

Federal Deposit Insurance Corporation  
Washington, D.C.

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended June 30, 2010

**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: 85-00885

**The Farmers Bank of Willards**

(Exact name of registrant as specified in its charter)

Maryland      52-0309468  
(State of incorporation)(I.R.S. Employer Identification No.)

7484 Market Street, Willards, Maryland 21874  
(Address of principal executive offices) (Zip Code)

(410) 835-8404  
(Issuer's telephone number)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. (as defined in Exchange Act Rule 12b-2).

Large accelerated filer

Accelerated filer

Non-accelerated filer  (do not check if smaller reporting company)

Smaller reporting company

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

On August 9, 2010, 1,364,898 shares of the issuer's common stock, par value \$1 per share, were issued and outstanding.



See accompanying notes to financial statements.



See accompanying notes to financial statements.

See accompanying notes to financial statements.

See accompanying notes to financial statements

## **Notes to Financial Statements:**

### 1. Basis of Presentation

The accompanying unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the Securities and Exchange Commission. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring entries) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. For further information, refer to the financial statements and footnotes thereto for the Bank's fiscal year ended December 31, 2009, included in the Bank's Form 10-K for the year ended December 31, 2009.

### 2. Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, unrestricted amounts due from banks, overnight investments in repurchase agreements, and federal funds sold.

### 3. Per Share Data

Earnings per common share and dividends per common share are determined by dividing net income and dividends by the average shares outstanding, giving retroactive effect to stock dividends distributed. The average shares outstanding for the first quarter and first half of both 2010 and 2009 were 1,364,898.

### 4. Defined Benefit Plan

The Bank has adopted a supplemental executive retirement plan for each of its three executive officers. The plan provides fixed annual benefits to each participant at their normal retirement or disability. The plans vest over the period from adoption to normal retirement age. These plans are funded through life insurance owned by the Bank. The Bank recorded expenses, including interest, of \$43,850 and \$39,119 for the six months ended June 30, 2010 and 2009, respectively. The comparable expense for the quarters ended June 30, 2010 and 2009 were \$21,925 and \$19,560, respectively.

### 5. Fair Value Measurements

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. The Financial Accounting Standards Board (FASB) defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair values. Their guidance also establishes a hierarchy for determining fair value measurements. The hierarchy includes three levels and is based upon the valuation techniques used to measure assets and liabilities.

Level one uses inputs of quoted prices, unadjusted, for identical assets or liabilities in active markets. Level two inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Level three assumes inputs to the valuation methodology that are unobservable and significant to the fair value measurement.

The Bank measures its foreclosed real estate, on a nonrecurring basis, at fair value less cost to sell. As of December 31, 2009 and June 30, 2010, the fair value of foreclosed real estate was based on offers and/or appraisals. Cost to sell the real estate was based on standard market factors. The Bank has

categorized its foreclosed real estate as level three. The lack of an active local real estate market makes these fair values “best estimates” only. There is no assurance that the Bank will realize the fair value of

**Notes to Financial Statements (Continued)**

#### 5. Fair Value Measurements (continued)

these properties as they are sold. The Bank does not measure the fair value of any of its other financial assets or liabilities on a recurring or nonrecurring basis.

The estimated fair values of the Bank’s other financial instruments, which are not measured on a recurring or nonrecurring basis, were as follows:

The fair values of a significant portion of financial instruments are estimates derived using present value techniques and may not be indicative of the net realizable or liquidation values. This estimate method is the least preferred and considered level three. Also, the calculation of estimated fair values is based on market conditions at a specific point in time and may not reflect current or future fair values.

The fair values of cash and due from banks, federal funds sold, and deposit liabilities without fixed rates equal the carrying amounts and are considered level one valuations. Rates have not changed since the investment in time and savings deposits. Consequently their carrying value is considered a good estimation of their fair value. The fair values of investment securities are estimated using a matrix that considers yield to maturity, credit quality, and marketability. This matrix generally is considered a level two valuation.

