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INSURANCE CORPORATION

ACCOUNTING & SECURITIES
DISCLOSURE SECTION



2010 ANNUAL REPORT



RECEIVED
FEDERAL DEPOSIT
INSURANCE CORPORATION

MAR 24 2011

◆ THE "COMMUNITY" BANK THAT PUTS PEOPLE FIRST ◆

Member FDIC

March 4, 2011

Dear Stockholders, Customers, and Friends:

ACCOUNTING & SECURITIES
DISCLOSURE SECTION

We are pleased to report that your Bank achieved the highest net income in its 91 year history during 2010. Net income for the year ended December 31, 2010 was \$2,197,737 or \$2.87 per share compared to \$1,237,772 or \$1.36 per share in 2009. This 78% increase in net income is a result of the widening in our net interest margin and an increase in earning assets. We continue to benefit from low loan losses and efficient operations. Return on average equity increased to 9.95% in 2010 from 6.02% in 2009. Return on average assets, another key measure of profitability, increased to 0.97% in 2010 versus 0.59% in 2009. Cash dividends paid to shareholders in 2010 increased 25% to \$0.75 per common share from \$0.60 per common share in 2009.

Total assets continued to grow at a significant rate during 2010. The year-end total of \$240 million represented a 12% increase from \$215 million at December 31, 2009. Loans outstanding increased 9% to \$175 million at December 31, 2010 from \$161 million at the end of 2009. Deposits experienced a double digit increase of 15%, growing to \$202 million at December 31, 2010 from \$176 million at December 31, 2009. Stockholders' Equity increased \$1,698,555 or 8% to \$22,610,425 at December 31, 2010 from \$20,911,870 at the end of 2009.

Our outstanding financial performance in 2010 earned us a #2 ranking among Maryland state chartered banks as determined by the Financial Management Consulting Group. We were the highest ranked Bank in the Baltimore Metropolitan area. The rankings were based upon profitability, efficiency, and asset quality among other criteria.

We continue to provide the safety and soundness that is important in today's challenging economy. The Bank is and has been for many years a well capitalized institution, according to FDIC criteria. We provide outstanding service to our customers and continue to meet the loan and deposit needs of our community. Our staff is sensitive to your financial needs in these difficult times and we encourage you to contact us to assist you.

The brokerage firm of RBC Wealth Management makes a market in our common stock. If you have an interest in buying or selling any Farmers and Merchants Bank common stock and you would like the assistance of RBC Wealth Management, please call Mr. Charles Luck or Mr. Derek Ehman at 1-800-247-7223. The Bank's common stock is traded through NASDAQ's Over-the-Counter Bulletin Board (trading symbol: FMFG).

We are very proud of the outstanding financial performance of Farmers and Merchants Bank in 2010. The Board of Directors and staff thank you for your confidence in and your continued support of our excellent community bank.

We wish you all the best in 2011!

Sincerely yours,

Kenneth W. Hoffmeyer,
Chairman

James R. Bosley, Jr.,
President

Farmers and Merchants Bank

About The Bank

General

Farmers and Merchants Bank (the "Bank") was incorporated October 24, 1919 under the laws of Maryland. The Bank is a Federal Deposit Insurance Corporation ("FDIC") insured independent community bank headquartered in Upperco, Maryland. The Bank currently has seven branch locations in Carroll and Baltimore Counties. The Bank's general market area runs along the Route 30 and Route 795 corridors south from Owings Mills and north to the Pennsylvania state line including the areas of Reisterstown, Upperco, Hampstead and Manchester.

Services of the Bank

The Bank provides comprehensive commercial and retail banking services to small and medium-sized businesses and to individuals. The following types of services are offered by the Bank:

Commercial Services

- Loans, including commercial mortgages, lines of credit, a wide range of demand, term, and time loans, for purposes such as fixed asset purchases, as well as loans guaranteed by the Small Business Administration ("SBA") and the Farm Services Agency ("FSA")
- Commercial checking accounts and Remote Deposit Banking services
- Certificates of Deposit and other interest-bearing accounts
- Direct deposit of payroll
- Merchant credit card services
- Letters of Credit.

Consumer Services

- Transaction accounts, including checking and NOW accounts
- Savings accounts
- Certificates of Deposit
- Money Market Accounts
- Individual Retirement Accounts
- Holiday and Vacation Club accounts
- Mortgages (Permanent and Construction)
- Home Equity loans
- Installment and Line of Credit loans
- Land loans
- Car and truck loans
- Agricultural loans
- Educational loans
- VISA Debit cards

The Bank offers 24 hour ATMs, including access to the Allpoint Network, on-line banking, safe deposit boxes, money orders, savings bonds, official checks, night depository, 24 hour Dial-A-Bank Telephone Access System, internet banking, remote deposit, and wire transfers. The Bank does not offer general trust services.

Farmers and Merchants Bank

MISSION STATEMENT

The mission of Farmers and Merchants Bank is to improve the quality of life in our community by being a people-oriented, independent, profitable community bank dedicated to providing products and services that fulfill the financial needs of local individuals and businesses.

LOCATIONS

Main Office
15226 Hanover Pike
Upperco, MD 21155
410-833-6600

Hampstead Office
735 Hanover Pike
Hampstead, MD 21074
410-239-4448

North Oaks
Senior Living Community
725 Mount Wilson Lane
Pikesville, MD 21208
410-484-7442

Greenmount Office
2205 Hanover Pike
Hampstead, MD 21074
410-374-3436

Reisterstown Office
P.O. Box 249
25 Westminster Pike
Reisterstown, MD 21136
410-517-3060

Mortgage Division
Hampstead Office
735 Hanover Pike
Hampstead, MD 21074
410-239-9650

Operations Center
P.O. Box 249
25 Westminster Pike
Reisterstown, MD 21136
410-517-3065

Owings Mills Office
9320 Lakeside Boulevard
Owings Mills, MD 21117
410-356-8200

Atrium Village
Senior Living Community
4730 Atrium Court
Owings Mills, MD 21117
410-998-8847

Commercial Loan Center
Owings Mills Office
9320 Lakeside Boulevard
Owings Mills, MD 21117
410-356-9303

Farmers and Merchants Bank
Directors
2010

Kenneth W. Hoffmeyer, Chairman
 Associate Controller
 Johns Hopkins University

Paul F. Wooden, Jr., Vice Chairman
 President
 Taylor Technologies, Inc.

James R. Bosley, Jr.
 President and CEO
 Farmers and Merchants Bank

Roger D. Cassell
 President
 Communications Electronics, Inc.

Edward A. Halle, Jr.
 Attorney, Fowley & Beckley, P.A.

Ronald W. Hux
 President, Douron, Inc.

T. Edward Lippy
 President, Lippy Brothers, Inc.

J. Lawrence Mekulski
 Principal, KLNb, LLC

Rudolf W. Nechay
 President
 Industrial Refrigeration Services, Inc.
 General Refrigeration, Inc.
 Polytemp Corporation

Bruce L. Schindler
 President
 Bob Davidson Ford Lincoln

John J. Schuster, Jr.
 President, Schuster Enterprises, Inc.

W. Ralph Wisner
 Vice President and Secretary
 Wisner Farms, Inc.

Director Emeritus

Glenn D. Cassell
 Chairman of the Board
 Communications Electronics, Inc.

Farmers and Merchants Bank
Officers
2010

James R. Bosley, Jr.
 President and CEO

Christopher T. Oswald
 Senior Vice President,
 Chief Operations Officer

Mark C. Krebs
 Senior Vice President,
 Chief Financial Officer

Senior Vice Presidents

Julie A. Harris-Hare.....Data Processing
 Cheryl Y. LewisLending
 J. Ritchie Solter.....Commercial Lending
 Yvonne G. Zeminski...Branch Administration

Vice Presidents

Lynnette Kitzmiller.....Corporate Secretary
 Kevin P. Bankert.....Commercial Loan Officer
 M. Eugene Bosley...Commercial Loan Officer
 Gary A. Harris.....Commercial Loan Officer

Other Bank Officers

Paul A. Davolos..Commercial Banking Officer
 T. Jeffrey Horner.....Controller
 Mark W. Lutrey.....Auditor
 J. Thomas Turner.....Mortgage Officer

Assistant Vice Presidents

Loan Officers

Debora A. Smith
 Betty J. Higgs-Swartz

Assistant Vice Presidents

Branch Managers

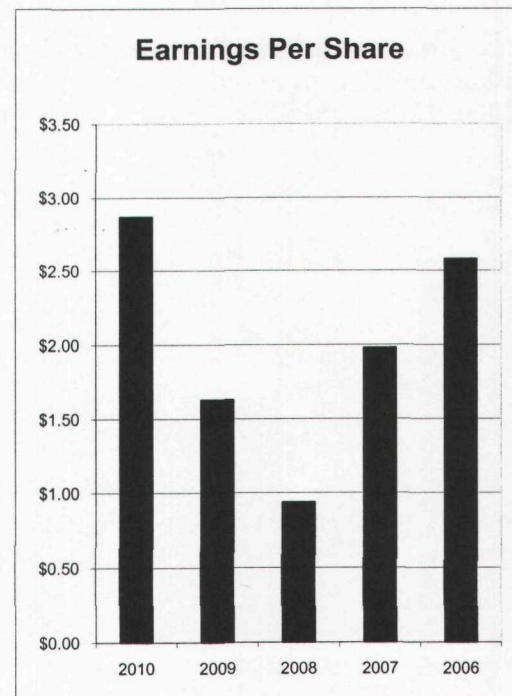
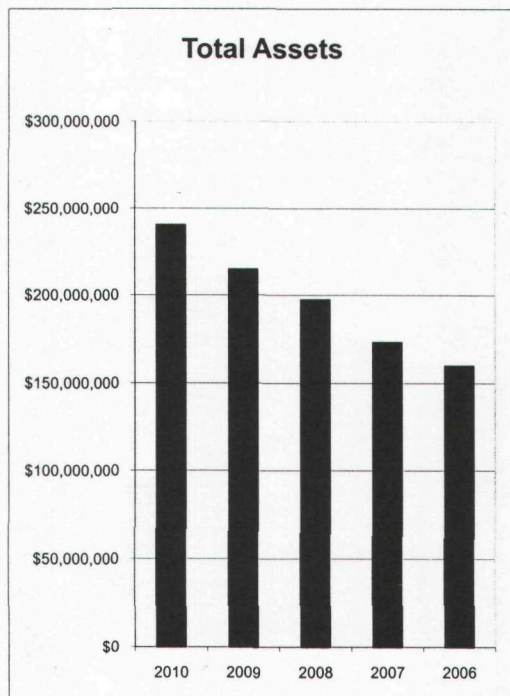
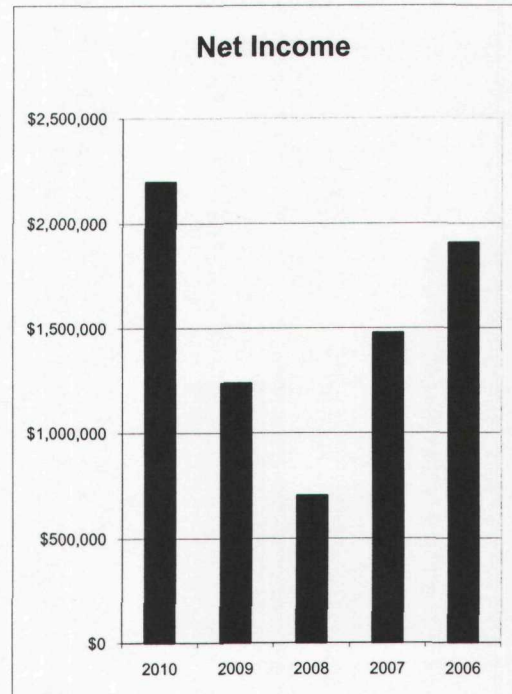
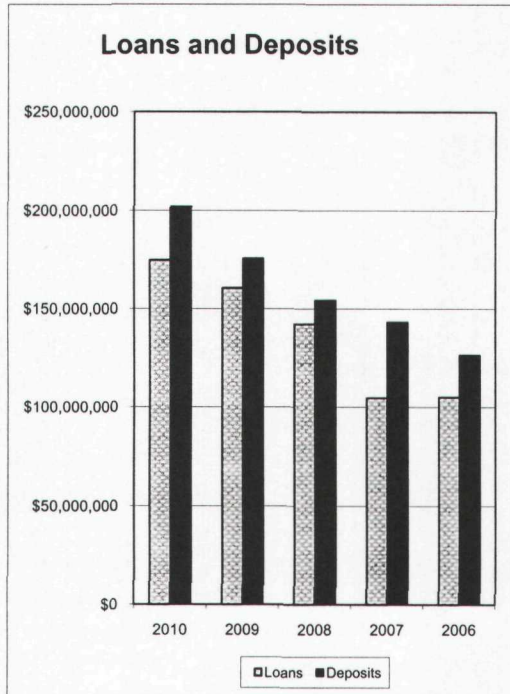
Wendy A. Panek.....Reisterstown
 Shannon M. Panek-Close.....Main Office
 Rachel L. Heird.....Owings Mills
 Kelly P. Johnson.....Hampstead
 Amy L. Collins.....Greenmount

