinancing activity of 2009. A correlating expense to that activity is the amortization of mortgage servicing rights. The income was discussed previously; the amortization is the offset to the income recognized. This increase occurred in both 2008 and 2009. 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 when 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. 2007 had net income from mortgage servicing rights of $95 thousand, 2008 had net income of $77 thousand, and 2009 had net income of $225 thousand. Of course, the value (or income) of the mortgage servicing right when sold also impacts the net position. The reason for 2009 s larger net position is due to the increase in the number of loans being serviced; thereby new rights are being established without having been offset by accelerated expense. This is evidenced by the year end number of loans and balances being up significantly. As of December 31 of each year, there were 3,571 loans serviced with outstanding balances of $267.8 million for 2009, 3,190 loans with balances of $233.9 million for 2008, and 3,178 loans with balances of $235.2 million for 2007. Returning to the expense only portion, expense for 2009 was $563 thousand higher than expense for 2008 and $676 thousand higher than 2007. As seen above, the increased expense was offset by a higher increase in income.

During the first part of 2009, some of the Bank s lending officers were also very busy in auto loan financing. This activity was spurred by government and auto manufacturer incentives along with large banks exiting the market in the first half of the year. The consumer loan portfolio grew by 26%, or almost $6 million. This increased activity offset the increased salary expense as deferred costs from these loans are recorded as a deduction to the salary expense when the loans are made. While salaries and wages decreased in 2009 as compared to 2008, it was this component that made it possible. Base salary expense increased just over $400 thousand with the deferred costs offsetting with a $50 thousand increase for 2009. In 2008, as compared to 2007, base salary increased by $835 thousand, but was offset by a $98 thousand increase in deferred costs. The increases in base salary have been driven by additional offices being opened and increase in revenue generating positions, such as additional staff in the Bank s financial planning division.

Employee benefits ended 2009 at $185 less than (or basically even) 2008 s and again it was for different reasons than the fluctuation of $214 thousand between 2008 and 2007. Employees group insurance costs were up $224 for 2009 over 2008 and 2008 costs were $51 thousand lower than 2007. The Bank is partially self-insured and fluctuations to costs are therefore caused by fluctuations in claims made by employees. In 2008, the Bank offered a Health Savings Account (HSA) option, along with offering its traditional medical plans. 70% of employees chose the HSA high deductible plan. Both options were available in 2009 and the decision was made to implement the HSA plan only bank-wide for 2010. The increase in medical expense was offset by a decrease of $201.5 thousand in miscellaneous personnel expense and in the BOLI retirement expense for 2009 as compared to 2008. Miscellaneous personnel expense includes such items as employee outings and the use of employment and executive search agencies. Bank Owned Life Insurance (BOLI) retirement expense represents the yearly cost to fund the liability of post retirement officers upon which the Bank has an insurance policy of which the Bank is the beneficiary. The total of these two expenses increased $216 thousand in 2008 as compared to 2007 and as stated previously was opposite of the movement in 2009 as compared to 2008.

Occupancy expense increased $84 thousand over 2008 with the largest impact stemming from the costs associated with holding Other Real Estate Owned (OREO). The balance in OREO increased from $426.7 thousand as of December 31, 2008 to $1.4 million as of December 31, 2009. The largest expense increase in occupancy was real estate taxes, which was driven by the additional holding of OREO and had increased $82.9 thousand. The larger increase of $465 thousand in occupancy expense in 2008 over 2007 was based on the increase in the number of offices and a decrease in the amount of building rent received from the Bank s brokerage division, FM Investments. The building rent received in 2009 was just 2% higher than in 2008, therefore it was not a factor in the increase for 2009.

As is often the case, an increase in technology costs is offset by efficiencies or cost savings found elsewhere on the statements of income. During 2008, the increase in furniture and equipment was caused by the increase in the number of offices and a new telephone system. The phone system utilizes the Bank s wide area data network, or VOIP (Voice Over Internet Protocol). The depreciation cost of which is offset by a reduction in long distance and line usage. In 2009, the increase in the furniture and equipment line item of $61 thousand over 2008 comes mainly from an increase in the expense of maintenance contracts. The majority of software utilized by the Bank includes an annual maintenance cost. This cost accounts for over 85% of the line item increase. It is an area that is closely monitored; however, not easily contained. Generally, to have additional revenue generated or expense decreased from new efficiencies, an additional expense will be incurred in furniture and equipment.

