

FARMERS AND MERCHANTS BANCSHARES, INC.

2018 Annual Report





Member FDIC

February 28, 2019

Dear Stockholders, Customers, and Friends:

On behalf of Farmers and Merchants Bancshares, Inc. (the “Company”), the parent of Farmers and Merchants Bank (the “Bank”), we are pleased to report that net income for the year ended December 31, 2018 was \$4,712,676, or \$2.82 per common share, compared to \$3,789,241, or \$2.28 per common share, in 2017. This is the highest net income in the history of the Company and the Bank surpassing the previous high achieved in 2015. While earnings before taxes remained stable, the increase in net income of \$923,435 from 2017 to 2018 was due primarily to a decrease in corporate income taxes of \$896,105. The decrease in income tax expense has two components. The first is due to the reduction in the federal income tax rate from 34% in 2017 to 21% in 2018 as a result of the Tax Cuts and Jobs Act. This reduced income tax by \$478,606 from 2017 to 2018. Secondly, as a result of the Act, the Company was required to revalue its deferred tax asset as of December 31, 2017. This revaluation required a \$410,391 one-time income tax charge in 2017.

Return on average equity was 10.77% in 2018 compared to 9.26% in 2017. Return on average assets was 1.14% in 2018 compared to 0.96% in 2017. Cash dividends paid to stockholders in 2018 increased 9% to \$0.83 per common share from \$0.76 per common share in 2017. During 2018, the price of the Company’s stock increased \$0.95 per share or 3.2%, from \$29.50 to \$30.45. The total return for the year, including the cash dividends, was 6.0%.

Total assets at December 31, 2018 were \$417 million, an increase of 4% from the \$403 million recorded at December 31, 2017. The loan portfolio increased 3% to \$341 million at December 31, 2018 from \$333 million at December 31, 2017. Deposits increased 11% to \$355 million at December 31, 2018 from \$320 million at the end of 2017. The book value of the common stock of the Company was \$26.97 per share at December 31, 2018, compared to \$25.06 per share at the end of 2017.

Please visit the Company’s investor relations section of our website – www.fmb1919.com. The investor relations section includes press releases, financial information, stock information, peer analysis, and information about the Company’s officers and directors.

We are excited to celebrate our 100th Anniversary with all of our shareholders and customers throughout 2019. We hope that you can join us at one of our branch parties this year. We have been truly blessed to work in the fine communities that we serve. Our success and longevity is due to our diligent Board of Directors and the hard work and dedication of our Officers and Staff. We sincerely appreciate all of your confidence in and your support of Farmers and Merchants Bancshares, Inc.

Paul F. Wooden, Jr.
Chairman

Sincerely yours,

James R. Bosley, Jr.
President

Farmers and Merchants Bancshares, Inc.

About The Company

General

Farmers and Merchants Bancshares, Inc. (the “Company”) was incorporated on August 8, 2016. The Company has two wholly-owned subsidiaries, Farmers and Merchants Bank (the “Bank”) and Series Protected Cell FCB-4 (the “Insurance Subsidiary”). 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 eight 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. The Insurance Subsidiary is a captive insurance entity that provides insurance coverage for Farmers and Merchants Bank.

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 U.S. Department of Agriculture (“USDA”)
- 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 | • Mortgages (Permanent and Construction) |
| • Savings accounts | • Home Equity loans |
| • Certificates of Deposit | • Installment and Line of Credit loans |
| • Money Market Accounts | • Land loans |
| • Individual Retirement Accounts | • Car and truck loans |
| • Holiday and Vacation Club accounts | • Agricultural loans |
| | • Educational loans |
| | • VISA Debit cards |

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

Farmers and Merchants Bancshares, Inc.

MISSION STATEMENT

The mission of Farmers and Merchants Bancshares, Inc. through our wholly-owned subsidiary, 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 individuals and businesses.

Farmers and Merchants Bank

LOCATIONS

Corporate Office
4510 Lower Beckleystown Road
Suite H
Hampstead, MD 21074
410-374-1510

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

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

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

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

Carroll Lutheran Village
205 Saint Mark Way, Suite 100
Westminster, MD 21158
410-848-1110

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

Greenmount Office
2320 Hanover Pike
Hampstead, MD 21074
410-374-3436

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

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

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

Farmers and Merchants Bancshares, Inc.
Farmers and Merchants Bank
Directors

Paul F. Wooden, Jr., Chairman
 Managing Executive
 The Taylor Foundation & Taylor Properties, LLC

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

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

Roger D. Cassell
 President
 Communications Electronics, Inc.

Steven W. Eline
 President
 Eline Funeral Home

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

Ronald W. Hux
 President
 Douron, Inc.

J. Lawrence Mekulski
 Retired Principal
 KLNB, LLC

Louna S. Primm
 Retired Bank Executive

Bruce L. Schindler
 President
 Bob Davidson Ford Lincoln

Teresa L. Smack
 President
 Terry's Tag & Title

Directors Emeritus

Kenneth W. Hoffmeyer

T. Edward Lippy

Farmers and Merchants Bancshares, Inc.
Officers

James R. Bosley, Jr., President & CEO
 Mark C. Krebs, Treasurer & CFO
 Christopher T. Oswald, Sr. Vice President
 Lynnette Kitzmiller, Secretary

Farmers and Merchants Bank
Officers

James R. Bosley, Jr.
 President & Chief Executive Officer

Christopher T. Oswald
 EVP/Chief Operations Officer

Mark C. Krebs
 EVP/Chief Financial Officer

Senior Vice Presidents

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

Vice Presidents

Lynnette Kitzmiller.....Corporate Secretary
 Kevin P. Bankert.....Commercial Banking
 M. Eugene Bosley.....Commercial Banking
 J. Thomas Turner.....Mortgage Officer

Other Bank Officers

T. Jeffrey Horner.....Controller
 Mark W. Lutrey.....Auditor
 Suzette L. Covalt.....Commercial Banking
 Thomas E. Long.....Commercial Banking

Assistant Vice Presidents

Loan Officers

Debora A. Smith
 Betty J. Higgs-Swartz
 Callie L. Jennings

Assistant Vice Presidents

Branch Managers

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

Farmers and Merchants Bancshares, Inc.

Selected Consolidated Financial Data

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
OPERATING DATA					
Interest income	\$ 17,768,333	\$ 16,594,803	\$ 15,351,497	\$ 14,705,401	\$ 14,080,625
Interest expense	<u>2,507,241</u>	<u>1,707,240</u>	<u>1,346,120</u>	<u>1,189,646</u>	<u>1,157,044</u>
Net interest income	15,261,092	14,887,563	14,005,377	13,515,755	12,923,581
Provision for loan losses	<u>475,000</u>	<u>410,000</u>	-	-	124,000
Net interest income after provision for loan losses	14,786,092	14,477,563	14,005,377	13,515,755	12,799,581
Noninterest income	1,365,273	1,337,094	1,465,197	1,986,260	1,240,360
Noninterest expense	<u>10,332,480</u>	<u>10,023,102</u>	<u>9,534,625</u>	<u>8,703,588</u>	<u>8,421,114</u>
Income before income taxes	5,818,885	5,791,555	5,935,949	6,798,427	5,618,827
Income taxes	<u>1,106,209</u>	<u>2,002,314</u>	<u>2,026,820</u>	<u>2,530,205</u>	<u>2,044,854</u>
Net income	<u>\$ 4,712,676</u>	<u>\$ 3,789,241</u>	<u>\$ 3,909,129</u>	<u>\$ 4,268,222</u>	<u>\$ 3,573,973</u>

PER SHARE DATA

Net income (Basic)	\$2.82	\$2.28	\$2.37	\$2.61	\$2.21
Dividends	\$0.83	\$0.76	\$0.70	\$0.64	\$0.59
Book value	\$26.97	\$25.06	\$23.55	\$21.99	\$20.08

KEY RATIOS

Return on average assets	1.14%	0.96%	1.08%	1.29%	1.15%
Return on average equity	10.77%	9.26%	10.26%	12.26%	11.43%
Net yield on interest-earning assets	3.88%	4.04%	4.21%	4.40%	4.47%
Efficiency ratio	62.15%	61.78%	61.63%	56.14%	59.45%
Average equity to average assets	10.60%	10.32%	10.56%	10.50%	10.05%
Dividend payout ratio	29.43%	33.33%	29.58%	24.52%	26.70%

AT PERIOD END

Total assets	\$ 417,157,877	\$ 402,904,469	\$ 379,831,359	\$ 345,309,996	\$322,787,387
Gross loans	343,940,842	335,595,916	298,126,919	271,263,338	265,595,867
Cash and cash equivalents	14,618,237	7,237,385	13,312,915	20,192,839	12,583,313
Securities	44,719,058	46,133,692	52,373,567	40,248,651	31,521,616
Deposits	354,713,003	319,796,424	302,715,136	275,964,737	261,210,530
Borrowings	14,012,000	38,768,507	36,226,159	31,490,619	27,639,327
Stockholders' equity	45,394,707	41,798,932	39,012,277	36,223,361	32,702,470

