FARMERS & MERCHANTS BANCORP
Form 10-Q
November 07, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008
or

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from ________ to ________

Commission File Number: 000-26099

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

Delaware	94-3327828
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
111 W. Pine Street, Lodi, California	95240
(Address of principal Executive offices)	(Zip Code)

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

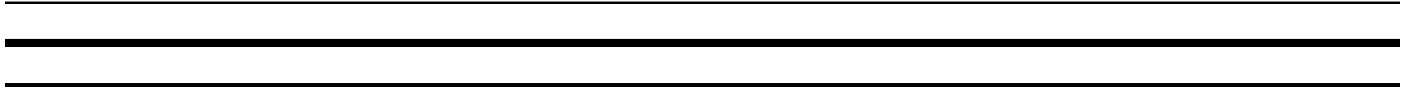
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such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

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

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

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

Number of shares of common stock of the registrant: Par value $0.01, authorized 20,000,000 shares; issued and outstanding 789,447 as of October 31, 2008.



FARMERS & MERCHANTS BANCORP

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PART I. - FINANCIAL INFORMATION

Item 1 - Financial Statements

FARMERS & MERCHANTS BANCORP
Consolidated Balance Sheets (Unaudited)

(in thousands)	Sept. 30, 2008	December 31, 2007	Sept. 30, 2007
Assets			
Cash and Cash Equivalents:			
Cash and Due From Banks	$ 51,900	$ 50,240	$ 43,406
Federal Funds Sold	28,300	1,150	700
Total Cash and Cash Equivalents	80,200	51,390	44,106
Investment Securities:			
Available-for-Sale	211,222	142,043	135,377
Held-to-Maturity	105,413	105,594	108,617
Total Investment Securities	316,635	247,637	243,994
Loans	1,161,506	1,140,969	1,122,515
Less: Allowance for Loan Losses	18,486	18,483	17,842
Loans, Net	1,143,020	1,122,486	1,104,673
Premises and Equipment, Net	22,039	20,188	19,566
Bank Owned Life Insurance	41,537	40,180	39,737
Interest Receivable and Other Assets	49,811	37,291	38,406
Total Assets	$ 1,653,242	$ 1,519,172	$ 1,490,482
Liabilities			
Deposits:			
Demand	$ 281,873	$ 307,299	$ 295,066
Interest Bearing Transaction	135,529	138,665	130,415
Savings	356,206	301,678	281,310
Time	627,095	563,148	579,243
Total Deposits	1,400,703	1,310,790	1,286,034
Securities Sold Under Agreement to Repurchase	60,000	-	-
Federal Home Loan Bank Advances	716	28,954	25,966
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	28,394	25,700	25,108
Total Liabilities	1,500,123	1,375,754	1,347,418
Shareholders' Equity			
Preferred Stock	-	-	-
Common Stock	8	8	8
Additional Paid-In Capital	80,508	84,437	86,993
Retained Earnings	71,921	57,990	56,605
Accumulated Other Comprehensive Gain (Loss)	682	983	(542)
Total Shareholders' Equity	153,119	143,418	143,064
Total Liabilities & Shareholders' Equity	$ 1,653,242	$ 1,519,172	$ 1,490,482

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

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FARMERS & MERCHANTS BANCORP
Consolidated Statements of Income (Unaudited)

(in thousands except per share data)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Interest Income				
Interest and Fees on Loans	$ 19,294	$ 21,633	$ 58,837	$ 62,954
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	137	53	181	441
Interest on Investment Securities:				
Taxable	3,122	2,070	8,434	5,839
Tax-Exempt	757	811	2,293	2,442
Total Interest Income	23,310	24,567	69,745	71,676
Interest Expense				
Deposits	5,349	7,703	17,541	22,235
Borrowed Funds	552	622	1,219	1,360
Subordinated Debentures	149	217	491	645
Total Interest Expense	6,050	8,542	19,251	24,240
Net Interest Income	17,260	16,025	50,494	47,436
Provision for Loan Losses	765	-	5,370	250
Net Interest Income After Provision for Loan Losses	16,495	16,025	45,124	47,186
Non-Interest Income				
Service Charges on Deposit Accounts	1,866	1,890	5,381	5,424
Net Gain (Loss) on Investment Securities	1	(652)	536	(1,735)
Credit Card Merchant Fees	20	575	1,109	1,642
Increase in Cash Surrender Value of Life Insurance	464	442	1,356	1,293
ATM Fees	321	348	1,072	1,012
Other	(209)	933	3,836	3,783
Total Non-Interest Income	2,463	3,536	13,290	11,419
Non-Interest Expense				
Salaries & Employee Benefits	5,292	6,427	18,895	21,074
Occupancy	665	655	2,009	1,956
Equipment	862	839	1,985	2,144
Credit Card Merchant Expense	-	436	828	1,233
Marketing	131	92	388	316
Other	2,345	1,766	5,830	5,452
Total Non-Interest Expense	9,295	10,215	29,935	32,175
Income Before Income Taxes	9,663	9,346	28,479	26,430
Provision for Income Taxes	3,606	3,471	10,696	9,420
Net Income	$ 6,057	$ 5,875	$ 17,783	$ 17,010
Earnings Per Share	$ 7.63	$ 7.26	$ 22.34	$ 20.98

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

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FARMERS & MERCHANTS BANCORP
Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)	Three Months Ended Sept 30, 2008	Three Months Ended Sept 30, 2007	Nine Months Ended Sept 30, 2008	Nine Months Ended Sept 30, 2007
Net Income	$ 6,057	$ 5,875	$ 17,783	$ 17,010
Other Comprehensive Loss -				
Unrealized Gains on Derivative Instruments:				
Reclassification adjustment for realized gains included in net income, net of related income tax effects of $0 and $0 for the quarters ended September 30, 2008 and 2007, respectively, and $0 and $0 for the nine months ended September 30, 2008 and 2007, respectively.	-	(1)	-	-
Unrealized Gains (Losses) on Securities:				
Unrealized holding gains (losses) arising during the period, net of income tax provision (benefit) of $894 and $729 for the quarters ended September 30, 2007 and 2006, respectively, and of $7 and $(601) for the nine months ended September 30, 2008 and 2007, respectively.	1,232	1,006	10	(828)
Reclassification adjustment for realized losses included in net income, net of related income tax effects of $0 and $273 for the quarters ended September 30, 2008 and 2007, respectively, and of $(225) and $729 for the nine months ended September 30, 2008 and 2007, respectively.	(1)	379	(311)	1,006
Total Other Comprehensive Gain (Loss)	1,231	1,384	(301)	178
Comprehensive Income	$ 7,288	$ 7,259	$ 17,482	$ 17,188