A positive reduction in data processing expense of $98 thousand occurred in 2009. This decrease is not attributable to just one vendor, but rather a negotiation with multiple vendors. This reduction is hoped to begin a trend of declining costs as the Bank plans to switch service providers in February 2010 at a cost savings. The pricing on many services, however, is based on number of accounts and the Bank fully expects those to increase with the KASASA additions and an improving economy.

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It was mentioned earlier that much of the lenders time was spent on mortgage refinancing and collections. The collection expense is included in the general and administrative expense. The collection expense increase of $92 thousand in 2008 as compared to 2007 has been followed by an additional $251 thousand increase in 2009 over 2008. A more positive comparison is the reduction by just under $74 thousand in 2009 of the expense associated with miscellaneous NSF (non-sufficient funds) and return checks. 2008 had seen an increase of $137 thousand over 2007 in this area where often the issue stems from fraudulent activity attempted on our customer accounts. This is often a reflection of a tough economy and the Bank worked hard to educate our customers and create an awareness to stop the losses. There are always a few that slip through the cracks but it is a credit to the Bank s front line personnel that a decrease to the expense took place.

The largest cost increase to the Bank in 2009 was the Provision for Loan Losses. A tough economic environment existed for most businesses in our primary market area during 2007 through 2009. In 2009, the provision expense was $1.8 million higher than 2008 and $2.7 million over 2007. Gross charge-offs were $3.3 million for 2009, as compared to 2008 s $2.6 million and 2007 s $1.6 million. Recoveries were $242, $348, and $732 thousand for 2009, 2008, and 2007, respectively. Unfortunately, 2009 had the highest charge-off and lowest recovery amounts, making the net charge-offs the highest at $3 million. 2008 had a net charge-off position of $2.2 million and 2007 had a position of less than $1 million. 2008 was impacted by mostly agricultural business and 2009 activity was mainly commercial driven. Further analysis by loan type is presented in the discussion of the allowance for credit losses.

Overall, the Company is proud to have another solid, positive year of performance during tough times. The Bank remains well capitalized and focused on how best to weather the economic climate. Some positive signs are beginning to show in our markets; however, the heavy burden of regulation is not easily overcome. FDIC assessments will be a way of life for the next three years. The Company forecasts moderate expansion while seeking opportunities to improve earnings and lower costs.

Net Interest Income

The net interest margin improved during 2009 as the Bank was able to adjust the majority of its deposit liabilities by a larger percentage down than which the loans were pricing down. A decrease occurred in both interest income and interest expense for the second straight year, however, the $4.2 million decrease in deposit interest expense alone outpaced the $2.7 million decrease in all interest income. Net interest income was $2.2 million higher than 2008 and 2008 was $2.0 million higher than 2007. As a percentage, net interest income was 17.7% higher than 2007, while the average balance on earning assets was only 5% higher for the same time period.

The following table presents net interest income, interest spread and net interest margin for the three years 2007 through 2009, comparing average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and expense. The table also shows their corresponding average rates of interest earned and paid. The tax-exempt asset yields have been tax affected to reflect a marginal corporate tax rate of 34%. 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.

As the charts indicate, the Company experienced significant increased growth on an average basis for year 2008 compared to 2007 at 9.54%. 2009 had an increase of average assets of 3.13%. Interest earning assets average balance increased during all periods. The biggest component of the interest earning assets was loans. The decrease on yields is more pronounced on the other earning assets. Specifically, the largest fluctuation is in short-term funds, Federal Funds Sold. In 2007, the yield on Federal Funds was 4.67%, 2008 was 2.90%, and in 2009 it was 0.38%.

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While the loan portfolio size has remained fairly constant in 2009, the yield, or income, generated has decreased for the second straight year. This is due to the low interest rate environment, with the lending prime rate within 26 basis points of the Company s net interest spread. Spread is the difference between what the Company earns on its assets and pays on its liabilities. It is on this spread that the Company must fund its operations and generate profit. When the asset yield decreases, so must the cost of funds 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. To mitigate the low rate environment, the Bank placed rate floors on most variable loans during 2009, which were typically 125 basis points over the current prime rate. This protected the Bank during a flat rate environment. The challenge will come when rates start to rise and the Bank will be affected by the index spreads also placed on the loans. An increased prime rate will not directly correlate to an increased yield on loans.

Overall, the tax equivalent yield on interest earning assets decreased to 5.52% for 2009 compared to 6.03% and 6.81% for 2008 and 2007 respectively. The percentage of interest earning assets to total assets increased slightly in 2009 over 2008 and remained above 90% at a respectable 93.55% for 2009.