SELECTED AVERAGE BALANCES

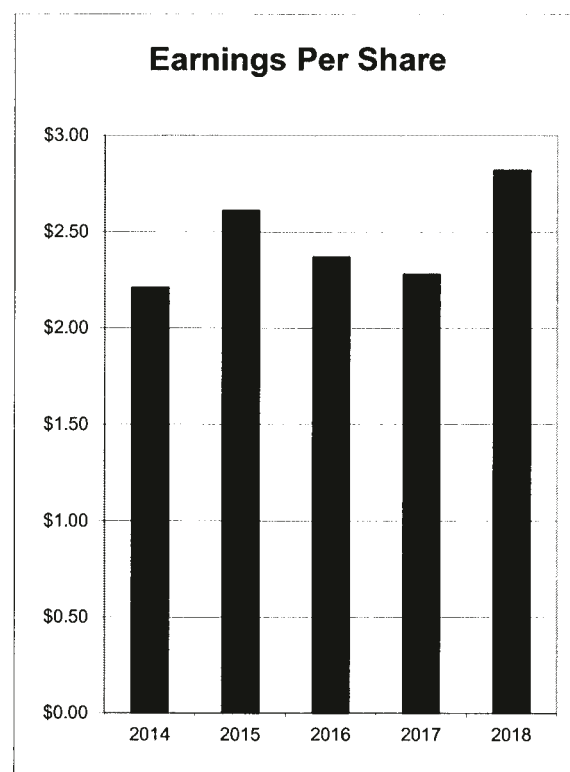
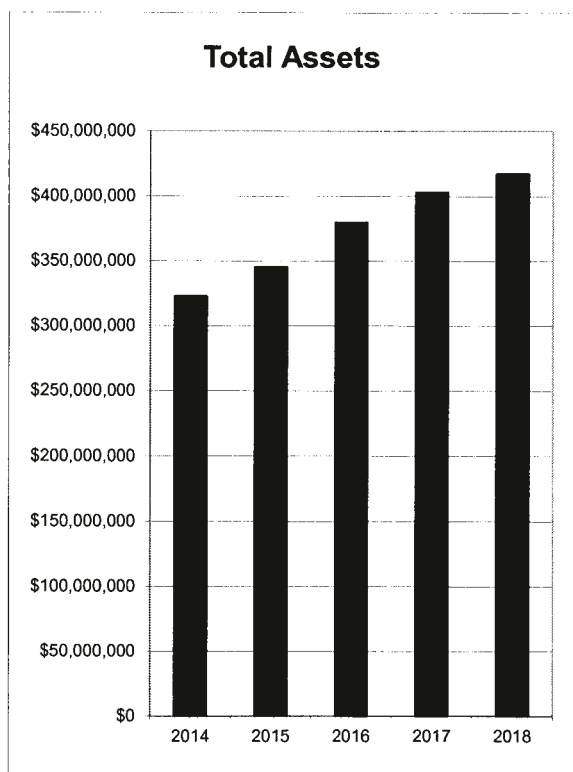
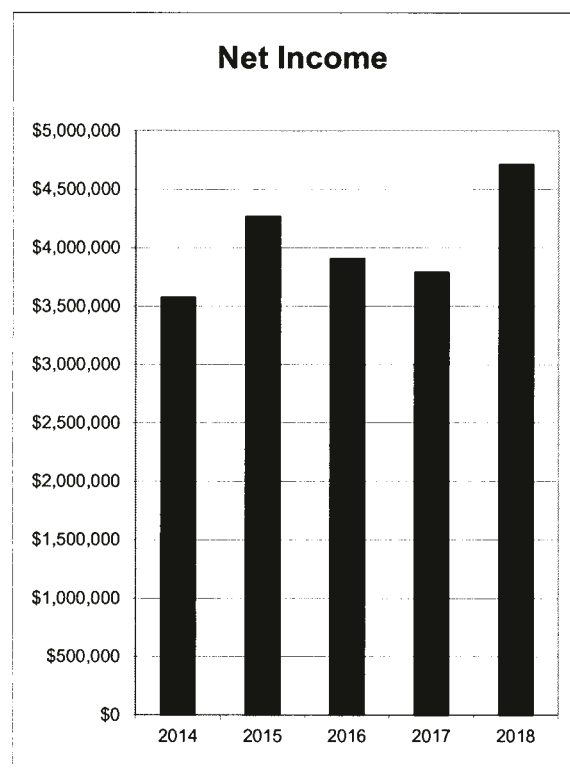
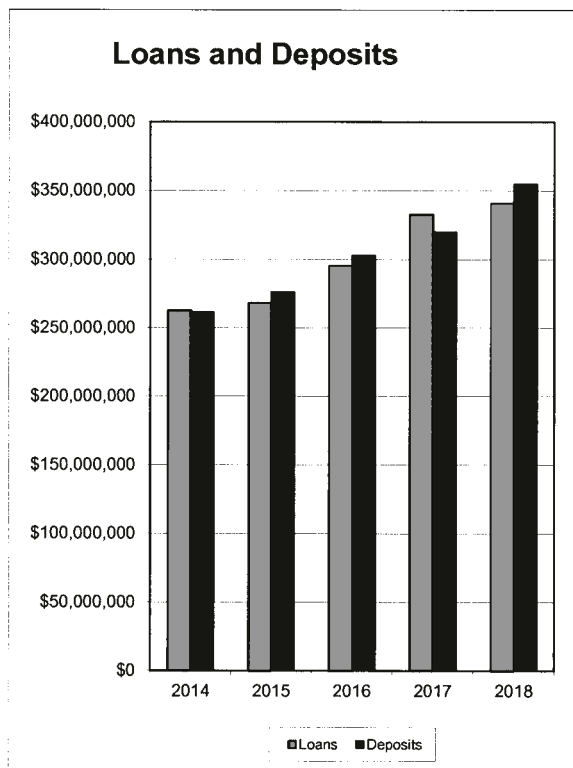
Total assets	\$ 412,586,954	\$ 396,454,271	\$ 361,005,005	\$ 331,522,302	\$311,036,540
Gross loans	343,573,784	319,825,707	284,804,975	273,626,511	253,363,935
Cash and cash equivalents	12,054,442	12,428,778	13,271,319	15,227,040	15,887,073
Securities	44,471,457	50,251,527	48,301,835	31,041,271	31,377,030
Deposits	339,624,630	315,159,559	284,921,811	265,634,314	249,741,172
Borrowings	26,524,352	38,627,588	36,175,989	29,363,070	28,672,245
Stockholders' equity	43,748,434	40,926,674	38,115,746	34,810,159	31,268,365

ASSET QUALITY

Nonperforming assets	\$ 1,209,468	\$ 2,657,702	\$ 1,166,889	\$ 1,429,313	\$ 943,846
Nonperforming assets/total assets	0.29%	0.66%	0.31%	0.41%	0.29%
Allowance for loan losses/total loans	0.73%	0.73%	0.79%	0.95%	1.05%

Farmers and Merchants Bancshares, Inc.

Selected Consolidated Financial Data



Farmers and Merchants Bancshares, Inc.

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

The following discussion and analysis should be read in conjunction with the consolidated financial statements and notes thereto for the years ended December 31, 2018 and 2017, which are presented elsewhere in this annual report.

The Company was incorporated on August 8, 2016 for the purpose of becoming the bank holding company of the Bank in a share exchange transaction that was intended to constitute a tax-free exchange under Section 351 of the IRC. This reorganization was consummated on November 1, 2016, at which time the Bank became a wholly-owned subsidiary of the Company and all of the Bank's stockholders became stockholders of the Company by virtue of the conversion of their shares of common stock of the Bank into an equal number of shares of common stock of the Company. Although we use the terms "Company", "we", "us", and "our" in this section of the annual report, the discussion and analysis with respect to periods ending prior to November 1, 2016 relate to the operations of the Bank and its consolidated subsidiaries, and the discussion and analysis with respect to periods ending on and after November 1, 2016 relate to the operations of the Company and its consolidated subsidiaries, including the Bank.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

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

Farmers and Merchants Bancshares, Inc.

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

Note 1 to the consolidated financial statements describes the methodology used to determine the allowance for loan losses.

FINANCIAL CONDITION

Total assets were \$417,157,877 at December 31, 2018, an increase of \$14,253,408, or 3.5%, over the \$402,904,469 recorded at December 31, 2017. The increase was due primarily to an increase of \$8,366,929 in loans and an increase of \$7,380,852 in cash and cash equivalents, offset by a decrease of \$1,337,519 in securities available for sale.

Total liabilities were \$371,763,170 at December 31, 2018, an increase of \$10,657,633, or 3.0%, over the \$361,105,537 recorded at December 31, 2017. The increase was due primarily to an increase of \$34,916,579 in deposits, offset by decreases of \$14,000,000 in Federal Home Loan Bank ("FHLB") advances and \$10,756,507 in securities sold under repurchase agreements. The increase in deposits was comprised of a \$36,602,192 increase in interest-bearing accounts, offset by a \$1,685,613 decrease in noninterest-bearing accounts.

