



2011 ANNUAL REPORT



◆ THE "COMMUNITY" BANK THAT PUTS PEOPLE FIRST ◆

Member FDIC

March 2, 2012

Dear Stockholders, Customers, and Friends:

We are pleased to report that your Bank achieved the highest net income in its history during 2011, topping the previous record set last year. Net income for the year ended December 31, 2011 was \$2,266,511 or \$2.92 per share compared to \$2,197,737 or \$2.87 per share in 2010. The increase in net income is a result of the widening in our net interest margin and an increase in earning assets as well as efficient operations tempered by an increase in loan losses. Return on average equity remained high at 9.40% in 2011 compared to 9.95% in 2010. Return on average assets, another key measure of profitability, also remained strong at 0.90% in 2011 compared to 0.97% in 2010. Cash dividends paid to shareholders in 2011 increased to \$0.91 per common share from \$0.75 per common share in 2010.

Asset growth continued at a healthy rate during 2011. The year-end total of \$254 million represented a 6% increase from \$240 million at December 31, 2010. Loans outstanding increased 7% to \$187 million at December 31, 2011 from \$175 million at the end of 2010. Deposits increased by 3%, growing to \$207 million at December 31, 2011 from \$202 million at December 31, 2010. Stockholders' Equity increased \$2,099,083 or 9% to \$24,709,508 at December 31, 2011 from \$22,610,425 at the end of 2010.

The Bank's outstanding performance in 2011 earned it a #2 ranking state-wide among Maryland state chartered banks for the second consecutive year as determined by the Financial Management Consulting Group. We were the highest rated bank in the Baltimore Metropolitan area, for the second consecutive year. The rankings were based upon profitability, efficiency, and asset quality among other criteria.

The Bank opened a branch in Westminster, MD in July of 2011. We are pleased to report that the branch is off to an outstanding start with total deposits at December 31, 2011 well in excess of our projections.

We continue to provide the safety and soundness that is important in today's difficult economic times. The Bank is and has been for many years a well capitalized institution, according to FDIC criteria. We continue to meet the loan and deposit needs of our community. Please contact us or visit us at one of our many locations.

The outstanding financial performance of Farmers and Merchants Bank is a result of the hard work and dedication of our directors, officers, and staff. Quality service, conservative management, and a disciplined approach to growth continue to be our focus. On behalf of the Board of Directors and staff, we thank you for your confidence in and your continued support of our excellent community bank.

Sincerely yours,

Kenneth W. Hoffmeyer
Chairman

James R. Bosley, Jr.
President

Main Office
15226 Hanover Pike
Upperco, MD 21155
(410) 833-6600 • (410) 429-1919
FAX (410) 526-3835

Hampstead Branch
735 Hanover Pike
Hampstead, MD 21074
(410) 239-4448 • (410) 374-4125
FAX (410) 374-4240

Greenmount In-Store Branch
2205 Hanover Pike
Hampstead, MD 21074
(410) 374-3436

Reisterstown Branch
25 Westminster Pike, P.O. Box 249
Reisterstown, MD 21136
(410) 517-3060
FAX (410) 517-3061

Owings Mills Branch
9320 Lakeside Blvd.
Owings Mills, MD 21117
(410) 356-8200
FAX (410) 356-5456

Westminster Branch
275 Clifton Road
Westminster, MD 21157
(410) 857-1100
FAX (410) 857-2360

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, Route 795, and Route 140 corridors south from Owings Mills and north to the Pennsylvania state line including the areas of Reisterstown, Upperco, Hampstead, Manchester, and Westminster.

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

Westminster Office
275 Clifton Boulevard
Westminster, MD 21157
410-857-1100

Commercial Loan Center
Westminster Office
275 Clifton Boulevard
Westminster, MD 21157
410-857-1700

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
2011

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
2011

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. Lewis Lending
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
J. Thomas Turner.....Mortgage Officer

Other Bank Officers

Paul A. Davolos..Commercial Banking Officer
T. Jeffrey Horner.....Controller
Mark W. Lutrey.....Auditor

Assistant Vice Presidents

Loan Officers

Debora A. Smith
Betty J. Higgs-Swartz

Assistant Vice Presidents

Branch Managers

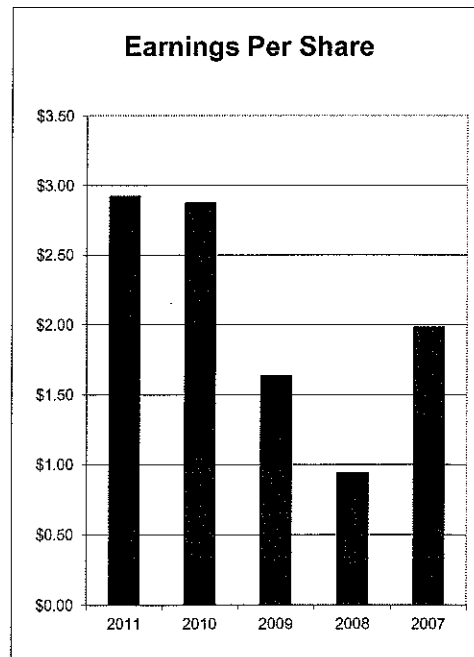
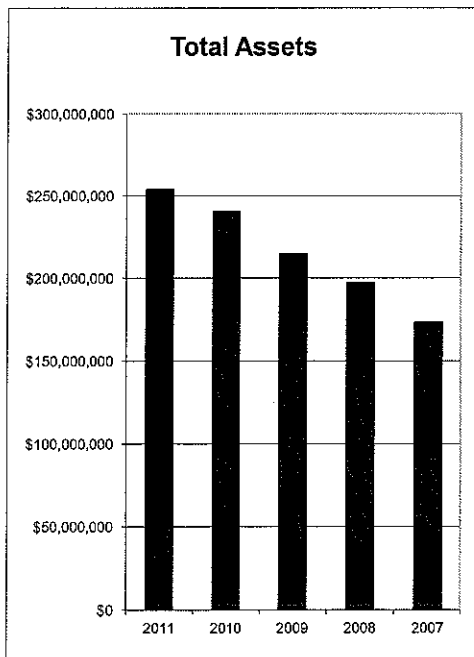
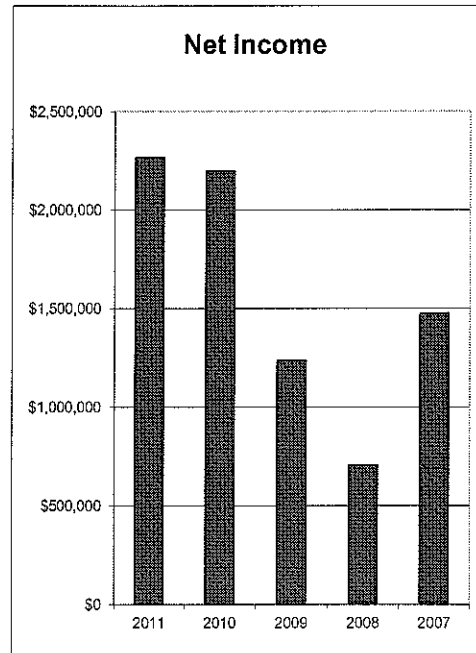
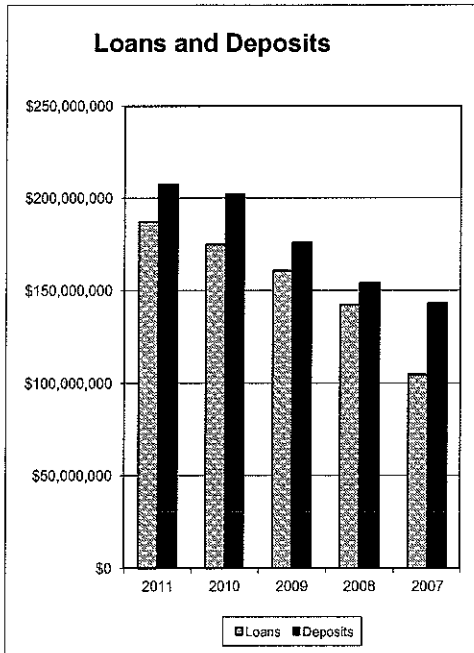
Wendy A. Panek.....Reisterstown
Shannon M. Panek-Close.....Main Office
Rachel L. Heird.....Owings Mills
Kelly P. Johnson.....Hampstead
Amy L. Collins.....Greenmount
Deborah Zepp.....Westminster