As stated previously, the decreased yield on the assets was fortunately outpaced by the decreased cost of funds. The average balances for interest bearing liabilities increased only $17.4 million compared to 2008 and $83.5 million as compared to 2007. While the balance increased, the costs on those funds were significantly lower. The average cost for 2009 was 2.00% compared to 2008 s 2.82% and 2007 s 3.77%. The balances in non-interest bearing liabilities also increased during the last three years.

As with the yields on assets, the largest fluctuation in the cost of funds is in the shorter term liabilities, savings deposits. The cost on savings decreased 66% while on time deposits the cost decreased 38%. The Bank has focused on increasing its core deposit base to lessen the dependency on higher cost time deposits. The Bank has also attempted to increase the duration of the time deposits; however, customers have maintained a short-term, twelve month focus.

As stated previously, the charts show the improvement of the net interest margin from 2008 to 2009. A slight tightening occurred during 2008. Net interest spread increased 17 basis points during 2008 and 30 basis points during 2009. Net interest margin dropped 2 basis points in 2008 compared to 2007 and a 19 basis point increase from 2008 to 2009. Competition played a major role in the pressure applied on these margins along with the fluctuating rate environment and the slope of the yield curve during 2007 through 2009. The ability to grow loans was directly impacted by the ability to aggressively price the loans and finding borrowers wishing to borrow. The continued decrease in the prime lending rate and deterioration of the economy made any improvement in interest income very difficult. The two biggest factors in the decrease of interest expense in the liabilities were the volume of other time deposits that re-priced to a significantly lower rate during 2008 and 2009 and the large drop in the Federal Funds rate which directly impacted the Federal funds purchased and securities sold under agreement to repurchase. The acquisition had a major impact on the average balances in 2008 as compared to 2007.

The yield on Tax-Exempt investments 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.

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	2009 (In Thousands) Average Balance	Interest/ Dividends	Yield/Rate
ASSETS			
Interest Earning Assets:			
Loans (1)	$ 558,869	$ 33,585	6.04%
Taxable investment securities	146,872	5,798	3.95%
Tax exempt investment securities	46,736	1,686	5.47%
Interest bearing deposits			0.00%
Federal funds sold	11,937	45	0.38%
Total Interest Earning Assets	764,414	$ 41,114	5.52%
Non-Interest Earning Assets:			
Cash and cash equivalents	19,209		
Other assets	39,007		
Total Assets	$ 822,630		
LIABILITIES AND SHAREHOLDERS EQUITY			
Interest Bearing Liabilities:			
Savings deposits	$ 257,345	$ 1,755	0.68%
Other time deposits	317,619	9,252	2.91%
Other borrowed money	38,498	1,727	4.49%
Federal funds purchased and securities sold under agreement to repurchase	45,920	486	1.06%
Total Interest Bearing Liabilities	659,382	$ 13,220	2.00%
Non-Interest Bearing Liabilities:			
Non-interest bearing demand deposits	57,630		
Other	13,778		
Total Liabilities	730,790		
Shareholders Equity	91,840		
Total Liabilities and Shareholders Equity	$ 822,630		
Interest/Dividend income/yield		$ 41,114	5.52%
Interest Expense / yield		13,220	2.00%
Net Interest Spread		$ 27,894	3.51%

Net Interest Margin	3.79%

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	2008 (In Thousands)		
	Average Balance	Interest/ Dividends	Yield/Rate
ASSETS			
Interest Earning Assets:			
Loans (1)	$ 544,310	$ 34,994	6.46%
Taxable investment securities	146,877	6,963	4.74%
Tax exempt investment securities	42,361	1,594	5.70%
Interest bearing deposits			0.00%
Federal funds sold	9,423	273	2.90%
Total Interest Earning Assets	742,971	$ 43,824	6.03%
Non-Interest Earning Assets:			
Cash and cash equivalents	19,399		
Other assets	35,317		
Total Assets	$ 797,687		
LIABILITIES AND SHAREHOLDERS EQUITY			
Interest Bearing Liabilities:			
Savings deposits	$ 240,880	$ 2,760	1.15%
Other time deposits	314,005	12,467	3.97%
Other borrowed money	38,110	1,747	4.58%
Federal funds purchased and securities sold under agreement to repurchase	49,014	1,127	2.30%
Total Interest Bearing Liabilities	642,009	$ 18,101	2.82%
Non-Interest Bearing Liabilities:			
Non-interest bearing demand deposits	53,208		
Other	12,928		
Total Liabilities	708,145		
Shareholders Equity	89,542		
Total Liabilities and Shareholders Equity	$ 797,687		
Interest/Dividend income/yield		$ 43,824	6.03%
Interest Expense / yield		18,101	2.82%