Stockholders' equity was \$45,394,707 at December 31, 2018 compared to \$41,798,932 at December 31, 2017, an increase of \$3,595,775. The increase was due primarily to net income for 2018 of \$4,712,676, offset by dividends paid, net of reinvestments, of \$933,903 and an increase in the after-tax unrealized loss on available for sale securities of \$174,132.

Loans

Major categories of loans at December 31, 2018, 2017, 2016, 2015, and 2014, are as follows:

	2018		2017		2016		2015		2014	
Real estate:										
Commercial	\$ 238,834,149	69%	\$ 234,026,574	70%	\$ 206,145,076	69%	\$ 186,703,868	69%	\$ 181,881,566	68%
Construction/Land development	18,265,505	5%	18,160,366	5%	14,392,992	5%	12,820,165	5%	18,592,315	7%
Residential	63,024,106	18%	59,241,416	18%	54,710,809	18%	51,290,828	19%	45,687,752	17%
Commercial	23,323,073	7%	23,613,543	7%	22,152,773	7%	19,562,302	7%	18,581,523	7%
Consumer	494,009	0%	554,017	0%	725,269	0%	886,175	0%	852,711	0%
	<u>343,940,842</u>	<u>100%</u>	<u>335,595,916</u>	<u>100%</u>	<u>298,126,919</u>	<u>100%</u>	<u>271,263,338</u>	<u>100%</u>	<u>265,595,867</u>	<u>100%</u>
Less: Allowance for loan losses	2,509,334		2,458,911		2,363,086		2,583,445		2,780,249	
Deferred origination fees net of cost	530,873		603,299		477,261		430,491		483,755	
	<u>\$ 340,900,635</u>		<u>\$ 332,533,706</u>		<u>\$ 295,286,572</u>		<u>\$ 268,249,402</u>		<u>\$ 262,331,863</u>	

The Company had no foreign loans for any of the years presented.

Loans increased by \$8,366,929, or 2.5%, to \$340,900,635 at December 31, 2018 from \$332,533,706 at December 31, 2017. The growth was due to increases in commercial real estate loans of \$4,807,575, construction/land development loans of \$105,139, and residential real estate loans of \$3,782,690, offset by decreases in commercial loans of \$290,470 and consumer loans of \$60,008. The allowance for loan losses increased \$50,423 to \$2,509,334 at December 31, 2018 as compared to \$2,458,911 at December 31, 2017.

Farmers and Merchants Bancshares, Inc.

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

The following table sets forth at December 31, 2018 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 take into account prepayments or scheduled principal repayment assumptions, which could shorten the average loan life.

	Maturing Within One Year	Maturing After One Year But Within Five Years	Maturing After Five Years	Total
Real estate:				
Commercial	\$ 27,329,350	\$ 116,208,364	\$ 95,296,435	\$ 238,834,149
Construction/Land development	8,754,281	9,403,157	108,067	18,265,505
Residential	8,110,528	38,412,362	16,501,216	63,024,106
Commercial	11,392,937	7,844,457	4,085,679	23,323,073
Consumer	79,970	293,616	120,423	494,009
	<u>\$ 55,667,066</u>	<u>\$ 172,161,956</u>	<u>\$ 116,111,820</u>	<u>\$ 343,940,842</u>
Classified by Sensitivity to Change In Interest Rates				
Fixed-Interest Rate Loans	\$ 37,662,287	\$ 152,825,501	\$ 83,166,052	\$ 273,653,840
Adjustable-Interest Rate Loans	18,004,778	19,336,455	32,945,769	70,287,002
	<u>\$ 55,667,065</u>	<u>\$ 172,161,956</u>	<u>\$ 116,111,821</u>	<u>\$ 343,940,842</u>

The Company 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 Company'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	Past Due 90 Days or More and Accruing
2018							
Real estate:							
Commercial	\$ -	\$ -	\$ 988,811	\$ 988,811	\$ 237,845,338	\$ 238,834,149	\$ -
Construction/Land development	-	-	-	-	18,265,505	18,265,505	-
Residential	-	-	10,507	10,507	63,013,599	63,024,106	10,507
Commercial	-	25,000	-	25,000	23,298,073	23,323,073	-
Consumer	-	-	-	-	494,009	494,009	-
Total	<u>\$ -</u>	<u>\$ 25,000</u>	<u>\$ 999,318</u>	<u>\$ 1,024,318</u>	<u>\$ 342,916,524</u>	<u>\$ 343,940,842</u>	<u>\$ 10,507</u>

Farmers and Merchants Bancshares, Inc.

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

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans	Past Due 90 Days or More and Accruing
2017							
Real estate:							
Commercial	\$ -	\$ -	\$ 2,245,743	\$ 2,245,743	\$ 231,780,831	\$ 234,026,574	\$ -
Construction/Land development	-	-	-	-	18,160,366	18,160,366	-
Residential	-	-	146,459	146,459	59,094,957	59,241,416	146,459
Commercial	-	-	-	-	23,613,543	23,613,543	-
Consumer	-	-	-	-	554,017	554,017	-
Total	\$ -	\$ -	\$ 2,392,202	\$ 2,392,202	\$ 333,203,714	\$ 335,595,916	\$ 146,459

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans	Past Due 90 Days or More and Accruing
2016							
Real estate:							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 206,145,076	\$ 206,145,076	\$ -
Construction/Land development	-	-	752,889	752,889	13,640,103	14,392,992	-
Residential	824,554	-	-	824,554	53,886,255	54,710,809	-
Commercial	48,719	-	-	48,719	22,104,054	22,152,773	-
Consumer	-	-	-	-	725,269	725,269	-
Total	\$ 873,273	\$ -	\$ 752,889	\$ 1,626,162	\$ 296,500,757	\$ 298,126,919	\$ -

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans	Past Due 90 Days or More and Accruing
2015							
Real estate:							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 186,703,868	\$ 186,703,868	\$ -
Construction/Land development	-	-	956,813	956,813	11,863,352	12,820,165	-
Residential	-	-	-	-	51,290,828	51,290,828	-
Commercial	-	-	-	-	19,562,302	19,562,302	-
Consumer	-	-	-	-	886,175	886,175	-
Total	\$ -	\$ -	\$ 956,813	\$ 956,813	\$ 270,306,525	\$ 271,263,338	\$ -

Farmers and Merchants Bancshares, Inc.

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

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or more Past Due	Total Past Due	Current	Total Loans	Past Due 90 Days or More and Accruing
2014							
Real estate:							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 181,881,566	\$ 181,881,566	\$ -
Construction/Land development	-	-	-	-	18,592,315	18,592,315	-
Residential	193,794	-	-	193,794	45,493,958	45,687,752	-
Commercial	-	-	-	-	18,581,523	18,581,523	-
Consumer	-	-	-	-	852,711	852,711	-
Total	\$ 193,794	\$ -	\$ -	\$ 193,794	\$ 265,402,073	\$ 265,595,867	\$ -

It is the Company's policy to place a loan in nonaccrual status when any portion of the principal or interest is 90 days past due and collateral is insufficient to discharge the debt in full. Management closely monitors nonaccrual loans. The Company returns a nonaccrual loan to accruing status when (i) the loan is brought current with the full payment of all principal and interest arrearages, (ii) all contractual payments are thereafter made on a timely basis for at least six months, and (iii) management determines, based on a credit review, that it is reasonable to expect that future payments will be made as and when required by the contract.

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

	2018	2017	2016	2015	2014
Non-accrual loans					
Commercial real estate	\$ 988,811	\$ 2,245,743	\$ -	\$ -	\$ -
Construction/Land development	-	-	752,889	956,813	-
Total non-accrual loans	\$ 988,811	\$ 2,245,743	\$ 752,889	\$ 956,813	\$ -

At December 31, 2018, the Company had two nonaccrual commercial real estate loans to the same borrower totaling \$988,811. The loans were secured by real estate and business assets and were personally guaranteed. Gross interest income of \$115,168 would have been recorded in 2018 if these nonaccrual loans had been current and performing in accordance with the original terms. The Company allocated \$0 of its allowance for loan losses to these nonaccrual loans. The balance of the nonaccrual loans was net of charge-offs of \$690,000 at December 31, 2018.

At December 31, 2017, the Company had one nonaccrual commercial real estate loan totaling \$2,245,743. The loan was secured by real estate and business assets and was personally guaranteed. Gross interest income of \$82,070 would have been recorded in 2017 if this nonaccrual loan had been current and performing in accordance with the original terms. The Company allocated \$127,213 of its allowance for loan losses to this nonaccrual loan. The balance of the nonaccrual loan was net of charge-offs of \$275,000 at December 31, 2017. This nonaccrual loan was paid off in 2018 with a recovery of \$197,660.

At December 31, 2018, the Company had one residential real estate loan totaling \$10,507 that was delinquent 90 days or greater in addition to the nonaccrual loans noted above. At December 31, 2017, the

Farmers and Merchants Bancshares, Inc.