Farmers and Merchants Bank

Selected Consolidated Financial Data

	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
<i>OPERATING DATA</i>					
Interest income	\$ 12,662,321	\$ 11,617,437	\$ 10,716,699	\$ 9,817,939	\$ 10,144,507
Interest expense	<u>1,844,423</u>	<u>2,255,263</u>	<u>3,196,670</u>	<u>3,384,201</u>	<u>3,510,242</u>
Net interest income	10,817,898	9,362,174	7,520,029	6,433,738	6,634,265
Provision for loan losses	<u>1,575,000</u>	<u>635,000</u>	<u>750,000</u>	<u>520,000</u>	<u>340,000</u>
Net interest income after provision for loan losses	9,242,898	8,727,174	6,770,029	5,913,738	6,294,265
Noninterest income	1,815,569	1,707,695	1,788,807	1,799,602	1,667,148
Noninterest expense	<u>7,615,046</u>	<u>7,000,305</u>	<u>6,674,128</u>	<u>6,774,376</u>	<u>5,748,785</u>
Income before income taxes	3,443,421	3,434,564	1,884,708	938,964	2,212,628
Income taxes	<u>1,176,910</u>	<u>1,236,827</u>	<u>646,936</u>	<u>234,201</u>	<u>735,508</u>
Net income	<u>\$ 2,266,511</u>	<u>\$ 2,197,737</u>	<u>\$ 1,237,772</u>	<u>\$ 704,763</u>	<u>\$ 1,477,120</u>
<i>PER SHARE DATA</i>					
Net income (Basic)	\$2.92	\$2.87	\$1.63	\$0.94	\$1.98
Dividends	\$0.91	\$0.75	\$0.60	\$0.99	\$0.95
Book value per share	\$31.43	\$29.20	\$27.37	\$26.53	\$26.27
Dividend payout ratio	31.16%	26.13%	36.81%	105.17%	47.98%
<i>KEY RATIOS</i>					
Return on average assets	0.90%	0.97%	0.59%	0.39%	0.87%
Return on average equity	9.40%	9.95%	6.02%	3.52%	7.58%
Net interest margin	4.70%	4.46%	3.87%	3.88%	4.30%
Efficiency ratio	60.28%	63.24%	71.70%	82.28%	69.25%
Average equity to average assets	9.61%	9.74%	9.88%	11.09%	11.53%
<i>AT PERIOD END</i>					
Total assets	\$253,901,460	\$ 240,427,031	\$ 214,703,396	\$ 197,271,437	\$ 173,211,324
Loans, net and loans held for sale	187,670,721	176,040,884	162,086,511	142,375,750	104,779,706
Cash, federal funds sold, and other interest-earning deposits	14,314,474	11,602,545	14,737,250	12,887,914	24,688,671
Securities	35,781,959	39,321,424	24,978,938	29,828,781	30,812,781
Deposits	207,275,557	201,990,686	175,914,655	154,332,920	143,460,039
Borrowings	21,188,190	15,131,657	17,235,751	21,968,438	9,268,451
Stockholders' equity	24,709,508	22,610,425	20,911,870	20,045,076	19,703,260
<i>SELECTED AVERAGE BALANCES</i>					
Total assets	\$ 250,795,495	\$ 226,927,649	\$ 208,096,804	\$ 180,780,956	\$ 168,941,480
Loans, net and loans held for sale	183,542,258	166,059,163	155,472,880	122,890,944	110,630,577
Cash, federal funds sold, and other interest-earning deposits	13,013,934	19,239,869	7,578,188	11,810,737	17,653,887
Securities	38,685,424	28,938,039	27,395,016	31,208,413	26,344,512
Deposits	206,454,365	188,050,432	167,803,586	144,044,763	138,289,943
Borrowings	19,534,304	16,088,557	18,874,328	16,030,065	10,420,512
Stockholders' equity	24,100,462	22,093,758	20,566,797	20,047,843	19,485,116
<i>ASSET QUALITY</i>					
Nonperforming assets	\$ 3,567,526	\$ 1,467,705	\$ 2,203,332	\$ 2,786,678	\$ 2,500,068
Nonperforming assets/total assets	1.41%	0.61%	1.03%	1.41%	1.44%
Allowance for loan losses/total loans	1.33%	1.37%	1.21%	1.05%	1.14%

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, 2011. 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

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

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 on the size of the DIF. This change went into effect in 2011 and has resulted in a decrease in FDIC premiums paid by the Bank.
- Impose comprehensive regulation of the over-the-counter derivatives market, including certain provisions that would effectively prohibit insured depository institutions from conducting certain derivatives businesses in the institution itself. This will have no impact on the Bank.
- 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. This provision will not impact the Bank until 2013.
- 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. This could cause the Bank's interest expense to increase.
- 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. This was implemented in 2011 and has resulted in a decrease in revenue to the Bank.

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. 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.

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

FINANCIAL CONDITION

Total assets increased by \$13,474,429 or 5.6% during 2011 to \$253,901,460 at December 31, 2011 from \$240,427,031 at December 31, 2010. The increase in total assets was due primarily to increases of \$12,209,337 in loans, \$2,711,929 in cash and cash equivalents, \$1,647,530 in premises and equipment, and \$1,194,483 in bank owned life insurance, offset by an aggregate decrease of \$3,539,465 in securities available for sale and securities held for investment.

Total liabilities increased \$11,375,346 or 5.2% during 2011 to \$229,191,952 at December 31, 2011 from \$217,816,606 at December 31, 2010. The increase was due primarily to increases of \$5,284,871 in deposits, \$3,056,533 in securities sold under repurchase agreements, and \$3,000,000 of Federal Home Loan Bank ("FHLB") advances. The increase in deposits was comprised of a \$2,327,509 increase in interest-bearing accounts and a \$2,957,362 increase in noninterest-bearing accounts.

Stockholders' equity increased by \$2,099,083 during 2011 to \$24,709,508 at December 31, 2011 from \$22,610,425 at December 31, 2010. The increase was due primarily to net income for the period of \$2,266,511 and an increase in accumulated other comprehensive income of \$250,074, offset by dividends paid, net of reinvestments, of \$417,502.

Loans

Loans increased by \$12,209,337 or 7.0% to \$187,084,721 at December 31, 2011 from \$174,875,384 at December 31, 2010. The increase was primarily attributable to increases in other commercial real estate loans of \$17,901,063 and residential real estate loans of \$2,144,970, offset by a decrease in commercial real estate construction/land development loans of \$8,478,916. The allowance for loan losses was \$2,518,511 at December 31, 2011 as compared to \$2,436,510 at December 31, 2010, an increase of \$82,001.

Major categories of loans are as follows:

	2011	2010
Commercial	\$ 10,908,301	\$ 10,237,364
Commercial Real Estate:		
Construction/Land development	18,906,285	27,385,201
Other	121,391,973	103,490,910
Consumer	532,255	467,403
Residential	38,201,754	36,056,784
	<u>189,940,568</u>	<u>177,637,662</u>
Less: Allowance for loan losses	2,518,511	2,436,510
Deferred origination fees net of costs	337,336	325,768
	<u>\$ 187,084,721</u>	<u>\$ 174,875,384</u>

The following table sets forth at December 31, 2011 and 2010 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.

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

	<u>2011</u>	<u>2010</u>
Variable rate, immediately	\$ 17,280,774	\$ 16,776,304
Due within one year	28,908,009	30,830,485
Due over one to five years	131,436,300	116,341,682
Due over five years	<u>12,315,485</u>	<u>13,689,191</u>
	<u>\$ 189,940,568</u>	<u>\$ 177,637,662</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. Management believes that 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, is 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
2011							
Commercial	\$ -	\$ -	\$ 22,400	\$ 22,400	\$ 10,885,901	\$ 10,908,301	\$ -
Commercial real estate:							
Constr./Land dev.	256,466	-	426,907	683,373	18,222,912	18,906,285	-
Other	-	-	1,435,896	1,435,896	119,956,077	121,391,973	-
Consumer	-	-	-	-	532,255	532,255	-
Residential real estate	27,765	-	1,682,323	1,710,088	36,491,666	38,201,754	-
Total	<u>\$ 284,231</u>	<u>\$ -</u>	<u>\$ 3,567,526</u>	<u>\$ 3,851,757</u>	<u>\$ 186,088,811</u>	<u>\$ 189,940,568</u>	<u>\$ -</u>
2010							
Commercial	\$ 23,578	\$ -	\$ -	\$ 23,578	\$ 10,213,786	\$ 10,237,364	\$ -
Commercial real estate:							
Constr./Land dev.	-	486,837	62,410	549,247	26,835,954	27,385,201	62,410
Other	232,917	523,809	-	756,726	102,734,184	103,490,910	-
Consumer	-	-	-	-	467,403	467,403	-
Residential real estate	472,518	74,116	1,424,110	1,970,744	34,086,040	36,056,784	189,322
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>

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

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:

	<u>2011</u>	<u>2010</u>
Commercial	\$ 22,400	\$ -
Commercial real estate:		
Construction/Land development	426,907	-
Other	1,435,896	232,917
Residential real estate	1,682,323	1,234,788
Total	<u>\$ 3,567,526</u>	<u>\$ 1,467,705</u>

At December 31, 2011, the Bank had 13 nonaccrual loans to 10 borrowers totaling \$3,567,526. The loans are collateralized by real estate, business assets, and personal guarantees. Gross interest income of \$270,678 would have been recorded in 2011 if these nonaccrual loans had been current and performing in accordance with the original terms. The Bank has allocated \$128,864 of its allowance for loan losses for these nonaccrual loans. The balance of nonaccrual loans is net of charge-offs of \$1,578,887 at December 31, 2011.

At 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 guarantees. 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. The balance of nonaccrual loans is net of charge-offs of \$181,491 at December 31, 2010.

At December 31, 2011, the bank had no loans delinquent 90 days or greater other than the nonaccrual loans noted above. At December 31, 2010, the Bank had two loans delinquent 90 days or greater totaling \$251,732 other than the nonaccrual loans noted above. At December 31, 2011, the Bank had \$6,213,707 of loans other than the nonaccrual and delinquent 90 days or greater noted above on a watch list for which the borrowers have the potential for experiencing financial difficulties. At December 31, 2010, the Bank had \$3,078,187 of such loans. These loans are subject to ongoing management attention and their classifications are reviewed regularly.

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense. 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. The Bank's allowance for loan loss methodology includes allowance allocations calculated in accordance with Accounting Standards Codification ("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

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

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 loan losses is designed to account for credit deterioration as it occurs. The provision for 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 loan losses by portfolio for the years ended December 31, 2011 and 2010. 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
2011						
Beginning balance	\$ 98,387	\$ 1,868,629	\$ 303,603	\$ 18,039	\$ 147,852	\$ 2,436,510
Provision for loan losses	22,337	1,141,928	546,081	(11,239)	(124,107)	1,575,000
Charge-offs	(27,853)	(1,098,152)	(384,555)	-	-	(1,510,560)
Recoveries	-	2,450	13,111	2,000	-	17,561
Net charge-offs	(27,853)	(1,095,702)	(371,444)	2,000	-	(1,492,999)
Ending balance	\$ 92,871	\$ 1,914,855	\$ 478,240	\$ 8,800	\$ 23,745	\$ 2,518,511
2010						
Beginning balance	\$ 130,085	\$ 1,628,640	\$ 167,910	\$ 19,191	\$ 27,472	\$ 1,973,298
Provision for loan losses	(31,698)	239,989	312,184	(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	\$ 1,868,629	\$ 303,603	\$ 18,039	\$ 147,852	\$ 2,436,510

	2011	2010
Allowance for loan losses to total loans outstanding	<u>1.33%</u>	<u>1.37%</u>
Ratio of net charge-offs to average loans outstanding during the period	<u>0.80%</u>	<u>0.10%</u>

Farmers and Merchants Bank

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

(continued)

The Bank recorded \$1,492,999 in net charge-offs in 2011 versus \$171,788 in net charge-offs in 2010. The provision for loan losses was \$1,575,000 for 2011 compared to \$635,000 in 2010. The increase was due to an increase in impaired loans and net-charge-offs. During 2011, the Bank sold several properties to third parties at foreclosure sales at substantially less than the appraised value due to the deteriorated condition of the properties resulting in losses in excess of the amount reserved.