Net Interest Spread	$ 25,723	3.21%
Net Interest Margin		3.60%

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	2007 (In Thousands)		
	Average Balance	Interest/ Dividends	Yield/Rate
ASSETS			
Interest Earning Assets:			
Loans (1)	$ 502,815	$ 37,429	7.48%
Taxable investment securities	132,047	6,181	4.68%
Tax exempt investment securities	40,433	1,533	5.74%
Interest bearing deposits	286	17	5.94%
Federal funds sold	5,658	264	4.67%
Total Interest Earning Assets	681,239	$ 45,424	6.81%
Non-Interest Earning Assets:			
Cash and cash equivalents	17,318		
Other assets	29,684		
Total Assets	$ 728,241		
LIABILITIES AND SHAREHOLDERS EQUITY			
Interest Bearing Liabilities:			
Savings deposits	$ 193,539	$ 3,978	2.06%
Other time deposits	312,515	14,424	4.62%
Other borrowed money	28,233	1,317	4.66%
Federal funds purchased and securities sold under agreement to repurchase	41,549	2,003	4.82%
Total Interest Bearing Liabilities	575,836	$ 21,722	3.77%
Non-Interest Bearing Liabilities:			
Non-interest bearing demand deposits	44,553		
Other	19,029		
Total Liabilities	639,418		
Shareholders Equity	88,823		
Total Liabilities and Shareholders Equity	$ 728,241		
Interest/Dividend income/yield		$ 45,424	6.81%
Interest Expense / yield		21,722	3.77%
Net Interest Spread		$ 23,702	3.04%

Net Interest Margin	3.62%

(1) For purposes of these computations, non-accruing loans are included in the daily average outstanding loan amounts.

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The primary source of the Company s traditional banking revenue is net interest income. Net interest income is the difference between interest income on interest earning assets, such as loans and securities, and interest expense on 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 as a result of two statistics interest spread and net interest margin. The difference between the yields on earning assets and the rates paid for interest bearing liabilities supporting those funds represents the interest spread. Because non-interest bearing sources of funds such as demand deposits and stockholders equity also support earning assets, the net interest margin exceeds the interest spread.

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.

		2009 vs 2008 (In Thousands)	
	Net	Due to Change in	
Interest Earned On:	Change	Volume	Rate
Loans	$ (1,409)	$ 941	$ (2,350)
Taxable investment securities	(1,165)		(1,165)
Tax-exempt investment securities	92	249	(157)
Interest bearing deposits			
Federal funds sold	(228)	73	(301)
Total Interest Earning Assets	$ (2,710)	$ 1,263	$ (3,973)
Interest Paid On:			
Savings deposits	$ (1,005)	$ 189	$ (1,194)
Other time deposits	(3,215)	143	(3,358)
Other borrowed money	(20)	18	(38)
Federal funds purchased and securties sold under agreement to repurchase	(641)	(71)	(570)
Total Interest Bearing Liabilities	$ (4,881)	$ 279	$ (5,160)

		2008 vs 2007 (In Thousands)	
	Net	Due to Change in	
Interest Earned On:	Change	Volume	Rate
Loans	$ (2,435)	$ 3,104	$ (5,539)
Taxable investment securities	782	694	88
Tax-exempt investment securities	61	111	(50)
Interest bearing deposits	(17)	(17)	
Federal funds sold	9	176	(167)
Total Interest Earning Assets	$ (1,600)	$ 4,068	$ (5,668)

Interest Paid On:			
Savings deposits	$ (1,218)	$ 973	$ (2,191)
Other time deposits	(1,957)	69	(2,026)
Other borrowed money	430	460	(30)
Federal funds purchased and securties sold under agreement to repurchase	(876)	360	(1,236)
Total Interest Bearing Liabilities	$ (3,621)	$ 1,862	$ (5,483)

Interest rates began to drop at the end of third quarter 2007 and continued that course throughout 2008. With the increase in average balances during 2008, the significant increase in interest was to be expected due to change in volume. The difference in the two comparisons is the amount of change due to interest rates remaining low through the two periods. What did remain the same in the two comparisons is that the change in interest expense outpaced the change in interest income. In the early part of 2007, the Bank employed a strategy to keep time deposit specials to shorter terms (12 to 15 months). As rates continued to decline in 2008 and remain low throughout 2009, this strategy accomplished its goal of significantly lowering the cost of time deposits during 2008 and 2009. The strategy currently is to extend the maturities of specials to over 24 months to prepare for rising rates. The other strategy employed during 2008 and 2009 was to increase core deposits by offering innovative products focused on customer needs: higher interest rates. In exchange for a high interest-bearing checking account, customers were asked to utilize services that benefited both the Bank and themselves. Smaller time deposit rate shoppers had an option to perhaps change their behavior of banking or those deposits were allowed to run off. The new core deposit products were indeed embraced by our customers and have helped to reach the deposit portfolio mix the Bank was after. The improved net interest margin played a large role in offsetting the increased operating costs of credit.