The fair values of variable rate and demand loans are estimated to equal their carrying amounts. The fair values of fixed rate loans are estimated using the discounted cash flows of the loan repayment schedules based on contractual maturities using publicized local current interest rates for similar loans. Discounted cash flow methods are considered level three.

The fair value of variable rate certificates of deposit is the certificate balance carrying amount. The fair value of fixed rate certificates of deposit is estimated by discounting cash flows of the deposits over the remaining maturities of the deposits using current rates offered by the Bank for deposits with similar maturities.

The fair value of the Federal Home Loan Bank (FHLB) advances is the estimate of the net present value of these advances as determined by the premium FHLB would charge if the debt was liquidated early.

## **Notes to Financial Statements (Continued)**

### **6. Subsequent Events**

We have evaluated subsequent events after June 30, 2010 through August 10, 2010, the date this report was available to be issued. No significant subsequent events were identified which would affect the presentation of the financial statements.

*This Report contains statements which constitute forward-looking statements within the meaning of and pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements appear in a number of places in this Report and include all statements regarding the intent, belief or current expectations of the Bank, its directors or its officers with respect to, among other things: (i) the Bank's financing plans; (ii) trends affecting the Bank's financial condition or results of operations; (iii) the Bank's growth strategy and operating strategy; and (iv) the declaration and payment of dividends. Investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those projected in the forward-looking statements as a result of various factors. Forward-looking statements are based on current assessments and expectations of market conditions, interest rates, and other economic conditions.*

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### General

The Farmers Bank of Willards (the Bank) is a Maryland commercial bank chartered on October 1, 1924. The Bank is engaged in a general commercial and retail banking business. The Bank has its main office in Willards, Maryland, and seven additional full service branches located in the Maryland communities of Willards, Salisbury, and Ocean City. The Bank's general market area covers the area encompassing Wicomico and Worcester Counties in Maryland. The Bank also serves lower Sussex County in Delaware.

The following discussion of the financial condition and results of operations of the Bank should be read in conjunction with the Bank's financial statements and related notes and other statistical information included elsewhere herein.

### Results of Operations

Net income for the Bank decreased \$196,587 to \$177,651 for the three months ended June 30, 2010, from \$374,238 during the corresponding period of 2009. Earnings per share for the quarter ended June 30, 2010, were \$.13, a decrease of 51.85% from earnings per share of \$0.27 for the quarter ended June 30, 2009. Net income for the six months ended June 30, 2010, decreased by \$216,416, or \$.16 per share to \$655,728, or \$.48 per share, from \$872,144, or \$.64 per share for the same period in 2009. First two quarter 2010 earnings decreased from the earnings for the first two quarters of 2009 primarily as a result of a \$1,108,053 increase in the provision for loan losses. This increased cost was offset by a decrease of \$48,890 in noninterest expense, \$731,680 increase in net interest income, and a decrease in income taxes of \$133,470.

Net interest income increased \$350,482 to \$3,439,437 for the quarter ended June 30, 2010 from \$3,088,955 for the quarter ended June 30, 2009 while net interest income for the first six months of 2010 increased \$731,680 compared to the first half of 2009. The 11.35% increase in net interest income for the quarter and the 12.20% increase in net interest income for the first half of 2010 were both attributed to deposit rates declining faster than loan rates while at the same time average loans increased. Net margin on interest-earning assets increased to 4.29% during the first half of 2010 from 4.27% during the first half of 2009. The average loan-to-deposit ratio was 109.19% for the first half of 2010 compared to 116.46% during the comparable 2009 period. This ratio has decreased as the result of a deposit promotion the Bank ran at the end of 2009 into the first month of 2010.

The following table shows that while rates on both earning assets and interest-bearing liabilities have decreased, the rates on time deposits have decreased more than loan rates, causing both the spread and net interest margin, on a fully taxable-equivalent basis, to increase.