Farmers and Merchants Bank

Selected Consolidated Financial Data

	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
<i>OPERATING DATA</i>					
Interest income	\$ 11,617,437	\$ 10,716,699	\$ 9,817,939	\$ 10,144,507	\$ 9,427,118
Interest expense	<u>2,255,263</u>	<u>3,196,670</u>	<u>3,384,201</u>	<u>3,510,242</u>	<u>2,577,445</u>
Net interest income	9,362,174	7,520,029	6,433,738	6,634,265	6,849,673
Provision for loan losses	<u>635,000</u>	<u>750,000</u>	<u>520,000</u>	<u>340,000</u>	<u>165,000</u>
Net interest income after provision for loan losses	8,727,174	6,770,029	5,913,738	6,294,265	6,684,673
Noninterest income	1,707,695	1,788,807	1,799,602	1,667,148	1,524,317
Noninterest expenses	<u>7,000,305</u>	<u>6,674,128</u>	<u>6,774,376</u>	<u>5,748,785</u>	<u>5,333,744</u>
Income before income taxes	3,434,564	1,884,708	938,964	2,212,628	2,875,246
Income taxes	<u>1,236,827</u>	<u>646,936</u>	<u>234,201</u>	<u>735,508</u>	<u>966,413</u>
Net income	<u>\$ 2,197,737</u>	<u>\$ 1,237,772</u>	<u>\$ 704,763</u>	<u>\$ 1,477,120</u>	<u>\$ 1,908,833</u>
<i>PER SHARE DATA</i>					
Net income (Basic)	\$2.87	\$1.63	\$0.94	\$1.98	\$2.58
Dividends	\$0.75	\$0.60	\$0.99	\$0.95	\$0.90
Book value per share	\$29.20	\$27.37	\$26.53	\$26.27	\$25.19
Dividend payout ratio	26.13%	36.81%	105.17%	47.98%	34.88%
<i>KEY RATIOS</i>					
Return on average assets	0.97%	0.59%	0.39%	0.87%	1.20%
Return on average equity	9.95%	6.02%	3.52%	7.58%	10.51%
Net interest margin	4.46%	3.87%	3.88%	4.30%	4.71%
Efficiency ratio	63.24%	71.70%	82.28%	69.25%	63.69%
Average equity to average assets	9.74%	9.88%	11.09%	11.53%	11.43%
<i>AT PERIOD END</i>					
Total assets	\$ 240,427,031	\$ 214,703,396	\$ 197,271,437	\$ 173,211,324	\$ 159,981,417
Loans, net and loans held for sale	176,040,884	162,086,511	142,375,750	104,779,706	105,182,335
Cash, federal funds sold, and other interest-earning deposits	11,602,545	14,737,250	12,887,914	24,688,671	19,246,824
Securities	39,321,424	24,978,938	29,828,781	30,812,781	24,977,379
Deposits	201,990,686	175,914,655	154,332,920	143,460,039	126,691,741
Borrowings	15,131,657	17,235,751	21,968,438	9,268,451	13,983,051
Stockholders' equity	22,610,425	20,911,870	20,045,076	19,703,260	18,765,720
<i>SELECTED AVERAGE BALANCES</i>					
Total assets	\$ 226,927,649	\$ 208,096,804	\$ 180,780,956	\$ 168,941,480	\$ 158,915,004
Loans, net and loans held for sale	166,059,163	155,472,880	122,890,944	110,630,577	107,648,491
Cash, federal funds sold, and other interest-earning deposits	19,239,869	7,578,188	11,810,737	17,653,887	12,079,672
Securities	28,938,039	27,395,016	31,208,413	26,344,512	25,557,866
Deposits	188,050,432	167,803,586	144,044,763	138,289,943	126,746,281
Borrowings	16,088,557	18,874,328	16,030,065	10,420,512	13,359,432
Stockholders' equity	22,093,758	20,566,797	20,047,843	19,485,116	18,167,290
<i>ASSET QUALITY</i>					
Nonperforming assets	\$ 1,467,705	\$ 2,203,332	\$ 2,786,678	\$ 2,500,068	\$ 1,311,851
Nonperforming assets/total assets	0.61%	1.03%	1.41%	1.44%	0.82%
Allowance for loan losses/total loans	1.37%	1.21%	1.05%	1.14%	1.16%

Farmers and Merchants Bank Selected Consolidated Financial Data



Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is qualified in its entirety by the more detailed information and the financial statements and notes thereto appearing elsewhere in this Annual Report. In addition to the historical information contained herein, the discussion in this Annual Report contains certain forward-looking statements that involve risks and uncertainties, such as statements of the Bank's plans, strategies, objectives, expectations and intentions, including, among other statements, statements involving the Bank's projected loan and deposit growth, loan collateral values, collectability of loans, anticipated changes in noninterest income, payroll and branching expenses, branch, office, and product expansion of the Bank and its affiliates, and liquidity and capital levels. These statements may be identified by such forward-looking terminology as "expect," "believe," "anticipate," or by expressions of confidence such as "continuing," or "strong," or similar statements or variations of such terms. The Bank's actual results could differ materially from those discussed herein and involve certain risks and uncertainties. These risks and uncertainties include, but are not limited to, general economic conditions and competition in the geographic and business areas in which the Bank and its subsidiaries operate, inflation, fluctuations in interest rates, legislation, and government regulation. These and other risks are discussed in more detail in Item 1A of Part I of the Bank's Annual Report on Form 10-K for the year ended December 31, 2010. The cautionary statements made in this Annual Report are applicable to all related forward-looking statements wherever they appear in this Annual Report.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

The consolidated financial statements of the Bank are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and follow general practices within the industry in which the Bank operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the consolidated financial statements; accordingly, as this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the consolidated financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The most significant accounting policies followed by the Bank are presented in Note 1 to the consolidated financial statements presented elsewhere in this Annual Report. These policies, along with the disclosures presented in the other financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has identified the determination of the allowance for loan losses as the accounting area that requires the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

The allowance for loan losses represents management's estimate of probable loan losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the balance sheet. Note 1 to the consolidated financial statements describes the methodology used to determine the allowance for loan losses.

RECENT DEVELOPMENTS

The Dodd-Frank Act

On July 21, 2010, financial regulatory reform legislation entitled the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Dodd-Frank Act") was signed into law. The Dodd-Frank Act implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, will:

- .. Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital, eliminate the ceiling on the size of the Deposit Insurance Fund ("DIF") and increase the floor of the size of the DIF.
- .. Impose comprehensive regulation of the over-the-counter derivatives market, which would include certain provisions that would effectively prohibit insured depository institutions from conducting certain derivatives businesses in the institution itself.
- .. Implement corporate governance revisions, including with regard to executive compensation and proxy access by shareholders, that apply to all public companies, not just financial institutions.
- .. Make permanent the \$250 thousand limit for federal deposit insurance and increase the cash limit of Securities Investor Protection Corporation protection from \$100 thousand to \$250 thousand and provide unlimited federal deposit insurance until December 31, 2012 for non-interest bearing demand transaction accounts at all insured depository institutions.
- .. Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- .. Amend the Electronic Fund Transfer Act ("EFTA") to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on the Bank, its customers or the financial industry more generally. Provisions in the legislation that affect the payment of interest on demand deposits and interchange fees are likely to increase the costs associated with deposits as well as place limitations on certain revenues those deposits may generate.. Some of the rules that have been proposed and, in some cases, adopted to comply with the Dodd-Frank Act's mandates are discussed further below.

FINANCIAL CONDITION

Total assets increased by \$25,723,635 or 12.0% to \$240,427,031 at December 31, 2010 from \$214,703,396 at December 31, 2009. The increase in total assets was due primarily to increases of \$14,342,486 in securities available for sale and held for investment and \$14,206,746 in loans, offset by a decrease in cash and due from banks of \$2,809,590

Total liabilities increased \$24,025,080 or 12.4% to \$217,816,606 at December 31, 2010 from \$193,791,526 at December 31, 2009. The increase was due primarily to increases in deposits of \$26,076,031 and securities sold under repurchase agreements of \$895,906, offset by a decrease in Federal Home Loan Bank ("FHLB") advances of \$3,000,000. The increase in deposits was comprised of a \$20,803,702 increase in interest-bearing accounts and a \$5,272,329 increase in noninterest-bearing accounts.

Stockholders' equity increased by \$1,698,555 to \$22,610,425 at December 31, 2010 from \$20,911,870 at December 31, 2009. The increase was due primarily to net income for the period of \$2,197,737, offset by dividends paid, net of reinvestments, of \$337,291 and a decrease in accumulated other comprehensive income of \$154,616.

Loans

Loans increased by \$14,206,746 or 8.8% to \$174,875,384 at December 31, 2010 from \$160,668,638 at December 31, 2009. The increase was primarily attributable to increases in other commercial real estate loans of \$10,915,529 and residential real estate loans of \$4,283,994. The allowance for loan losses was \$2,436,510 at December 31, 2010 an increase of \$463,212 when compared to the allowance at December 31, 2009.

Major categories of loans are as follows:

	2010	2009
Commercial	\$ 10,237,364	\$ 10,359,989
Commercial Real Estate:		
Construction	6,063,742	6,409,784
Other	124,916,851	114,001,322
Consumer	467,403	499,253
Residential	<u>35,952,302</u>	<u>31,668,308</u>
	177,637,662	162,938,656
Less: Allowance for loan losses	(2,436,510)	(1,973,298)
Deferred origination fees net of costs	<u>(325,768)</u>	<u>(296,720)</u>
	<u>\$ 174,875,384</u>	<u>\$ 160,668,638</u>

The following table sets forth at December 31, 2010 and 2009 the maturity and rate repricing distribution of the loan portfolio. Demand loans and overdrafts are reported as due in one year or less. The table does not include prepayment and scheduled principal repayment assumptions, which could shorten the average loan life.

	<u>2010</u>	<u>2009</u>
Variable rate, immediately	\$ 16,776,304	\$ 19,631,680
Due within one year	30,830,485	27,155,419
Due over one to five years	116,341,682	100,857,256
Due over five years	<u>13,689,191</u>	<u>15,294,301</u>
	<u>\$ 177,637,662</u>	<u>\$ 162,938,656</u>

The Bank has adopted policies and procedures that seek to mitigate credit risk and to maintain the quality of the loan portfolio. These policies include underwriting standards for new credits as well as the continuous monitoring and reporting of asset quality and the adequacy of the allowance for loan losses. These policies, coupled with continuous training efforts, have provided effective checks and balances for the risk associated with the lending process. Lending authority is based on the level of risk, size of the loan, and the experience of the lending officer. The Bank's policy is to make the majority of its loan commitments in the market area it serves. This tends to reduce risk because management is familiar with the credit histories of loan applicants and has in-depth knowledge of the risk to which a given credit is subject. Although the loan portfolio is diversified, its performance will be influenced by the economy of the region.

An age analysis of past due loans, segregated by class of loans, as of year-end, was as follows:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans	Value Over 89 Days and Accruing
2010							
Commercial	\$ 23,578	\$ -	\$ -	\$ 23,578	\$ 10,213,786	\$ 10,237,364	\$ -
Commercial real estate:							
Construction	-	486,837	-	486,837	5,576,905	6,063,742	-
Other	232,917	523,809	1,317,386	2,074,112	121,677,239	123,751,351	251,732
Consumer	-	-	-	-	467,403	467,403	-
Residential - prime	472,518	74,116	169,134	715,768	36,402,034	37,117,802	-
Total	<u>\$ 729,013</u>	<u>\$ 1,084,762</u>	<u>\$ 1,486,520</u>	<u>\$ 3,300,295</u>	<u>\$ 174,337,367</u>	<u>\$ 177,637,662</u>	<u>\$ 251,732</u>
2009							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 10,359,989	\$ 10,359,989	\$ -
Commercial real estate:							
Construction	228,961	273,862	-	502,823	5,906,961	6,409,784	-
Other	1,515,810	-	2,400,427	3,916,237	110,085,085	114,001,322	197,095
Consumer	-	-	-	-	499,253	499,253	-
Residential - prime	-	601,128	-	601,128	31,067,180	31,668,308	-
Total	<u>\$ 1,744,771</u>	<u>\$ 874,990</u>	<u>\$ 2,400,427</u>	<u>\$ 5,020,188</u>	<u>\$ 157,918,468</u>	<u>\$ 162,938,656</u>	<u>\$ 197,095</u>

It is the policy of the Bank to place a loan in nonaccrual status whenever there is substantial doubt about the ability of the borrower to pay principal or interest on any outstanding credit. Management considers such factors as payment history, the nature of the collateral securing the loan, and the overall economic situation of the borrower when making a nonaccrual decision. Management closely monitors nonaccrual loans. A nonaccruing loan is restored to current status when the prospects of future contractual payments are not in doubt.

Year-end non-accrual loans, segregated by class of loans, were as follows:

	2010	2009
Commerical real estate:		
Other	\$ 1,298,571	\$ 2,203,322
Residential- prime	169,134	-
Total	<u>\$ 1,467,705</u>	<u>\$ 2,203,322</u>

At December 31, 2010, the Bank had four nonaccrual loans to three borrowers totaling \$1,467,705. The loans were collateralized by real estate and personal guarantees. Gross interest income of \$48,519 would have been recorded in 2010 if the nonaccrual loans had been current and performing in accordance with its original terms. The Bank has allocated \$34,077 of its allowance for loan losses for these nonaccrual loans. At December 31, 2009, the Bank had two nonaccrual loans to two borrowers totaling \$2,203,332. The loans were collateralized by real estate and personal guarantees. Gross interest income of \$74,333 would have been recorded in 2009 if the nonaccrual loans had been current and performing in accordance with its original terms. The Bank had allocated \$575,068 of its allowance for loan losses for these nonaccrual loans. As of December 31, 2010, one of these loans was no longer in nonaccrual status since the loan was current and had made 12 consecutive payments on time. The other loan is now other real estate owned and is actively marketed for sale.

At December 31, 2010, the Bank had two loans delinquent greater than 90 days of \$251,732 other than the nonaccrual loans noted above. At December 31, 2009, the Bank had one loan delinquent greater than 90 days of \$197,095 other than the nonaccrual loans noted above. This loan was paid off in January 2010. As of December 31, 2010, the Bank had \$3,078,187 of loans other than the nonaccrual and delinquent greater than 90 days loans noted above on a watch list for which the borrowers have the potential for experiencing financial difficulties. As of December 31, 2009, the Bank had \$198,173 of such loans. These loans are subject to ongoing management attention and their classifications are reviewed regularly.