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

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FARMERS & MERCHANTS BANCORP
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands except share data)	Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2006	811,933	$ 8	$ 89,926	$ 43,126	$ (720)	$ 132,340
Net Income		-	-	17,010	-	17,010
Cash Dividends Declared on Common Stock		-	-	(3,531)	-	(3,531)
Repurchase of Stock	(6,265)	-	(2,933)	-	-	(2,933)
Change in Net Unrealized Loss on Securities Available for Sale		-	-	-	178	178
Balance, September 30, 2007	805,668	$ 8	$ 86,993	$ 56,605	$ (542)	$ 143,064
Balance, December 31, 2007	800,112	$ 8	$ 84,437	$ 57,990	$ 983	$ 143,418
Net Income		-	-	17,783	-	17,783
Cash Dividends Declared on Common Stock		-	-	(3,852)	-	(3,852)
Repurchase of Stock	(8,590)	-	(3,929)	-	-	(3,929)
Change in Net Unrealized Gain on Securities Available for Sale		-	-	-	(301)	(301)
Balance, September 30, 2008	791,522	$ 8	$ 80,508	$ 71,921	$ 682	$ 153,119

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

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FARMERS & MERCHANTS BANCORP
Consolidated Statements of Cash Flows (Unaudited)
(in thousands)

	Nine Months Ended	
	Sept 30, 2008	Sept 30, 2007
Operating Activities:		
Net Income	$ 17,783	$ 17,010
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	5,370	250
Depreciation and Amortization	838	1,506
Net Amortization of Investment Security Discounts & Premium	88	50
Net (Gain) Loss on Investment Securities	(536)	1,735
Net Gain on Sale of Property & Equipment	(8)	-
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets	(13,659)	(7,220)
Net Increase in Interest Payable and Other Liabilities	2,694	2,585
Net Cash Provided by Operating Activities	12,570	15,916
Investing Activities:		
Securities Available-for-Sale:		
Purchased	(131,979)	(33,409)
Sold, Matured or Called	62,808	29,237
Securities Held-to-Maturity:		
Purchased	(4,500)	(2,164)
Matured or Called	4,602	4,730
Net Loans Originated or Acquired	(26,183)	(76,322)
Principal Collected on Loans Previously Charged Off	279	212
Net Additions to Premises and Equipment	(2,689)	(576)
Proceeds from Sale of Property and Equipment	8	-
Net Cash Used by Investing Activities	(97,654)	(78,292)
Financing Activities:		
Net Increase in Demand, Interest-Bearing Transaction, and Savings Accounts	25,966	7,755
Increase in Time Deposits	63,947	79,751
Net Increase in Securities Sold Under Agreement to Repurchase	60,000	-
Net Decrease in Federal Home Loan Bank Advances	(28,238)	(21,566)
Cash Dividends	(3,852)	(3,531)
Stock Repurchases	(3,929)	(2,933)
Net Cash Provided by Financing Activities	113,894	59,476
Increase (Decrease) in Cash and Cash Equivalents	28,810	(2,900)
Cash and Cash Equivalents at Beginning of Year	51,390	47,006
Cash and Cash Equivalents as of Sept. 30, 2008 and Sept. 30, 2007	$ 80,200	$ 44,106

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

FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

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

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

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

The accompanying consolidated financial statements include the accounts of the Company and the Company's wholly owned subsidiaries, F & M Bancorp, Inc. and the Bank, along with the Bank's wholly owned subsidiaries, Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Significant inter-company transactions have been eliminated in consolidation. The results of operations for the nine-month period ended September 30, 2008 may not necessarily be indicative of the operating results for the full year 2008.

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

2. Fair Value Measurements

Effective January 1, 2008, the Company adopted SFAS No. 157 (SFAS 157), "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In

this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

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

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

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

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

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired (see "Financial Condition – Non-Performing Assets") and an allowance for loan losses is established. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, Accounting by Creditors for Impairment of a Loan (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2008, substantially all impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses observable data, the Company records the impaired loan as nonrecurring Level 2. Otherwise, the Company records the impaired loan as nonrecurring Level 3.

Other Real Estate Owned ("OREO") is reported at fair value on a non-recurring basis. When the fair value of the OREO is based on an observable market price or a current appraised value which uses observable data, the Company records the OREO as nonrecurring Level 2. Otherwise, the Company records the OREO as nonrecurring Level 3.

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

(in thousands)	Fair Value September 30, 2008	Fair Value Measurements At September 30, 2008, Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities	$ 211,222	$ -	$ 211,222	$ -

Total Assets Measured at Fair Value On a Recurring Basis	$ 211,222	$ -	$ 211,222	$ -

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

(in thousands)	Fair Value September 30, 2008	Fair Value Measurements At September 30, 2008, Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans	$ 6,291	$ -	$ 6,291	$ -
Other Real Estate Owned	6,393	-	6,393	-
Total Assets Measured at Fair Value On a Non-Recurring Basis	$ 12,684	$ -	$ 12,684	$ -

Impaired loans and OREO are measured for impairment using the fair value of the collateral because the loans/OREO are considered to be collateral dependent. Impaired loans were $7.6 million with an allowance for loan losses of $1.3 million and OREO was $6.9 million with a reserve of $500,000.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115." This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. The Company adopted SFAS 159 on January 1, 2008, and has not elected the fair value option for any financial assets or liabilities at September 30, 2008.

3. Accounting for Split-Dollar Life Insurance Arrangements

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

4. Dividends and Earnings Per Share

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. On May 6, 2008, the Board of Directors of Farmers & Merchants Bancorp declared a mid-year cash dividend of $4.85 per share, an 11.5% increase over the $4.35 per share paid on July 1, 2007. The cash dividend was paid on July 1, 2008, to shareholders of record on June 9, 2008.

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

September 30, 2008 and 2007.

(net income in thousands)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net Income	$ 6,057	$ 5,875	$ 17,783	$ 17,010
Average Number of Common Shares Outstanding	793,407	809,244	795,855	810,878
Per Share Amount	$ 7.63	$ 7.26	$ 22.34	$ 20.98

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5. Recent Accounting Pronouncements

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

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

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

On October 10, 2008, the FASB issued FSP FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." The FSP clarifies the application of FASB Statement No. 157, "Fair Value Measurements", in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective immediately, and includes prior period financial statements that have not yet been issued, and therefore the Company is subject to the provision of the FSP effective September 30, 2008. The implementation of FSP FAS 157-3 did not affect the Company's fair value measurement as of September 30, 2008.