The Bank's loan portfolio increased to \$290,781,179 at June 30, 2010 from \$271,005,231 at June 30, 2009, while the portfolio totaled \$292,905,730 at December 31, 2009. The Bank's provision for loan losses was \$1,489,182 for the quarter ended June 30, 2010, while a provision of \$783,129 was recorded for the quarter ended June 30, 2009. The 2010 provision for the first six months is \$1,108,053 greater than the provision recorded for the first six months of 2009. As the economy has slowed and remained sluggish, the Bank has experienced rising delinquencies and foreclosures. The Bank's total nonperforming loans have also increased.

During the second quarter of 2009, in lieu of foreclosure or asset repossession, the Bank elected to restructure the debt of borrowers that management thinks can pay under a different loan repayment scenario. Management evaluates the cash flow of the debtor, modifying loan terms to reduce the debt cash flow needs of the borrower to an amount within their expected ability to repay. As part of this restructure, management may charge-off a portion of interest and/or principal. The interest rate for the borrower may be reduced and the borrower may be allowed to pay interest only for a set period of time, usually twelve months. At the end of the interest only period, management will reevaluate the current economy and the borrower's cash flow to determine how to modify the payments. As of June 30, 2010 and 2009, the outstanding balance of troubled debt restructures totaled \$18,962,211 and \$3,063,134, respectively.

The allowance for loan losses was \$4,973,972 at June 30, 2010, or 1.68% of total loans compared to \$2,923,328 at June 30, 2009, or 1.07% of total loans, and \$4,223,637 at December 31, 2009, or 1.42% of total loans. The level of the allowance for loan losses represents management's current estimate of future losses in the loan portfolio; however, there can be no assurance that loan losses in future periods will not exceed the allowance for loan losses or that additional increases in the allowance will not be required.

The following table sets forth information regarding nonaccrual loans and certain delinquent loans for the six months ended June 30, 2010, compared to the six months ended June 30, 2009, and the twelve months ended December 31, 2009.

Net charge-offs for the first half of 2010 were \$1,713,847, compared to \$948,961 for the first half of 2009. The following table summarizes the activity in the allowance for the six months ended June 30, 2010, compared to the six months ended June 30, 2009, and the twelve months ended December 31, 2009.

Noninterest income decreased \$25,365, or 13.53 %, to \$162,039 for the three months ended June 30, 2010, from \$187,404 for the three months ended June 30, 2009; while noninterest income decreased \$22,403, or 5.69 %, to \$371,328 for the six months ended June 30, 2010, from \$393,731 for the six months ended June 30, 2009. Included in this income were write downs and realized losses from foreclosed property and repossessed assets of \$141,872 and \$85,723 in the second quarters of 2010 and 2009, respectively and \$84,551 and \$64,131 in the first quarters of 2010 and 2009, respectively. Offsetting these increased losses was an increase in automatic teller machine and debit card fees of \$45,661 and an increase of \$3,394 from merchant credit card fee for the first half of 2010 compared to the first half of 2009.

Noninterest expense decreased \$90,520, or 4.60% to \$1,879,268 for the three months ended June 30, 2010, from \$1,969,788 for the three months ended June 30, 2009; while noninterest expense for the first half of 2010 decreased \$48,890, or 1.31%, over noninterest expense for the first half of 2009. The decrease was primarily related to the decrease in total FDIC insurance premiums recorded.

Compensation, including salaries and benefits, increased \$25,543 to \$2,020,711 for the first half of 2010 from \$1,995,168 for the first half of 2009. In July of 2009, the Bank opened a new Ocean City branch and in June of 2010 a seasoned bank accountant was hired. These additional salaries and average raises of 2.09% caused a \$99,817 increase in salaries for the first half of 2010 compared to the first half of 2009. An increasing salary base and higher state unemployment experience rate caused the total unemployment expense to increase \$14,400 during the first six months of 2010 compared to the comparable 2009 period. Offsetting these higher costs were lower pension and bonus expenses. The bonus pool is 10% of net income so it decreased ratably with net income, or \$21,642. In its original 2010 budget, management budgeted to fund the general retirement plan at 10% of base salaries but in June, management revised this estimate down to 5% of base salaries. During the first half of 2009, this retirement was accrued at 10%.