The allowance for possible loan losses is a reserve established through a provision for possible loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The Bank's allowance for possible loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, "Receivables" and allowance allocations calculated in accordance with ASC Topic 450, "Contingencies." Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Bank's process for determining the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. The provision for possible loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, classified and criticized loans and net charge-offs or recoveries, among other factors.

Although management believes that, based on information currently available, the Bank's allowance for loan losses is sufficient to cover losses inherent in its loan portfolio at this time, no assurances can be given that the Bank's level of allowance for loan losses will be sufficient to cover future loan losses incurred by the Bank or that future adjustments to the allowance for loan losses will not be necessary if economic and other conditions differ substantially from the economic and other conditions at the time management determined the current level of the allowance for loan losses.

The following table details activity in the allowance for possible loan losses by portfolio for the years ended December 31, 2010 and 2009. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Commercial					
	Commercial	Real Estate	Residential	Consumer	Unallocated	Total
2010						
Beginning balance	\$ 130,085	\$ 1,628,640	\$ 167,910	\$ 19,191	\$ 27,472	\$ 1,973,298
Provision for loan losses	(31,698)	232,983	319,190	(5,855)	120,380	635,000
Charge-offs	-	-	(181,491)	-	-	(181,491)
Recoveries	-	-	5,000	4,703	-	9,703
Net charge-offs	-	-	(176,491)	4,703	-	(171,788)
Ending balance	\$ 98,387	\$ 1,861,623	\$ 310,609	\$ 18,039	\$ 147,852	\$ 2,436,510
2009						
Beginning balance	\$ 96,815	\$ 1,252,178	\$ 126,670	\$ 26,543	\$ 5,032	\$ 1,507,238
Provision for loan losses	33,270	660,402	41,240	(7,352)	22,440	750,000
Charge-offs		(344,337)				(344,337)
Recoveries		60,397				60,397
Net charge-offs	-	(283,940)	-	-	-	(283,940)
Ending balance	\$ 130,085	\$ 1,628,640	\$ 167,910	\$ 19,191	\$ 27,472	\$ 1,973,298

	2010	2009
Allowance for loan losses to total loans outstanding	<u>1.37%</u>	<u>1.21%</u>
Ratio of net (charge-offs) recoveries to average loans outstanding during the period	<u>(0.10)%</u>	<u>(0.18)%</u>

The Bank recorded \$171,788 in net charge-offs in 2010 versus \$283,940 in net charge-offs for 2009. The provision for loan losses was \$635,000 for 2010 compared to \$750,000 in 2009. The decrease in the provision is due to the Bank's recent loan loss experience and a decline in the amount of net loan additions during 2010 (\$14.2 million) versus 2009 (\$18.3 million).

Other Real Estate Owned

Other real estate owned at December 31, 2010 included two properties with a total carrying value of \$1,238,039. The first property is land in Cecil County, Maryland with a carrying value of \$685,000. This property was acquired through foreclosure in 2007 and consists of 40 unimproved lots on 10.43 acres earmarked for townhouse and single family residential housing development. In January 2010, a

This property was acquired through foreclosure in 2007 and consists of 40 unimproved lots on 10.43 acres earmarked for townhouse and single family residential housing development. In January 2010, a contract was signed to sell the property for \$690,000. After closing costs, the Bank expects to net \$685,000. Closing is expected to take place in the first quarter of 2012. The other property with carrying value of \$553,039 is land in Prince Georges County, Maryland. The Bank was a participant lender. The property was acquired by the lead bank through a deed-in-lieu of foreclosure in 2010 and consists of 18 acres that is proposed for development with 450 multi-family units and 134 condominium units. The property is being actively marketed for sale.

Other real estate owned at December 31, 2009 included the above-mentioned property in Cecil County, Maryland with a carrying value of \$760,000.

Investment Securities

Investment securities increased \$14,342,486 or 57.4% to \$39,321,424 at December 31, 2010 from \$24,978,938 at December 31, 2009. At December 31, 2010, the Bank had classified 68% of the investment portfolio as available for sale, compared to 56% at December 31, 2009. The balance of the portfolio was classified as held to maturity.

Securities classified as available for sale are held for an indefinite period of time and may be sold in response to changing market and interest rate conditions as part of the Bank's asset/liability management strategy. Available for sale securities are carried at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of income taxes. Securities classified as held to maturity, which management has both the positive intent and ability to hold to maturity, are reported at amortized cost. The Bank does not currently follow a strategy of making security purchases with a view to near-term sales, and, therefore, does not own trading securities. The Bank manages the investment portfolio within policies that seek to achieve desired levels of liquidity, manage interest rate sensitivity, meet earnings objectives, and provide required collateral for deposit and borrowing activities.

The following table sets forth the carrying value of investment securities at December 31,

	<u>2010</u>	<u>2009</u>
<u>Available for sale</u>		
U.S. government agency	\$3,943,126	\$992,501
State and municipal	<u>2,483,879</u>	<u>3,257,707</u>
	6,427,005	4,250,208
Mortgage-backed securities	20,283,126	9,801,158
Equity security	<u>20,000</u>	<u>20,000</u>
Total	<u>\$26,730,131</u>	<u>\$14,071,366</u>
	<u>2010</u>	<u>2009</u>
<u>Held to maturity</u>		
U.S. government agency	\$170,410	\$242,490
State and municipal	<u>7,376,070</u>	<u>1,695,025</u>
	7,546,480	1,937,515
Mortgage-backed securities	<u>5,044,813</u>	<u>8,970,057</u>
Total	<u>\$12,591,293</u>	<u>\$10,907,572</u>

The following table sets forth the scheduled maturities of investment securities at December 31, 2010,

	<u>Available for Sale</u>			<u>Held to Maturity</u>		
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Yield</u>	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Yield</u>
Within 1 year	\$ -	-	-	\$ -	\$ -	-
Over 1 to 5 years	-	-	-	1,274,842	1,319,414	4.52%
Over 5 to 10 years	2,000,000	1,972,188	2.00%	-	-	-
Over 10 years	<u>4,491,829</u>	<u>4,454,817</u>	3.02%	<u>6,271,638</u>	<u>5,993,933</u>	3.78%
	6,491,829	6,427,005		7,546,480	7,313,347	
Mortgage-backed Securities	20,141,856	20,283,126	3.52%	5,044,813	5,599,602	5.47%
Equity security	<u>20,000</u>	<u>20,000</u>	-	<u>-</u>	<u>-</u>	-
	<u>\$26,653,685</u>	<u>\$26,730,131</u>		<u>\$12,591,293</u>	<u>\$12,912,949</u>	

Deposits

Total deposits increased by \$26,076,031 or 14.8% to \$201,990,686 at December 31, 2010 from \$175,914,655 at December 31, 2009. The increase in deposits was due primarily to a \$14,950,612 increase in time deposits, a \$5,272,329 increase in noninterest-bearing accounts, a \$2,998,731 increase in savings accounts, a \$1,527,500 increase in interest bearing checking accounts, and a \$1,326,859 increase in money market accounts. The following table shows the average balances and average costs of deposits for the years ended December 31:

	<u>2010</u>		<u>2009</u>	
	<u>Average Balance</u>	<u>Cost</u>	<u>Average Balance</u>	<u>Cost</u>
Noninterest bearing demand deposits	\$30,044,738	0.00%	\$25,516,432	0.00%
Interest bearing demand deposits	18,606,139	0.21%	18,567,960	0.24%
Savings deposits	46,268,498	0.47%	40,632,702	0.63%
Time deposits	<u>93,131,057</u>	<u>1.90%</u>	<u>83,086,492</u>	<u>2.98%</u>
	<u>\$188,050,432</u>	<u>1.28%</u>	<u>\$167,803,586</u>	<u>1.71%</u>

As of December 31, 2010 certificates of deposit mature as follows:

2011	\$63,874,797
2012	11,877,558
2013	21,090,812
2014	955,072
2015	<u>4,470,716</u>
Total	<u>\$102,268,955</u>

Off-Balance Sheet Arrangements and Contractual Obligations

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, lines of credit, including home-equity lines and commercial lines, and letters of credit. Loan commitments generally have interest rates at current market values, fixed expiration dates, and may require a fee. Lines of credit generally have variable interest rates and do not necessarily represent future cash flow requirements because it is unlikely that all customers will draw upon their lines in full at any one time. Letters of credit are commitments issued to guarantee the performance of a customer to a third party. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, lines of credit, and letters of credit is represented by the contractual notional amount of these instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

At December 31, 2010, the Bank's off-balance sheet financial instruments were as follows:

Loan commitments	\$ 13,637,852
Unused lines of credit	\$ 19,638,491
Letters of credit	\$ 1,820,903

Management does not believe that any of the foregoing arrangements are reasonably likely to have a materially adverse effect on the Bank's financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

Borrowings and Other Contractual Obligations

The Bank's contractual obligations consist primarily of borrowings and operating leases for various facilities.

Securities sold under agreements to repurchase represent overnight borrowings from customers. Securities owned by the Bank which are used as collateral for these borrowings are primarily U.S. government agency securities.

Specific information about the Bank's borrowings and contractual obligations is set forth in the following table:

	At December 31,	
	<u>2010</u>	<u>2009</u>
Amount outstanding at year-end:		
Securities sold under		
repurchase agreements	\$15,131,657	\$14,235,751
Federal Home Loan Bank advances	-	3,000,000
Weighted average rate paid at December 31:		
Securities sold under		
repurchase agreements	1.11%	1.80%
Federal Home Loan Bank advances	-	0.85%

	For years ended December 31,	
	<u>2010</u>	<u>2009</u>
Maximum amount of borrowings outstanding at any month end:		
Securities sold under repurchase agreements	\$15,513,154	\$15,299,904
Federal Home Loan Bank advances	3,000,000	6,000,000
Borrowings from commercial banks	-	-
Average amount of borrowings outstanding with respect to:		
Securities sold under repurchase agreements	\$14,236,502	\$14,789,396
Federal Home Loan Bank advances	1,841,096	4,084,932
Borrowings from commercial banks	10,959	-
Weighted average rate paid for the year:		
Securities sold under repurchase agreements	1.49%	2.18%
Federal Home Loan Bank advances	0.85%	2.37%
Borrowings from commercial banks	0.60%	-

The terms of the Bank's operating leases, including the future minimum payments under those leases, are disclosed in Note 7 to the consolidated financial statements presented elsewhere in this Annual Report.

RESULTS OF OPERATIONS

Overview

The Bank reported net income of \$2,197,737 for the year ended December 31, 2010 compared to \$1,237,772 for the year ended December 31, 2009. The increase of \$959,965 was due primarily to an increase of \$1,842,145 in net interest income and a decrease in the provision for loan losses of \$115,000, offset by an increase of \$326,117 in noninterest expense, a decrease of \$81,112 in noninterest income, and an increase of \$589,891 in income taxes.

Net Interest Income

The primary source of income for the Bank is net interest income, which is the difference between interest income on interest-earning assets, such as investment securities and loans, and interest expense incurred on interest-bearing sources of funds, such as deposits and borrowings.

The Bank's net interest income increased \$1,842,145 to \$9,362,174 for 2010 compared to \$7,520,029 for 2009. The increase was primarily attributable to a decline in the cost of interest-bearing liabilities and an increase in interest-earning assets. The cost of interest-bearing liabilities decreased 68 basis points to 1.30% in 2010 compared to 1.98% in 2009, while the yield on interest-earning assets increased 1 basis point to 5.53% in 2010 from 5.52% in 2009. The Bank's interest rate spread increased 69 basis points to 4.23% in 2010 from 3.54% for 2009. Average interest earning assets increased \$15,813,352 to \$209,971,252 in 2010 from \$194,157,900 in 2009.

Total interest income increased \$900,738 to \$11,617,437 in 2010 compared to \$10,716,699 in 2009. The increase was due primarily to a \$15,813,352 increase in average interest earning assets to \$209,971,252 in 2010 from \$194,157,900 in 2009.

Interest income from loans increased \$964,645 to \$10,380,748 for 2010 compared to \$9,416,103 for 2009. This increase was attributable to a \$12,755,038 increase in the average balance of loans to \$168,227,918 for 2010 from \$155,472,880 for 2009 and a 11 basis points increase in the average yield on loans to 6.17% in 2010 from 6.06% in 2009.

Interest income on securities and other interest-earning assets (FHLB stock and certificates of deposit) decreased \$77,602 to \$1,203,518 for 2010 compared to \$1,281,120 for 2009. The decrease was due to a 48 basis point decrease in the average yield to 4.13% in 2010 from 4.61% in 2009, offset by a \$1,392,405 increase in the average balance of securities and other interest-earning assets to \$29,153,588 during 2010 from \$27,761,183 during 2009.

Interest income on federal funds sold and FHLB deposits increased \$13,695 to \$33,171 for 2010 compared to \$19,476 for 2009. The increase was due to a \$1,665,909 increase in the average balance of federal funds sold and FHLB deposits to \$12,589,746 for 2010 from \$10,923,837 for 2009 and an 8 basis point increase in the average yield to 0.26% in 2010 from 0.18% in 2009.

Total interest expense decreased \$941,407 to \$2,255,263 for 2010 compared to \$3,196,670 for 2009. The decrease was primarily due to a 68 basis point decrease in the cost of interest-bearing liabilities to 1.30% for 2010 from 1.98% for 2009 and was offset by an increase of \$12,932,769 in the average balance of interest-bearing liabilities to \$174,094,251 for 2010 from \$161,161,482 for 2009.

Interest paid on NOW, savings, and money market deposit accounts decreased \$42,778 to \$257,495 for 2010 compared to \$300,273 for 2009. The decrease was due to an 11 basis point decrease in average interest rate paid to 0.40% in 2010 from 0.51% in 2009 offset by a \$5,673,975 increase in the average balance of deposits to \$64,874,637 for 2010 from \$59,200,662 for 2009.