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

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three and nine months ended September 30, 2008. This analysis should be read in conjunction with our 2007 Annual Report to Shareholders on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

Forward–Looking Statements

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

Such factors include the following: (i) the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto; (ii) the effect of changing regional and national economic conditions; (iii) significant changes in interest rates and prepayment speeds; (iv) credit risks of lending and investment activities; (v) changes in federal and state banking laws or regulations; (vi) competitive pressure in the banking industry; (vii) changes in governmental fiscal or monetary policies; (viii) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (ix) other factors discussed in Item 1A. Risk Factors of the Company's 2007 Annual Report on form 10-K.

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

Introduction

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

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

Overview

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

For the three and nine months ended September 30, 2008, Farmers & Merchants Bancorp reported net income of $6,057,000 and $17,783,000, earnings per share of $7.63 and $22.34 and return on average assets of 1.50% and 1.53%, respectively. Return on average shareholders' equity was 16.34% and 16.05% for the three and nine months ended September 30, 2008.

For the three and nine months ended September 30, 2007, Farmers & Merchants Bancorp reported net income of $5,875,000 and $17,010,000, earnings per share of $7.26 and $20.98 and return on average assets of 1.60% and 1.57%, respectively. Return on average shareholders' equity was 16.79% and 16.44% for the three and nine months ended September 30, 2007.

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

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

- Net income increased 4.5% to $17.8 million from $17.0 million.
- Earnings per share increased 6.5% to $22.34 from $20.98.

- Total assets increased 10.9% to $1.6 billion.

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- Total loans increased 3.5% to $1.2 billion.
- Total deposits increased 8.9% to $1.4 billion.
- Net interest income increased 6.4% to $50.5 million from $47.4 million.

Results of Operations

Net Interest Income / Net Interest Margin
The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the three and nine-month periods ended September 30, 2008 and 2007.

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

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

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

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

3rd Quarter 2008 vs. 3rd Quarter 2007
Net interest income for the third quarter of 2008 increased 7.7% or $1.2 million to $17.3 million. On a taxable equivalent basis, net interest income increased 7.3% and totaled $17.6 million for the third quarter of 2008. As more fully discussed below, the increase in net interest income was due to an increase in earning assets, partially offset by an eight basis point drop in net interest margin.

Net interest income on a taxable equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For the quarter ended September 30, 2008, the Company's net interest margin was 4.71% compared to 4.79% for the quarter ended September 30, 2007. The Company continues to experience aggressive competitor pricing for both loans and deposits, which it has responded to in order to retain key customers. This trend will continue, in management's opinion, to place pressure on the Company's net interest margin in future quarters.

Loans, generally the Company's highest earning assets, increased $39.0 million as of September 30, 2008 compared to September 30, 2007. See "Financial Condition – Loans" for further discussion on this increase. On an average balance

basis, loans increased by $30.2 million for the quarter ended September 30, 2008. Despite a 325 basis point decrease in the prime rate occurring between September 19, 2007 and May 1, 2008, the yield on the loan portfolio only decreased 102 basis points or 13.2% to a yield of 6.71% for the quarter ended September 30, 2008 compared to a yield of 7.73% for the quarter ended September 30, 2007. Some of the resilience in loan yields is due to pricing floors that the Bank has placed in some of its customer loan agreements. However, these floors typically expire annually and are renegotiated based upon current market conditions. The growth in loan balances during the third quarter partially offset this decrease in yield resulting in interest revenue from loans decreasing only 10.8% to $19.3 million for the quarter ended September 30, 2008.

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The investment portfolio is the other main component of the Company's earning assets. The debt securities in the Company's investment portfolio are comprised primarily of Mortgage-backed securities, U.S. Government Agencies and high grade Municipals. All of the Mortgage-backed securities are issued by government-sponsored entities. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans. Importantly, the Company has never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC".

Average investment securities were $314.8 million for the third quarter of 2008 an increase of $68.1 million compared to $246.7 million for the third quarter of 2007. See "Financial Condition – Investment Securities" for further discussion on this increase. Interest income on securities increased $965,000 to $4.2 million for the quarter ended September 30, 2008 compared to $3.3 million for the quarter ended September 30, 2007. The average yield, on a taxable equivalent basis (TE), in the investment portfolio was 5.39% for the third quarter of 2008 compared to 5.31% for the third quarter of 2007. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a taxable equivalent basis (TE), which is higher than net interest income on the Consolidated Statements of Income because of adjustments that relate to income on certain securities that are exempt from federal income taxes.

Average interest-bearing sources of funds increased $139.1 million or 13.5% during the third quarter of 2008 as compared to the third quarter of 2007. Of that increase, average borrowed funds (primarily FHLB Advances) decreased $45.1 million; interest-bearing deposits increased $124.2 million, subordinated debt remained unchanged and securities sold under agreement to repurchase, a new type of borrowing initially used during the first quarter of 2008 to assist in managing the Company's interest rate risk, increased $60 million.

The increase in average interest-bearing deposits was in time deposits, which grew $70.6 million, and lower cost savings and interest bearing DDA which increased by $53.6 million. Total interest expense on deposit accounts for the third quarter of 2008 was $5.3 million as compared to $7.7 million for the third quarter of 2007. The average rate paid on interest-bearing deposits was 1.93% in the third quarter of 2008 and 3.14% in the third quarter of 2007. See "Financial Condition – Deposits" for further discussion.

Nine Months Ending September 30, 2008 vs. Nine Months Ending September 30, 2007

During the first nine months of 2008, net interest income increased 6.4% to $50.5 million, compared to $47.4 million at September 30, 2007. On a taxable equivalent basis, net interest income increased 6.1% and totaled $51.6 million at September 30, 2008, compared to $48.6 million at September 30, 2007. The increase in net interest income was due to an increase in earning assets partially offset by a five basis point drop in net interest margin.

For the nine months ended September 30, 2008, the Company's net interest margin was 4.82% compared to 4.87% for the same period in 2007.

Loans, on an average balance basis, increased by $44.8 million for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007. The yield on the loan portfolio decreased 80 basis points to 6.98% for the nine months ended September 30, 2008 compared to 7.78% for the nine months ended September 30, 2007. This decrease in yield, partially offset by an increase in average balances, resulted in interest revenue from loans decreasing 6.5% or $4.1 million for the first nine months of 2008.