Occupancy costs increased \$12,915 to \$115,568 for the second quarter of 2010 from \$102,653 for the second quarter of 2009; while occupancy costs for the first half of 2010 increased \$6,559, or 2.92%, compared to the comparable 2009 period. During the first quarter of 2009, the Bank had branches with burst pipes as the result of a week of very cold weather. During the first quarter of 2010, the Eastern Shore of Maryland received more snows than normal resulting in higher grounds maintenance and utility costs. Late in 2009 the Bank purchased property in Delaware for a future branch. The property has tenants that have paid rental income of \$8,475 in each of the first two quarters of 2010. During the second quarter, the Bank purchased a building to use as its administrative center. The building was occupied during June of 2010.

Furniture and equipment expense decreased \$1,427 and \$10,977 for the quarter and half year ended June 30, 2010, compared to June 30, 2009, respectively, primarily due to lower depreciation costs as our furniture and equipment age. The second quarter of 2010 showed higher automobile depreciation due to the replacement of the car used by the president.

The FDIC premiums, including FICO bond interest, decreased \$88,167 for the six months ended June 30, 2010 and \$140,175 for the quarter ended June 30, 2010. During the second quarter of 2009, the FDIC notified banks of a special assessment based on asset size levied for the second quarter but to be collected in September, 2009. In June of 2009 management estimated and accrued this special assessment at \$140,287.

Data communications and processing costs increased 46.08%, or \$44,014 during the first six months of 2010 compared to the comparable 2009 period. The Bank received an increase in the cost charged for its data processing lines from the local phone company, increasing this cost approximately \$4,100 per month beginning in July, 2009. Just over half, or \$23,713 of these increased costs occurred in the second quarter of 2010.

Advertising and promotional expenses, including charitable donations, decreased to \$69,631 for the first two quarters of 2010 from \$84,976 for the same quarters of 2009 while these expenses increased \$5,147 for the second quarter of 2010 compared to the second quarter of 2009. The Bank made a special \$2000 donation in January, 2009 to the Willards Volunteer Fire Department building fund. Media advertising is down \$4,464 in 2010 as the Bank has reduced some of its advertising. In the first quarter of 2009 the Bank paid for caps and other promotional customer gifts in excess of 2010 expenses by \$9,988. During the second quarter of 2010, the Bank held a grand opening of its newest Ocean City branch, which opened in the middle of beach season in 2009, incurring promotional expenses of \$5,302. Without these costs, the second quarter advertising and promotional expenses would have been comparable to the second quarter 2009 expenses.

The final component of noninterest expense, other operating costs, showed a net decrease of \$10,517 for the six months ended June 30, 2010 compared to the comparable period in 2009. These expenses showed a net increase of \$68,540 during the second quarter of 2010 compared to the second quarter of 2009. Management decided in the second half of 2009 to send our own foreclosure letters instead of using the attorney. Consequently costs for the first quarter of 2010 compared to the first quarter of 2009 decreased. But collection and processing costs were higher by \$84,299 during the second quarter of 2010 compared to the same 2009 quarter, resulting in total increase for the first half of 2010 over 2009 of \$49,774. During the second quarter of 2010, the attorneys were involved in several pending foreclosures. The local tax departments also charged a processing fee when the Bank paid, to protect its interest in mortgaged properties, the real estate taxes of borrowers. During 2008 the Bank sold foreclosed property that had been listed with a realtor. The real estate company returned the deposit and charged no commission as the Bank found a buyer on its own. In 2009 the Bank paid a settlement of \$35,000 to a realtor who left this real estate company prior to the sale of the property.