Interest paid on time deposits decreased \$707,907 to \$1,769,447 for 2010 compared to \$2,477,354 for 2009. The decrease in interest expense was due to a decrease of 108 basis points in the average rate paid to 1.90% for 2010 from 2.98% for 2009 offset by an increase of \$10,044,565 in the average balance to \$93,131,057 for 2010 from \$83,086,492 for 2009.

Interest paid on securities sold under repurchase agreements decreased \$109,130 to \$212,645 for 2010 compared to \$321,775 for 2009. This decrease was attributable to a decrease of 69 basis points in the average rate to 1.49% for 2010 from 2.18% for 2009 and a \$552,894 decrease in the average balance of securities sold under repurchase agreements to \$14,236,502 for 2010 from \$14,789,396 for 2009.

Interest paid on FHLB advances and commercial bank borrowings decreased \$81,592 to \$15,676 in 2010 from \$97,268 in 2009. The average balance decreased by \$2,232,877 to \$1,852,055 in 2010 from \$4,084,932 for 2009 and a decrease of 153 basis points in the average interest rate to 0.85% in 2009 from 2.38% in 2009.

The following table sets forth certain information relating to the Bank's average interest-earning assets and interest-bearing liabilities for the periods indicated. The yields are calculated by dividing interest income or expense by the average daily balance of assets or liabilities, respectively.

Average Balance Sheet, Interest and Yields

For the Years Ended December 31,

	2010			2009		
	Average Balance	Interest	Yield	Average Balance	Interest	Yield
<u>Assets:</u>						
Loans (1)	\$168,227,918	\$10,380,748	6.17%	\$155,472,880	\$9,416,103	6.06%
Securities, taxable	22,470,366	959,239	4.27%	22,266,166	1,066,991	4.79%
Securities, tax exempt	5,978,562	242,043	4.05%	4,780,205	212,170	4.44%
Federal funds sold and FHLB deposit	12,589,746	33,171	0.26%	10,923,837	19,476	0.18%
Other interest-earning assets	704,660	2,236	0.32%	714,812	1,959	0.27%
Total interest-earning assets	209,971,252	11,617,437	5.53%	194,157,900	10,716,699	5.52%
Noninterest-earning assets	16,956,397			13,938,904		
Total assets	<u>\$226,927,649</u>			<u>\$208,096,804</u>		
<u>Liabilities and Stockholders' Equity:</u>						
NOW, savings, and money market	\$64,874,637	\$257,495	0.40%	\$59,200,662	\$300,273	0.51%
Certificates of deposit	93,131,057	1,769,447	1.90%	83,086,492	2,477,354	2.98%
Securities sold under repurchase agreements	14,236,502	212,645	1.49%	14,789,396	321,775	2.18%
FHLB advances and other borrowings	1,852,055	15,676	0.85%	4,084,932	97,268	2.38%
Total interest-bearing liabilities	174,094,251	2,255,263	1.30%	161,161,482	3,196,670	1.98%
Noninterest-bearing deposits	30,044,738			25,516,432		
Noninterest-bearing liabilities	694,902			852,093		
Total liabilities	204,833,891			187,530,007		
Stockholders' equity	22,093,758			20,566,797		
Total liabilities and stockholders' equity	<u>\$226,927,649</u>			<u>\$208,096,804</u>		
Net interest income		<u>\$9,362,174</u>			<u>\$7,520,029</u>	
Interest rate spread			<u>4.23%</u>			<u>3.54%</u>
Net yield on interest-earning assets			<u>4.46%</u>			<u>3.87%</u>
Ratio of average interest-earning assets to Average interest-bearing liabilities			<u>120.61%</u>			<u>120.47%</u>

(1) Includes nonaccrual loans and deferred loan fees.

The following table sets forth the dollar amount of changes in interest income and interest expense for the major categories of the Bank's interest-earning assets and interest-bearing liabilities. The table distinguishes between (1) changes in net interest income attributed to volume (change in volume multiplied by the prior year's interest rate), and (2) changes in net interest income attributed to rate (change in rate multiplied by the prior year's volume). The change in interest due to the combined rate and volume changes is allocated proportionally to the change in volume and rate.

RATE/VOLUME ANALYSIS

	Year ended December 31, 2010 compared to 2009 Change due to variance in			Year ended December 31, 2009 compared to 2008 Change due to variance in		
	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>
Interest income:						
Loans	\$784,345	\$180,300	\$964,645	\$2,010,147	\$(655,754)	\$1,354,393
Securities, taxable	9,702	(117,453)	(107,751)	(209,185)	(24,589)	(233,774)
Securities, tax exempt	49,729	(19,856)	29,873	26,993	5,483	32,476
Federal funds sold and FHLB deposit	3,313	10,382	13,695	(70,385)	(162,446)	(232,831)
Other interest-earning assets	<u>(28)</u>	<u>305</u>	<u>277</u>	<u>(1,097)</u>	<u>(20,407)</u>	<u>(21,504)</u>
Total interest-earning assets	<u>847,062</u>	<u>53,677</u>	<u>900,739</u>	<u>1,756,473</u>	<u>(857,713)</u>	<u>898,760</u>
Interest expense:						
NOW, savings, and money Market	26,865	(69,643)	(42,778)	29,635	(74,969)	(45,334)
Certificates of deposit	272,337	(980,244)	(707,907)	601,291	(722,717)	(121,426)
Securities sold under repurchase agreements	(11,628)	(97,502)	(109,130)	53,315	(74,128)	(20,813)
FHLB advances	<u>(37,442)</u>	<u>(44,150)</u>	<u>(81,592)</u>	<u>17,672</u>	<u>(17,630)</u>	<u>42</u>
Total interest-bearing liabilities	<u>250,132</u>	<u>(1,191,539)</u>	<u>(941,407)</u>	<u>701,913</u>	<u>(889,444)</u>	<u>(187,531)</u>
Change in net interest income	<u>\$596,929</u>	<u>\$1,245,217</u>	<u>\$1,842,146</u>	<u>\$1,054,560</u>	<u>\$31,731</u>	<u>\$1,086,291</u>

Noninterest Income

Total noninterest income decreased \$81,112 or 4.5% to \$1,707,695 for 2010 from \$1,788,807 for 2009. Service charges on deposit accounts decreased \$85,895 to \$992,326 for 2010 from \$1,078,221 for 2009. Mortgage division fees increased \$53,626 during 2010 when compared to 2009 as a result of a higher volume of residential loan originations and refinancing due to a lower interest rate environment. Management expects mortgage division fees to decrease in 2011 as a result of decreased refinance activity and the continuation of a depressed housing market. The Bank experienced an increase of \$30,885 in income attributable to the value of its bank-owned life insurance ("BOLI") to \$105,397 for 2010 from \$74,512 for 2009. The tax exempt return for 2010 was 2.4% on an average BOLI investment of \$4,471,672 versus a tax exempt return of 1.8% on an average BOLI investment of \$4,391,772 for 2009. Net gains on available for sale securities decreased \$78,976 in 2010 compared to 2009 due to an \$84,496 realized gain on one security in 2009.

Noninterest Expense

Total noninterest expense increased by \$326,177 or 4.9% to \$7,000,305 for 2010 from \$6,674,128 for 2009. The increase was due primarily to increases in salary and employee benefit expenses and other expenses, offset by decreases in furniture and equipment and FDIC premiums.

Salary and benefit expense increased \$277,789 or 7.6% to \$3,911,800 for 2010 compared to \$3,634,011 for 2009. The increase was due primarily to increases in staff, merit increases in salaries paid to existing staff, higher bonuses and incentives paid to management, higher commissions paid to commercial and residential lenders as a result of higher origination volumes, higher social security tax expenses, higher health care costs and higher 401(k) matching contribution expense. In addition, a supplemental executive retirement plan was put in place in 2010 which resulted in \$118,943 of expense.

Occupancy and furniture and equipment expenses decreased \$80,638 or 7.7% to \$967,844 for 2010 compared to \$1,048,482 for 2009.

Federal deposit insurance premiums decreased \$69,256 to \$278,551 in 2010 from \$347,807 in 2009. The 2009 amount included a special assessment which did not occur in 2010.

Other expenses increased by \$198,282 or 12.1% to \$1,842,110 for 2010 compared to \$1,643,828 for 2009. ATM and debit card expenses increased \$77,418 to \$365,407 in 2010 from \$287,989 in 2009. Professional services expenses increased \$74,289 to \$266,150 in 2010 from \$191,861 in 2009 due to higher legal, consulting, and recruiting fees. Further information about this category of expenses is contained in Note 12 to the consolidated financial statements.

Income Taxes

The effective tax rate for the Bank increased to 36.0% in 2010 from 34.3% in 2009. The increase in 2010 was due to a lower percentage of Federal tax-exempt income (primarily tax exempt interest income on state and municipal investments and bank owned life insurance cash value increases) as a percentage of net income before income tax expense in 2010 when compared to 2009. Note 13 to the consolidated financial statements provides additional information about the Bank's taxes, including a reconciliation of the Federal tax expense computed using the Federal Statutory rate of 34%.

INTEREST RATE RISK

The Bank's principal market risk is exposure to the risk that the interest rates associated with our interest-bearing liabilities and interest-earning assets will fluctuate. This risk arises from the Bank's lending, investing and deposit-taking activities, and is affected by many factors, including economic and financial conditions, movements in interest rates and consumer preferences. Interest rate fluctuation has a direct impact on the Bank's net interest income. Net interest income is susceptible to interest rate risk when deposits and other short-term liabilities have different repricing intervals than do loans, investments and other interest-earning assets. When interest-earning assets mature or reprice faster than interest-bearing liabilities, a decline in interest rates may cause a decline in net interest income. Conversely, when interest-bearing liabilities mature or reprice faster than interest-earning assets, an increase in interest rates may cause a decline in net interest income.

The Bank recognizes that there are many types of interest rate risk. However, the three that pose the greatest potential threat to current and long-term earnings are:

- Repricing risk – the difference in the timing of the scheduled maturity and re-pricing dates of assets and liabilities within a certain time frame;
- Option risk – interest rate related options embedded in the Bank's assets and liabilities which change the cash flow characteristics of the assets and liabilities; and
- Yield curve / basis risk – changes in the relationship between different interest rates with the same maturity or interest rates across a maturity spectrum which create compression or expansion of our net interest margin.

The Bank uses earnings at risk and economic value at risk measures to quantify our exposure to these types of interest rate risk. We believe that using simulations that measure all three types of risks in combination is a more efficient tool for measurement, and we therefore do not routinely process models to isolate each risk. Rather, we combine the three types of analyses, which we believe provide a better overall result than a single system and a more economical use of resources than targeted models. Following is a description of the analyses to be utilized:

Earnings at Risk

Earnings at Risk ("EAR") measures exposure to net changes in net interest income, and is considered the Bank's best source of managing short-term interest rate risk (one-year and two-year time frames). EAR is a dynamic analysis, which can capture all the different forms of interest rate risk under many different interest rate scenarios, and using various assumptions for growth, optionality, and yield curve structure.

Economic Value of Equity

Economic Value of Equity ("EVE") is management's primary analytical tool for measuring long-term interest rate risk, and helps to measure if the long-term safety and soundness of the Bank is being compromised for the sake of short-term results. However, the Bank also recognizes the inherent difficulties of calculating a definitive value for many sections of the balance sheet as well as the weakness that EVE ignores future events (i.e. growth). These difficulties, coupled with the nature of our core business, allow the Bank to adopt wide limits for this measure.

In order to mitigate the impact of changing interest rates, the Board of Directors has established policies and procedures that include acceptable parameters for the relationship between rate sensitive assets to rate sensitive liabilities as measured by earnings at risk and economic value at risk. The Asset/Liability Committee reviews rate sensitivity measures on a quarterly basis. Material deviations from policy parameters are reported to the Board of Directors and corrective action is initiated and monitored.

The Bank's net interest rate spread increased to 4.23% in 2010 from 3.54% in 2009.

LIQUIDITY MANAGEMENT

Liquidity describes the ability of the Bank to meet financial obligations that arise out of the ordinary course of business. Liquidity is primarily needed to meet depositor withdrawal requirements, to fund loans, and to fund the Bank's other debts and obligations as they come due in the normal course of business. The Bank maintains its asset liquidity position internally through short-term investments, the maturity distribution of the investment portfolio, loan repayments, and income from earning assets. In addition, the Bank can also use the proceeds from the sale of securities available for sale if additional liquidity is needed. As of December 31, 2010, \$12,825,133 of available for sale securities were unpledged. On the liability side of the balance sheet, liquidity is affected by the timing of maturing liabilities and the ability to generate new deposits or borrowings as needed. The Bank is approved to borrow 75% of eligible pledged single family residential loans and 50% of eligible pledged commercial loans, or approximately \$22.7 million under a secured line of credit with the FHLB and has a \$7,000,000 (\$2,000,000 unsecured and \$5,000,000 secured) overnight federal funds line of credit available from a commercial bank. FHLB advances of \$0 and \$3,000,000 were outstanding as of December 31, 2010 and 2009, respectively. There were no borrowings from commercial banks at December 31, 2010 and 2009. The Bank is in the process of establishing a borrowing facility with the Federal Reserve Bank of Richmond and expects the availability to exceed \$10,000,000. The Bank believes that it has adequate liquidity sources to meet all anticipated liquidity needs over the next 12 months. Management knows of

no trend or event which is likely to have a material impact on the Bank's ability to maintain liquidity at satisfactory levels.

Information about the various financial obligations, including contractual obligations and commitments that may require future cash payments, to which the Bank is subject is set forth above under the captions "Off-Balance Sheet Transactions" and "Borrowings and Other Contractual Obligations".

CAPITAL RESOURCES AND ADEQUACY

One measure of the Bank's capital adequacy is the leverage ratio, which is calculated by dividing Tier 1 capital by the average total assets for the most recent quarter. The regulatory minimum for this ratio is 4.0%, with 5.0% being the regulatory minimum to be classified as well capitalized. The Tier 1 leverage capital ratio for the Bank as of December 31, 2010 was 9.52%.