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

Company had two residential real estate loans totaling \$146,459 that were delinquent 90 days or greater in addition to the nonaccrual loans noted above.

Year-end impaired loans are set forth in the following table:

	2018	2017	2016	2015	2014
Impaired loans no valuation allowance	\$ 3,177,381	\$ 2,937,439	\$ 2,348,275	\$ 2,443,681	\$ -
Impaired loans with a valuation allowance	-	2,245,743	994,469	956,813	1,024,044
Total impaired loans	<u>\$ 3,177,381</u>	<u>\$ 5,183,182</u>	<u>\$ 3,342,744</u>	<u>\$ 3,400,494</u>	<u>\$ 1,024,044</u>
Valuation allowance related to impaired loans	<u>\$ -</u>	<u>\$ 127,213</u>	<u>\$ 24,167</u>	<u>\$ 167,211</u>	<u>\$ 167,418</u>

Impaired loans include certain loans that have been modified in troubled debt restructurings ("TDRs") where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

At December 31, 2018, the Company had one commercial real estate loan totaling \$2,134,570 and one residential loan totaling \$54,000 classified as TDRs. The \$54,000 loan was restructured as a TDR during 2018. All are included in impaired loans above. Each loan is paying as agreed. There have been no charge-offs or allowances associated with these two loans.

At December 31, 2017, the Company had three commercial real estate loans totaling \$2,937,439 classified as TDRs. Two loans totaling \$774,274 were restructured as TDRs during 2017. All are included in impaired loans above. Two of the loans paid off in 2018. There have been no charge-offs or allowances associated with these three loans.

	2018	2017	2016	2015	2014
Restructured loans (TDRs):					
Performing as agreed	\$ 2,188,570	\$ 2,937,439	\$ 2,348,275	\$ 2,443,681	\$ -
Not performing as agreed	-	-	241,580	-	-
Total TDRs	<u>\$ 2,188,570</u>	<u>\$ 2,937,439</u>	<u>\$ 2,589,855</u>	<u>\$ 2,443,681</u>	<u>\$ -</u>

As part of our portfolio risk management, the Company assigns a risk grade to each loan. 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 any guarantor, and cash flow projections of the borrower. Special mention, Substandard, and Doubtful grades are assigned to loans with a higher frequency of delinquent payments and/or the collateral and/or cash flow are insufficient to support the loan and such loans are included on the Company's watch list. The Special mention grade is intended to be a temporary grade. During 2018, the Company decided to shorten the time period loans were in the Special mention category and as a result all loans were moved to Substandard. This change did not have an impact on the allowance for loan losses.

Farmers and Merchants Bancshares, Inc.

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

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
Special mention	\$ -	\$ 5,391,589	\$ 8,962,940	\$ 6,366,296	\$ 9,605,422
Substandard	11,448,021	4,625,568	6,399,618	7,843,897	8,517,800
Doubtful	<u>78,467</u>	<u>2,274,162</u>	<u>29,742</u>	<u>25,525</u>	<u>35,212</u>
Total	<u>\$ 11,526,488</u>	<u>\$ 12,291,319</u>	<u>\$ 15,392,300</u>	<u>\$ 14,235,718</u>	<u>\$ 18,158,434</u>

The allowance for loan losses is a reserve established through a provision for loan losses and is 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 Company'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 and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions.

The Company'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, based on information currently available, that the Company'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 Company's level of allowance for loan losses will be sufficient to cover future loan losses incurred by the Company or that future adjustments to the allowance for loan losses will not be necessary if economic or 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 tables detail activity in the allowance for loan losses by portfolio for the years ended December 31, 2018, 2017, 2016, 2015, and 2014. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
						Individually	Collectively	Individually	Collectively
December 31, 2018									
Real estate:									
Commercial	\$ 1,867,397	\$ 372,315	\$ (690,000)	\$ 204,660	\$ 1,754,372	\$ -	\$ 1,754,372	\$ 3,177,381	\$ 235,656,768
Construction and land development	223,274	(78,496)	(12,115)	63,711	196,374	-	196,374	-	18,265,505
Residential	247,953	153,673	-	-	401,626	-	401,626	-	63,024,106
Commercial	87,353	6,090	-	9,167	102,610	-	102,610	-	23,323,073
Consumer	7,027	3,401	-	-	10,428	-	10,428	-	494,009
Unallocated	<u>25,907</u>	<u>18,017</u>	<u>-</u>	<u>-</u>	<u>43,924</u>	<u>-</u>	<u>43,924</u>	<u>-</u>	<u>-</u>
	<u>\$ 2,458,911</u>	<u>\$ 475,000</u>	<u>\$ (702,115)</u>	<u>\$ 277,538</u>	<u>\$ 2,509,334</u>	<u>\$ -</u>	<u>\$ 2,509,334</u>	<u>\$ 3,177,381</u>	<u>\$ 340,763,461</u>

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

December 31, 2017	Beginning balance	Provision		Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
		for loan losses	Charge offs			Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,717,749	\$ 419,868	\$ (275,000)	\$ 4,780	\$ 1,867,397	\$ 127,213	\$ 1,740,184	\$ 5,183,182	\$228,843,392
Construction and									
land development	204,860	65,850	(47,436)	-	223,274	-	223,274	-	18,160,366
Residential	247,437	368	-	148	247,953	-	247,953	-	59,241,416
Commercial	125,260	(41,240)	-	3,333	87,353	-	87,353	-	23,613,543
Consumer	8,826	(1,799)	-	-	7,027	-	7,027	-	554,017
Unallocated	58,954	(33,047)	-	-	25,907	-	25,907	-	-
	\$ 2,363,086	\$ 410,000	\$ (322,436)	\$ 8,261	\$ 2,458,911	\$ 127,213	\$ 2,331,698	\$ 5,183,182	\$330,412,734

December 31, 2016	Beginning balance	Provision				Allowance for loan losses ending balance evaluated		Outstanding loan balances evaluated	
		for loan losses	Charge offs	Recoveries	Ending balance	for impairment:		for impairment:	
						Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,718,256	\$ 29,493	\$ (30,000)	\$ -	\$ 1,717,749	\$ 7,580	\$ 1,710,169	\$ 2,425,089	\$203,719,987
Construction and									
land development	306,982	97,878	(200,000)	-	204,860	16,587	188,273	752,889	13,640,103
Residential	322,084	(184,773)	-	110,126	247,437	-	247,437	-	54,710,809
Commercial	132,362	93,383	(100,485)	-	125,260	-	125,260	164,766	21,988,007
Consumer	7,900	926	-	-	8,826	-	8,826	-	725,269
Unallocated	95,861	(36,907)	-	-	58,954	-	58,954	-	-
	<u>\$ 2,583,445</u>	<u>\$ -</u>	<u>\$ (330,485)</u>	<u>\$ 110,126</u>	<u>\$ 2,363,086</u>	<u>\$ 24,167</u>	<u>\$ 2,338,919</u>	<u>\$ 3,342,744</u>	<u>\$294,784,175</u>

Farmers and Merchants Bancshares, Inc.

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

December 31, 2015	Beginning balance	Provision		Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
		for loan losses	Charge offs			Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,848,163	\$ (129,907)	\$ -	\$ -	\$ 1,718,256	\$ -	\$ 1,718,256	\$ 2,240,046	\$ 184,463,822
Construction and land development	458,211	48,771	(200,000)	-	306,982	167,211	139,771	956,813	11,863,352
Residential	278,943	42,299	-	842	322,084	-	322,084	-	51,290,828
Commercial	171,104	(41,096)	-	2,354	132,362	-	132,362	203,635	19,358,667
Consumer	8,215	(315)	-	-	7,900	-	7,900	-	886,175
Unallocated	15,613	80,248	-	-	95,861	-	95,861	-	-
	\$ 2,780,249	\$ -	\$ (200,000)	\$ 3,196	\$ 2,583,445	\$ 167,211	\$ 2,416,234	\$ 3,400,494	\$ 267,862,844

December 31, 2014	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
						Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,955,984	\$ (107,821)	\$ -	\$ -	\$ 1,848,163	\$ -	\$ 1,848,163	\$ -	\$ 181,881,566
Construction and land development	170,498	287,713	-	-	458,211	167,418	290,793	1,024,044	17,568,271
Residential	323,756	(66,316)	(4,602)	26,105	278,943	-	278,943	-	45,687,752
Commercial	109,651	59,853	-	1,600	171,104	-	171,104	-	18,581,523
Consumer	12,150	(10,127)	-	6,192	8,215	-	8,215	-	852,711
Unallocated	54,915	(39,302)	-	-	15,613	-	15,613	-	-
	\$ 2,626,954	\$ 124,000	\$ (4,602)	\$ 33,897	\$ 2,780,249	\$ 167,418	\$ 2,612,831	\$ 1,024,044	\$ 264,571,823

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
Allowance for loan losses to total loans outstanding	<u>0.73%</u>	<u>0.73%</u>	<u>0.79%</u>	<u>0.95%</u>	<u>1.05%</u>
Ratio of net charge-offs to average loans outstanding during the period	<u>0.12%</u>	<u>0.10%</u>	<u>0.08%</u>	<u>0.07%</u>	<u>-0.01%</u>

The Company recorded \$424,577 in net charge-offs in 2018 versus \$314,175 in net charge-offs in 2017. The provision for loan losses was \$475,000 in 2018 and \$410,000 in 2017.