In March and April of 2009 the Bank paid untimely billed condominium fees on foreclosed property of \$8,553 and \$6,251, respectively. This property was sold in late 2009 so no condominium fees have been paid in 2010 related to foreclosed properties. During the second quarter of 2010, the Bank incurred costs totaling approximately \$17,000 related to wetland and electric issues with two foreclosed properties that partially offset the second quarter 2009 fees totaling approximately \$21,650 to resolve some title issues with property held as a result of foreclosures.

The Bank paid \$6,825 and \$1,950 less in directors' fees in the first half and second quarter of 2010, respectively. In 2009 a high loan demand required more loan committee meetings. Offsetting these decreases was an increase of \$3,880 for the State Bank Commissioner fee. This increased as our assets increased and as the formula changed, resulting in a higher rate.

Insurance expense increased \$8,980 for the first six months of 2010 compared to the first six months of 2009 due to higher premiums on all policies. The second quarter insurance expense for 2010 is higher than the first quarter expense due to the timing of group membership rebates. The Bank has incurred lower teller machine processing expenses during both the second quarter and first half of 2010 compared to the comparable periods in 2009. During the second quarter of 2009 the Bank experienced more frauds and possible compromise of its ATM/debit card base resulting in expenses of \$14,200. These 2009 costs have offset the general increase in processing as a result of more volume and processing real time.

Meals have increased for both the second quarter and first half of 2010 compared to the same periods in 2009 due to the second quarter caterer fee for the Talbot location grand opening and the first quarter caterer fee for a staff meeting with all employees to discuss the Bank's new mission statement.

If the Bank's noninterest expense were to increase at a faster rate than its net interest income and noninterest income, the efficiency ratio will worsen. The Bank's efficiency ratio for the first half of 2010 was 50.12% compared 56.93% for the first half of 2009. The efficiency ratios for the second quarter of 2010 and 2009 were 50.22% and 58.66%, respectively.

## Financial Condition

Total assets of the Bank increased \$11,699,684, or 3.50%, to \$346,112,956 on June 30, 2010 from \$334,413,272 on December 31, 2009. Deposits funded this asset growth, increasing \$19,850,872, or 7.93%, during the first half of 2010. Management ran a certificate of deposit promotion in January to raise funds to pay off the \$8,000,000 Federal Home Loan Bank (FHLB) advance that was due in January. Management expects to pay off a second advance, totaling \$10,000,000, in September of this year. In addition to the deposit promotion, the Bank is still acquiring customers from the late 2008 merger of a Maryland Bank, with the largest market share in our market area, with a larger out-of-state bank. Most of this growth occurred in the first quarter with asset and deposit growth of \$2,233,969 and \$2,218,346, respectively in the second quarter. After the deposit promotion, management priced its deposits at levels competitive in the market. Management has been controlling growth to preserve capital.

During the first quarter of 2010, gross loans decreased \$3,117,290 while second quarter gross loans increased \$1,743,074. As a result, gross loans decreased \$1,374,216 or 0.46% to \$295,755,151 from \$297,129,367 as of December 31, 2009. The nonperforming loans of the Bank, which include nonaccrual loans plus all loans over ninety days delinquent, increased from \$12,515,657, or 3.74% of total assets, at December 31, 2009 to \$18,019,198, or 5.21% of total assets, as of June 30, 2010. The allowance for loan losses to total nonperforming loans was 27.60% and 33.75% as of June 30, 2010 and December 31, 2009, respectively. The slowing economy of the Eastern Shore of Maryland during the last several quarters, has contributed to rising loan delinquencies. Consequently, management has been increasing its provisions and allowance for loan losses as a percentage of gross loans.

## Liquidity

The Bank's primary source of liquidity is cash on hand plus short-term investments. Another source of liquidity is the \$12 million line of credit the Bank has from a correspondent bank. Investment securities are pledged as collateral to partially secure the line of credit. The Bank's membership in the Federal Home Loan Bank allows the Bank to borrow up to 25% of its total assets. Collateral for this line is the Bank's portfolio of residential mortgages which can limit available borrowings. As of June 30, 2010, the Bank had qualifying collateral to support approximately \$55 million in total borrowings from the Federal Home Loan Bank. If additional liquidity is needed, the Bank will sell participations in its loans. Management is also investigating the possibility of establishing a line to borrow from Federal Reserve using nonmortgage loans as collateral.