Other Real Estate Owned

Other real estate owned at December 31, 2011 and 2010 included two properties with a total carrying value of \$1,221,541 and \$1,238,039, respectively. The first property is land in Cecil County, Maryland with a carrying value of \$675,000. 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. The property is being actively marketed for sale. The other property with a carrying value of \$546,541 is land in Prince Georges County, Maryland. The Bank was a participant lender and holds a 12.1% interest in the property. 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.

Investment Securities

Investment securities decreased \$3,539,465 or 9.0% to \$35,781,959 at December 31, 2011 from \$39,321,424 at December 31, 2010. At December 31, 2011 and 2010, the Bank had classified 68% of the investment portfolio as available for sale. 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:

	2011	2010
<u>Available for sale</u>		
U.S. government agency	\$ 1,002,151	\$ 3,943,126
State and municipal	2,674,336	2,483,879
	3,676,487	6,427,005
Mortgage-backed securities	20,774,907	20,283,126
Equity security	6,000	20,000
	<u>\$ 24,457,394</u>	<u>\$ 26,730,131</u>
<u>Held to maturity</u>		
U.S. government agency	\$ 130,128	\$ 170,410
State and municipal	8,385,857	7,376,070
	8,515,985	7,546,480
Mortgage-backed securities	2,808,580	5,044,813
	<u>\$ 11,324,565</u>	<u>\$ 12,591,293</u>

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

The following table sets forth the scheduled maturities of investment securities at December 31, 2011:

	<u>Available for Sale</u>			<u>Held to Maturity</u>		
	Amortized Cost	Fair Value	Yield	Amortized Cost	Fair Value	Yield
Within 1 year	\$ -	\$ -	-	\$ 130,128	\$ 134,397	5.09%
Over 1 to 5 years	-	-	-	1,104,627	1,118,785	4.45%
Over 5 to 10 years	-	-	-	388,408	396,560	3.75%
Over 10 years	<u>3,489,003</u>	<u>3,676,487</u>	<u>3.89%</u>	<u>6,892,822</u>	<u>7,258,332</u>	<u>3.53%</u>
	3,489,003	3,676,487	3.89%	8,515,985	8,908,074	3.68%
Motgage-backed securities	20,472,974	20,774,907	3.34%	2,808,580	3,370,652	6.10%
Equity security	<u>6,000</u>	<u>6,000</u>	-	-	-	-
	<u>\$ 23,967,977</u>	<u>\$ 24,457,394</u>	<u>3.42%</u>	<u>\$ 11,324,565</u>	<u>\$ 12,278,726</u>	<u>4.28%</u>

Deposits

Total deposits increased by \$5,284,871 or 2.6% during 2011 to \$207,275,557 at December 31, 2011 from \$201,990,686 at December 31, 2010. The increase in deposits was due primarily to a \$4,233,990 increase in money market accounts, a \$2,957,362 increase in noninterest-bearing accounts, a \$2,746,675 increase in interest bearing checking accounts, and an \$839,373 increase in savings accounts, offset by a decrease of \$5,492,529 in time deposits. The following table shows the average balances and average costs of deposits for the years ended December 31:

	<u>2011</u>		<u>2010</u>	
	Average Balance	Cost	Average Balance	Cost
Noninterest bearing demand deposits	\$ 34,335,116	0.00%	\$ 30,044,738	0.00%
Interest bearing demand deposits	19,638,411	0.14%	18,606,139	0.21%
Savings deposits	51,297,605	0.36%	46,268,498	0.47%
Time deposits	<u>101,183,232</u>	<u>1.46%</u>	<u>93,131,057</u>	<u>1.90%</u>
	<u>\$ 206,454,364</u>	<u>0.82%</u>	<u>\$ 188,050,432</u>	<u>1.08%</u>

As of December 31, 2011, certificates of deposit mature as follows:

<u>Year</u>	<u>Balance</u>
2012	\$ 52,703,742
2013	28,757,694
2014	8,039,776
2015	4,354,838
2016	<u>2,920,376</u>
Total	<u>\$ 96,776,426</u>

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

Off-Balance Sheet Arrangements

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.

For commitments to extend credit, lines of credit, and letters of credit, the Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument 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, 2011, the Bank's off-balance sheet financial instruments were as follows:

Loan commitments	\$ 16,651,646
Unused lines of credit	\$ 26,687,851
Letters of credit	\$ 1,838,679

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,	
	2011	2010
Amount outstanding at year-end:		
Securities sold under repurchase agreements	\$ 18,188,190	\$ 15,131,657
Federal Home Loan Bank advances (matures May 25, 2012)	3,000,000	-
Weighted average rate paid at December 31:		
Securities sold under repurchase agreements	0.89%	1.11%
Federal Home Loan Bank advances	0.30%	0.00%

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

	<u>For years ended December 31,</u>	
	<u>2011</u>	<u>2010</u>
Maximum amount of borrowings outstanding at any month end:		
Securities sold under repurchase agreements	\$ 19,384,434	\$ 15,513,154
Federal Home Loan Bank advances	7,500,000	3,000,000
Borrowings from commercial banks	-	-
Average amount of borrowings outstanding with respect to:		
Securities sold under repurchase agreements	\$ 15,472,657	\$ 14,236,502
Federal Home Loan Bank advance	4,060,274	1,841,096
Borrowings from commercial banks	1,373	10,959
Weighted average rate paid for the year:		
Securities sold under repurchase agreements	0.95%	1.49%
Federal Home Loan Bank advances	0.25%	0.85%
Borrowings from commercial banks	0.51%	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 \$2,266,511 for the year ended December 31, 2011 compared to \$2,197,737 for the year ended December 31, 2010. The increase of \$68,774 was due primarily to an increase of \$1,455,724 in net interest income, an increase of \$107,874 in noninterest income, and a decrease in income taxes of \$59,917, offset by an increase in the provision for loan losses of \$940,000 and an increase of \$614,741 in noninterest expense.

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 \$1,455,724 to \$10,817,898 for 2011 compared to \$9,362,174 for 2010. The increase was attributable primarily to a decline in the cost of interest-bearing liabilities and an increase in the average balance of interest-earning assets. The cost of interest-bearing liabilities decreased 34 basis points to 0.96% in 2011 compared to 1.30% in 2010, while the yield on interest-earning assets decreased 3 basis points to 5.50% in 2011 from 5.53% in 2010. The Bank's interest rate spread increased 31 basis points to 4.54% in 2011 from 4.23% for 2010. Average interest earning assets increased \$20,418,705 to \$230,389,957 in 2011 from \$209,971,252 in 2010.

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

Total interest income increased \$1,044,884 to \$12,662,321 in 2011 compared to \$11,617,437 in 2010. The increase was due primarily to a \$20,418,705 increase in average interest earning assets.

Interest income from loans increased \$787,202 to \$11,167,950 in 2011 compared to \$10,380,748 in 2010. This increase was attributable to an \$18,166,338 increase in the average balance of loans to \$186,394,256 in 2011 from \$168,227,918 in 2010, offset by an 18 basis point decrease in the average yield on loans to 5.99% in 2011 from 6.17% in 2010.

Interest income on securities increased \$276,233 to \$1,477,515 for 2011 compared to \$1,201,282 for 2010. This increase was attributable to a \$10,236,495 increase in the average balance of securities to \$38,685,423 in 2011 from \$28,448,928 in 2010, offset by a 40 basis point decrease in the average yield on securities to 3.82% in 2011 from 4.22% in 2010.

Interest income on federal funds sold and other interest-earning assets (FHLB stock and certificates of deposit) decreased \$18,551 to \$16,856 in 2011 compared to \$35,407 for 2010. The decrease was due to a \$7,984,128 decrease in the average balance of federal funds sold and other interest-earning assets to \$5,310,278 in 2011 from \$13,294,406 for 2010, offset by a 5 basis point increase in the average yield to 0.32% in 2011 from 0.27% in 2010.

Total interest expense decreased \$410,840 to \$1,844,423 in 2011 compared to \$2,255,263 in 2010. The decrease was primarily due to a 34 basis point decrease in the cost of interest-bearing liabilities to 0.96% in 2011 from 1.30% in 2010, offset by an increase of \$17,559,301 in the average balance of interest-bearing liabilities to \$191,653,552 in 2011 from \$174,094,251 in 2010.

Interest paid on NOW, savings, and money market deposit accounts decreased \$42,404 to \$215,091 in 2011 compared to \$257,495 in 2010. The decrease was due to a 10 basis point decrease in average interest rate paid to 0.30% in 2011 from 0.40% in 2010, offset by a \$6,061,379 increase in the average balance of deposits to \$70,936,016 in 2011 from \$64,874,637 in 2010.

Interest paid on time deposits decreased \$297,536 to \$1,471,911 in 2011 compared to \$1,769,447 in 2010. The decrease in interest expense was due to a decrease of 44 basis points in the average rate paid to 1.46% in 2011 from 1.90% in 2010 offset by an increase of \$8,052,175 in the average balance to \$101,183,232 in 2011 from \$93,131,057 in 2010.

Interest paid on securities sold under repurchase agreements decreased \$65,306 to \$147,339 in 2011 compared to \$212,645 in 2010. The decrease was attributable to a decrease of 54 basis points in the average rate to 0.95% in 2011 from 1.49% in 2010, offset by a \$1,236,155 increase in the average balance of securities sold under repurchase agreements to \$15,472,657 in 2011 from \$14,236,502 in 2010.

Interest paid on FHLB advances and other borrowings decreased \$5,594 to \$10,082 in 2011 from \$15,676 in 2010. The decrease was attributable to a decrease of 60 basis points in the average rate to 0.25% in 2011 from 0.85% in 2010, offset by a \$2,209,592 increase in the average balance of FHLB advances and other borrowings to \$4,061,647 in 2011 from \$1,852,055 in 2010.