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

Other Real Estate Owned

Other real estate owned ("OREO") at December 31, 2018 and 2017 included one property with a carrying value of \$210,150 and \$265,500, respectively. The property is land in Cecil County, Maryland and was acquired through foreclosure in 2007. The property consists of 10.43 acres and is currently under contract for a gross sales price of \$295,000 with closing expected in the second half of 2019.

	2018	2017	2016	2015	2014
Other Real Estate Owned	<u>\$ 210,150</u>	<u>\$ 265,500</u>	<u>\$ 414,000</u>	<u>\$ 472,500</u>	<u>\$ 943,846</u>

Investment Securities

Investment securities decreased \$1,414,634, or 3.1%, to \$44,719,058 at December 31, 2018 from \$46,133,692 at December 31, 2017. At December 31, 2018 and 2017, the Company had classified 59% and 61%, respectively, of the investment portfolio as available for sale. The remaining 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 Company'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 Company 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 Company 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:

	2018	2017	2016
<u>Available for sale</u>			
State and municipal	\$ 1,506,505	\$ 1,539,207	\$ 1,566,327
SBA pools	2,719,372	3,199,846	2,263,834
Mortgage-backed securities	<u>22,366,114</u>	<u>23,190,457</u>	<u>30,063,535</u>
	<u>\$ 26,591,991</u>	<u>\$ 27,929,510</u>	<u>\$ 33,893,696</u>
<u>Held to maturity</u>			
State and municipal	<u>\$ 18,127,067</u>	<u>\$ 18,204,182</u>	<u>\$ 17,987,628</u>

Farmers and Merchants Bancshares, Inc.

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, 2018:

	<u>Available for Sale</u>			<u>Held to Maturity</u>		
	Amortized Cost	Fair Value	Yield	Amortized Cost	Fair Value	Yield
Within 1 year	\$ 375,000	\$ 375,653	5.02%	\$ 1,009,284	\$ 1,011,165	1.92%
Over 1 to 5 years	260,587	249,920	2.25%	590,522	598,528	3.83%
Over 5 to 10 years	870,424	880,932	4.72%	1,858,695	1,876,364	3.85%
Over 10 years	-	-	0.00%	14,668,566	14,547,036	3.28%
	1,506,011	1,506,505	4.37%	18,127,067	18,033,093	3.28%
SBA Pools	2,779,411	2,719,372	3.07%	-	-	-
Mortgage-backed securities	23,090,618	22,366,114	2.31%	-	-	-
	<u>\$ 27,376,040</u>	<u>\$ 26,591,991</u>	<u>2.50%</u>	<u>\$ 18,127,067</u>	<u>\$ 18,033,093</u>	<u>3.28%</u>

SBA pools and mortgage-backed securities are due in monthly installments.

Deposits

Total deposits were \$354,713,003 at December 31, 2018 compared to \$319,796,424 at December 31, 2017, an increase of \$34,916,579, or 10.9%. The increase was due to a \$22,865,072 increase in time deposits, a \$1,244,668 increase in money market accounts, and a \$12,757,329 increase in interest bearing checking accounts, offset by a \$264,877 decrease in savings accounts and a \$1,685,613 decrease in noninterest-bearing accounts. The following table shows the average balances and average costs of deposits for the years ended December 31:

	<u>2018</u>		<u>2017</u>		<u>2016</u>	
	Average Balance	Cost	Average Balance	Cost	Average Balance	Cost
Noninterest bearing demand deposits	\$ 61,972,038	0.00%	\$ 60,346,388	0.00%	\$ 58,845,893	0.00%
Interest bearing demand deposits	48,070,664	0.22%	42,370,867	0.14%	36,431,530	0.13%
Savings and money market deposits	97,644,061	0.25%	104,943,540	0.23%	94,995,586	0.23%
Time deposits	131,937,867	1.42%	107,498,764	1.00%	94,648,802	0.88%
	<u>\$ 339,624,630</u>	<u>0.65%</u>	<u>\$ 315,159,559</u>	<u>0.44%</u>	<u>\$ 284,921,811</u>	<u>0.39%</u>

As of December 31, 2018, certificates of deposit of \$100,000 or more mature as follows:

<u>Period</u>	<u>Balance</u>
3 months or less	\$ 12,710,424
Over 3 months to 6 months	6,165,538
Over 6 months to 12 months	13,351,960
Over 12 months	25,237,688
Total	<u>\$ 57,465,610</u>

Farmers and Merchants Bancshares, Inc.

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

Off-Balance Sheet Arrangements

The Company 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 Company'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 Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

At December 31, 2018, the Company's off-balance sheet financial instruments were as follows:

Loan commitments	\$ 12,354,870
Unused lines of credit	\$ 26,984,173
Letters of credit	\$ 1,905,553

Management does not believe that any of the foregoing arrangements are reasonably likely to have a materially adverse effect on the Company'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 Company'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 Company which are used as collateral for these borrowings are primarily U.S. government agency securities.

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

Farmers and Merchants Bancshares, Inc.

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

	At December 31,		
	<u>2018</u>	<u>2017</u>	<u>2016</u>
Amount outstanding at year-end:			
Securities sold under repurchase agreements	\$ 11,012,000	\$ 21,768,507	\$ 27,226,159
Federal Home Loan Bank advances	3,000,000	17,000,000	9,000,000
Federal Home Loan Bank advances mature in:			
2017	\$ -	\$ -	\$ 2,000,000
2018	-	14,000,000	5,000,000
2019	3,000,000	3,000,000	2,000,000
Weighted average rate paid at December 31:			
Securities sold under repurchase agreements	1.07%	0.65%	0.63%
Federal Home Loan Bank advances	1.50%	1.35%	1.11%
Maximum amount of borrowings outstanding at any month end:			
Securities sold under repurchase agreements	\$ 22,173,010	\$ 30,786,064	\$ 32,287,740
Federal Home Loan Bank advances	19,000,000	18,000,000	16,000,000
Average amount of borrowings outstanding with respect to:			
Securities sold under repurchase agreements	\$ 17,479,418	\$ 24,702,931	\$ 25,320,795
Federal Home Loan Bank advances	8,795,890	13,846,575	10,833,333
Borrowings from FRB and commercial banks	249,047	78,082	21,861
Average rate paid for the year:			
Securities sold under repurchase agreements	0.83%	0.66%	0.64%
Federal Home Loan Bank advances	1.50%	1.20%	0.94%
Borrowings from FRB and commercial banks	1.93%	1.64%	0.67%

The terms of the Company's operating leases, including the future minimum payments under those leases, are disclosed in Note 7 to the consolidated financial statements.

RESULTS OF OPERATIONS

Overview

The Company reported net income of \$4,712,676 for the year ended December 31, 2018 compared to \$3,789,241 for the year ended December 31, 2017. The increase of \$923,435 over 2017 was due to an increase in net interest income of \$373,529, an increase in noninterest income of \$28,179, and a decrease in income taxes of \$896,105, offset by an increase in noninterest expense of \$309,378 and an increase in the provision for loan losses of \$65,000.

Farmers and Merchants Bancshares, Inc.

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

Net Interest Income

The primary source of income for the Company 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.

For the year ended December 31, 2018, the Company recorded net interest income of \$15,261,092 compared to \$14,887,563 for 2017, an increase of \$373,529. The increase was attributable primarily to an increase in the average balance of interest-earning assets, offset by a decline in the net yield on interest-earning assets. Average interest earning assets increased \$20,518,743 to \$396,686,136 in 2018 from \$376,167,393 in 2017. The net average tax equivalent yield on interest earning assets declined 16 basis points to 3.88% in 2018 when compared to the 4.04% recorded in 2017.

Total interest income for the year ended December 31, 2018 increased by \$1,173,530 to \$17,768,333, compared to \$16,594,803 for 2017. The increase was due primarily to the aforementioned increase in average interest earning assets and an increase of 2 basis points in the yield on interest earning assets to 4.51% in 2018 from 4.49% in 2017.

Interest income from loans was \$16,401,554 in 2018 compared to \$15,189,238 in 2017, an increase of \$1,212,316. This increase was attributable to a \$23,748,077 increase in the average balance of loans to \$343,573,784 in 2018 from \$319,825,707 in 2017 and a 2 basis point increase in the average yield on loans to 4.77% in 2018 from 4.75% in 2017.