Another measure of capital adequacy is the risk-based capital ratio, or the ratio of total capital to risk weighted assets. Total capital is composed of both core capital (Tier 1) and supplemental capital (Tier 2), including a limited amount of the allowance for loan losses. In calculating risk-weighted assets, specific risk percentages are applied to each category of asset and to off-balance sheet items such as letters of credit. The regulatory minimum for the risk-based capital ratio is 8%, with 10.0% being the regulatory minimum to be classified as well capitalized. The ratio of total capital to risk weighted assets ratio for the Bank as of December 31, 2010 was 13.42%. According to FDIC capital guidelines, the Bank is considered to be "well capitalized." Further information about the Bank's regulatory capital levels can be found in Note 14 to the consolidated financial statements.

The Bank intends to fund future growth primarily with cash, federal funds, maturities of investment securities and deposit growth. Management knows of no other trend or event that will have a material impact on capital.

RECENT ACCOUNTING PRONOUNCEMENTS

Management has the responsibility for the selection and use of appropriate accounting policies. The significant accounting policies used by the Bank are described in the notes to the consolidated financial statements.

The following accounting guidance has been approved by the Financial Accounting Standards Board and would apply to the Bank if the Bank entered into an applicable activity. Some of these new pronouncements become effective in 2010.

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. 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. 2009-17, "Consolidations (Topic 810) - Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities." ASU 2009-17 amends prior guidance to change how a company determines when an entity that is insufficiently capitalized or is not controlled through

voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. ASU 2009-17 requires additional disclosures about the reporting entity's involvement with variable-interest entities and any significant changes in risk exposure due to that involvement as well as its affect on the entity's financial statements. As further discussed below, ASU No. 2010-10, "Consolidations (Topic 810) - Amendments for Certain Investment Funds," deferred the effective date of ASU 2009-17 for a reporting entity's interests in investment companies. The provisions of ASU 2009-17 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 (i) 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, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) 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 (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) company's 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 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 be required for the Bank beginning January 1, 2011. The remaining disclosure requirements and clarifications made by ASU 2010-06 became effective for the Bank on January 1, 2010. See Note 16 – Fair Value Measurements.

ASU No. 2010-10, "Consolidations (Topic 810) - Amendments for Certain Investment Funds." ASU 2010-10 defers the effective date of the amendments to the consolidation requirements made by ASU 2009-17 to a company's interest in an entity (i) that has all of the attributes of an investment company, as specified under ASC Topic 946, "Financial Services - Investment Companies," or (ii) for which it is industry practice to apply measurement principles of financial reporting that are consistent with those in ASC Topic 946. As a result of the deferral, a company will not be required to apply the ASU 2009-17 amendments to the Subtopic 810-10 consolidation requirements to its interest in an entity that meets the criteria to qualify for the deferral. ASU 2010-10 also clarifies that any interest held by a related party should be treated as though it is an entity's own interest when evaluating the criteria for determining whether such interest represents a variable interest. In addition, ASU 2010-10 also clarifies that a quantitative calculation should not be the sole basis for evaluating whether a decision maker's or service provider's fee is a variable interest. The provisions of ASU 2010-10 became effective for the Bank as of January 1, 2010 and did not have a significant impact on the Bank's financial statements.

ASU No. 2010-11, "Derivatives and Hedging (Topic 815) - Scope Exception Related to Embedded Credit Derivatives." ASU 2010-11 clarifies that the only form of an embedded credit derivative that is exempt from embedded derivative bifurcation requirements are those that relate to the subordination of one financial instrument to another. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit derivative feature. The provisions of ASU 2010-11 became effective for the Bank on July 1, 2010 and did not have a significant impact on the Bank's financial statements.

ASU No. 2010-20, "Receivables (Topic 310) - Disclosures about the Credit Quality of Financing

Receivables and the Allowance for Credit Losses." ASU 2010-20 requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 will be effective for the Bank's financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period will be required for the Bank's financial statements that include periods beginning on or after January 1, 2011.

The accounting policies adopted by management are consistent with authoritative GAAP and are consistent with those followed by peer Banks.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Farmers and Merchants Bank
Upperco, Maryland

We have audited the accompanying consolidated balance sheets of Farmers and Merchants Bank and Subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Bank is not required to have, and we were not engaged to perform, an audit of the Bank's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Farmers and Merchants Bank and Subsidiaries as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Rowles & Company, LLP

Baltimore, Maryland
March 4, 2011

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Farmers and Merchants Bank and Subsidiaries

Consolidated Balance Sheets

December 31,	2010	2009
Assets		
Cash and due from banks	\$ 7,833,386	\$ 10,642,976
Federal funds sold and other interest bearing deposits	3,769,159	4,094,274
Certificate of deposit in other banks	100,000	100,000
Securities available for sale	26,730,131	14,071,366
Securities held to maturity	12,591,293	10,907,572
Federal Home Loan Bank stock, at cost	558,600	625,300
Loans held for sale	1,165,500	1,417,873
Loans, less allowance for loan losses of \$2,436,510 and \$1,973,298	174,875,384	160,668,638
Premises and equipment	4,229,113	4,310,097
Accrued interest receivable	856,502	714,907
Deferred income taxes	1,006,383	674,652
Other real estate owned	1,238,039	760,000
Bank owned life insurance	4,532,986	4,427,589
Other assets	940,555	1,288,152
	<u>\$ 240,427,031</u>	<u>\$ 214,703,396</u>
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing	\$ 32,864,626	\$ 27,592,297
Interest-bearing	<u>169,126,060</u>	<u>148,322,358</u>
Total deposits	201,990,686	175,914,655
Securities sold under repurchase agreements	15,131,657	14,235,751
Federal Home Loan Bank of Atlanta advances	-	3,000,000
Accrued interest payable	235,263	451,537
Income taxes payable	109,461	85,081
Other liabilities	<u>349,539</u>	<u>104,502</u>
	217,816,606	193,791,526
Stockholders' equity		
Common stock, par value \$10 per share, authorized 5,000,000 shares; issued and outstanding 774,237.608 shares in 2010 and 764,006.934 shares in 2009	7,742,376	7,640,069
Surplus	7,882,965	7,755,167
Undivided profits	6,938,792	5,315,726
Accumulated other comprehensive income	<u>46,292</u>	<u>200,908</u>
	22,610,425	20,911,870
	<u>\$ 240,427,031</u>	<u>\$ 214,703,396</u>

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

Farmers and Merchants Bank and Subsidiaries

Consolidated Statements of Income

Years Ended December 31,	2010	2009
Interest income		
Loans, including fees	\$ 10,380,748	\$ 9,416,103
Investment securities - taxable	961,475	1,068,950
Investment securities - tax exempt	242,043	212,170
Federal funds sold and other interest bearing deposits	33,171	19,476
Total interest income	<u>11,617,437</u>	<u>10,716,699</u>
Interest expense		
Deposits	2,026,942	2,777,627
Securities sold under repurchase agreements	212,645	321,775
Federal Home Loan Bank advances and other borrowings	15,676	97,268
Total interest expense	<u>2,255,263</u>	<u>3,196,670</u>
Net interest income	9,362,174	7,520,029
Provision for loan losses	<u>635,000</u>	<u>750,000</u>
Net interest income after provision for loan losses	<u>8,727,174</u>	<u>6,770,029</u>
Noninterest income		
Service charges on deposit accounts	992,326	1,078,221
Mortgage banking income	504,775	451,149
Bank owned life insurance cash surrender value increase	105,397	74,512
Net gain (loss) on available for sale securities	5,520	84,496
Other fees and commissions	99,677	100,429
Total noninterest income	<u>1,707,695</u>	<u>1,788,807</u>
Noninterest expense		
Salaries	3,114,888	3,012,511
Employee benefits	796,912	621,500
Occupancy	511,021	505,731
Furniture and equipment	456,823	542,751
Federal Deposit Insurance premiums	278,551	347,807
Other	1,842,110	1,643,828
Total noninterest expense	<u>7,000,305</u>	<u>6,674,128</u>
Income before income taxes	3,434,564	1,884,708
Income taxes	<u>1,236,827</u>	<u>646,936</u>
Net income	<u>\$ 2,197,737</u>	<u>\$ 1,237,772</u>
Earnings per share - basic and diluted	<u>\$ 2.87</u>	<u>\$ 1.63</u>

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

**Farmers and Merchants Bank
and Subsidiaries**

Consolidated Statements of Changes in Stockholders' Equity

Years Ended December 31, 2010 and 2009

	Common stock			Undivided	Accumulated other	Total
	Shares	Par value	Surplus	profits	comprehensive income	stockholders' equity
Balance, December 31, 2008	755,571.376	\$ 7,555,714	\$ 7,668,111	\$ 4,532,265	\$ 288,986	\$ 20,045,076
Net income	-	-	-	1,237,772	-	1,237,772
Unrealized loss on securities available for sale net of income tax benefit of \$57,373	-	-	-	-	(88,078)	(88,078)
Comprehensive income						1,149,694
Cash dividends, \$0.60 per share	-	-	-	(454,311)	-	(454,311)
Dividends reinvested	9,193.756	91,937	96,746	-	-	188,683
Common stock repurchased	(758.198)	(7,582)	(9,690)	-	-	(17,272)
Balance, December 31, 2009	764,006.934	\$ 7,640,069	\$ 7,755,167	\$ 5,315,726	\$ 200,908	\$ 20,911,870
Net income	-	-	-	2,197,737	-	2,197,737
Unrealized loss on securities available for sale net of income tax benefit of \$100,716	-	-	-	-	(154,616)	(154,616)
Comprehensive income						2,043,121
Cash dividends, \$0.75 per share	-	-	-	(574,671)	-	(574,671)
Dividends reinvested	10,530.674	105,307	132,073	-	-	237,380
Common stock repurchased	(300.000)	(3,000)	(4,275)	-	-	(7,275)
Balance, December 31, 2010	774,237.608	\$ 7,742,376	\$ 7,882,965	\$ 6,938,792	\$ 46,292	\$ 22,610,425

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

**Farmers and Merchants Bank
and Subsidiaries**

Consolidated Statements of Cash Flows

Years Ended December 31,	2010	2009
Cash flows from operating activities		
Interest received	\$ 11,504,889	\$ 10,624,246
Fees and commissions received	1,596,778	1,609,076
Interest paid	(2,471,537)	(3,327,939)
Proceeds from sale of mortgage loans held for sale	30,959,301	34,492,868
Origination of mortgage loans for sale	(30,706,928)	(35,910,741)
Cash paid to suppliers and employees	(6,129,631)	(7,362,530)
Income taxes paid	(1,443,461)	(760,321)
	<u>3,309,411</u>	<u>(635,341)</u>
Cash flows from investing activities		
Proceeds from maturity and call of securities		
Available for sale	8,717,023	2,658,551
Held to maturity	4,603,851	4,150,366
Proceeds from sale of securities		
Available for sale	535,000	1,318,742
Purchase of securities		
Available for sale	(22,195,169)	(3,331,572)
Held to maturity	(6,276,287)	-
Loans made to customers, net of principal collected	(15,423,832)	(19,811,180)
(Purchase) redemption of stock in Federal Home Loan Bank of Atlanta	66,700	(43,500)
Proceeds of sale of other real estate owned	-	947,841
Write-off of other real estate owned	75,000	71,014
Disbursements for other real estate owned, net	-	(6,446)
Proceeds from disposal of premises and equipment	-	2,584
Purchases of premises, equipment and software	(173,773)	(37,871)
	<u>(30,071,487)</u>	<u>(14,081,471)</u>
Cash flows from financing activities		
Net increase (decrease) in		
Noninterest-bearing deposits	5,272,329	2,391,026
Interest-bearing deposits	20,803,702	19,190,709
Securities sold under repurchase agreements	895,906	(1,732,687)
Federal Home Loan Bank of Atlanta advances	(3,000,000)	(3,000,000)
Dividends paid, net of reinvestments	(337,291)	(265,628)
Common stock repurchased	(7,275)	(17,272)
	<u>23,627,371</u>	<u>16,566,148</u>
Net increase in cash and cash equivalents	(3,134,705)	1,849,336
Cash and cash equivalents at beginning of year	<u>14,737,250</u>	<u>12,887,914</u>
Cash and cash equivalents at end of year	<u>\$ 11,602,545</u>	<u>\$ 14,737,250</u>

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

**Farmers and Merchants Bank
and Subsidiaries**

Consolidated Statements of Cash Flows
(Continued)

Years Ended December 31,	2010	2009
Reconciliation of net income to net cash provided by operating activities		
Net income	\$ 2,197,737	\$ 1,237,772
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	274,741	336,133
Provision for loan losses	635,000	750,000
Net (gain) loss on disposal of investment securities	(5,520)	(84,496)
Net (gain) loss on disposal of premises and equipment	-	(171)
Decrease (increase) in mortgage loans held for sale	252,373	(1,417,873)
Deferred income taxes	(231,014)	(118,339)
Amortization of premiums and accretion of discounts, net	23,283	(7,198)
Increase (decrease) in		
Deferred loan fees	29,047	883
Accrued interest payable	(216,274)	(131,269)
Income taxes payable	24,380	4,954
Other liabilities	245,037	(157,568)
Decrease (increase) in		
Accrued interest receivable	(141,595)	(93,336)
Bank owned life insurance cash surrender value	(105,397)	(74,512)
Other assets	327,613	(880,321)
	<u>\$ 3,309,411</u>	<u>\$ (635,341)</u>

Noncash transactions for the transfer of loans to other real estate owned totaled **\$553,039** and \$767,409 in the years ended December 31, 2010 and 2009, respectively.