Allowance for Credit Losses

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 ACL increased during 2009 as compared to 2008 as net charge-offs and past due loans had increased during 2009. The increase takes into account the high level of nonaccruals and watch list loans and the extended time period it may involve for resolution. $3.3 million in loans were charged off in 2009 compared to $2.6 million for 2008 and $1.6 million for 2007. The Company increased the allowance for credit losses for 2007 as $301 thousand of the increase was the allowance that came across from the acquisition. The allowance stands at $6.2 million for 2009 compared to $5.7 million for 2008 and $6.1 million for 2007. Provision expense was up $1.8 million for 2009 and $916 thousand for 2008, bringing the total expense to $3.6 million for 2009 compared to $1.8 million for 2008 and $871 thousand for 2007. The AULC remained almost equal to 2008, ending at $156 thousand for 2007, increased to $225 thousand for 2008, and ended 2009 at $227 thousand. Historical factors along with current economic conditions are part of the calculation to determine the adequacy of the allowance.

Non-interest Income

Non-interest income of $7.8 million is an increase of $982 thousand over 2008, while 2008 and 2007 were within $94 thousand of each other at $6.5 and $6.4 million, respectively. The largest fluctuations in non-interest income were impacted with the residential mortgage loan activity and sale of securities. Both of these were opportunities created from the low interest rate environment and may not be repeated in 2010.

Non-interest Expense

The increase of $1.8 million in non-interest expense for 2009 as compared to 2008 was mainly the increased FDIC assessment cost of $1.2 million and the $563 thousand of mortgage servicing rights amortization. The FDIC is a result of funding the insurance reserve for the increased number of failed banks the last two years and this cost will continue for the next few years to come. The mortgage servicing rights amortization came from the same residential mortgage activity as did the income; however, it was limited to the refinancing portion.

The difference in 2008 and 2007 was for entirely different reasons. Salaries and wages increased in 2008 as compared to 2007. Full time equivalent numbers of employees for December 2008 compared to September 2007 increased by seventeen with the addition of new offices. The incentive paid based on performance for

2008 was lower than 2007 as the overall performance of the Bank was lower. Employee benefits were lower as the Bank s cost for medical insurance decreased during 2008 with lower claims and 401(k) expense was lower due to performance. This impact was discussed earlier.

Federal Income Taxes

Effective tax rates were 27.26%, 26.71%, and 26.78%, for 2009, 2008, and 2007, respectively. The effect of tax-exempt interest from holding tax-exempt securities and Industrial Development Bonds (IDBs) was $629, $654, and $650 thousand for 2009, 2008, and 2007, respectively.

Financial Condition

Average earning assets increased $21.4 million during 2009 over 2008 and were higher by $83.2 million as compared to 2007. The main cause of fluctuation was caused by the acquisition and repositioning the balance sheet. Average interest bearing liabilities increased $17.4 million over 2008 and $83.5 million from 2007. The increase in 2009 over 2008 was due to the success of the Reward Checking product to attract funds into the savings deposit bucket. The increase in 2008 over 2007 was from the acquisition and to fund the increase in loans.

Securities

Security balances as of December 31 are summarized below:

	(In Thousands)		
	2009	2008	2007
U.S. Treasury	$ 5,219	$	$
U.S. Government agency	104,676	82,675	104,737
Mortgage-backed securities	36,848	51,826	39,367
State and local governments	60,538	43,160	41,467
	$ 207,281	$ 177,661	$ 185,571

The following table sets forth (dollars in thousands) the maturities of investment securities as of December 31, 2009 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 thirty-four percent rate have been made in yields on obligations of state and political subdivisions. Stocks of domestic corporations have not been included.

	Maturities (Amounts in Thousands)			
	Within One Year		After One Year Within Five Years	
	Amount	Yield	Amount	Yield
U.S. Treasury	$	0.00%	$ 5,219	1.26%
U.S. Government agency	31,037	2.90%	63,947	3.05%
Mortgage-backed securities	4,846	3.77%	32,002	4.91%
State and local governments	15,095	3.93%	18,578	3.40%
Taxable state and local governments		0.00%	2,089	3.50%