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

	Three Months Ended Sept 30, 2008			Three Months Ended Sept 30, 2007		
Assets	Balance	Interest	Rate	Balance	Interest	Rate
Federal Funds Sold	$ 28,786	$ 137	1.89%	$ 4,209	$ 53	5.00%
Investment Securities Available-for-Sale						
Municipals - Non-Taxable	8,954	166	7.40%	11,078	200	7.21%
Mortgage Backed Securities	197,255	2,648	5.37%	120,960	1,598	5.28%
Other	3,384	88	6.59%	5,836	67	3.52%
Total Investment Securities Available-for-Sale	209,593	2,902	5.54%	137,874	1,865	5.41%
Investment Securities Held-to-Maturity						
U.S. Agencies	30,373	319	4.20%	30,477	317	4.16%
Municipals - Non-Taxable	67,176	955	5.68%	68,891	1,009	5.86%
Mortgage Backed Securities	5,708	55	3.85%	7,411	72	3.89%
Other	1,992	13	2.61%	2,107	16	3.04%
Total Investment Securities Held-to-Maturity	105,249	1,342	5.10%	108,886	1,414	5.19%
Loans						
Real Estate	667,068	11,446	6.81%	631,519	11,638	7.31%
Home Equity	65,162	1,070	6.51%	66,278	1,330	7.96%
Agricultural	188,981	3,208	6.73%	206,207	4,400	8.47%
Commercial	205,995	3,327	6.41%	186,547	3,837	8.16%
Consumer	12,156	239	7.80%	13,408	291	8.61%
Credit Card	0	0	0.00%	5,467	133	9.65%
Municipal	1,357	4	1.17%	1,140	4	1.39%
Total Loans	1,140,719	19,294	6.71%	1,110,566	21,633	7.73%
Total Earning Assets	1,484,347	$ 23,674	6.33%	1,361,535	$ 24,964	7.27%
Unrealized Loss on Securities Available-for-Sale	(1,772)			(2,547)		
Allowance for Loan Losses	(18,513)			(17,809)		
Cash and Due From Banks	35,264			38,782		

All Other Assets	112,935			92,430		
Total Assets	$ 1,612,261			$ 1,472,391		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits						
Interest Bearing DDA	$ 129,686	$ 33	0.10%	$ 129,208	$ 30	0.09%
Savings	331,377	879	1.05%	278,224	1,076	1.53%
Time Deposits	636,785	4,437	2.76%	566,183	6,597	4.62%
Total Interest Bearing Deposits	1,097,848	5,349	1.93%	973,615	7,703	3.14%
Securities Sold Under Agreement to Repurchase	60,000	541	3.58%	-	-	0.00%
Other Borrowed Funds	724	11	6.03%	45,835	622	5.38%
Subordinated Debentures	10,310	149	5.73%	10,310	217	8.35%
Total Interest Bearing Liabilities	1,168,882	$ 6,050	2.05%	1,029,760	$ 8,542	3.29%
Interest Rate Spread			4.27%			3.98%
Demand Deposits (Non-Interest Bearing)	266,939			278,961		
All Other Liabilities	28,169			23,704		
Total Liabilities	1,463,990			1,332,425		
Shareholders' Equity	148,271			139,966		
Total Liabilities & Shareholders' Equity	$ 1,612,261			$ 1,472,391		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.44%			0.80%
Net Interest Income and Margin on Total Earning Assets		17,624	4.71%		16,422	4.79%
Tax Equivalent Adjustment		(364)			(397)	
Net Interest Income		$ 17,260	4.61%		$ 16,025	4.67%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $385,000 and $641,000 for the quarters ended September 30, 2008 and 2007, respectively. Yields on securities available-for-sale are based on historical cost.

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

	Nine Months Ended Sept. 30, 2008			Nine Months Ended Sept. 30, 2007		
Assets	Balance	Interest	Rate	Balance	Interest	Rate
Federal Funds Sold	$ 12,362	$ 181	1.96%	$ 11,137	$ 441	5.29%
Investment Securities Available-for-Sale						
Municipals - Non-Taxable	8,955	502	7.47%	11,334	602	7.08%
Mortgage Backed Securities	174,771	7,025	5.36%	112,602	4,388	5.20%
Other	3,504	240	5.88%	6,954	223	3.38%
Total Investment Securities Available-for-Sale	187,230	7,767	5.53%	130,890	5,213	5.31%
Investment Securities Held-to-Maturity						
U.S. Agencies	30,399	953	4.18%	30,503	953	4.17%
Municipals - Non-Taxable	66,459	2,892	5.80%	69,424	3,038	5.83%
Mortgage Backed Securities	6,124	177	3.85%	7,942	228	3.83%
Other	1,998	39	2.60%	2,110	47	2.97%
Total Investment Securities Held-to-Maturity	104,980	4,061	5.16%	109,979	4,266	5.17%
Loans						
Real Estate	661,124	34,304	6.94%	624,818	34,309	7.34%
Home Equity	65,007	3,293	6.77%	66,140	3,939	7.96%
Agricultural	183,499	9,964	7.26%	196,049	12,436	8.48%
Commercial	199,921	10,228	6.84%	174,770	10,957	8.38%
Consumer	12,489	772	8.26%	13,655	898	8.79%
Credit Card	3,506	265	10.11%	5,433	403	9.92%
Municipal	1,187	11	1.24%	1,075	12	1.49%
Total Loans	1,126,733	58,837	6.98%	1,081,940	62,954	7.78%
Total Earning Assets	1,431,305	$ 70,846	6.62%	1,333,946	$ 72,874	7.30%
Unrealized Gain (Loss) on Securities Available-for-Sale	1,163			(1,611)		
Allowance for Loan Losses	(18,790)			(17,981)		
Cash and Due From Banks	36,498			38,563		

All Other Assets	103,130			90,938		
Total Assets	$ 1,553,306			$ 1,443,855		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits						
Interest Bearing DDA	$ 129,870	$ 90	0.09%	$ 129,895	$ 76	0.08%
Savings	321,197	2,716	1.13%	285,770	3,119	1.46%
Time Deposits	601,873	14,735	3.27%	549,823	19,040	4.63%
Total Interest Bearing Deposits	1,052,940	17,541	2.23%	965,488	22,235	3.08%
Securities Sold Under Agreement to Repurchase	38,102	987	3.46%	-	-	0.00%
Other Borrowed Funds	10,425	232	2.98%	34,280	1,360	5.30%
Subordinated Debentures	10,310	491	6.37%	10,310	645	8.36%
Total Interest Bearing Liabilities	1,111,777	$ 19,251	2.32%	1,010,078	$ 24,240	3.21%
Interest Rate Spread			4.30%			4.10%
Demand Deposits (Non-Interest Bearing)	267,698			273,897		
All Other Liabilities	26,095			21,949		
Total Liabilities	1,405,570			1,305,924		
Shareholders' Equity	147,736			137,931		
Total Liabilities & Shareholders' Equity	$ 1,553,306			$ 1,443,855		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.52%			0.78%
Net Interest Income and Margin on Total Earning Assets		51,595	4.82%		48,634	4.87%
Tax Equivalent Adjustment		(1,101)			(1,198)	
Net Interest Income		$ 50,494	4.72%		$ 47,436	4.75%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $1.7 million and $1.8 million for the nine months ended September 30, 2008 and 2007, respectively. Yields on securities available-for-sale are based on historical cost.