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

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,					
	2011			2010		
	<u>Average</u> <u>Balance</u>	<u>Interest</u>	<u>Yield</u>	<u>Average</u> <u>Balance</u>	<u>Interest</u>	<u>Yield</u>
<u>Assets:</u>						
Loans	\$ 186,394,256	\$ 11,167,950	5.99%	\$ 168,227,918	\$ 10,380,748	6.17%
Securities, taxable	29,810,742	1,133,475	3.80%	22,470,366	959,239	4.27%
Securities, tax exempt	8,874,681	344,040	3.88%	5,978,562	242,043	4.05%
Federal funds sold and other interest earning assets	<u>5,310,278</u>	<u>16,856</u>	<u>0.32%</u>	<u>13,294,406</u>	<u>35,407</u>	<u>0.27%</u>
Total interest-earning assets	230,389,957	12,662,321	5.50%	209,971,252	11,617,437	5.53%
Noninterest-earning assets	<u>20,395,685</u>			<u>16,956,397</u>		
Total assets	<u>\$ 250,785,642</u>			<u>\$ 226,927,649</u>		
<u>Liabilities and Stockholders' Equity:</u>						
NOW, savings, and money market	\$ 70,936,016	215,091	0.30%	\$ 64,874,637	257,495	0.40%
Certificates of deposit	101,183,232	1,471,911	1.46%	93,131,057	1,769,447	1.90%
Securities sold under repurchase agreements	15,472,657	147,339	0.95%	14,236,502	212,645	1.49%
FHLB advances and other borrowings	<u>4,061,647</u>	<u>10,082</u>	<u>0.25%</u>	<u>1,852,055</u>	<u>15,676</u>	<u>0.85%</u>
Total interest-bearing deposits	191,653,552	1,844,423	0.96%	174,094,251	2,255,263	1.30%
Noninterest-bearing deposits	34,335,116			30,044,738		
Noninterest-bearing liabilities	<u>696,512</u>			<u>694,902</u>		
Total liabilities	226,685,180			204,833,891		
Stockholders' equity	<u>24,100,462</u>			<u>22,093,758</u>		
Total liabilities and stockholders' equity	<u>\$ 250,785,642</u>			<u>\$ 226,927,649</u>		
Net interest income		<u>\$ 10,817,898</u>			<u>\$ 9,362,174</u>	
Interest rate spread			<u>4.54%</u>			<u>4.23%</u>
Net yield on interest-earning assets			<u>4.70%</u>			<u>4.46%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities			<u>120.21%</u>			<u>120.61%</u>

Farmers and Merchants Bank

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

(continued)

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, 2011 compared to 2010			Year ended December 31, 2010 compared to 2009		
	Change due to variance in			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	\$ 1,095,340	\$ (308,138)	\$ 787,202	\$ 784,345	\$ 180,300	\$ 964,645
Securities, taxable	287,688	(113,452)	174,236	9,702	(117,453)	(107,751)
Securities, tax exempt	112,673	(10,676)	101,997	49,729	(19,856)	29,873
Federal funds sold and other interest-earning assets	<u>(19,457)</u>	<u>906</u>	<u>(18,551)</u>	<u>3,285</u>	<u>10,687</u>	<u>13,972</u>
Total interest-earning assets	<u>1,476,244</u>	<u>(431,360)</u>	<u>1,044,884</u>	<u>847,061</u>	<u>53,678</u>	<u>900,739</u>
Interest expense:						
NOW, savings, and money market	22,448	(64,852)	(42,404)	26,865	(69,643)	(42,778)
Certificates of deposit	143,325	(440,861)	(297,536)	272,337	(980,244)	(707,907)
Securities sold under repurchase agreements	17,171	(82,477)	(65,306)	(11,628)	(97,502)	(109,130)
FHLB advances and other borrowings	<u>10,402</u>	<u>(15,996)</u>	<u>(5,594)</u>	<u>(37,442)</u>	<u>(44,150)</u>	<u>(81,592)</u>
Total interest-bearing liabilities	<u>193,346</u>	<u>(604,186)</u>	<u>(410,840)</u>	<u>250,132</u>	<u>(1,191,539)</u>	<u>(941,407)</u>
Change in net interest income	<u>\$ 1,282,898</u>	<u>\$ 172,826</u>	<u>\$ 1,455,724</u>	<u>\$ 596,929</u>	<u>\$ 1,245,217</u>	<u>\$ 1,842,146</u>

Noninterest Income

Total noninterest income increased \$107,874 or 6.3% to \$1,815,569 in 2011 from \$1,707,695 in 2010. Service charges on deposit accounts decreased \$111,347 to \$880,979 in 2011 from \$992,326 in 2010 as a result of recent legislation limiting fees that may be imposed in connection with overdrafts and debit card transactions. Mortgage division fees decreased \$107,462 during 2011 when compared to 2010 as a result of decreased refinance activity and the continuation of a depressed housing market. The Bank experienced an increase of \$71,086 in income attributable to the value of its bank-owned life insurance ("BOLI") to \$176,483 in 2011 from \$105,397 in 2010. The Bank invested an additional \$1,018,000 in BOLI during 2011. The tax exempt return for 2011 was 3.2% on an average BOLI investment of \$5,535,812 versus a tax exempt return of 2.4% on an average BOLI investment of \$4,471,672 in 2010. Net gains on sales of securities increased \$77,578 to \$82,098 in 2011 compared to \$5,520 in 2010 as a result of the Bank selling 30 small balance securities (mortgage backed securities and collateralized mortgage obligations) with an aggregate principal balance of \$1,831,637. The Bank sold land at its main office location to the Maryland State Highway Administration for road improvements resulting in a gain of \$188,353.

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

Noninterest Expense

Total noninterest expense increased by \$614,741 or 8.8% to \$7,615,046 in 2011 from \$7,000,305 in 2010. The increase was due primarily to increases in salary and employee benefit expenses, occupancy, and other expenses, offset by a decrease in FDIC premiums.

Salary and benefit expense increased \$539,971 or 13.8% to \$4,451,771 in 2011 compared to \$3,911,800 in 2010. The increase was due primarily to increases in staff (a new branch was opened in July which added seven positions), merit increases in salaries paid to existing staff, higher bonuses and incentives paid to management, higher commissions paid to commercial lenders as a result of higher origination volumes, higher social security tax expenses, higher health care costs and higher 401(k) matching contribution expense.

Occupancy and furniture and equipment expenses increased \$60,575 or 6.3% to \$1,028,419 in 2011 compared to \$967,844 in 2010 due primarily to the acquisition, renovation, and furnishing of the new branch in Westminster, Maryland.

Federal deposit insurance premiums decreased \$67,930 to \$210,621 in 2011 from \$278,551 in 2010 due to the change in the assessed base as a result of the Dodd-Frank Act.

Other expenses increased by \$82,125 or 4.5% to \$1,924,235 in 2011 compared to \$1,842,110 in 2010. Advertising expenses increased by \$48,049 due primarily to the opening of the new branch. Foreclosure related expenses increased \$43,041 as a result of more foreclosed loans. Telephone expenses increased \$22,293 due primarily to the new branch. Other real estate owned expenses decreased \$77,011. 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 decreased to 34.2% in 2011 from 36.0% in 2010. The decrease was due to a higher 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 2011 when compared to 2010. 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

Farmers and Merchants Bank

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

(continued)

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. Management believes that the three types 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 provides a better overall result than a simulation based on 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 (e.g., growth, etc.). 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 4.54% in 2011 from 4.23% in 2010.

Farmers and Merchants Bank

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

(continued)

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, 2011, \$12,061,511 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 \$24.1 million under a secured line of credit with the FHLB. The Bank also has a facility with the Federal Reserve Bank of Richmond (the "FRB") whereby the Bank can borrow approximately \$34.5 million. Finally, the Bank has an \$11,000,000 (\$2,000,000 unsecured and \$9,000,000 secured) overnight federal funds line of credit available from a commercial bank. FHLB advances of \$3,000,000 and \$0 were outstanding as of December 31, 2011 and 2010, respectively. There were no borrowings from the FRB or commercial bank at December 31, 2011 and 2010. 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

The Bank is subject to risk-based capital regulations, which were adopted and are monitored by federal banking regulators. These guidelines are used to evaluate capital adequacy and are based on an institution's asset risk profile and off-balance sheet exposures, such as unused loan commitments and stand-by letters of credit. The regulatory guidelines require that a portion of total capital be Tier 1 capital, consisting of common stockholders' equity, qualifying portion of trust issued preferred securities, and perpetual preferred stock, less goodwill and certain other deductions. The remaining capital, or Tier 2 capital, consists of elements such as subordinated debt, mandatory convertible debt, remaining portion of trust issued preferred securities, and grandfathered senior debt, plus the allowance for loan losses, subject to certain limitations.

Under the risk-based capital regulations, banking institutions are required to maintain a minimum 8% (10% for well capitalized banks) total risk-based capital ratio (total qualifying capital divided by risk-weighted assets), including a Tier 1 ratio of 4% (6% for well capitalized banks). The risk-based capital rules have been further supplemented by a leverage ratio, defined as Tier I capital divided by average assets, after certain adjustments. The minimum leverage ratio is 4% (5% for well capitalized banks) for banking institutions that do not anticipate significant growth and have well-diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity and good earnings. Other banking organizations not in this category are expected to have ratios of at least 4-5%, depending on their particular condition and growth plans. Regulators may require higher capital ratios when warranted by the particular circumstances or risk profile of a given banking organization. In the current regulatory

Farmers and Merchants Bank

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

(continued)

environment, banking institutions must stay well capitalized in order to receive favorable regulatory treatment on acquisition and other expansion activities and favorable risk-based deposit insurance assessments. The Bank's capital policy establishes guidelines meeting these regulatory requirements and takes into consideration current or anticipated risks as well as potential future growth opportunities.

As of December 31, 2011, the Bank's total risk-based capital ratio was 13.56%, and the Bank's Tier 1 leverage capital ratio was 9.62%.