Average liquid assets (cash and amounts due from banks, interest bearing deposits in other banks, federal funds sold, and investment securities) compared to average assets were 7.63% for the first half of 2009 compared to 9.70% for the first half of 2010. Liquidity increased during the first quarter of 2010 as the result of increased deposits resulting in \$11,713,304 funds invested in a money market account with a correspondent and increased Federal funds sold. The Bank had Federal funds sold of \$6,100,097 at June 30, 2010 compared to Federal funds sold of \$2,227,386 as of December 31, 2009.

## Plans of Operation

The Bank conducts general commercial banking business in its service areas of Wicomico and Worcester Counties, while emphasizing the banking needs of individuals and small- to medium-sized businesses and professional concerns. The Bank offers a full range of federally insured deposit services that are typically available in most commercial banks and savings and loan associations. This includes checking accounts, NOW accounts, savings accounts, and other deposits that range from money market accounts to term certificates of deposit.

The Bank offers a full range of short-term commercial, agricultural and personal loans and originates all types of non-guaranteed mortgage loans. These loans are made with the intent and ability of the Bank to hold these loans in its portfolio.

Other Bank services include cash management services, safe deposit boxes, travelers' checks, direct deposit, debit cards, and automatic drafts of all accounts. The Bank is associated with the Honor/VISA network that may be used throughout the Bank's service area and other regions. The Bank offers credit card services through another institution. The Bank has internet banking with bill pay.

Total stockholders' equity increased by the first six month earnings. Under the guidelines of the federal regulatory agencies, the Bank is required to maintain a minimum total risk-based capital ratio of 8%, a Tier 1 risk-based capital ratio of 4% and a Tier 1 leverage ratio of 3%. Tier 1 risk-based capital ratios of the Bank as of June 30, 2010, December 31, 2009, and June 30, 2009 were 11.25%, 11.10%, and 12.46%, respectively.

**To support continued growth, the Bank may need to raise additional capital, either at the Bank level or following formation of a holding company.** The ability to raise additional capital, if needed, will depend in part on conditions in the capital markets at that time, which are outside of management's control. Accordingly, no assurance is provided of the ability to raise additional capital, if needed, on terms acceptable to the Bank. If the Bank cannot raise additional capital when needed, the ability to further expand operations through internal growth and acquisitions could be materially impaired. In addition, if management decides to raise additional equity capital, each stockholder's interest could be diluted. Management expects to preserve capital by controlling future growth. At the annual meeting of the stockholders, held in May, 2010, the Bank president informed shareholders that they should expect lower future cash dividends, as compared to 2009 levels, until the economy recovers and the earnings of the Bank increase.

#### Off-balance sheet arrangements

The Bank has no off-balance sheet arrangements except for loan commitments, including outstanding letters of credit. Loan commitments and lines of credit are agreements to lend to a customer as long as there is no violation of any condition to the contract. Loan commitments generally have interest fixed at current market rates, fixed expiration dates, and may require payment of a fee. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at any time.

Letters of credit are commitments issued to guarantee the performance of a customer to a third party. Loan commitments, lines of credit and letters of credit are made on the same terms, including collateral, as outstanding loans. The Bank's exposure to loss in the event of nonperformance by the borrower is represented by the contract amount of the commitment. Management is not aware of any accounting loss the Bank will incur by the funding of these commitments.

The Bank has the following commitments outstanding as of June 30, 2010:

## Changes in Contractual Obligations

The Bank has entered into one new contract, a new five-year software license, since December 31, 2009. During the second quarter of 2010 the Bank was investigating and negotiating terms for a more sophisticated asset liability model. In early July the Bank signed a contract that will include one-time training and installation fees of \$6,000 and monthly fees of \$821.