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Farmers & Merchants Bancorp
Volume and Rate Analysis of Net Interest Revenue
(Rates on a Taxable Equivalent Basis)

(in thousands)	Three Months Ended Sept. 30, 2008 compared to Sept. 30, 2007			Nine Months Ended Sept. 30, 2008 compared to Sept. 30, 2007		
Interest Earning Assets	Volume	Rate	Net Chg.	Volume	Rate	Net Chg.
Federal Funds Sold	$ 135	$ (51)	$ 84	$ 45	$ (305)	$ (260)
Investment Securities Available for Sale						
Municipals - Non-Taxable	(39)	5	(34)	(132)	32	(100)
Mortgage Backed Securities	1,024	26	1,050	2,495	142	2,637
Other	(23)	44	21	(98)	115	17
Total Investment Securities Available for Sale	962	75	1,037	2,265	289	2,554
Investment Securities Held to Maturity						
U.S. Agencies	(1)	3	2	(3)	3	0
Municipals - Non-Taxable	(24)	(30)	(54)	(129)	(17)	(146)
Mortgage Backed Securities	(16)	(1)	(17)	(52)	1	(51)
Other	(1)	(2)	(3)	(2)	(6)	(8)
Total Investment Securities Held to Maturity	(42)	(30)	(72)	(186)	(19)	(205)
Loans:						
Real Estate	629	(821)	(192)	1,942	(1,947)	(5)
Home Equity	(22)	(238)	(260)	(67)	(579)	(646)
Agricultural	(346)	(846)	(1,192)	(761)	(1,711)	(2,472)
Commercial	367	(877)	(510)	1,454	(2,183)	(729)
Consumer	(26)	(26)	(52)	(74)	(52)	(126)
Credit Card	(66)	(67)	(133)	(145)	7	(138)
Other	1	(1)	0	1	(2)	(1)
Total Loans	537	(2,876)	(2,339)	2,350	(6,467)	(4,117)
Total Earning Assets	1,592	(2,882)	(1,290)	4,474	(6,502)	(2,028)
Interest Bearing Liabilities						
Interest Bearing Deposits:						
Transaction	-	3	3	-	14	14
Savings	178	(375)	(197)	357	(760)	(403)
Time Deposits	734	(2,894)	(2,160)	1,681	(5,986)	(4,305)
Total Interest Bearing Deposits	912	(3,266)	(2,354)	2,038	(6,732)	(4,694)
Securities Sold Under Agreement to Repurchase	541	-	541	987	-	987
Other Borrowed Funds	(677)	66	(611)	(691)	(437)	(1,128)
Subordinated Debentures	-	(68)	(68)	-	(154)	(154)
Total Interest Bearing Liabilities	776	(3,268)	(2,492)	2,334	(7,323)	(4,989)
Total Change	$ 816	$ 386	$ 1,202	$ 2,140	$ 821	$ 2,961

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

Average investment securities were $292.2 million for the nine months ended September 30, 2008 compared to $240.8 million for the same period in 2007. The average yield (TE) for the nine months ended September 30, 2008 was 5.40% compared to 5.25% for the nine months ended September 30, 2007. The increase in the yield on investment securities, in addition to the increase in volume, resulted in an increase in interest income of $2.3 million or 24.8%, for the nine months ended September 30, 2008.

Average interest-bearing sources of funds increased $101.7 million or 10.1% during the nine months ended September 30, 2008. Of that increase, average borrowed funds (primarily FHLB Advances) decreased $23.8 million; interest-bearing deposits increased $87.4 million, subordinated debt remained unchanged and securities sold under agreement to repurchase, a new type of borrowing added during the first quarter of 2008 to manage the Company's interest rate risk, increased $38.1 million.

The increase in average interest-bearing deposits was in time deposits, which grew $52.0 million, and lower cost savings and interest bearing DDA which increased by $35.4 million. Total interest expense on deposit accounts for the first nine months of 2008 was $17.5 million as compared to $22.2 million for the first nine months of 2007. The average rate paid on interest-bearing deposits was 2.23% in the first nine months of 2008 and 3.08% in the first nine months of 2007.

Provision and Allowance for Loan Losses

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

The Company has established credit management policies and procedures that govern both the approval of new loans and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans to one borrower and by restricting loans made primarily to its principal market area where management believes it is better able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. Management reports regularly to the Board of Directors regarding trends and conditions in the loan portfolio and regularly conducts credit reviews of individual loans. Loans that are performing but have shown some signs of weakness are subject to more stringent reporting and oversight.

The provision for loan losses during the first nine months of 2008 was $5.4 million, and $250,000 for the first nine months of 2007. Changes in the provision between the first nine months of 2008 and 2007 were the result of management's evaluation of the adequacy of the allowance for loan losses relative to factors such as the credit quality of the loan portfolio, loan growth, current loan losses and the prevailing economic climate and its effect on borrowers' ability to repay loans in accordance with the terms of the notes. During the second quarter of 2008, resolution of a problem loan to one of the Bank's customers resulted in $3.9 million of principal being charged against the allowance for loan losses. See "Note 1. Significant Accounting Policies – Allowance for Loan Losses" in the Company's 2007 Annual Report on Form 10-K and "Item 3. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk" and "Part II Item 1a. Risk Factors" of this report.

The allowance for loan losses was $18.5 million or 1.59% of total loan balances at September 30, 2008 and $17.8 million or 1.59% of total loan balances at September 30, 2007. As of December 31, 2007, the allowance for loan losses was $18.5 million, which represented 1.62% of the total loan balance. After reviewing all factors above, management concluded that the allowance for loan losses as of September 30, 2008 was adequate. See the table below for allowance for loan loss activity for the periods indicated.