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.

Accounting Standards Update ("ASU") No. 2011-02, "Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring." ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 became effective for the Bank on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011 (See Note 4 - Loans).

ASU 2011-04, "Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs." ASU 2011-04 amends Topic 820, "Fair Value Measurements and Disclosures," to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 is effective for annual periods beginning after December 15, 2011, and is not expected to have a significant impact on the Bank's financial statements.

ASU 2011-05, "Comprehensive Income (Topic 220) - Presentation of Comprehensive Income." ASU 2011-05 amends Topic 220, "Comprehensive Income," to require that all nonowner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of

Farmers and Merchants Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 is effective for annual and interim periods beginning after December 15, 2011, and is not expected to have a significant impact on the Bank's financial statements. ASU 2011-12 (discussed below) defers certain portions of ASU 2011-05.

ASU 2011-11, "Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities." ASU 2011-11 amends Topic 210, "Balance Sheet," to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on January 1, 2013, and is not expected to have a significant impact on the Bank's financial statements.

ASU 2011-12 "Comprehensive Income (Topic 220) - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." ASU 2011-12 defers changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to redeliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12. ASU 2011-12 is effective for annual and interim periods beginning after December 15, 2011 and is not expected to have a significant impact on the Bank's financial statements.

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 Subsidiary as of December 31, 2011 and 2010, 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 Subsidiary as of December 31, 2011 and 2010, 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 1, 2012

Farmers and Merchants Bank and Subsidiary
Consolidated Balance Sheets

December 31,	2011	2010
Assets		
Cash and due from banks	\$ 13,390,890	\$ 7,833,386
Federal funds sold and other interest bearing deposits	<u>923,584</u>	<u>3,769,159</u>
Cash and cash equivalents	14,314,474	11,602,545
Certificate of deposit in other bank	100,000	100,000
Securities available for sale	24,457,394	26,730,131
Securities held to maturity	11,324,565	12,591,293
Federal Home Loan Bank stock, at cost	622,400	558,600
Loans held for sale	586,000	1,165,500
Loans, less allowance for loan losses of \$2,518,511 and \$2,436,510	187,084,721	174,875,384
Premises and equipment	5,876,643	4,229,113
Accrued interest receivable	877,062	856,502
Prepaid income taxes	122,206	-
Deferred income taxes	806,043	1,006,383
Other real estate owned	1,221,541	1,238,039
Bank owned life insurance	5,727,469	4,532,986
Other assets	<u>780,942</u>	<u>940,555</u>
	<u><u>\$ 253,901,460</u></u>	<u><u>\$ 240,427,031</u></u>
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing	\$ 35,821,988	\$ 32,864,626
Interest-bearing	<u>171,453,569</u>	<u>169,126,060</u>
Total deposits	207,275,557	201,990,686
Securities sold under repurchase agreements	18,188,190	15,131,657
Federal Home Loan Bank of Atlanta advances	3,000,000	-
Accrued interest payable	206,363	235,263
Income taxes payable	-	109,461
Other liabilities	<u>521,842</u>	<u>349,539</u>
	<u><u>229,191,952</u></u>	<u><u>217,816,606</u></u>
Stockholders' equity		
Common stock, par value \$10 per share, authorized 5,000,000 shares; issued and outstanding 786,085 shares in 2011 and 774,238 shares in 2010	7,860,847	7,742,376
Surplus	8,054,288	7,882,965
Undivided profits	8,498,007	6,938,792
Accumulated other comprehensive income	<u>296,366</u>	<u>46,292</u>
	<u><u>24,709,508</u></u>	<u><u>22,610,425</u></u>
	<u><u>\$ 253,901,460</u></u>	<u><u>\$ 240,427,031</u></u>

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

Farmers and Merchants Bank and Subsidiary
Consolidated Statements of Income

Years Ended December 31,	2011	2010
Interest income		
Loans, including fees	\$ 11,167,950	\$ 10,380,748
Investment securities - taxable	1,133,475	959,239
Investment securities - tax exempt	344,040	242,043
Federal funds sold and other interest earning assets	16,856	35,407
Total interest income	<u>12,662,321</u>	<u>11,617,437</u>
Interest expense		
Deposits	1,687,002	2,026,942
Securities sold under repurchase agreements	147,339	212,645
Federal Home Loan Bank advances and other borrowings	10,082	15,676
Total interest expense	<u>1,844,423</u>	<u>2,255,263</u>
Net interest income	10,817,898	9,362,174
Provision for loan losses	<u>1,575,000</u>	<u>635,000</u>
Net interest income after provision for loan losses	<u>9,242,898</u>	<u>8,727,174</u>
Noninterest income		
Service charges on deposit accounts	880,979	992,326
Mortgage banking income	397,313	504,775
Bank owned life insurance cash surrender value increase	176,483	105,397
Net gain on sale of securities	82,098	5,520
Write down of security	(14,000)	-
Gain on sale of land	188,353	-
Other fees and commissions	104,343	99,677
Total noninterest income	<u>1,815,569</u>	<u>1,707,695</u>
Noninterest expense		
Salaries	3,539,560	3,114,888
Employee benefits	912,211	796,912
Occupancy	578,912	511,021
Furniture and equipment	449,507	456,823
Federal Deposit Insurance premiums	210,621	278,551
Other	1,924,235	1,842,110
Total noninterest expense	<u>7,615,046</u>	<u>7,000,305</u>
Income before income taxes	3,443,421	3,434,564
Income taxes	<u>1,176,910</u>	<u>1,236,827</u>
Net income	<u>\$ 2,266,511</u>	<u>\$ 2,197,737</u>
 Earnings per share - basic and diluted	 <u>\$ 2.92</u>	 <u>\$ 2.87</u>

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

Farmers and Merchants Bank and Subsidiary
Consolidated Statements of Changes in Stockholders' Equity

	Common stock			Undivided	Accumulated other	Total
	Shares	Par value	Surplus	profits	comprehensive income	stockholders' equity
Balance, December 31, 2009	764,007	\$ 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	10,531	105,307	132,073			237,380
Common stock repurchased	(300)	(3,000)	(4,275)	-	-	(7,275)
Balance, December 31, 2010	774,238	\$ 7,742,376	\$ 7,882,965	\$ 6,938,792	\$ 46,292	\$ 22,610,425
Net income	-	-	-	2,266,511	-	2,266,511
Unrealized gain on securities available for sale net of income tax expense of \$162,896	-	-	-	-	250,074	250,074
Comprehensive income						2,516,585
Cash dividends, \$0.91 per share	-	-	-	(707,296)	-	(707,296)
Dividends reinvested	11,847	118,471	171,323			289,794
Balance, December 31, 2011	\$ 786,085	\$ 7,860,847	\$ 8,054,288	\$ 8,498,007	\$ 296,366	\$ 24,709,508

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

Farmers and Merchants Bank and Subsidiary
Consolidated Statements of Cash Flows

Years Ended December 31,	2011	2010
Cash flows from operating activities		
Interest received	\$ 12,653,330	\$ 11,504,889
Fees and commissions received	1,382,635	1,596,778
Interest paid	(1,873,323)	(2,471,537)
Proceeds from sale of mortgage loans held for sale	25,211,757	30,959,301
Origination of mortgage loans held for sale	(24,632,257)	(30,706,928)
Cash paid to suppliers and employees	(6,981,205)	(6,054,631)
Income taxes paid	(1,371,134)	(1,443,461)
	<u>4,389,803</u>	<u>3,384,411</u>
Cash flows from investing activities		
Proceeds from maturity and call of securities		
Available for sale	12,043,595	8,717,023
Held to maturity	2,034,777	4,603,851
Proceeds from sale of securities		
Available for sale	1,511,837	535,000
Held to maturity	319,800	-
Purchase of securities		
Available for sale	(10,886,475)	(22,195,169)
Held to maturity	(1,046,305)	(6,276,287)
Loans made to customers, net of principal collected	(13,795,906)	(15,423,832)
(Purchase) redemption of stock in FHLB of Atlanta	(63,800)	66,700
Other real estate owned proceeds	16,498	-
Purchase of bank owned life insurance	(1,018,000)	-
Proceeds from the sale of land	199,400	-
Purchases of premises, equipment and software	(1,917,197)	(173,773)
	<u>(12,601,776)</u>	<u>(30,146,487)</u>
Cash flows from financing activities		
Net increase (decrease) in		
Noninterest-bearing deposits	2,957,362	5,272,329
Interest-bearing deposits	2,327,509	20,803,702
Securities sold under repurchase agreements	3,056,533	895,906
Federal Home Loan Bank of Atlanta advances	3,000,000	(3,000,000)
Dividends paid, net of reinvestments	(417,502)	(337,291)
Common stock repurchased	-	(7,275)
	<u>10,923,902</u>	<u>23,627,371</u>
Net increase in cash and cash equivalents	2,711,929	(3,134,705)
Cash and cash equivalents at beginning of period	<u>11,602,545</u>	<u>14,737,250</u>
Cash and cash equivalents at end of period	<u>\$ 14,314,474</u>	<u>\$ 11,602,545</u>

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

Farmers and Merchants Bank and Subsidiary
Consolidated Statements of Cash Flows

Years Ended December 31,	2011	2010
Reconciliation of net income to net cash provided by operating activities		
Net income	\$ 2,266,511	\$ 2,197,737
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	259,956	274,741
Provision for loan losses	1,575,000	635,000
Net gain on disposal of investment securities	(82,098)	(5,520)
Write down of investment security	14,000	-
Write down of other real estate owned	-	75,000
Net gain on sale of land	(188,353)	-
Net loss on disposal of equipment	4,277	-
Decrease (increase) in mortgage loans held for sale	579,500	252,373
Deferred income taxes	37,443	(231,014)
Amortization of premiums and accretion of discounts, net	43,305	23,283
Increase (decrease) in		
Deferred loan fees	11,569	29,047
Accrued interest payable	(28,900)	(216,274)
Income taxes payable	(109,461)	24,380
Other liabilities	172,303	245,037
Decrease (increase) in		
Accrued interest receivable	(20,560)	(141,595)
Bank owned life insurance cash surrender value	(176,483)	(105,397)
Prepaid income taxes	(122,206)	-
Other assets	154,000	327,613
	<u>\$ 4,389,803</u>	<u>\$ 3,384,411</u>

Noncash transactions for the transfer of loans to other real estate owned totaled \$0 and \$553,039 in the years ended December 31, 2011 and 2010, respectively.