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

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

The accounting and reporting policies reflected in the financial statements conform to accounting principles generally accepted in the United States and to general practices within the banking industry. Management makes estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosures of commitments and contingent liabilities at the balance sheet date, and revenues and expenses during the year. These estimates and assumptions may affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Principles of consolidation

The consolidated financial statements include the accounts of Farmers and Merchants Bank ("the Bank") and its subsidiaries, Reliable Community Financial Services, Inc. and Community Real Estate Holdings, Inc. Intercompany balances and transactions have been eliminated.

Business

The Bank provides banking services to individuals and businesses located in Baltimore County, Maryland, Carroll County, Maryland and surrounding areas of northern Maryland.

Reliable Community Financial Services, Inc. can provide a wide range of investment and insurance products to its customers.

Community Real Estate Holdings, Inc. was dissolved on October 26, 2010. The company had owned and managed assets that were acquired by the Bank as the result of foreclosure or other loan defaults.

Reclassifications

Certain reclassifications have been made to the 2009 financial statements to conform to the current year presentation. These reclassifications had no effect on net income.

Cash and cash equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, money market funds, and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

Comprehensive income

Comprehensive income includes net income and the unrealized gains or loss on investment securities available for sale, net of income taxes.

Investment securities

As securities are purchased, management determines if the securities should be classified as held to maturity or available for sale. Securities which management has the intent and ability to hold to maturity are recorded at amortized cost, which is cost adjusted for amortization of premiums and accretion of discounts to maturity. Securities held to meet liquidity needs or which may be sold before maturity are classified as available for sale and carried at fair value with unrealized gains and losses included in stockholders' equity on an after-tax basis. Gains and losses on disposal are determined using the specific-identification method. The Bank amortizes premiums and accretes discounts using the interest method.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

Loans and allowance for loan losses

Loans are stated at the current amount of unpaid principal, adjusted for deferred origination costs, deferred origination fees, and the allowance for loan losses. Interest on loans is accrued based on the principal amounts outstanding. Origination fees and costs are amortized to income over the terms of loans. The accrual of interest is discontinued when any portion of the principal or interest is 90 days past due and collateral is insufficient to discharge the debt in full.

Loans are considered impaired when, based on current information, management considers it unlikely that the collection of principal and interest payments will be made according to contractual terms. Generally, loans are not reviewed for impairment until the accrual of interest has been discontinued. If collection of principal is evaluated as a loss, all payments are applied to principal.

The allowance for loan losses represents an amount which, in management's judgment, will be adequate to absorb probable losses on existing loans and other extensions of credit that may become uncollectible. Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectability of loans. Management performs an ongoing review of the Bank's portfolio, maintaining a watch list of problem loans. These problem loans are graded and assigned risk-based factors for probable losses. The balances of the loans are assigned risk based factors based on delinquency and loan type, without a detailed current review of the individual credits. An unallocated component is maintained to reflect the unknown losses that could affect management's estimate of the allowance for loan losses. The unallocated component of the allowance reflects the lack of information for unknown losses in the underlying assumptions used for estimating specific and general losses in the portfolio. The total allowance is evaluated based on past loan loss experience and current economic conditions. The amounts ultimately collected on these loans could differ materially from the estimated collections. Loan losses are charged to the allowance when management believes that collection is unlikely. Collections of loans previously charged off are added to the allowance at the time of recovery.

Loans held for sale

Loans held for sale are carried at the lower of aggregate cost or market value based on the current fair market value of each outstanding loan. Sales of loans are recorded when the proceeds are received, with any gain or loss recorded in mortgage banking income.

Premises and equipment

Premises and equipment are recorded at cost less accumulated depreciation and amortization. Depreciation on buildings and equipment is computed over the estimated useful lives of the assets using the straight-line and accelerated methods. Leasehold improvements are amortized using the straight-line method over the term of the lease or the estimated useful lives of the asset, whichever is shorter.

Other real estate owned

Real estate acquired through foreclosure or by deed in lieu foreclosure is recorded at the lower of cost or fair market value on the date acquired. Losses incurred at the time of acquisition of the property are charged to the allowance for loan losses. Subsequent reductions in the estimated value of the property are included in other operating expense.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

Income taxes

The provision for income taxes includes income taxes payable for the current year and deferred income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement bases and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

Per share data

Earnings per share are determined by dividing net income by the weighted average number of shares of common stock outstanding, giving retroactive effect to any stock dividends. Weighted average shares were **766,292.952** and 757,546.750 for 2010 and 2009, respectively.

2. Cash and Equivalents

The Bank normally carries balances with other banks that exceed the federally insured limit. Average balances carried in excess of the limit during 2010 and 2009 were **\$5,629,380** and \$6,775,526, respectively. The Bank sold federal funds to other banks, excluding the Federal Home Loan Bank ("FHLB") of Atlanta, on an unsecured basis that averaged **\$2,265,517** and \$6,775,526 for 2010 and 2009, respectively.

Banks are required to carry noninterest-bearing cash reserves of specified percentages of deposit balances. The Bank's normal balances of cash on hand and on deposit with other banks are sufficient to satisfy the reserve requirements.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

3. Investment Securities

Investment securities are summarized as follows:

December 31, 2010	Amortized cost	Unrealized gains	Unrealized losses	Fair value
<i>Available for sale</i>				
U. S. government agency	\$ 4,000,000	\$ 5,000	\$ 61,874	\$ 3,943,126
State and municipal	<u>2,491,829</u>	<u>45,777</u>	<u>53,727</u>	<u>2,483,879</u>
	6,491,829	50,777	115,601	6,427,005
Mortgage-backed securities	20,141,856	345,653	204,383	20,283,126
Equity security	<u>20,000</u>	<u>-</u>	<u>-</u>	<u>20,000</u>
	<u>\$ 26,653,685</u>	<u>\$ 396,430</u>	<u>\$ 319,984</u>	<u>\$ 26,730,131</u>
<i>Held to maturity</i>				
U. S. government agency	\$ 170,410	\$ 5,425	\$ -	\$ 175,835
State and municipal	<u>7,376,070</u>	<u>39,146</u>	<u>277,704</u>	<u>7,137,512</u>
	7,546,480	44,571	277,704	7,313,347
Mortgage-backed securities	<u>5,044,813</u>	<u>554,975</u>	<u>186</u>	<u>5,599,602</u>
	<u>\$ 12,591,293</u>	<u>\$ 599,546</u>	<u>\$ 277,890</u>	<u>\$ 12,912,949</u>
December 31, 2009				
<i>Available for sale</i>				
U. S. government agency	\$ 998,827	\$ 938	\$ 7,264	\$ 992,501
State and municipal	<u>3,213,187</u>	<u>61,158</u>	<u>16,638</u>	<u>3,257,707</u>
	4,212,014	62,096	23,902	4,250,208
Mortgage-backed securities	9,507,573	302,281	8,696	9,801,158
Equity security	<u>20,000</u>	<u>-</u>	<u>-</u>	<u>20,000</u>
	<u>\$ 13,739,587</u>	<u>\$ 364,377</u>	<u>\$ 32,598</u>	<u>\$ 14,071,366</u>
<i>Held to maturity</i>				
U. S. government agency	\$ 242,490	\$ 13,983	\$ -	\$ 256,473
State and municipal	<u>1,695,025</u>	<u>67,675</u>	<u>-</u>	<u>1,762,700</u>
	1,937,515	81,658	-	2,019,173
Mortgage-backed securities	<u>8,970,057</u>	<u>510,225</u>	<u>3,199</u>	<u>9,477,083</u>
	<u>\$ 10,907,572</u>	<u>\$ 591,883</u>	<u>\$ 3,199</u>	<u>\$ 11,496,256</u>

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

3. Investment Securities (Continued)

Contractual maturities, shown below, will differ from actual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 2010	Available for Sale		Held to Maturity	
	Amortized cost	Fair value	Amortized cost	Fair value
Within one year	\$ -	\$ -	\$ -	\$ -
Over one to five years	-	-	1,274,842	1,319,414
Over five to ten years	2,000,000	1,972,188	-	-
Over ten years	4,491,829	4,454,817	6,271,638	5,993,933
	<u>6,491,829</u>	<u>6,427,005</u>	<u>7,546,480</u>	<u>7,313,347</u>
Mortgage-backed securities, due in monthly installments	20,141,856	20,283,126	5,044,813	5,599,602
Equity security	20,000	20,000	-	-
	<u>\$ 26,653,685</u>	<u>\$ 26,730,131</u>	<u>\$ 12,591,293</u>	<u>\$ 12,912,949</u>
December 31, 2009				
Within one year	\$ 290,015	\$ 291,235	\$ 590,787	\$ 594,507
Over one to five years	928,517	940,855	1,346,728	1,424,666
Over five to ten years	498,827	491,563	-	-
Over ten years	2,494,655	2,526,556	-	-
	<u>4,212,014</u>	<u>4,250,209</u>	<u>1,937,515</u>	<u>2,019,173</u>
Mortgage-backed securities, due in monthly installments	9,507,573	9,801,158	8,970,057	9,477,083
Equity security	20,000	20,000	-	-
	<u>\$ 13,739,587</u>	<u>\$ 14,071,367</u>	<u>\$ 10,907,572</u>	<u>\$ 11,496,256</u>

The equity security of \$20,000 represents an investment in a Maryland bank that provides services for other banks in Maryland and surrounding states. The equity security is carried at cost, does not pay dividends, and is not actively traded.

Securities with a carrying value of \$19,431,338 and \$20,531,160 as of December 31, 2010 and 2009, respectively, were pledged as collateral for government deposits and securities sold under repurchase agreements

In 2010, the Bank realized a gross gain of \$5,520 on the sale of one available for sale security with gross proceeds of \$535,000.

In 2009, the Bank realized a gross gain of \$84,496 on the sale of one available for sale security with gross proceeds of \$1,318,742.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

3. Investment Securities (Continued)

The following table sets forth the Bank's gross unrealized losses on a continuous basis for investment securities, by category and length of time at December 31, 2010.

Description of investments	Less than 12 months		12 months or more		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
U.S. government agency	\$ 2,938,126	\$ 61,874	\$ -	\$ -	\$ 2,938,126	\$ 61,874
State and municipal	6,825,714	331,431	-	-	6,825,714	331,431
Mortgage-backed securities	12,334,637	203,267	102,741	1,302	12,437,378	204,569
Total	\$ 22,098,477	\$ 596,572	\$ 102,741	\$ 1,302	\$ 22,201,218	\$ 597,874

The gross unrealized losses are not considered by management to be other-than-temporary impairments. The obligations of government agency or government sponsored mortgaged-backed securities are all rated AAA. Management knows of no credit quality problems related to any securities it owns. Management has the ability to hold these securities until maturity. Each security is expected to be redeemed at face value at, or prior to, maturity. In most cases, temporary impairment is caused by market interest rate fluctuations.

4. Related Party Transactions

Certain executive officers and directors of the Bank, including their immediate families and companies in which they are significant owners (more than 10%), were indebted to the Bank. The loans were made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with borrowers who are not related to the Bank. During the years ended December 31, 2010 and 2009, the activity of these loans is as follows:

	2010	2009
Balance, beginning of year	\$10,031,310	\$ 7,168,012
Additions	3,348,600	6,734,323
Amounts collected	(4,012,695)	(3,871,025)
Balance, end of year	<u>\$ 9,367,215</u>	<u>\$ 10,031,310</u>

Unused lines of credit to related parties totaled **\$2,259,327** and \$1,860,907, at December 31, 2010 and 2009, respectively. Two directors were issued letters of credit at December 31, 2010 and 2009 in the aggregate amount of **\$158,361**.

Deposits at the Bank from directors, officers and related parties totaled **\$9,875,875** and \$8,196,870 at December 31, 2010 and 2009, respectively.

Payments to a retailer affiliated with two directors totaled **\$1,163** in 2010 and \$376 in 2009. Another director was paid **\$3,000** in 2010 and 2009 for his oversight of branch office repairs and maintenance.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans

Major categories of loans are as follows:

	2010	2009
Commercial	\$ 10,237,364	\$ 10,359,989
Commerical real estate:		
Construction	6,063,742	6,409,784
Other	124,916,851	114,001,322
Consumer	467,403	499,253
Residential real estate - prime	<u>35,952,302</u>	<u>31,668,308</u>
	177,637,662	162,938,656
Less: Allowance for loan losses	2,436,510	1,973,298
Deferred origination fees net of costs	<u>325,768</u>	<u>296,720</u>
	<u>\$ 174,875,384</u>	<u>\$ 160,668,638</u>

The maturity and rate repricing distribution of the loan portfolio as of December 31, 2010 and 2009, is as follows:

Variable rate, immediately	\$ 16,776,304	\$ 19,631,680
Due within one year	30,830,485	27,155,419
Due over one to five years	116,341,682	100,857,256
Due over five years	<u>13,689,191</u>	<u>15,294,301</u>
	<u>\$ 177,637,662</u>	<u>\$ 162,938,656</u>

Year-end non-accrual loans, segregated by class of loans, were as follows:

	2010	2009
Commerical real estate:		
Other	\$ 1,298,571	\$ 2,203,322
Residential- prime	<u>169,134</u>	<u>-</u>
Total	<u>\$ 1,467,705</u>	<u>\$ 2,203,322</u>

As of December 31, 2010, the Bank had four nonaccrual loans to three borrowers totaling \$1,467,705. The loans are collateralized by real estate and personal guaranties. Gross interest income of \$48,519 would have been recorded in 2010 if these nonaccrual loans had been current and performing in accordance with its original terms. The Bank has allocated \$34,077 of its allowance for loan losses for these nonaccrual loans.