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(in thousands)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Balance at Beginning of Period	$ 18,682	$ 17,930	$ 18,483	$ 18,099
Provision Charged to Expense	765	-	5,370	250
Recoveries of Loans Previously Charged Off	61	65	295	212
Loans Charged Off	(1,022)	(153)	(5,662)	(719)
Balance at End of Period	$ 18,486	$ 17,842	$ 18,486	$ 17,842

Non-Interest Income

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

3rd Quarter 2008 vs. 3rd Quarter 2007

Overall, non-interest income decreased $1.1 million for the three months ended September 30, 2008 compared to the same period of 2007. This decrease was due to three main events as outlined below.

Gain (Loss) on investment securities was a gain of $1,000 for the third quarter of 2008 compared to a loss of $652,000 for the third quarter of 2007. During the first and second quarters of 2007 the Company recorded $1.08 million of impairment losses on one of its investment securities whose drop in market value was determined to be “other than temporary”. An additional impairment loss of $652,000 was recorded during the third quarter of 2007. During the first quarter of 2008 the Company disposed of its remaining interest in this investment (see “Investment Securities”) recording a loss of $215,000.

Credit card merchant fees have declined since the third quarter of 2007 due to the sale of the credit card merchant portfolio during the second quarter of 2008.

Other non-interest income decreased $1.1 million for the three months ended September 30, 2008 compared to the same period of 2007. This was primarily due to $1.1 million in market value losses on balances held in non-qualified deferred compensation plans in 2008 compared to gains of $250,000 during the same period in 2007. The Company allows executives who participate in non-qualified deferred compensation plans to self-direct the investment of their vested balances. Market value gains/losses on these plan balances fluctuate depending on the type of investments held and market trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is made to salary expense resulting in no effect on the Company’s net income.

Nine Months Ending September 30, 2008 vs. Nine Months Ending September 30, 2007

Non-interest income increased $1.9 million for the nine-months ended September 30, 2008 compared to the same period of 2007 (see discussion above).

Gain (Loss) on investment securities was a gain of $536,000 for the first nine months of 2008 compared to a loss of $1.7 million for the first nine months of 2007 (see discussion above).

Other non-interest income remained substantially unchanged, increasing only $53,000. This small increase was comprised of the following factors: (1) the sale of the Company’s credit card and merchant portfolios during the second quarter of 2008 resulted in a combined one-time gain of $2.9 million; (2) $1.2 million in market value losses on balances held in non-qualified deferred compensation plans in 2008 compared to $815,000 of gains in 2007; and

(3) $870,000 in one-time gains in 2007 from a liquidating dividend on the Company's partial ownership in WSBA.

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Non-Interest Expense

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

3rd Quarter 2008 vs. 3rd Quarter 2007

Non-interest expense decreased $920,000 or 9.0% from the third quarter of 2007 primarily as a result of: (1) market value losses of $1.1 million on balances held in non-qualified deferred compensation plans in 2008 compared to gains of $250,000 during the same period in 2007 (see "Non-Interest Income"); (2) decreased credit card merchant expense due to the sale of the merchant portfolio during the second quarter of 2008; and (3) a $500,000 valuation provision made to Other Real Estate Owned in 2008 compared to $0 in 2007.

Nine Months Ending September 30, 2008 vs. Nine Months Ending September 30, 2007

Non-interest expense for the nine months ended September 30, 2008 decreased $2.2 million or 7.0% from the same period in 2007. The primary factors affecting non-interest expense were: (1) market value losses of $1.2 million on balances held in non-qualified deferred compensation plans in 2008 compared to gains of $815,000 in 2007 (see "Non-Interest Income"); (2) decreased credit card merchant expense due to the sale of the merchant portfolio during the second quarter of 2008; and (3) as stated above, a $500,000 valuation provision made to Other Real Estate Owned.

Income Taxes

The provision for income taxes increased 3.9% to $3.6 million for the third quarter of 2008. The Company's effective tax rate increased for the third quarter of 2008 and was 37.3% compared to 37.1% for the same period in 2007.

The provision for income taxes increased 13.5% to $10.7 million for the first nine months of 2008. The Company's effective tax rate increased for the first nine months of 2008 and was 37.6% compared to 35.6% for the same period in 2007.

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

Financial Condition

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

Investment Securities

The investment portfolio provides the Company with an income alternative to loans. The Company's investment portfolio at September 30, 2008 was $316.6 million compared to $247.6 million at the end of 2007, an increase of $69.0 million or 27.9%. At September 30, 2007, the investment portfolio totaled $244.0 million. The Company grew the available-for-sale portion of its investment portfolio during the first nine months of 2008 as part of a leveraging strategy implemented to manage the Company's interest rate risk. This increase in the investment portfolio was funded primarily through Repurchase Agreements.

The Company's total investment portfolio currently represents 19.1% of the Company's total assets as compared to 16.3% at December 31, 2007 and 16.4% at September 30, 2007. Not included in the investment portfolio are

overnight investments in Federal Funds Sold. Average Federal Funds Sold for the nine-months ended September 30, 2008 was $12.4 million compared to $10.4 million for the twelve-months ended December 31, 2007 and $11.1 million for the nine-months ended September 30, 2007.

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The Company classifies its investments as held-to-maturity, trading or available-for-sale. Securities are classified as held-to-maturity and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of September 30, 2008, December 31, 2007 and September 30, 2007 there were no securities in the trading portfolio. Securities classified as available-for-sale include securities which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity (see "Consolidated Statements of Comprehensive Income"), net of related income taxes. See "Note 2. Fair Value Measurements" for further discussion.

The debt securities in the Company's investment portfolio are comprised primarily of Mortgage-backed securities, U.S. Government Agencies and high grade municipals. All of the Mortgage-backed securities are issued by federal government-sponsored entities. Importantly, the Company has never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC".

Loans
The Company's loan portfolio at September 30, 2008 increased $20.5 million or 1.8% from December 31, 2007. Compared to September 30, 2007, loans have increased $39.0 million or 3.5%. Most of the current year's growth occurred in Commercial Real Estate (with a specific focus on owner-occupied commercial real estate properties), Real Estate Secured by Farmland and Commercial loans, market segments where the Company believes that current market rates and/or credit risks are more reasonable than in the areas of Consumer, Home Equity and Real Estate Construction loans.

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

On an average balance basis, loans have increased $44.8 million or 4.1% since September 30, 2007. The table following sets forth the distribution of the loan portfolio by type and percent as of the periods indicated.