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

Farmers and Merchants Bank and Subsidiary

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 subsidiary, Reliable Community Financial Services, Inc. A former subsidiary, Community Real Estate Holdings, Inc., was dissolved on October 26, 2010 after years of inactivity. 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.

Reclassifications

Certain reclassifications have been made to the 2010 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 Subsidiary

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 or are included on the watch list. 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. The Bank's allowance for loan losses consists of three elements: (i) specific valuation allowances determined based on probable losses on specific loans; (ii) historical valuation allowances determined based on historical loan loss experience for similar loans with similar characteristics; and (iii) adjustments to the historical valuation allowances based on general economic conditions and other qualitative risk factors both internal and external to the Bank.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Management maintains a watch list of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; (iii) the economic environment; and (iv) for commercial borrowers, the industry in which the borrower operates. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower, among other things.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans. The Bank calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool over the prior eight quarters. The historical loss ratios are updated quarterly based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool.

Adjustments to the historical valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Bank. In general, such adjustments are determined by evaluating, among other things: (i) the impact of economic conditions on the portfolio; (ii) changes in asset quality, including delinquency trends; (iii) the impact of changing interest rates on portfolio risk; (iv) changes in legislative and regulatory policy; (v) the composition and concentrations of credit; and (vi) the effectiveness of the internal loan review function. Management evaluates these qualitative factors on a quarterly basis. Each factor could result in an adjustment that is positive, negative, or no impact.

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.

Farmers and Merchants Bank and Subsidiary

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

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 method. 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 of foreclosure is recorded at the lower of cost or fair market value less estimated costs to sell 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.

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 777,434 and 766,293 for 2011 and 2010, respectively. There are no potentially dilutive shares outstanding.

Subsequent events

The Bank has evaluated subsequent events for potential recognition and/or disclosure through March 1, 2012, the date the consolidated financial statements were issued. No recognition or disclosure is required.

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 2011 and 2010 were **\$1,174,949** and **\$5,629,380**, respectively. The Bank sold federal funds to other banks, excluding the Federal Home Loan Bank ("FHLB") of Atlanta, on an unsecured basis that averaged **\$601,656** and **\$2,265,517** for 2011 and 2010, 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 Subsidiary

Notes to Consolidated Financial Statements (Continued)

3. Investment Securities

Investment securities are summarized as follows:

December 31, 2011	Amortized cost	Unrealized gains	Unrealized losses	Fair value
<i>Available for sale</i>				
U. S. government agency	\$ 1,000,000	\$ 2,151	\$ -	\$ 1,002,151
State and municipal	<u>2,489,003</u>	<u>185,333</u>	<u>-</u>	<u>2,674,336</u>
	3,489,003	187,484	-	3,676,487
Mortgage-backed securities	20,472,974	378,443	76,510	20,774,907
Equity security	<u>6,000</u>	<u>-</u>	<u>-</u>	<u>6,000</u>
	<u>\$ 23,967,977</u>	<u>\$ 565,927</u>	<u>\$ 76,510</u>	<u>\$24,457,394</u>
<i>Held to maturity</i>				
U. S. government agency	\$ 130,128	\$ 4,269	\$ -	\$ 134,397
State and municipal	<u>8,385,857</u>	<u>387,820</u>	<u>-</u>	<u>8,773,677</u>
	8,515,985	392,089	-	8,908,074
Mortgage-backed securities	<u>2,808,580</u>	<u>562,072</u>	<u>-</u>	<u>3,370,652</u>
	<u>\$ 11,324,565</u>	<u>\$ 954,161</u>	<u>\$ -</u>	<u>\$12,278,726</u>
December 31, 2010				
<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>

Farmers and Merchants Bank and Subsidiary

Notes to Consolidated Financial Statements (Continued)

3. Investment Securities (Continued)

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

	Available for Sale		Held to Maturity	
	Amortized cost	Fair value	Amortized cost	Fair value
December 31, 2011				
Within one year	\$ -	\$ -	\$ 130,128	\$ 134,397
Over one to five years	-	-	1,104,627	1,118,785
Over five to ten years	-	-	388,408	396,560
Over ten years	<u>3,489,003</u>	<u>3,676,487</u>	<u>6,892,822</u>	<u>7,258,332</u>
	3,489,003	3,676,487	8,515,985	8,908,074
Mortgage-backed securities, due in monthly installments	20,472,974	20,774,907	2,808,580	3,370,652
Equity security	<u>6,000</u>	<u>6,000</u>	-	-
	<u>\$ 23,967,977</u>	<u>\$ 24,457,394</u>	<u>\$ 11,324,565</u>	<u>\$ 12,278,726</u>
December 31, 2010				
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	<u>4,491,829</u>	<u>4,454,817</u>	<u>6,271,638</u>	<u>5,993,933</u>
	6,491,829	6,427,005	7,546,480	7,313,347
Mortgage-backed securities, due in monthly installments	20,141,856	20,283,126	5,044,813	5,599,602
Equity security	<u>20,000</u>	<u>20,000</u>	-	-
	<u>\$ 26,653,685</u>	<u>\$ 26,730,131</u>	<u>\$ 12,591,293</u>	<u>\$ 12,912,949</u>

The equity security of \$6,000 represents an investment in stock issued by a Maryland bank that provides services for other banks in Maryland and surrounding states. The stock was written down by \$14,000 from a cost of \$20,000 in the second quarter of 2011. It does not pay dividends and is not actively traded.

Securities with a carrying value of **\$21,674,549** and \$19,431,338 as of December 31, 2011 and 2010, respectively, were pledged as collateral for government deposits and securities sold under repurchase agreements.

In 2011, the Bank realized gross gains of **\$88,860** and gross losses of **\$6,762** on the sale of 30 securities with gross proceeds of **\$1,831,637**.

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

Farmers and Merchants Bank and Subsidiary

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, 2011.

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	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
State and municipal	-	-	-	-	-	-
Mortgage-backed securities	<u>4,653,615</u>	<u>20,612</u>	<u>4,286,816</u>	<u>55,898</u>	<u>8,940,431</u>	<u>76,510</u>
Total	<u>\$ 4,653,615</u>	<u>\$ 20,612</u>	<u>\$ 4,286,816</u>	<u>\$ 55,898</u>	<u>\$ 8,940,431</u>	<u>\$ 76,510</u>

Management has the ability and intent to hold securities classified as held to maturity until they mature, at which time the Bank should receive full value for the securities. As of December 31, 2011, management did not have the intent to sell any of the securities classified as available for sale before a recovery of cost. The unrealized losses are due to increases in market interest rates over the yields available at the time the underlying securities were purchased as well as other market conditions for each particular security based upon the structure and remaining principal balance. The fair values of the investment securities are expected to recover as the securities approach their maturity dates or repricing dates or if market yields for such investments decline. Based on the these factors, as of December 31, 2011, management believes the unrealized losses detailed in the table above are not other than temporary and, accordingly, none of these unrealized losses have been recognized in the Bank's consolidated statement of income.

4. Related Party Transactions

Certain executive officers and directors of the Bank, including members of 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, 2011 and 2010, the activity of these loans was as follows:

	2011	2010
Balance, beginning of year	\$ 9,367,215	\$ 10,031,310
Additions	3,049,400	3,348,600
Amounts collected	<u>(4,459,532)</u>	<u>(4,012,695)</u>
Balance, end of year	<u>\$ 7,957,083</u>	<u>\$ 9,367,215</u>

Unused lines of credit to related parties totaled **\$2,839,548** and \$2,259,327, at December 31, 2011 and 2010, respectively. Letters of credit were issued to directors totaling **\$64,589** and \$158,361 at December 31, 2011 and 2010, respectively.

Deposits at the Bank from directors, officers and related parties totaled **\$8,228,152** and \$9,875,875 at December 31, 2011 and 2010, respectively.

Payments to a company controlled by a director totaled **\$62,754** in 2011 and \$8,593 in 2010. Payments to a retailer affiliated with two directors totaled **\$318** in 2011 and \$1,163 in 2010. Another director was paid **\$3,000** in 2011 and 2010 for his oversight of branch office repairs and maintenance.

Farmers and Merchants Bank and Subsidiary

Notes to Consolidated Financial Statements (Continued)

5. Loans

Major categories of loans are as follows:

	2011	2010
Commercial	\$ 10,908,301	\$ 10,237,364
Commercial real estate:		
Construction/Land development	18,906,285	27,385,201
Other	121,391,973	103,490,910
Consumer	532,255	467,403
Residential real estate	38,201,754	36,056,784
	189,940,568	177,637,662
Less: Allowance for loan losses	2,518,511	2,436,510
Deferred origination fees net of costs	337,336	325,768
	<u>\$ 187,084,721</u>	<u>\$ 174,875,384</u>

The maturity and rate repricing distribution of the loan portfolio as of December 31, 2011 and 2010, is as follows:

Variable rate, immediately	\$ 17,280,774	\$ 16,776,304
Due within one year	28,908,009	30,830,485
Due over one to five years	131,436,300	116,341,682
Due over five years	12,315,485	13,689,191
	<u>\$ 189,940,568</u>	<u>\$ 177,637,662</u>

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

	2011	2010
Commercial	\$ 22,400	\$ -
Commercial real estate:		
Construction/Land development	426,907	-
Other	1,435,896	232,917
Residential real estate	1,682,323	1,234,788
Total	<u>\$ 3,567,526</u>	<u>\$ 1,467,705</u>

At December 31, 2011, the Bank had 13 nonaccrual loans to 10 borrowers totaling \$3,567,526. The loans are collateralized by real estate, business assets, and personal guarantees. Gross interest income of \$270,678 would have been recorded in 2011 if these nonaccrual loans had been current and performing in accordance with the original terms. The Bank has allocated \$128,864 of its allowance for loan losses for these nonaccrual loans. The balance of nonaccrual loans is net of charge-offs of \$1,578,887 at December 31, 2011.