## Recent Accounting Standards

The following are recent accounting standards updates.

*Accounting Standards Update (ASU) No. 2009-16, "Transfers and Servicing (Topic 860) - Accounting for Transfers of Financial Assets."* ASU 2009-16 amends prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. Because the Bank does not sell loans on the secondary market, this will have limited application. ASU 2009-16 eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. ASU 2009-16 also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The provisions of ASU 2009-16 became effective on January 1, 2010 and did not have a significant impact on the Bank's financial statements.

*ASU No. 2010-06, "Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures About Fair Value Measurements."* ASU 2010-06 requires expanded disclosures related to fair value measurements including the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, the policy for determining when transfers between levels of the fair value hierarchy are recognized and for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. ASU 2010-06 further clarifies that fair value measurement disclosures should be provided for each class of assets and liabilities rather than by major category. Banks should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosure requirements generally became effective on January 1, 2010; but the disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy will not be required until January 1, 2011.

*ASU No. 2010-20, "Receivables (Topic 830) - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses."* ASU 2010-20 requires expanded disclosures to make it easier for financial statement users to evaluate the credit quality risk and the related changes in the allowance for loan losses. Roll forward information will be required for the allowance and certain nonperforming or modified loans. The roll forward disclosures will be required for financial statements beginning after December 31, 2010 while other disclosure elements as of a period end will be required to be included in financial statements as of December 31, 2010.

## Recent Legislation of Import to Financial Institutions

On July 21, 2010, the President signed the “Dodd-Frank Wall Street Reform and Consumer Protection Act” which impacts all financial institutions. This new legislation creates a new agency and will require new regulatory rules to be written. The provisions of this act and the subsequent rules will occur over several years. Some of the provisions of this act that will affect the Bank include:

1. Create the Consumer Financial Protection Bureau, which is to centralize responsibility for consumer financial protection. Management cannot determine what impact this will cause until the new agency has developed its rules and has examined a few banks to determine how its oversight will differ from oversight currently administered by the Bank’s primary Federal regulator, the FDIC.
2. Change the assessment base for federal deposit insurance to total assets less tangible capital from total insured deposits. It is expected that this will increase the assessment base and cost of deposit insurance for the Bank.
3. Change corporate governance that will cause the Bank to provide more information and a vote in its proxy on executive compensation as well as additional proxy access for shareholders. The new legislation will effectively delay the requirement that the Bank’s Sarbanes-Oxley internal control report be audited until such time as the Bank becomes an accelerated filer.
4. Permanently increase the level of FDIC insurance from \$100,000 to \$250,000.
5. Repeal the prohibition of interest on business demand deposit accounts. As banks pay interest on business checking accounts, their cost of funds will increase.
6. Grant the Federal Reserve authority to establish rules for the fees charged for electronic debit transactions. Depending on the rules established, this may lower revenues of the Bank.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

**The Bank’s principal market risk exposure relates to interest rates on interest-earning assets and interest-bearing liabilities. The assets and liabilities of financial institutions such as the Bank are primarily monetary in nature; therefore, interest rates have a significant effect on the Bank’s performance. Changes in the general rate of the inflation and in prices do not always move in the same direction or in the same magnitude as the prices of goods and services. Management monitors and seeks to manage the relationships between interest sensitive assets and liabilities in order to protect against wide interest rate fluctuations, including those resulting from inflation.**