Loan Portfolio	September 30, 2008		December 31, 2007		September 30, 2007	
(in thousands)	$	%	$	%	$	%
Commercial Real Estate	$ 267,760	23.0%	$ 245,925	21.5%	$ 247,370	22.0%
Real Estate Secured by Farmland	228,153	19.6%	207,890	18.2%	203,421	18.1%
Real Estate Construction	77,335	6.6%	80,651	7.1%	80,798	7.2%
Residential 1st Mortgages	107,355	9.2%	109,764	9.6%	110,547	9.8%
Home Equity Lines and Loans	66,093	5.7%	65,953	5.8%	65,639	5.8%
Agricultural	192,220	16.5%	215,798	18.9%	198,805	17.7%
Commercial	212,073	18.2%	197,108	17.2%	198,914	17.7%
Consumer	12,766	1.1%	20,061	1.8%	19,366	1.7%
Total Loans	1,163,755	100.0%	1,143,150	100.0%	1,124,860	100.0%
Less:						
Unearned Income	2,249		2,181		2,345	
Allowance for Loan Losses	18,486		18,483		17,842	
Net Loans	$ 1,143,020		$ 1,122,486		$ 1,104,673	

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Non-Performing Assets

Loans on which the accrual of interest has been discontinued are designated as non-performing loans. Accrual of interest on loans is generally discontinued either when: (1) a loan becomes contractually past due by 90 days or more with respect to interest or principal; or (2) the loan is considered by management to be impaired because it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When loans are 90 days past due, but in Management's judgment are well secured and in the process of collection, they may not be classified as non-accrual. When a loan is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. The Company reported $6.7 million of Non-Performing Loans at September 30, 2008, $69,000 at December 31, 2007, and $520,000 at September 30, 2007. These balances are reported net of guarantees of the U.S. Government, including its agencies and its government-sponsored agencies, in the amounts of $860,000, $134,000 and $266,000, respectively. Non-Performing Loans as a percentage of Total Loans were 0.57% at September 30, 2008, 0.01% at December 31, 2007, and 0.05% at September 30, 2007. Non-performing loans, while still low compared to many other banks in our market area, have increased as a result of overall weakness in the economy. The Allowance for Loan Losses as a percentage of Non-Performing Loans was 276.45% at September 30, 2008, 26,786.9% at December 31, 2007, and 1,720.5% at September 30, 2007.

Interest income on non-accrual loans, which would have been recognized during the period, if all such loans had been current in accordance with their original terms, totaled $387,000 at September 30, 2008, $31,000 at December 31, 2007, and $133,000 at September 30, 2007.

Repossessed collateral that is real property is classified as other real estate owned ("OREO") or, if the collateral is personal property, the collateral is classified as other assets on the Company's financial statements. The Company reported $6.4 million of OREO at September 30, 2008, net of $500,000 OREO reserves and $251,000 of OREO at December 31, 2007 and September 30, 2007. The increase in OREO took place during the second quarter of 2008 as a result of the Company resolving a problem loan to one of the Bank’s customers.

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

Deposits

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

The Company's deposit balances at September 30, 2008 increased $89.9 million or 6.9% from December 31, 2007, and have increased $114.7 million or 8.9% compared to September 30, 2007. Core deposits (exclusive of Public Time Deposits) increased $77.7 million or 6.7% from December 31, 2007 and $101.6 million or 8.9% since September 30, 2007. Public Time Deposits have increased $12.2 million since December 31, 2007, and $13.1 million since September 30, 2007 primarily because of the Company’s decision to increase its use of public time deposits for short-term funding needs instead of using FHLB Advances (see “Federal Home Loan Bank Advances”).

Demand and Interest-Bearing transaction accounts decreased $28.6 million or 6.4% since December 31, 2007 and 1.9% since September 30, 2007 while savings and time deposit accounts have increased $118.5 million or 13.7% since December 31, 2007 and $122.7 million or 14.3% since September 30, 2007. Demand and Interest bearing transaction accounts have declined as customers have transferred funds to higher yielding savings and time deposit accounts with the Bank.

Securities Sold Under Agreement to Repurchase

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

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

Federal Home Loan Bank Advances

Advances from the Federal Home Loan Bank are another key source of funds to support earning assets (see "Item 3. Quantitative and Qualitative Disclosures about Market Risk and Liquidity Risk"). These advances are also used to manage the Company's interest rate risk exposure, and as opportunities exist, to borrow and invest the proceeds at a positive spread through the investment portfolio. FHLB Advances as of September 30, 2008 were $716,000 compared to $28.9 million at December 31, 2007 and $25.9 million at September 30, 2007. The decrease of $28.2 million since December 31, 2007 and $25.2 million since September 30, 2007, is a result of the Company's increased use of public time deposits and repurchase agreements as opposed to FHLB advances.

Long-term Subordinated Debentures

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

Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders' Equity totaled $153.1 million at September 30, 2008, $143.4 million at December 31, 2007, and $143.1 million at September 30, 2007.

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

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

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

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(in thousands)	Actual		Regulatory Capital Requirements		To Be Well Capitalized Under Prompt Corrective Action Provisions	
The Company:	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2008						
Total Capital to Risk Weighted Assets	$ 180,174,673	12.71%	$ 113,448,076	8.0%	N/A	N/A
Tier 1 Capital to Risk Weighted Assets	$ 162,437,278	11.45%	$ 56,724,038	4.0%	N/A	N/A
Tier 1 Capital to Average Assets	$ 162,437,278	10.16%	$ 63,981,147	4.0%	N/A	N/A

(in thousands)	Actual		Regulatory Capital Requirements		To Be Well Capitalized Under Prompt Corrective Action Provisions	
The Bank:	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2008						
Total Capital to Risk Weighted Assets	$ 176,427,888	12.48%	$ 113,137,709	8.0%	$ 141,422,136	10.0%
Tier 1 Capital to Risk Weighted Assets	$ 158,738,389	11.22%	$ 56,568,854	4.0%	$ 84,853,282	6.0%
Tier 1 Capital to Average Assets	$ 158,738,389	9.96%	$ 63,768,134	4.0%	$ 79,710,167	5.0%

As previously discussed (see Long-term Subordinated Debentures), in order to supplement its regulatory capital base, during December 2003 the Company issued $10 million of trust preferred securities. On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of trust preferred securities (“TPS”) by bank holding companies (“BHCs”). Under the final rule BHCs may include TPS in Tier 1 capital in an amount equal to 25% of the sum of core capital net of goodwill. The quantitative limitation concerning goodwill will not be effective until September 30, 2009. Since the Company has no goodwill on its balance sheet, this rule will have no impact. Any portion of trust-preferred securities not qualifying as Tier 1 capital would qualify as Tier 2 capital subject to certain limitations. The Company has received notification from the Federal Reserve Bank of San Francisco that all of the Company’s trust preferred securities currently qualify as Tier 1 capital.