At 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 guarantees. 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. The balance of nonaccrual loans is net of charge-offs of \$181,491 at December 31, 2010.

Farmers and Merchants Bank and Subsidiary

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, is 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
2011							
Commercial	\$ -	\$ -	\$ 22,400	\$ 22,400	\$ 10,885,901	\$ 10,908,301	\$ -
Commercial real estate:							
Constr./Land dev.	256,466	-	426,907	683,373	18,222,912	18,906,285	-
Other	-	-	1,435,896	1,435,896	119,956,077	121,391,973	-
Consumer	-	-	-	-	532,255	532,255	-
Residential real estate	27,765	-	1,682,323	1,710,088	36,491,666	38,201,754	-
Total	\$ 284,231	\$ -	\$ 3,567,526	\$ 3,851,757	\$ 186,088,811	\$ 189,940,568	\$ -
2010							
Commercial	\$ 23,578	\$ -	\$ -	\$ 23,578	\$ 10,213,786	\$ 10,237,364	\$ -
Commercial real estate:							
Constr./Land dev.	-	486,837	62,410	549,247	26,835,954	27,385,201	62,410
Other	232,917	523,809	-	756,726	102,734,184	103,490,910	-
Consumer	-	-	-	-	467,403	467,403	-
Residential real estate	472,518	74,116	1,424,110	1,970,744	34,086,040	36,056,784	189,322
Total	\$ 729,013	\$ 1,084,762	\$ 1,486,520	\$ 3,300,295	\$ 174,337,367	\$ 177,637,662	\$ 251,732

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
2011						
Commercial	\$ 50,254	\$ 7,500	\$ 14,901	\$ 22,401	\$ 14,901	\$ 11,200
Commercial real estate						
Construction/Land development	1,773,278	426,907	1,197,034	1,623,941	36,828	\$ 811,971
Other	2,384,710	693,000	742,895	1,435,895	111,500	\$ 1,659,553
Residential real estate	2,179,731	910,720	816,129	1,726,849	9,165	\$ 1,480,819
	\$ 6,387,973	\$ 2,038,127	\$ 2,770,959	\$ 4,809,086	\$ 172,394	\$ 3,963,543
2010						
Commercial real estate - other	\$ 1,883,211	\$ -	\$ 1,883,211	\$ 1,883,211	\$ 694,371	\$ 2,576,094
Residential real estate	1,416,279	1,234,788	-	1,234,788	-	617,394
	\$ 3,299,490	\$ 1,234,788	\$ 1,883,211	\$ 3,117,999	\$ 694,371	\$ 3,193,488

The Bank has one commercial real estate loan classified as a troubled debt restructuring as of December 31, 2011. The loan is included in impaired loans above and has a recorded investment amount of \$693,000, net of a \$948,815 charge-off. As of December 31, 2011, the loan is over 90 days delinquent, on non-accrual, and in the process of foreclosure. In January 2012, the foreclosure sale was held and the Bank now owns the property pending ratification by the court.

Farmers and Merchants Bank and Subsidiary

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

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, are as follows:

	Commercial real estate					
	Commercial	Other	Construction/ Land Dev.	Residential Real Estate	Consumer	Total
2011						
Excellent	\$ 74,576	\$ -	\$ -	\$ 403,693	\$ 28,579	\$ 506,848
Above Average	2,159,904	15,999,168	2,784,437	6,159,001	196,514	27,299,024
Average	7,345,303	85,496,692	6,522,389	25,532,951	175,033	125,072,368
Below Average	752,647	2,584,515	4,132,297	3,632,703	25,288	11,127,450
Especially Mentioned	251,505	12,329,237	3,304,425	2,182,847	-	18,068,014
Substandard	309,465	4,982,361	2,162,737	290,559	59,770	7,804,892
Doubtful	14,901	-	-	-	47,071	61,972
	<u>\$ 10,908,301</u>	<u>\$ 121,391,973</u>	<u>\$ 18,906,285</u>	<u>\$ 38,201,754</u>	<u>\$ 532,255</u>	<u>\$ 189,940,568</u>

	Commercial real estate					
	Commercial	Other	Construction/ Land Dev.	Residential Real Estate	Consumer	Total
2010						
Excellent	\$ 82,175	\$ 278,610	\$ -	\$ 465,070	\$ 10,628	\$ 836,483
Above Average	1,478,170	13,487,497	3,042,471	7,117,646	162,117	25,287,901
Average	7,070,248	69,111,312	15,622,004	21,620,835	138,842	113,563,241
Below Average	1,194,090	4,615,985	960,824	2,436,716	13,452	9,221,067
Especially Mentioned	27,737	11,792,886	7,759,902	3,968,395	56,094	23,605,014
Substandard	384,944	4,204,620	-	448,122	-	5,037,686
Doubtful	-	-	-	-	86,270	86,270
	<u>\$ 10,237,364</u>	<u>\$ 103,490,910</u>	<u>\$ 27,385,201</u>	<u>\$ 36,056,784</u>	<u>\$ 467,403</u>	<u>\$ 177,637,662</u>

Farmers and Merchants Bank and Subsidiary

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, 2011 and 2010. 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 Real Estate	Consumer	Unallocated	Total
2011						
Beginning balance	\$ 98,387	\$ 1,868,629	\$ 303,603	\$ 18,039	\$ 147,852	\$ 2,436,510
Provision for loan losses	22,337	1,141,928	546,081	(11,239)	(124,107)	1,575,000
Charge-offs	(27,853)	(1,098,152)	(384,555)	-	-	(1,510,560)
Recoveries	-	2,450	13,111	2,000	-	17,561
Net charge-offs	(27,853)	(1,095,702)	(371,444)	2,000	-	(1,492,999)
Ending balance	\$ 92,871	\$ 1,914,855	\$ 478,240	\$ 8,800	\$ 23,745	\$ 2,518,511
Period-end amount allocated to:						
Loans individually evaluated for impairment	\$ 14,901	\$ 148,328	\$ 9,165	\$ -	\$ -	\$ 172,394
Loans collectively evaluated for impairment	77,970	1,766,527	469,075	8,800	23,745	2,346,117
Ending balance	\$ 92,871	\$ 1,914,855	\$ 478,240	\$ 8,800	\$ 23,745	\$ 2,518,511
2010						
Beginning balance	\$ 130,085	\$ 1,628,640	\$ 167,910	\$ 19,191	\$ 27,472	\$ 1,973,298
Provision for loan losses	(31,698)	239,989	312,184	(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	\$ 1,868,629	\$ 303,603	\$ 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	1,174,258	303,603	18,039	147,852	1,742,139
Ending balance	\$ 98,387	\$ 1,868,629	\$ 303,603	\$ 18,039	\$ 147,852	\$ 2,436,510

Loan Balance by Type:

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Total
2011					
Loans individually evaluated for impairment	\$ 22,401	\$ 3,059,836	\$ 1,726,849	\$ -	\$ 4,809,086
Loans collectively evaluated for impairment	10,885,900	137,238,422	36,474,905	532,255	185,131,482
	\$ 10,908,301	\$ 140,298,258	\$ 38,201,754	\$ 532,255	\$ 189,940,568
2010					
Loans individually evaluated for impairment	\$ -	\$ 1,883,211	\$ 1,234,788	\$ -	\$ 3,117,999
Loans collectively evaluated for impairment	10,237,364	128,992,900	34,821,996	467,403	174,519,663
	\$ 10,237,364	\$ 130,876,111	\$ 36,056,784	\$ 467,403	\$ 177,637,662

Farmers and Merchants Bank and Subsidiary

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

Loans with a balance of approximately **\$47.1** million were pledged as collateral to the FHLB of Atlanta as of December 31, 2011. Loans with a balance of approximately **\$40.0** million were pledged as collateral to the Federal Reserve Bank of Richmond as of December 31, 2011. At December 31, 2011 and 2010, the Bank serviced participation loans for others totaling **\$12.1** million and \$13.0 million, respectively.

The Bank makes loans to customers located primarily in Baltimore County and 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	2011	2010
Land and improvements	-	\$1,952,998	\$ 1,619,713
Buildings and improvements	15-39 years	5,430,514	4,357,849
Furniture and equipment	3-10 years	2,811,319	2,321,384
		10,194,831	8,298,946
Accumulated depreciation and amortization		4,318,188	4,069,833
		\$5,876,643	\$ 4,229,113
Depreciation and amortization expense		\$ 254,343	\$ 254,757

Software with a net book value of **\$464** and \$6,077 as of December 31, 2011 and 2010, respectively, is included in other assets. Amortization expense of **\$5,613** and \$19,984 was recorded in 2011 and 2010, 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 original term of the agreement expired on November 30, 2011. The lease has been extended until April 30, 2012. In 2011, the Bank entered into a lease for a new Greenmount location which will begin in May 2012. The initial term of the lease is for five years with options to renew for two additional consecutive five-year terms. The Bank has an operating lease for its Atrium branch facility with a term of one year and nine one-year renewals. The lease was renewed in 2011 for another year.

Future minimum payments under the agreements are as follows:

Year	Amount
2012	\$145,365
2013	82,603
2014	75,552
2015	45,747
2016	47,577
Thereafter	<u>3,978</u>
	<u>\$400,822</u>

Rent expense was **\$88,881** and \$91,781 in 2011 and 2010, respectively.

Farmers and Merchants Bank and Subsidiary

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:

	2011	2010
Loan commitments		
Construction and land development	\$ 1,184,848	\$ 153,812
Commercial	-	6,948,040
Commercial real estate	13,818,298	6,361,000
Residential	1,648,500	175,000
	<u>\$16,651,646</u>	<u>\$ 13,637,852</u>
Unused lines of credit		
Home-equity lines	\$ 3,739,249	\$ 3,725,720
Commercial lines	22,948,602	15,912,771
	<u>\$26,687,851</u>	<u>\$ 19,638,491</u>
Letters of credit	<u>\$ 1,838,679</u>	<u>\$ 1,820,903</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. Employee and employer contributions are 100% vested when made. The Bank's contributions to this plan, included in expenses, were \$116,292 and \$103,240 for 2011 and 2010, respectively.