As of December 31, 2009, the Bank had two nonaccrual loans to two borrowers totaling \$2,203,332. The loans are collateralized by real estate and personal guaranties. Gross interest income of \$74,333 would have been recorded in 2009 if these nonaccrual loans had been current and performing in accordance with its original terms. The Bank has allocated \$575,068 of its allowance for loan losses for these nonaccrual loans.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

An age analysis of past due loans, segregated by class of loans, as of year-end, was as follows:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans	Past Due Over 89 Days and Accruing
2010							
Commercial	\$ 23,578	\$ -	\$ -	\$ 23,578	\$ 10,213,786	\$ 10,237,364	\$ -
Commercial real estate:							
Construction	-	486,837	-	486,837	5,576,905	6,063,742	-
Other	232,917	523,809	1,317,386	2,074,112	121,677,239	123,751,351	251,732
Consumer	-	-	-	-	467,403	467,403	-
Residential - prime	472,518	74,116	169,134	715,768	36,402,034	37,117,802	-
Total	\$ 729,013	\$ 1,084,762	\$ 1,486,520	\$ 3,300,295	\$ 174,337,367	\$ 177,637,662	\$ 251,732
2009							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 10,359,989	\$ 10,359,989	\$ -
Commercial real estate:							
Construction	228,961	273,862	-	502,823	5,906,961	6,409,784	-
Other	1,515,810	-	2,400,427	3,916,237	110,085,085	114,001,322	197,095
Consumer	-	-	-	-	499,253	499,253	-
Residential - prime	-	601,128	-	601,128	31,067,180	31,668,308	-
Total	\$ 1,744,771	\$ 874,990	\$ 2,400,427	\$ 5,020,188	\$ 157,918,468	\$ 162,938,656	\$ 197,095

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

Year-end impaired loans, segregated by class of loans, are set forth in the following table:

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
2010						
Commercial real estate - other	\$ 2,948,865	\$ 1,065,654	\$ 1,883,211	\$ 2,948,865	\$ 694,371	\$ 2,576,094
Residential - prime	350,625	169,134	-	169,134	-	84,567
	<u>\$ 3,299,490</u>	<u>\$ 1,234,788</u>	<u>\$ 1,883,211</u>	<u>\$ 3,117,999</u>	<u>\$ 694,371</u>	<u>\$ 2,660,661</u>
2009						
Commercial real estate - other	\$ 2,203,322	\$ -	\$ 2,203,322	\$ 2,203,322	\$ 575,068	\$ 2,495,000
Residential - prime	-	-	-	-	-	-
	<u>\$ 2,203,322</u>	<u>\$ -</u>	<u>\$ 2,203,322</u>	<u>\$ 2,203,322</u>	<u>\$ 575,068</u>	<u>\$ 2,495,000</u>

The Bank grades every loan as an assessment of risk. The factors used to determine the grade are the payment history of the loan and the borrower, the value of the collateral and net worth of the guarantor, and cash flow projections of the borrower. Excellent, Above Average, and Average grades are assigned to loans with limited or no delinquent payments and more than sufficient collateral and/or cash flow. Loans with Below Average and Especially Mentioned grades typically have a higher frequency of delinquent payments and/or collateral/cash flow that may not be sufficient to support the loan. Loans with Substandard and Doubtful grades have such a high frequency of delinquent payments and/or the collateral/cash flow is insufficient to support the loan that the loan is included on the Bank's Watch list.

Loans by credit grade, segregated by loan type, at year-end, were as follows:

	Commercial	Commercial Real Estate Other	Commercial Real Estate Construction	Residential	Consumer	Total
2010						
Excellent	\$ 82,175	\$ 278,610	\$ -	\$ 465,070	\$ 10,628	\$ 836,483
Above Average	1,478,170	16,422,929	-	7,224,685	162,117	25,287,901
Average	7,070,248	79,177,384	5,319,220	21,857,546	138,842	113,563,240
Below Average	1,194,090	5,543,200	-	2,470,326	13,452	9,221,068
Especially Mentioned	27,737	19,243,740	744,522	3,532,921	56,094	23,605,014
Substandard	384,944	4,250,988	-	401,754	-	5,037,686
Doubtful	-	-	-	-	86,270	86,270
	<u>\$ 10,237,364</u>	<u>\$ 124,916,851</u>	<u>\$ 6,063,742</u>	<u>\$ 35,952,302</u>	<u>\$ 467,403</u>	<u>\$ 177,637,662</u>

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

The following table details activity in the allowance for loan losses by portfolio for the years ended December 31, 2010 and 2009. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Commercial					Total
	Commercial	Real Estate	Residential	Consumer	Unallocated	
2010						
Beginning balance	\$ 130,085	\$ 1,628,640	\$ 167,910	\$ 19,191	\$ 27,472	\$ 1,973,298
Provision for loan losses	(31,698)	232,983	319,190	(5,855)	120,380	635,000
Charge-offs	-	-	(181,491)	-	-	(181,491)
Recoveries	-	-	5,000	4,703	-	9,703
Net charge-offs	-	-	(176,491)	4,703	-	(171,788)
Ending balance	\$ 98,387	\$ 1,861,623	\$ 310,609	\$ 18,039	\$ 147,852	\$ 2,436,510
Period-end amount allocated to:						
Loans individually evaluated for impairment	\$ -	\$ 694,371	\$ -	\$ -	\$ -	\$ 694,371
Loans collectively evaluated for impairment	98,387	1,167,252	310,609	18,039	147,852	1,742,139
Ending balance	\$ 98,387	\$ 1,861,623	\$ 310,609	\$ 18,039	\$ 147,852	\$ 2,436,510
2009						
Beginning balance	\$ 96,815	\$ 1,252,178	\$ 126,670	\$ 26,543	\$ 5,032	\$ 1,507,238
Provision for loan losses	33,270	660,402	41,240	(7,352)	22,440	750,000
Charge-offs	-	(344,337)	-	-	-	(344,337)
Recoveries	-	60,397	-	-	-	60,397
Net charge-offs	-	(283,940)	-	-	-	(283,940)
Ending balance	\$ 130,085	\$ 1,628,640	\$ 167,910	\$ 19,191	\$ 27,472	\$ 1,973,298
Period-end amount allocated to:						
Loans individually evaluated for impairment	\$ -	\$ 575,068	\$ -	\$ -	\$ -	\$ 575,068
Loans collectively evaluated for impairment	130,085	1,053,572	167,910	19,191	27,472	1,398,230
Ending balance	\$ 130,085	\$ 1,628,640	\$ 167,910	\$ 19,191	\$ 27,472	\$ 1,973,298
Loan Balance by Type:						
	Commercial				Total	
	Commercial	Real Estate	Residential	Consumer		
2010						
Loans individually evaluated for impairment	\$ -	\$ 2,948,865	\$ 169,134	\$ -	\$ 3,117,999	
Loans collectively evaluated for impairment	10,237,364	128,031,728	35,783,168	467,403	174,519,663	
	\$ 10,237,364	\$ 130,980,593	\$ 35,952,302	\$ 467,403	\$ 177,637,662	
2009						
Loans individually evaluated for impairment	\$ -	\$ 2,203,322	\$ -	\$ -	\$ 2,203,322	
Loans collectively evaluated for impairment	10,359,989	118,207,784	31,668,308	499,253	160,735,334	
	\$ 10,359,989	\$ 120,411,106	\$ 31,668,308	\$ 499,253	\$ 162,938,656	

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

Loans with a balance of approximately **\$43.3** million were pledged as collateral to the FHLB of Atlanta as of December 31, 2010. At December 31, 2010 and 2009, the Bank serviced loans for others totaling **\$13.0** million and \$13.6 million, respectively.

The Bank makes loans to customers located primarily in the Baltimore County, Maryland, Carroll County, Maryland and in surrounding areas of northern Maryland. Although the loan portfolio is diversified, many loans are secured by real estate and its performance will be influenced by the economy of the region, including local real estate markets.

6. Premises and Equipment

A summary of premises and equipment is as follows:

	Useful lives	2010	2009
Land and improvements	-	\$1,619,713	\$ 1,619,713
Buildings and improvements	15-39 years	4,357,849	4,371,544
Furniture and equipment	3-10 years	2,321,384	2,133,915
		8,298,946	8,125,172
Accumulated depreciation and amortization		4,069,833	3,815,075
		\$4,229,113	\$ 4,310,097
Depreciation and amortization expense		\$ 254,757	\$ 286,367

Software with a net book value of **\$6,077** and \$27,914 as of December 31, 2010 and 2009, respectively, is included in other assets. Amortization expense of **\$19,984** and \$70,166 was recorded in 2010 and 2009, respectively.

7. Lease Commitments

The Bank has an operating lease for the land on which the Hampstead branch is located. The initial term of the lease expired on September 30, 2009 and the lease was renewed for a five year term with an expiration date of September 30, 2014. The lease has options to renew for seven additional consecutive five-year terms. The Bank has an operating license for certain facilities where the Greenmount branch is located. The term of the agreement is five years and expires on November 30, 2011. The Bank has an operating lease for its Atrium branch facility. The initial term of the lease was one year, with nine one-year renewals. The Atrium lease was renewed in 2010 for another year. The Bank has an operating lease for its North Oaks facility. The initial term of the lease was three years and expired on September 16, 2010, with options to renew for five additional three year terms. The lease was renewed in 2010 for another three year term with an expiration date of September 16, 2013.

Future minimum payments under the agreements are as follows:

Year	Amount
2011	\$ 86,805
2012	45,742
2013	45,276
2014	31,564
	\$209,387

Rent expense was **\$91,781** and \$90,446 in 2010 and 2009, respectively.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

8. Credit Commitments

Outstanding loan commitments, unused lines of credit, and letters of credit as of December 31, are as follows:

	2010	2009
Loan commitments		
Construction and land development	\$ 153,812	\$ 474,531
Commercial	6,948,040	321,165
Commercial real estate	6,361,000	5,855,000
Residential	175,000	1,754,145
	<u>\$ 13,637,852</u>	<u>\$ 8,404,841</u>
Unused lines of credit		
Home-equity lines	\$ 3,725,720	\$ 4,054,323
Commercial lines	15,912,771	14,283,353
	<u>\$ 19,638,491</u>	<u>\$ 18,337,676</u>

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 rates at current market amounts, 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.

The maximum exposure to credit loss in the event of nonperformance by the customer is the contractual amount of the commitment. Loan commitments, lines of credit and letters of credit are made on the same terms, including collateral, as outstanding loans. Management is not aware of any accounting loss that is likely to be incurred as a result of funding its credit commitments.

9. Retirement Plans

The Bank has a profit sharing plan qualifying under Section 401(k) of the Internal Revenue Code. All employees age 21 or more with six months of service and 1,000 annual employment hours are eligible for participation in the plan.

The Bank matches employee contributions up to 4% of total compensation and may make additional discretionary contributions. Prior to 2008, the Bank matched 3%. Employee contributions are 100% vested when made. Employer contributions vest immediately for contributions made after December 31, 2007 and over six years beginning after one full year of service for contributions made prior to January 1, 2008. All contributions are 100% vested upon disability, death, or reaching normal retirement age.

The Bank's contributions to this plan, included in expenses, were **\$103,240** and \$101,980 for 2010 and 2009, respectively.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

9. Retirement Plan (Continued)

The Bank has entered into agreements with 12 employees to provide certain life insurance benefits payable in connection with policies of life insurance on those employees that are owned by the Bank. Each of the agreements provides for the amount of death insurance benefits to be paid to beneficiaries of the insured. For this plan, the Bank expensed **\$4,925** and \$4,535 in 2010 and 2009, respectively.

In 2010, the Bank adopted a supplemental executive retirement plan for two of its executives. The plan provides cash compensation to the executive officers under certain circumstances, including a separation of service. The benefits vest over the period from adoption to a certain age for each executive. The Bank recorded expenses, including interest, of **\$118,943** for the year ended December 31, 2010.

10. Interest-Bearing Deposits

Major classifications of interest-bearing deposits are as follows:

	2010	2009
NOW	\$ 19,585,168	\$ 18,057,668
Money market	22,131,065	20,804,206
Savings	25,140,872	22,142,141
Certificates of deposit, \$100,000 or more	49,525,222	36,681,906
Other time deposits	52,743,733	50,636,437
	<u>\$169,126,060</u>	<u>\$ 148,322,358</u>

As of December 31, 2010, certificates of deposit mature as follows:

<u>Year</u>	<u>Amount</u>
2011	\$ 63,874,797
2012	11,877,558
2013	21,090,812
2014	955,072
2015	4,470,716
	<u>\$ 102,268,955</u>

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

11. Borrowed Funds

Borrowed funds consist of securities sold under repurchase agreements, which essentially represent overnight or term borrowings from customers, advances from the FHLB of Atlanta and overnight borrowings from commercial banks. The government agency securities that are the collateral for these agreements are owned by the Bank and maintained in the custody of an unaffiliated agent designated by the Bank. Additional information is as follows:

	2010	2009
Amounts outstanding at year-end:		
Securities sold under repurchase agreements	<u>\$ 15,131,657</u>	<u>\$ 14,235,751</u>
Federal Home Loan Bank advance	<u>\$ -</u>	<u>\$ 3,000,000</u>
Weighted average rate paid at December 31:		
Securities sold under repurchase agreements	1.11%	1.80%
Federal Home Loan Bank advances	-	0.85%
Maximum month-end amount outstanding:		
Securities sold under repurchase agreements	\$ 15,513,154	\$ 15,299,904
Federal Home Loan Bank advance	3,000,000	6,000,000
Average amount outstanding:		
Securities sold under repurchase agreements	\$ 14,236,502	\$ 14,789,396
Federal Home Loan Bank advance	1,841,096	4,084,932
Borrowings from commercial banks	10,959	-
Average rate paid during the year:		
Securities sold under repurchase agreements	1.49%	2.18%
Federal Home Loan Bank advance	0.85%	2.37%
Borrowings from commercial banks	0.60%	0.00%
Investment securities underlying the securities agreements at year end:		
Carrying value	\$ 18,465,681	\$ 18,944,512
Estimated fair value	18,963,024	19,446,127
Loans receivable underlying the Federal Home Loan Bank advances at year-end:		
Carrying value	\$ 43,255,618	\$ 44,483,659

The Bank is approved to borrow up to 75% of eligible pledged single family residential loans and 50% of eligible pledged commercial loans, or approximately \$22.7 million, under a secured line of credit with the FHLB of Atlanta. The Bank also has available an unsecured federal funds line of credit of \$2 million and a secured federal funds line of credit of \$5 million from a commercial bank.