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

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

Repurchases under the program will continue to be made on the open market or through private transactions. The repurchase program also requires that no repurchases may be made if the Bank would not remain “well-capitalized” after the repurchase. All shares repurchased under the repurchase program will be retired. See the Company’s 2007

Form 10-K, Part II, "Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities."

During the third quarter of 2008, the Company repurchased 2,514 shares at an average share price of $451 per share. During the third quarter of 2007, the Company repurchased 5,071 shares at an average share price of $458. Since the second share repurchase program was expanded in 2006, the Company has repurchased over 28,000 shares for total consideration of $13.6 million. (See Part II, Item 2. Unregistered Sales of Equity Securities and Use of Proceeds).

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

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

Critical Accounting Policies and Estimates

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

For a full discussion of the Company's critical accounting policies and estimates see "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report to Shareholders on Form 10-K for the year ended December 31, 2007.

Off Balance Sheet Arrangements

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

In the ordinary course of business, the Company enters into commitments to extend credit to its customers. As of September 30, 2008, the Company had entered into commitments with certain customers amounting to $364.3 million compared to $440.3 million at December 31, 2007 and $449.5 million at September 30, 2007. Letters of credit at September 30, 2008, December 31, 2007 and September 30, 2007, were $7.4 million, $8.4 million and $8.9 million, respectively. These commitments are not reflected in the accompanying consolidated financial statements and do not significantly impact operating results.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Risk Management

The Company has adopted a Risk Management Plan, which aims to ensure the proper control and management of all risk factors inherent in the operation of the Company. Specifically, credit risk, interest rate risk, liquidity risk, compliance risk, strategic risk, reputation risk and price risk can all affect the market risk of the Company. These specific risk factors are not mutually exclusive. It is recognized that any product or service offered by the Company may expose the Company to one or more of these risk factors.

Credit Risk

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

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

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

The Company's methodology for assessing the appropriateness of the allowance is applied on a regular basis and considers all loans. The systematic methodology consists of two major elements. The first major element includes a detailed analysis of the loan portfolio in two phases. The first phase is conducted in accordance with SFAS No. 114, "Accounting by Creditors for the Impairment of a Loan" as amended by SFAS No. 118, "Accounting by Creditors for Impairment of a Loan — Income Recognition and Disclosures." Individual loans are reviewed to identify loans for impairment. A loan is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan. Impairment is measured as either the expected future cash flows discounted at each loan's effective interest rate, the fair value of the loan's collateral if the loan is collateral dependent, or an observable market price of the loan (if one exists). Upon measuring the impairment, the Company will ensure an appropriate level of allowance is present or established.

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

Based on the risk rating system, specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicates the possibility of loss. Management performs a detailed analysis of these loans, including, but not limited to, cash flows, appraisals of the collateral, conditions of the marketplace for liquidating the collateral and assessment of the guarantors. Management then determines the inherent loss potential and allocates a portion of the allowance for losses as a specific allowance for each of these credits.

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

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

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

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

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

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

Market Risk - Interest Rate Risk

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

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

The Gap analysis measures, at specific time intervals, the divergence between earning assets and interest bearing liabilities for which repricing opportunities will occur. A positive difference, or Gap, indicates that earning assets will

reprice faster than interest-bearing liabilities. This will generally produce a greater net interest margin during periods of rising interest rates and a lower net interest margin during periods of declining interest rates. Conversely, a negative Gap will generally produce a lower net interest margin during periods of rising interest rates and a greater net interest margin during periods of decreasing interest rates.

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

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

The simulation model estimates the impact of changing interest rates on interest income from all interest earning assets and the interest expense paid on all interest bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 200 basis point downward shift in interest rates. A shift in rates over a 12-month period is assumed. Results that exceed policy limits, if any, are analyzed for risk tolerance and reported to the Board with appropriate recommendations. At September 30, 2008, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was a decrease in net interest income of 0.65% if rates increase by 200 basis points and an increase in net interest income of 0.39% if rates decline 100 basis points. Comparatively, at December 31, 2007, the Company's estimated net interest income sensitivity was a decrease in net interest income of 0.40% if rates increase by 200 basis points and an increase in net interest income of 0.90% if rates decrease 200 basis points. All results are within the Company's policy limits.

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

Liquidity Risk

Liquidity risk is the risk to earnings or capital resulting from the Company's inability to meet its obligations when they come due without incurring unacceptable losses. It includes the ability to manage unplanned decreases or changes in funding sources and to recognize or address changes in market conditions that affect the Company's ability to liquidate assets or acquire funds quickly and with minimum loss of value. The Company endeavors to maintain a cash flow adequate to fund operations, handle fluctuations in deposit levels, respond to the credit needs of borrowers and to take advantage of investment opportunities as they arise. The principal sources of liquidity include credit facilities from correspondent banks, brokerage firms and the Federal Home Loan Bank, as well as interest and principal payments on loans and investments, proceeds from the maturity or sale of investments, and growth in deposits.

In general, liquidity risk is managed by controlling the level of borrowings and the use of funds provided by the cash flow from the investment portfolio. At September 30, 2008, the Company maintained Federal Funds borrowing lines of $68 million with major banks subject to the customary terms and conditions for such arrangements and $50 million in repurchase lines with major brokers. In addition, the Company has additional borrowing capacity of $174.5 million from the Federal Home Loan Bank.

At September 30, 2008, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities of approximately $80.2 million, which represents 4.8% of total assets.

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ITEM 4. CONTROLS AND PROCEDURES

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

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

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

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

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

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

ITEM 1A. Risk Factors

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

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

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

Third Quarter 2008	Number of Shares	Average Price per Share	Number of Shares Purchased as Part of a Publicly Announced	Approximate Dollar Value of Shares that May Yet Be Purchased

			Plan or Program	Under the Plan or Program
07/01/2008 - 07/31/2008	-	-	-	$ 2,533,454
08/01/2008 - 08/31/2008	327	460	327	2,383,034
09/01/2008 - 09/30/2008	2,187	450	2,187	1,398,884
Total	2,514	451	2,514	$ 1,398,884

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

ITEM 3. Defaults Upon Senior Securities

Not applicable

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

None

ITEM 5. Other Information

None

ITEM 6. Exhibits

See Exhibit Index on page 31.

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SIGNATURES

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

FARMERS & MERCHANTS BANCORP

Date: November 7, 2008

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

Date: November 7, 2008

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

Index to Exhibits

Exhibit No.	Description
31(a)	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31(b)	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.