Farmers and Merchants Bank and Subsidiary

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 \$4,573 and \$4,110 in 2011 and 2010, 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 \$139,868 and \$118,943 in 2011 and 2010, respectively, for these plans.

10. Interest-Bearing Deposits

Major classifications of interest-bearing deposits are as follows:

	2011	2010
NOW	\$ 22,331,843	\$ 19,585,168
Money market	26,365,055	22,131,065
Savings	25,980,245	25,140,872
Certificates of deposit, \$100,000 or more	43,483,596	49,525,222
Other time deposits	<u>53,292,830</u>	<u>52,743,733</u>
	<u>\$171,453,569</u>	<u>\$ 169,126,060</u>

As of December 31, 2011, certificates of deposit mature as follows:

<u>Year</u>	<u>Amount</u>
2012	\$ 52,703,742
2013	28,757,694
2014	8,039,776
2015	4,354,838
2016	<u>2,920,376</u>
	<u>\$ 96,776,426</u>

Farmers and Merchants Bank and Subsidiary

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, the Federal Reserve Bank of Richmond (the "FRB"), and overnight borrowings from a commercial bank. 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:

	2011	2010
Amounts outstanding at year-end:		
Securities sold under repurchase agreements	<u>\$ 18,188,190</u>	<u>\$ 15,131,657</u>
Federal Home Loan Bank advance (matures May 25, 2012)	<u>\$ 3,000,000</u>	<u>\$ -</u>
Weighted average rate paid at December 31:		
Securities sold under repurchase agreements	0.89%	1.11%
Federal Home Loan Bank advances	0.30%	-
Maximum month-end amount outstanding:		
Securities sold under repurchase agreements	\$ 19,384,434	\$ 15,513,154
Federal Home Loan Bank advance	7,500,000	3,000,000
Average amount outstanding:		
Securities sold under repurchase agreements	\$ 15,472,657	\$ 14,236,502
Federal Home Loan Bank advance	4,060,274	1,841,096
Borrowings from commercial banks	1,373	10,959
Average rate paid during the year:		
Securities sold under repurchase agreements	0.95%	1.49%
Federal Home Loan Bank advance	0.25%	0.85%
Borrowings from commercial banks	0.51%	0.60%
Investment securities underlying the securities agreements at year end:		
Carrying value	\$ 21,674,549	\$ 18,465,681
Estimated fair value	22,247,600	18,963,024
Loans pledged to the Federal Home Loan Bank at year-end:		
Carrying value	\$ 47,076,077	\$ 43,255,618
Loans pledged to the Federal Reserve Bank at year-end:		
Carrying value	\$ 40,008,132	\$ -

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 \$24.1 million, under a secured line of credit with the FHLB of Atlanta. In addition, the Bank has a facility with the FRB whereby the Bank can borrow up to \$34.5 million. The Bank also has available an unsecured federal funds line of credit of \$2 million and a secured federal funds line of credit of \$9 million from a commercial bank.

**Farmers and Merchants Bank
and Subsidiary**

Notes to Consolidated Financial Statements (Continued)

12. Other Noninterest Expenses

Other noninterest expenses include the following:

	2011	2010
Automated teller machine and debit card expenses	\$ 369,411	\$ 365,407
Professional services	261,872	266,150
Advertising	187,753	139,704
Directors fees	174,469	162,455
Stationery, printing, and supplies	163,331	153,692
Postage, delivery, and armored carrier	159,770	159,131
Telephone	123,222	100,929
Internet banking fees	67,665	71,832
Correspondent bank services	53,994	52,147
Travel and conferences	43,200	44,584
Foreclosure related expenses	43,041	-
Liability insurance	36,809	26,037
Dues and subscriptions	33,239	24,975
Maryland state assessment	31,438	27,754
Contributions	20,860	18,695
Credit reports	19,533	20,242
Education and training	15,310	11,882
Other real estate owned	14,951	91,962
Loss and error	7,382	25,057
Other	96,985	79,475
	<u>\$1,924,235</u>	<u>\$1,842,110</u>

13. Income Taxes

The components of income tax expense are as follows:

	2011	2010
Current		
Federal	\$ 862,049	\$1,146,271
State	277,418	321,570
	1,139,467	1,467,841
Deferred	37,443	(231,014)
	<u>\$ 1,176,910</u>	<u>\$1,236,827</u>

**Farmers and Merchants Bank
and Subsidiary**

Notes to Consolidated Financial Statements (Continued)

13. **Income Taxes** (Continued)

The components of the deferred tax expense are as follows:

	2011	2010
Depreciation	\$ 129,650	\$ 19,739
Provision for loan losses	87,849	(169,482)
Other real estate owned allowance for loss	(5,819)	(44,536)
Write-down of equity securities	(5,522)	-
Nonaccrual interest	(110,456)	10,182
Post-retirement benefits	(58,259)	(46,917)
	<u>\$ 37,443</u>	<u>\$ (231,014)</u>

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

Deferred tax assets		
Allowance for loan losses	\$ 794,994	\$ 882,843
Other real estate owned loss	164,745	158,926
Write-down of equity securities	5,522	-
Nonaccrual interest	129,595	19,139
Post-retirement benefits	113,165	54,906
	<u>1,208,021</u>	<u>1,115,814</u>
Deferred tax liabilities		
Depreciation	208,928	79,277
Unrealized gain on securities available-for-sale	193,050	30,154
	<u>401,978</u>	<u>109,431</u>
Net deferred tax asset	<u>\$ 806,043</u>	<u>\$ 1,006,383</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	(5.0)	(3.3)
State income taxes, net of federal income tax benefit	5.0	5.2
Nondeductible expenses	0.2	0.1
	<u>34.2 %</u>	<u>36.0 %</u>

Farmers and Merchants Bank and Subsidiary

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, 2011 and 2010, 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, 2011						
Total capital (to risk-weighted assets)	\$ 26,893	13.56%	\$ 15,868	8.00%	\$ 19,835	10.00%
Tier 1 capital (to risk-weighted assets)	24,413	12.31%	7,934	4.00%	11,901	6.00%
Tier 1 capital (to average assets)	24,413	9.62%	10,148	4.00%	12,685	5.00%
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%

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 Subsidiary

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 instruments 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,			
	2011		2010	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Cash and equivalents	\$14,314,474	\$14,314,474	\$ 11,602,545	\$ 11,602,545
Certificate of deposit	100,000	100,000	100,000	100,000
Investment securities	35,781,959	36,736,120	39,321,424	39,643,080
Loans held for sale	586,000	590,117	1,165,500	1,178,547
Loans, net	187,084,721	188,785,883	174,875,384	175,527,000
Federal Home Loan Bank stock	622,400	622,400	558,600	558,600
Financial liabilities				
Noninterest-bearing deposits	\$35,821,988	\$35,821,988	\$ 32,864,626	\$ 32,864,626
Interest-bearing deposits	171,453,569	172,185,569	169,126,060	170,024,060
Securities sold under repurchase agreements	18,188,190	18,188,190	15,131,657	15,131,657
Federal Home Loan Bank advances	3,000,000	3,000,000	-	-

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

The fair values of interest-bearing checking, savings, and money market deposit accounts are equal to their carrying amounts. The fair values of fixed-maturity time deposits are 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 Subsidiary

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) of 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 determined by 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 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.
- Impaired loans: Nonrecurring fair value adjustments to impaired loans reflect full or partial write-downs and reserves that are based on the impaired loan's observable market price or current appraised value of the collateral. Since the market for impaired loans is not active, such loans 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 Subsidiary**

Notes to Consolidated Financial Statements (Continued)

15. **Fair Value of Financial Instruments (Continued)**

	Total	Active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<u>December 31, 2011</u>				
Recurring				
Available for sale investment securities	\$24,457,394	\$ 21,777,058	\$ 2,674,336	\$ 6,000
Nonrecurring				
Other real estate owned	\$ 1,221,541	\$ -	\$ 1,221,541	\$ -
Impaired loans	\$ 4,636,692	\$ -	\$ 4,636,692	\$ -
<u>December 31, 2010</u>				
Recurring				
Available for sale investment securities	\$ 26,730,131	\$ 24,226,252	\$ 2,483,879	\$ 20,000
Nonrecurring				
Other real estate owned	\$ 1,238,039	\$ -	\$ 1,238,039	\$ -
Impaired loans	\$ 2,423,628	\$ -	\$ 2,423,628	\$ -
<u>Reconciliation of Level 3 balance:</u>				
December 31, 2010 balance		\$ 20,000		
Write down of security		(14,000)		
December 31, 2011 balance		<u>\$ 6,000</u>		

**Farmers and Merchants Bank
and Subsidiary**

Notes to Consolidated Financial Statements (Continued)

16. Quarterly Results of Operations

	Three Months Ended			
	Unaudited			
2011	December 31	September 30	June 30	March 31
Interest income	\$3,205,253	\$ 3,223,750	\$3,140,318	\$3,093,000
Interest expense	430,078	453,121	467,880	493,344
Net interest income	2,775,175	2,770,629	2,672,438	2,599,656
Provision for loan losses	575,000	650,000	200,000	150,000
Net income	534,853	380,000	671,598	680,060
Earnings per share - basic and diluted	\$ 0.68	\$ 0.49	\$ 0.87	\$ 0.88
2010				
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

17. Litigation

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.

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, 2012 there were 782,418 shares of Common Stock issued and outstanding held by approximately 597 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>2011</u>			
Quarter ended December 31	\$26.35	\$20.25	\$0.46
Quarter ended September 30	28.00	23.60	0.00
Quarter ended June 30	28.50	25.00	0.45
Quarter ended March 31	26.99	24.25	0.00
<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

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, 2011.

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 24, 2012 at 3:00 p.m.
at the Piney Branch Golf and Country Club,
located at 5301 Trenton Mill Road, Upperco, Maryland 21155.
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 at (302) 252-9437 or (866) 544-0438, or Derek Ehman
at (410) 785-6000.

Transfer Agent

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**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:**

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Farmers and Merchants Bank
P. O. Box 249
25 Westminster Pike
Reisterstown, Maryland 21136