For the year ended December 31, 2018, the Company recorded interest income on securities of \$1,181,480. For the same period of 2017, interest income on securities was \$1,308,357. The \$126,877 decrease in 2018 was attributable to a \$5,780,070 decrease in the average balance of securities to \$44,471,457 in 2018 from \$50,251,527 in 2017 and a 23 basis point decrease in the average tax equivalent yield on securities to 2.95% in 2018 from 3.18% in 2017.

Interest income on federal funds sold and other interest-earning assets (FHLB stock and certificates of deposit) increased \$88,091 to \$185,299 in 2018 compared to \$97,208 in 2017. The increase was due to a 54 basis point increase in the average tax equivalent yield to 2.18% in 2018 from 1.64% in 2017, and a \$2,550,736 increase in the average balance of federal funds sold and other interest-earning assets to \$8,640,895 in 2018 from \$6,090,159 in 2017.

Total interest expense increased \$800,001 to \$2,507,241 in 2018 compared to \$1,707,240 in 2017. The increase was primarily due to an increase of \$10,736,185 in the average balance of interest-bearing liabilities to \$304,176,944 in 2018 from \$293,440,759 in 2017 and a 24 basis point increase in the cost of interest-bearing liabilities to 0.82% in 2018 from 0.58% in 2017.

Interest paid on NOW, savings, and money market deposit accounts increased \$48,830 to \$348,416 in 2018 compared to \$299,586 in 2017. The increase was due to a 4 basis point increase in the cost of funds to 0.24% in 2018 from 0.20% in 2017, offset by a \$1,599,682 decrease in the average balance of these deposits to \$145,714,725 in 2018 from \$147,314,407 in 2017.

Interest paid on time deposits increased \$798,478 to \$1,877,200 in 2018 compared to \$1,078,722 in 2017. The increase in interest expense was due to an increase of 42 basis points in the average rate paid to 1.42% in 2018 from 1.00% in 2017 and an increase of \$24,439,103 in the average balance to \$131,937,867 in 2018 from \$107,498,764 in 2017.

Farmers and Merchants Bancshares, Inc.

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

Interest paid on securities sold under repurchase agreements decreased \$17,033 to \$144,881 in 2018 compared to \$161,914 in 2017. The decrease was attributable to a \$7,223,513 decrease in the average balance of securities sold under repurchase agreements to \$17,479,418 in 2018 from \$24,702,931 in 2017, offset by an increase of 17 basis points in the average rate to 0.83% in 2018 from 0.66% in 2017.

Interest paid on FHLB advances and other borrowings decreased \$30,274 to \$136,744 in 2018 from \$167,018 in 2017. The decrease was attributable to a \$4,879,723 decrease in the average balance of FHLB advances and other borrowings to \$9,044,934 in 2018 from \$13,924,657 in 2017, offset by an increase of 31 basis points in the average rate to 1.51% in 2018 from 1.20% in 2017.

The following table sets forth certain information relating to the Company'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. Non-accruing loans are included in the average balance.

	2018			2017			2016		
	<u>Average Balance</u>	<u>Interest</u>	<u>Yield</u>	<u>Average Balance</u>	<u>Interest</u>	<u>Yield</u>	<u>Average Balance</u>	<u>Interest</u>	<u>Yield</u>
Assets:									
Loans	\$ 343,573,784	\$ 16,401,554	4.77%	\$ 319,825,707	\$ 15,189,238	4.75%	\$ 284,804,975	\$ 14,024,899	4.92%
Securities, taxable	26,807,959	617,249	2.30%	32,115,690	715,689	2.23%	32,808,588	769,115	2.34%
Securities, tax exempt	17,663,498	695,282	3.94%	18,135,837	883,901	4.87%	15,493,247	740,395	4.78%
Federal funds sold and other interest earning assets	8,640,895	188,479	2.18%	6,090,159	99,840	1.64%	5,796,135	66,231	1.14%
Total interest-earning assets	396,686,136	17,902,564	4.51%	376,167,393	16,888,668	4.49%	338,902,945	15,600,640	4.60%
Noninterest-earning assets	15,900,818			20,286,878			22,102,060		
Total assets	<u>\$ 412,586,954</u>			<u>\$ 396,454,271</u>			<u>\$ 361,005,005</u>		
Liabilities and Stockholders' Equity:									
NOW, savings, and money market	\$ 145,714,725	348,416	0.24%	\$ 147,314,407	299,586	0.20%	\$ 131,427,116	267,533	0.20%
Certificates of deposit	131,937,867	1,877,200	1.42%	107,498,764	1,078,722	1.00%	94,648,802	831,454	0.88%
Securities sold under repurchase agreements	17,479,418	144,881	0.83%	24,702,931	161,914	0.66%	25,320,795	144,620	0.57%
FHLB advances and other borrowings	9,044,934	136,744	1.51%	13,924,657	167,018	1.20%	10,855,194	102,513	0.94%
Total interest-bearing deposits	304,176,944	2,507,241	0.82%	293,440,759	1,707,240	0.58%	262,251,907	1,346,120	0.51%
Noninterest-bearing deposits	61,972,038			60,346,388			58,845,893		
Noninterest-bearing liabilities	2,689,538			1,740,450			1,791,459		
Total liabilities	368,838,520			355,527,597			322,889,259		
Stockholders' equity	43,748,434			40,926,674			38,115,746		
Total liabilities and stockholders' equity	<u>\$ 412,586,954</u>			<u>\$ 396,454,271</u>			<u>\$ 361,005,005</u>		
Net interest income		<u>\$ 15,395,323</u>			<u>\$ 15,181,428</u>			<u>\$ 14,254,520</u>	
Interest rate spread			<u>3.69%</u>			<u>3.91%</u>			<u>4.09%</u>
Net yield on interest-earning assets			<u>3.88%</u>			<u>4.04%</u>			<u>4.21%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities			<u>130.41%</u>			<u>128.19%</u>			<u>129.23%</u>

Interest on tax-exempt investments are reported on a fully taxable equivalent basis

Farmers and Merchants Bancshares, Inc.

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 Company's interest-earning assets and interest-bearing liabilities. The table distinguishes between (i) changes in net interest income attributed to volume (change in volume multiplied by the prior year's interest rate), and (ii) 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, 2018 compared to 2017			Year ended December 31, 2017 compared to 2016		
	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	\$ 1,133,307	\$ 79,009	\$ 1,212,316	\$ 1,676,977	\$ (512,638)	\$ 1,164,339
Securities, taxable	(121,552)	23,112	(98,440)	(16,003)	(37,423)	(53,426)
Securities, tax exempt	(22,493)	(166,126)	(188,619)	128,532	14,974	143,506
Federal funds sold and other interest-earning assets	<u>49,541</u>	<u>39,098</u>	<u>88,639</u>	<u>3,512</u>	<u>30,097</u>	<u>33,609</u>
Total interest-earning assets	<u>1,038,803</u>	<u>(24,907)</u>	<u>1,013,896</u>	<u>1,793,018</u>	<u>(504,990)</u>	<u>1,288,028</u>
Interest expense:						
NOW, savings, and money market	(3,286)	52,116	48,830	32,309	(256)	32,053
Certificates of deposit	281,349	517,129	798,478	120,725	126,543	247,268
Securities sold under repurchase agreements	(53,923)	36,890	(17,033)	(3,603)	20,897	17,294
FHLB advances and other borrowings	<u>(67,274)</u>	<u>37,000</u>	<u>(30,274)</u>	<u>32,991</u>	<u>31,514</u>	<u>64,505</u>
Total interest-bearing liabilities	<u>156,866</u>	<u>643,135</u>	<u>800,001</u>	<u>182,422</u>	<u>178,698</u>	<u>361,120</u>
Change in net interest income	<u>\$ 881,937</u>	<u>\$ (668,042)</u>	<u>\$ 213,895</u>	<u>\$ 1,610,596</u>	<u>\$ (683,688)</u>	<u>\$ 926,908</u>

Noninterest Income

Total noninterest income increased by \$28,179, or 2.1%, to \$1,365,273 in 2018 from \$1,337,094 in 2017. Write down of other real estate owned decreased \$93,150 due to a smaller write-down in 2018 as compared to 2017 of the value of the property included as OREO. Service charges on deposit accounts decreased \$30,138, primarily due to lower overdraft fees. The net unrealized loss on equity securities increased by \$11,429.

Noninterest Expense

Total noninterest expense increased by \$309,378, or 3.1%, to \$10,332,480 in 2018 from \$10,023,102 in 2017. The increase was due primarily to increases in salary and employee benefit expenses of \$287,568, or 4.6%, to \$6,508,263 in 2018 compared to \$6,220,695 in 2017. The increase was due primarily to merit increases in salaries paid to existing staff and higher payroll taxes and benefits.

Farmers and Merchants Bancshares, Inc.

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

Income Taxes

Income taxes decreased \$896,105 to \$1,106,209 in 2018 from \$2,002,314 in 2017. The impact of the reduction of the federal corporate income tax rate from 34% to 21% as a result of the Tax Cuts and Jobs Act enacted in December 2017 accounted for \$478,606 of the decrease. The other primary driver of the decrease was that income taxes for 2017 included a one-time charge of \$410,391 as a result of the revaluation of the Company's net deferred tax asset required by the aforementioned Act.