The Bank uses a modified gap model as a tool to measure its exposure to changing interest rates. As of June 30, 2010, the Bank’s interest rate sensitivity, as measured by gap analysis assuming a falling rate environment, reflected that the Bank was liability-sensitive with a one-year cumulative gap of 31.14% as a percentage of total interest-earning assets; while the Bank is asset sensitive in a rising rate environment with a one-year cumulative gap of 7.12%. Generally asset-sensitivity indicates that assets reprice more quickly than liabilities and in a falling rate environment net interest income typically decreases. The Bank has classified its demand mortgage and commercial loans as immediately repricing. These loans are not tied to any index or margin. Accordingly, they do not reprice automatically; management determines the timing of any adjustments to interest rates on demand loans. Most of the certificates of deposit of the Bank have a step-up feature, which allows the depositor one opportunity during the term of the certificate to increase the rate to current market rates. In a declining rate environment, these deposits are not treated as immediately repricable. The current model would not decrease loan rates as quickly as deposit rates in a declining rate environment, which does not consider that borrowers may seek to refinance their loans at lower rates. The Bank currently uses modified gap analysis to monitor its asset liability sensitivity. Management has been investigating the purchase of a more sophisticated model. In early July, a contract was signed to purchase software that will improve the bank’s model. It is expected that this model will be used in the fourth quarter of 2010, but may be delayed until the first quarter of 2011.

#### **Item 4. Controls and Procedures**

As of June 30, 2010, management of the Bank, under the supervision and with the participation of the Bank's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Bank's disclosure controls and procedures. Based on this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Bank's disclosure controls and procedures were effective. There were no significant changes in the Bank's internal controls subsequent to the date of the evaluation that could significantly affect the controls.

### **PART II – OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

There are no material pending legal proceedings to which the Bank is a party or of which any of its property is the subject.

#### **Item 1A. Risk Factors**

There were no material changes from the risk factors presented in our annual report on Form 10-K for the year ended December 31, 2009.

#### **Item 2. Changes in Securities**

None.

#### **Item 3. Defaults Upon Senior Securities**

Not applicable.

#### **Item 4. Submission of Matters to a Vote of Security Holders**

The annual meeting of the stockholders was held on May 5, 2010. The Class I directors listed in the proxy statement were re-elected for an additional three-year term.

#### **Item 5. Other Information**

None.

#### **Item 6. Exhibits and Reports on Form 8-K**

##### **(a) Exhibits**

1. Section 302 Certification by Chief Executive Officer for Disclosure Controls and Internal Control over Financial Reporting
2. Section 302 Certification by Chief Financial Officer for Disclosure Controls and Internal Control over Financial Reporting
32. Section 906 Certification of Chief Executive Officer and Chief Financial Officer

##### **(b) Reports on Form 8-K**

None.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**The Farmers Bank of Willards**

(Registrant)

Date: August 10, 2010

By: /s/Christopher F. Davis

Christopher F. Davis.

President and

Chief Executive Officer

Date: August 10, 2010

By: /s/Renee M. Lovell

Renee M. Lovell, CPA

Chief Financial Officer

## Exhibit 31.1 Certification

I, Christopher F. Davis, chief executive officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The Farmers Bank of Willards;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls and procedures over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 10, 2010

By: /s/Christopher F. Davis  
Christopher F. Davis.  
Chief Executive Officer

## Exhibit 31.2 Certification

I, Renee M. Lovell, chief financial officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The Farmers Bank of Willards;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls and procedures over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 10, 2010

By: /s/Renee M. Lovell  
Renee M. Lovell, CPA  
Chief Financial Officer



**Exhibit 32**

**THE FARMERS BANK OF WILLARDS CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER**

**Certification of Chief Executive Officer and Chief Financial Officer**

Pursuant to 18 U.S.C. 1350

(Section 906 of the Sarbanes-Oxley Act of 2002)

We, the undersigned, certify that to the best of our knowledge, based upon a review of the registrant's Report on Form 10-Q for the period ended June 30, 2010 (the "Report"):

The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the registrant.

**The Farmers Bank of Willards**

(Registrant)

Date: August 10, 2010

By: /s/Christopher F. Davis  
Christopher F. Davis.  
President and  
Chief Executive Officer

Date: August 10, 2010

By: /s/Renee M. Lovell  
Renee M. Lovell, CPA  
Chief Financial Officer