**Farmers and Merchants Bank
and Subsidiaries**

Notes to Consolidated Financial Statements (Continued)

12. Other Noninterest Expenses

Other noninterest expenses include the following:

	2010	2009
Automated teller machine and debit card expenses	\$ 365,407	\$ 287,989
Professional services	266,150	191,861
Directors fees	162,455	162,550
Postage, delivery, and armored carrier	159,131	156,555
Stationery, printing, and supplies	153,692	138,427
Advertising	139,704	132,036
Telephone	100,929	97,884
Other real estate owned	91,962	112,285
Internet banking fees	71,832	75,702
Correspondent bank services	52,147	61,543
Travel and conferences	44,584	24,018
Maryland state assessment	27,754	25,684
Liability insurance	26,037	25,876
Loss and error	25,057	7,579
Dues and subscriptions	24,975	28,150
Credit reports	20,242	17,003
Contributions	18,695	5,060
Education and training	11,882	14,286
Other	79,475	79,340
	<u>\$1,842,110</u>	<u>\$1,643,828</u>

13. Income Taxes

The components of income tax expense are as follows:

	2010	2009
Current		
Federal	\$ 1,146,271	\$ 600,448
State	<u>321,570</u>	<u>164,826</u>
	1,467,841	765,274
Deferred	<u>(231,014)</u>	<u>(118,338)</u>
	<u>\$ 1,236,827</u>	<u>\$ 646,936</u>

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

13. Income Taxes (Continued)

The components of the deferred tax expense are as follows:

	2010	2009
Depreciation	\$ 19,739	\$ (38,460)
Provision for loan losses	(169,482)	(172,407)
Other real estate owned allowance for loss	(44,536)	113,163
Nonaccrual interest	10,182	(18,845)
Post-retirement benefits	(46,917)	(1,789)
	<u>\$ (231,014)</u>	<u>\$ (118,338)</u>

The components of the net deferred tax asset are as follows:

Deferred tax assets		
Allowance for loan losses	\$ 882,843	\$ 713,361
Other real estate owned loss	158,926	114,391
Nonaccrual interest	19,139	29,321
Post-retirement benefits	54,906	7,989
	<u>1,115,814</u>	<u>865,062</u>
Deferred tax liabilities		
Depreciation	79,277	59,539
Unrealized gain on securities available-for-sale	30,154	130,871
	<u>109,431</u>	<u>190,410</u>
Net deferred tax asset	<u>\$1,006,383</u>	<u>\$ 674,652</u>

The differences between the federal income tax rate of 34% and the effective tax rate for the Bank are reconciled as follows:

Statutory federal income tax rate	34.0 %	34.0 %
Increase (decrease) resulting from:		
Federal tax-exempt income	(3.3)	(4.8)
State income taxes, net of federal income tax benefit	5.2	5.1
Nondeductible expenses	0.1	0.1
Other	-	(0.1)
	<u>36.0 %</u>	<u>34.3 %</u>

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

14. Capital Standards

The Federal Deposit Insurance Corporation has adopted risk-based capital standards for banking organizations. These standards require ratios of capital to assets for minimum capital adequacy and to be classified as well capitalized under prompt corrective action provisions. The following tables set forth the Bank's actual capital ratios as of December 31, 2010 and 2009, as well as the ratios necessary to be classified as adequately capitalized (minimum) and well capitalized.

(Dollars in thousands)	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2010						
Total capital (to risk-weighted assets)	\$ 24,884	13.42%	\$ 14,838	8.00%	\$ 18,548	10.00%
Tier 1 capital (to risk-weighted assets)	22,564	12.17%	7,419	4.00%	11,129	6.00%
Tier 1 capital (to average assets)	22,564	9.52%	9,477	4.00%	11,846	5.00%
December 31, 2009						
Total capital (to risk-weighted assets)	\$ 22,684	12.97%	\$ 13,994	8.00%	\$ 17,493	10.00%
Tier 1 capital (to risk-weighted assets)	20,711	11.84%	6,997	4.00%	10,496	6.00%
Tier 1 capital (to average assets)	20,711	9.69%	8,545	4.00%	10,682	5.00%

Tier 1 capital consists of common stock, surplus, and undivided profits. Total capital includes a limited amount of the allowance for loan losses. In calculating risk-weighted assets, specified risk percentages are applied to each category of asset and off-balance sheet items.

Failure to meet the capital requirements could affect the Bank's ability to pay dividends and accept deposits and may significantly affect the operations of the Bank.

In the most recent regulatory report, the Bank was categorized as well capitalized under the prompt corrective action regulations. Management knows of no events or conditions that are likely to change this classification.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

15. Fair Value of Financial Instruments

The estimated fair values of the Bank's financial instruments are summarized below. The fair values of a significant portion of these financial statements are estimates derived using present value techniques and may not be indicative of the net realizable value or liquidation values. 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 values.

	December 31,			
	2010		2009	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Cash and equivalents	\$ 11,602,545	\$ 11,602,545	\$ 14,737,250	\$ 14,737,250
Certificates of deposit	100,000	100,000	100,000	100,000
Investment securities	39,321,424	39,643,080	24,978,938	25,567,622
Loans held for sale	1,165,500	1,178,547	1,417,873	1,425,621
Loans, net	174,875,384	175,527,000	160,668,638	161,030,080
Federal Home Loan Bank stock	558,600	558,600	625,300	625,300
Financial liabilities				
Noninterest-bearing deposits	\$ 32,864,626	\$ 32,864,626	\$ 27,592,297	\$ 27,592,297
Interest-bearing deposits	169,126,060	170,024,060	148,322,358	149,598,115
Securities sold under repurchase agreements	15,131,657	15,131,657	14,235,751	14,235,751
Federal Home Loan Bank advances	-	-	3,000,000	3,000,000

The fair value of fixed-rate loans is estimated to be the present value of scheduled payments discounted using interest rates currently in effect. The fair value of variable-rate loans, including loans with a demand feature, is estimated to equal the carrying amount. The valuation of loans is adjusted for possible loan losses.

The fair value of interest-bearing checking, savings, and money market deposit accounts is equal to the carrying amount. The fair value of fixed-maturity time deposits is estimated based on interest rates currently offered for deposits of similar remaining maturities.

It is not practicable to estimate the fair value of outstanding loan commitments, unused lines of credit, and letters of credit.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

15. Fair Value of Financial Instruments (Continued)

ASC Topic 820, *Fair Value Measurements*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The price in the principal market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

ASC Topic 820 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Bank uses the following methods and significant assumptions to estimate fair value for financial assets and financial liabilities:

- Securities available for sale: The fair value of securities available for sale is determined by obtaining quoted prices from a nationally recognized securities pricing agent. If quoted market prices are not available, fair value is determined using quoted market prices for similar securities. The equity security is an investment in a banker's bank and reported at cost.
- Loans held for sale: The fair value of loans held for sale is valued at the lower of cost or market based on the cost versus the price to be realized upon sale.
- Other real estate owned: Nonrecurring fair value adjustments to other real estate owned ("OREO") reflect full or partial write-downs that are based on the OREO's observable market price or current appraised value of the collateral. Since the market for impaired loans and OREO is not active, loans or OREO subjected to nonrecurring fair value adjustments based on the current appraised value of the collateral are classified as Level 2.

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

15. Fair Value of Financial Instruments (Continued)

Carrying value at December 31, 2010

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Recurring				
Available for sale investment securities	\$ 26,730,131	\$ 24,226,252	\$ 2,483,879	\$ 20,000
Nonrecurring				
Other real estate owned (OREO)	\$ 1,238,039	\$ -	\$ 1,238,039	\$ -

16. Quarterly Results of Operations

	Three Months Ended			
	Unaudited			
2010	December 31	September 30	June 30	March 31
Interest income	\$ 3,062,025	\$ 2,947,207	\$ 2,825,683	\$ 2,782,522
Interest expense	505,047	521,708	585,838	642,670
Net interest income	2,556,978	2,425,499	2,239,845	2,139,852
Provision for loan losses	170,000	120,000	215,000	130,000
Net income	555,851	700,894	472,603	468,389
Earnings per share - basic and diluted	0.72	0.91	0.62	0.61
2009				
Interest income	\$ 2,764,733	\$ 2,738,812	\$ 2,638,803	\$ 2,574,351
Interest expense	696,594	758,830	859,509	881,737
Net interest income	2,068,139	1,979,982	1,779,294	1,692,614
Provision for loan losses	325,000	225,000	100,000	100,000
Net income	372,134	309,626	247,782	308,230
Earnings per share - basic and diluted	0.48	0.41	0.33	0.41

Farmers and Merchants Bank and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

17. Litigation

In January 2010, the Bank, along with Baltimore County Savings Bank and Carrollton Bank, entered into a settlement agreement with Global Express Money Orders, Inc. ("Global") to end an outstanding lawsuit. The settlement was not an admission of liability, but was negotiated to avoid further litigation expenses. The Bank agreed to pay Global \$50,000 to settle any and all claims. The direct expense to the Bank was **\$10,000** in 2010 with the remaining \$40,000 paid by the Bank's insurance carrier.

In the ordinary course of its business, the Bank is periodically party to various legal actions normally associated with a financial institution. Management does not believe that any of these normal course proceedings are likely to have a material adverse effect on the financial condition or liquidity of the Bank.

18. Subsequent Events

The Bank has evaluated subsequent events for potential recognition and/or disclosure through March 4, 2011, the date the consolidated financial statements were issued.

In February 2011, the Bank entered into a contract to purchase land and a building in Westminster, Maryland for \$1,100,000 for the purpose of opening a branch office. The purchase is subject to approval by the FDIC and the State of Maryland which the Bank fully expects to obtain.

Farmers and Merchants Bank

MARKET FOR THE BANK'S COMMON EQUITY AND OTHER RELATED SHAREHOLDER MATTERS

The Bank's Articles of Incorporation authorize the Bank to issue up to 5,000,000 shares of common stock, par value \$10.00 per share (the "Common Stock"). As of March 1, 2011 there were 774,237.608 shares of Common Stock issued and outstanding held by approximately 599 stockholders of record.

The shares of Common Stock are traded in the over-the-counter market through the NASDAQ Stock Market's Over-the-Counter Bulletin Board ("OTCBB") under the symbol "FMFG.OB". The table below sets forth, to the best of the Bank's knowledge, the per share high and low bid prices for each quarterly period during the past two years as reported through the OTCBB and the cash dividends declared by the Bank during those periods. These prices reflect inter-dealer prices, do not include retail mark-up, mark-down or commission, and may not represent actual transactions.

	<u>High</u>	<u>Low</u>	<u>Dividend Per Share</u>
<u>2010</u>			
Quarter ended December 31	\$25.00	\$20.62	\$0.40
Quarter ended September 30	24.50	20.50	0.00
Quarter ended June 30	26.75	21.50	0.35
Quarter ended March 31	26.75	23.50	0.00
<u>2009</u>			
Quarter ended December 31	\$30.00	\$20.15	\$0.30
Quarter ended September 30	21.70	19.66	0.00
Quarter ended June 30	23.75	20.15	0.30
Quarter ended March 31	24.00	21.00	0.00

As a depository institution whose deposits are insured by the FDIC, the Bank may not pay dividends or distribute any of its capital assets while it remains in default on any assessment due the FDIC. The Bank currently is not in default on any of its obligations to the FDIC. The Bank's ability to pay dividends is also limited by certain restrictions imposed on Maryland banks and corporations generally. Under Maryland law, the Bank may declare cash dividends from undivided profits or, with the prior approval of the Maryland Commissioner of Financial Regulation, out of surplus in excess of 100% of its required capital stock, and (in either case) after providing for due or accrued expenses, losses, interest and taxes. Notwithstanding the above, dividends are at the discretion of the Board of Directors, and there can be no assurance that the Bank will declare or pay cash dividends at any time. These restrictions are discussed in detail in Exhibit 99.1 to the Bank's Annual Report on Form 10-K for the year ended December 31, 2010.

The Bank has adopted a Dividend Reinvestment Plan that permits stockholders to reinvest cash dividends in shares of Common Stock. Stockholders who elect to reinvest their dividends in Common Stock will receive the number of shares equal to the amount of the dividend divided by the applicable purchase price per share.

Farmers and Merchants Bank

Stockholder Information

Corporate Headquarters

15226 Hanover Pike
Upperco, MD 21155
410-833-6600

Annual Meeting

The annual meeting of stockholders will be held
April 26, 2011 at 3:00 p.m.
at the Piney Branch Golf and Country Club,
located at 5301 Trenton Mill Road, Hampstead, Maryland 21074.
All shareholders are invited to attend.

Securities Markets

Shares of common stock of Farmers and Merchants Bank
are publicly traded on the NASDAQ Stock Market's Over-the-Counter
Bulletin Board under the trading symbol "FMFG."

The market maker is the brokerage firm of RBC Wealth Management
100 Light Street, Baltimore, Maryland 21202.

Direct inquiries to: Charles Luck or Derek Ehman at (800) 247-7223.

Transfer Agent

American Stock Transfer & Trust Company
59 Maiden Lane
New York, NY 10038
(212) 936-5100

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Website

www.farmersandmerchantsbk.com or www.fmb1919.com

A copy of the Farmers and Merchants Bank annual report to the FDIC on
Form 10-K, including financial statements, may be obtained without charge upon
written request to:

Mark C. Krebs, Senior Vice President, Chief Financial Officer
Farmers and Merchants Bank
P. O. Box 249
25 Westminster Pike
Reisterstown, Maryland 21136