The Company's effective tax rate decreased to 23.4% in 2018, from 34.6% in 2017. The decrease was due to the reduction of the federal corporate income tax rate from 34% to 21% discussed above and the reduction in 2018 from the revaluation of net deferred tax assets and liabilities in 2017 discussed above, offset by the lower impact of Federal tax-exempt income and state income taxes due to the lower federal income tax rate. Note 12 to the consolidated financial statements provides additional information about the Company's taxes, including a reconciliation of the Company's effective tax rate to the Federal statutory rate of 19%.

INTEREST RATE RISK

The Company'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 Company'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 Company's net interest income. Net interest income is susceptible to interest rate risk when deposits and other short-term liabilities have different repricing intervals than do loans, investments and other interest-earning assets. When interest-earning assets mature or reprice faster than interest-bearing liabilities, a decline in interest rates may cause a decline in net interest income. Conversely, when interest-bearing liabilities mature or reprice faster than interest-earning assets, an increase in interest rates may cause a decline in net interest income.

The Company 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 Company'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 Company 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:

Farmers and Merchants Bancshares, Inc.

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

Earnings at Risk

Earnings at Risk ("EAR") measures exposure to net changes in net interest income ("NII"), and is considered the Company'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 Company is being compromised for the sake of short-term results. However, the Company 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 Company 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.

Measures of NII at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

Based upon the simulation analysis performed at December 31, 2018 and 2017, management estimated the following changes in NII, assuming the indicated rate changes:

<u>Change in Rate</u>	<u>2018</u>	<u>2017</u>
400 basis point increase	\$ (623,000)	\$(879,000)
300 basis point increase	(384,000)	(580,000)
200 basis point increase	(204,000)	(348,000)
100 basis point increase	(80,000)	(171,000)
100 basis point decrease	193,000	46,000
200 basis point decrease	48,000	(115,000)
300 basis point decrease	(41,000)	(174,000)

LIQUIDITY MANAGEMENT

Liquidity describes our ability 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 our other debts and obligations as they come due in the normal course of business. We maintain our asset liquidity position internally through short-term investments, the maturity distribution of the investment portfolio, loan repayments, and income from earning assets. 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 as well as investment securities, or approximately \$46.4 million under a secured line of credit with the FHLB. The Bank also has a facility with the Federal Reserve Bank of Richmond

Farmers and Merchants Bancshares, Inc.

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

(the "Reserve Bank") under which the Bank can borrow approximately \$25.6 million. Finally, the Bank has an \$18,500,000 (\$9,500,000 unsecured and \$9,000,000 secured) overnight federal funds line of credit available from commercial banks. FHLB advances of \$3,000,000 and \$17,000,000 were outstanding as of December 31, 2018 and 2017, respectively. There were no borrowings from the Reserve Bank or our commercial bank lender at December 31, 2018 and 2017. Management believes that we have 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 our 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 we are subject is set forth above under the captions "Off-Balance Sheet Transactions" and "Borrowings and Other Contractual Obligations".

CAPITAL RESOURCES AND ADEQUACY

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional, discretionary actions by the regulators that, if undertaken, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices.

The Basel III Capital Rules became effective for the Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of Common Equity Tier 1 capital, Tier 1 capital, and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

Additional information regarding the capital requirements that apply to us can be found in footnote 14 of the consolidated financial statements and notes thereto included in the Annual Report.

The following table presents actual and required capital ratios as of December 31, 2018 and 2017, for the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2018 and 2017, based on the phase-in provisions of the Basel III Capital Rules. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

Farmers and Merchants Bancshares, Inc.

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

(Dollars in thousands)	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2018						
Total capital (to risk-weighted assets)	\$ 47,857	13.50%	\$ 34,996	9.88%	\$ 35,439	10.00%
Tier 1 capital (to risk-weighted assets)	45,348	12.80%	27,908	7.88%	28,351	8.00%
Common equity tier 1 (to risk-weighted assets)	45,348	12.80%	22,593	6.38%	23,036	6.50%
Tier 1 leverage (to average assets)	45,348	10.86%	16,698	4.00%	20,872	5.00%
December 31, 2017						
Total capital (to risk-weighted assets)	\$ 44,039	12.54%	\$ 32,477	9.25%	\$ 35,110	10.00%
Tier 1 capital (to risk-weighted assets)	41,580	11.84%	25,455	7.25%	28,088	8.00%
Common equity tier 1 (to risk-weighted assets)	41,580	11.84%	20,188	5.75%	22,822	6.50%
Tier 1 leverage (to average assets)	41,580	10.31%	16,135	4.00%	20,169	5.00%

The Company 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 Company are described in the notes to the consolidated financial statements.

The following accounting guidance has been approved by the Financial Accounting Standards Board (the "FASB") and would apply to the Company if the Company entered into an applicable activity.

In February 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-02, "Leases (Topic 841)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company anticipates that the impact of ASU 2016-02's implementation will be an equal increase in assets and liabilities of approximately \$1,500,000.

Farmers and Merchants Bancshares, Inc.

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

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments – Credit Losses”. The ASU sets forth a “current expected credit loss” (CECL) model which requires the Company to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost and applies to some off-balance sheet credit exposures. This ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company has engaged a third-party vendor to assist in the implementation of this ASU.

In March 2017, the FASB issued ASU 2017-08, “Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20) – Premium Amortization on Purchased Callable Debt Securities.” ASU 2017-08 shortens the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. ASU 2017-08 will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early application permitted. The Company adopted this standard effective January 1, 2018 and it did not have a material impact on the Company’s financial statements.

In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820) - Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement.” ASU 2018-13 modifies the disclosure requirements on fair value measurements in Topic 820. The amendments in this update remove disclosures that no longer are considered cost beneficial, modify/clarify the specific requirements of certain disclosures, and add disclosure requirements identified as relevant. ASU 2018-13 will be effective for us on January 1, 2020, with early adoption permitted, and is not expected to have a material impact on the Company’s financial statements.

In August 2018, the FASB issued ASU 2018-14, “Compensation - Retirement Benefits-Defined Benefit Plans-General (Subtopic 715-20).” ASU 2018-14 amends and modifies the disclosure requirements for employers that sponsor defined benefit pension or other post-retirement plans. The amendments in this update remove disclosures that no longer are considered cost beneficial, clarify the specific requirements of disclosures, and add disclosure requirements identified as relevant. ASU 2018-14 will be effective for us on January 1, 2021, with early adoption permitted, and is not expected to have a material impact on the Company’s financial statements.

In August 2018, the FASB issued ASU 2018-15, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) - Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract.” ASU 2018-15 clarifies certain aspects of ASU 2015-05, “Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement,” which was issued in April 2015. Specifically, ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). ASU 2018-15 does not affect the accounting for the service element of a hosting arrangement that is a service contract. ASU 2018-15 will be effective for us on January 1, 2020, with early adoption permitted, and is not expected to have a material impact on the Company’s financial statements.

The accounting policies adopted by management are consistent with authoritative GAAP and are consistent with those followed by our peers.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Farmers and Merchants Bancshares, Inc.
Hampstead, Maryland

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Farmers and Merchants Bancshares, Inc. (the Company) as of December 31, 2018 and 2017, and the related statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2018, and the related notes (collectively referred to as the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits, we are required to obtain an understanding of internal control over financial reporting, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Rowles & Company, LLP

We have served as the Company's auditor since 1997.
Baltimore, Maryland
February 28, 2019

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443-725-5395 Fax 443-725-5074
Website: www.Rowles.com**

Farmers and Merchants Bancshares, Inc. and Subsidiaries
Consolidated Balance Sheets

December 31,	2018	2017
Assets		
Cash and due from banks	\$ 11,480,608	\$ 6,235,186
Federal funds sold and other interest-bearing deposits	<u>3,137,629</u>	<u>1,002,199</u>
Cash and cash equivalents	14,618,237	7,237,385
Certificate of deposit in other bank	100,000	100,000
Securities available for sale	26,591,991	27,929,510
Securities held to maturity	18,127,067	18,204,182
Equity security at fair value	503,827	503,881
Federal Home Loan Bank stock, at cost	575,800	1,063,600
Mortgage loans held for sale	573,638	327,700
Loans, less allowance for loan losses of \$2,509,334 and \$2,458,911	340,900,635	332,533,706
Premises and equipment	5,075,310	5,206,271
Accrued interest receivable	990,529	1,020,256
Deferred income taxes	1,179,454	998,032
Other real estate owned	210,150	265,500
Bank owned life insurance	7,053,354	6,891,590
Other assets	<u>657,885</u>	<u>622,856</u>
	<u>\$ 417,157,877</u>	<u>\$ 402,904,469</u>
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing	\$ 62,717,520	\$ 64,403,133
Interest-bearing	<u>291,995,483</u>	<u>255,393,291</u>
Total deposits	354,713,003	319,796,424
Securities sold under repurchase agreements	11,012,000	21,768,507
Federal Home Loan Bank of Atlanta advances	3,000,000	17,000,000
Accrued interest payable	311,489	180,620
Other liabilities	<u>2,726,678</u>	<u>2,359,986</u>
	<u>371,763,170</u>	<u>361,105,537</u>
Stockholders' equity		
Common stock, par value \$.01 per share, authorized 5,000,000 shares; issued and outstanding 1,682,997 shares in 2018 and 1,667,813 shares in 2017	16,830	16,678
Additional paid-in capital	27,324,794	26,869,796
Retained earnings	18,621,382	15,306,625
Accumulated other comprehensive loss	<u>(568,299)</u>	<u>(394,167)</u>
	<u>45,394,707</u>	<u>41,798,932</u>
	<u>\$ 417,157,877</u>	<u>\$ 402,904,469</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Consolidated Statements of Income

Years Ended December 31,	2018	2017
Interest income		
Loans, including fees	\$ 16,401,554	\$ 15,189,238
Investment securities - taxable	610,951	710,438
Investment securities - tax exempt	570,529	597,919
Federal funds sold and other interest earning assets	185,299	97,208
Total interest income	<u>17,768,333</u>	<u>16,594,803</u>
Interest expense		
Deposits	2,225,616	1,378,308
Securities sold under repurchase agreements	144,881	161,914
Federal Home Loan Bank advances and other borrowings	136,744	167,018
Total interest expense	<u>2,507,241</u>	<u>1,707,240</u>
Net interest income	15,261,092	14,887,563
Provision for loan losses	<u>475,000</u>	<u>410,000</u>
Net interest income after provision for loan losses	<u>14,786,092</u>	<u>14,477,563</u>
Noninterest income		
Service charges on deposit accounts	670,653	700,791
Mortgage banking income	271,767	279,364
Bank owned life insurance income	161,764	170,588
Unrealized loss on equity security	(11,429)	-
Write down of other real estate owned	(55,350)	(148,500)
Gain on sale of SBA loans	226,026	223,251
Other fees and commissions	101,842	111,600
Total noninterest income	<u>1,365,273</u>	<u>1,337,094</u>
Noninterest expense		
Salaries	5,194,871	4,931,432
Employee benefits	1,313,392	1,289,263
Occupancy	706,193	684,173
Furniture and equipment	632,330	644,576
Other	2,485,694	2,473,658
Total noninterest expense	<u>10,332,480</u>	<u>10,023,102</u>
Income before income taxes	5,818,885	5,791,555
Income taxes	<u>1,106,209</u>	<u>2,002,314</u>
Net income	<u>\$ 4,712,676</u>	<u>\$ 3,789,241</u>
 Earnings per share - basic and diluted	 <u>\$ 2.82</u>	 <u>\$ 2.28</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries
Consolidated Statements of Comprehensive Income

Years Ended December 31,	2018	2017
Net income	\$ 4,712,676	\$ 3,789,241
Other comprehensive income (loss), net of income taxes:		
Securities available for sale		
Net unrealized loss arising during the period	(254,609)	(81,019)
Income tax benefit	<u>70,061</u>	<u>31,958</u>
Total other comprehensive loss	<u>(184,548)</u>	<u>(49,061)</u>
Total comprehensive income	<u>\$ 4,528,128</u>	<u>\$ 3,740,180</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries
Consolidated Statements of Changes in Stockholders' Equity

	Common stock		Additional	Retained	Accumulated other	Total
	Shares	Par value	paid-in capital	earnings	comprehensive loss	stockholders' equity
Balance, December 31, 2016	1,656,390	\$ 16,564	\$ 26,562,919	\$ 12,713,099	\$ (280,305)	\$ 39,012,277
Net income	-	-	-	3,789,241	-	3,789,241
Unrealized loss on securities available for sale net of income tax benefit of \$31,958	-	-	-	-	(49,061)	(49,061)
Reclassification due to adoption of ASU No. 2018-02	-	-	-	64,801	(64,801)	-
Cash dividends, \$0.76 per share	-	-	-	(1,260,516)	-	(1,260,516)
Dividends reinvested	11,423	114	306,877	-	-	306,991
Balance, December 31, 2017	1,667,813	16,678	26,869,796	15,306,625	(394,167)	41,798,932
Net income	-	-	-	4,712,676	-	4,712,676
Unrealized loss on securities available for sale net of income tax benefit of \$70,061	-	-	-	-	(184,548)	(184,548)
Reclassification due to adoption of ASU No. 2016-01	-	-	-	(10,416)	10,416	-
Shares issued	50	1	1,549	-	-	1,550
Cash dividends, \$0.83 per share	-	-	-	(1,387,503)	-	(1,387,503)
Dividends reinvested	15,134	151	453,449	-	-	453,600
Balance, December 31, 2018	1,682,997	\$ 16,830	\$ 27,324,794	\$ 18,621,382	\$ (568,299)	\$ 45,394,707

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Years Ended December 31,	2018	2017
Cash flows from operating activities		
Interest received	\$ 17,714,259	\$ 16,646,808
Fees and commissions received	1,044,262	1,093,256
Interest paid	(2,376,372)	(1,668,523)
Proceeds from sale of mortgage loans held for sale	13,093,197	13,063,992
Origination of mortgage loans held for sale	(13,339,135)	(12,507,192)
Cash paid to suppliers and employees	(9,372,508)	(7,773,163)
Income taxes paid	(1,399,920)	(1,170,196)
Cash provided by operating activities	<u>5,363,783</u>	<u>7,684,982</u>
Cash flows from investing activities		
Proceeds from maturity and call of securities		
Available for sale	4,943,748	6,854,680
Held to maturity	223,000	1,612,309
Purchase of securities		
Available for sale	(4,007,664)	(1,132,224)
Held to maturity	(122,313)	(1,805,924)
Loans made to customers, net of principal collected	(11,427,440)	(40,409,645)
Proceeds from sale of SBA loans	2,883,963	2,849,724
Redemption (purchase) of stock in FHLB of Atlanta	487,800	(285,300)
Purchases of premises, equipment and software	(191,744)	(114,243)
Cash used by investing activities	<u>(7,210,650)</u>	<u>(32,430,623)</u>
Cash flows from financing activities		
Net increase (decrease) in		
Noninterest-bearing deposits	(1,685,613)	1,611,298
Interest-bearing deposits	36,602,192	15,469,990
Securities sold under repurchase agreements	(10,756,507)	(5,457,652)
Federal Home Loan Bank of Atlanta advances	(14,000,000)	8,000,000
Dividends paid, net of reinvestments	(933,903)	(953,525)
Common stock issued	1,550	-
Cash provided by financing activities	<u>9,227,719</u>	<u>18,670,111</u>
Net increase (decrease) in cash and cash equivalents	<u>7,380,852</u>	<u>(6,075,530)</u>
Cash and cash equivalents at beginning of period	<u>7,237,385</u>	<u>13,312,915</u>
Cash and cash equivalents at end of period	<u>\$ 14,618,237</u>	<u>\$ 7,237,385</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries
Consolidated Statements of Cash Flows

Years Ended December 31,	2018	2017
Reconciliation of net income to net cash provided by operating activities		
Net income	\$ 4,712,676	\$ 3,789,241
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	380,461	419,281
Provision for loan losses	475,000	410,000
Write down of other real estate owned	55,350	148,500
Write down of other assets	4,500	1,500
Equity security dividends reinvested	(11,375)	(10,740)
Unrealized loss on equity security	11,429	-
Gain on sale of SBA loans	(226,026)	(223,251)
Deferred income taxes	(111,360)	(347,446)
Revaluation of deferred tax asset due to change in corporate income tax rate	-	410,391
Amortization of premiums and accretion of discounts, net	123,253	136,874
Increase (decrease) in		
Deferred loan fees	(72,426)	126,038
Accrued interest payable	130,869	38,717
Other liabilities	366,692	624,102
Decrease (increase) in		
Mortgage loans held for sale	(245,938)	556,800
Accrued interest receivable	29,727	(63,293)
Bank owned life insurance cash surrender value	(161,764)	(170,587)
Other assets	(97,285)	1,838,855
Cash provided by operating activities	<u>\$ 5,363,783</u>	<u>\$ 7,684,982</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

The accounting and reporting policies reflected in the financial statements conform to accounting principles generally accepted in the United States of America 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 Bancshares, Inc. and its wholly owned subsidiaries, Farmers and Merchants Bank (the “Bank”), and Series Protected Cell FCB-4 (the “Insurance Subsidiary”), and one subsidiary of the Bank, Reliable Community Financial Services, Inc. (collectively the “Company”, “we”, “us”, or “our”). The Insurance Subsidiary is a series investment, 100% owned by the Company, in First Community Bankers Insurance Co., LLC, a Tennessee “series” limited liability company and licensed property and casualty insurance company. Intercompany balances and transactions have been eliminated.

Business

Farmers and Merchants Bank provides banking services to individuals and businesses located in Baltimore County, Maryland, Carroll County, Maryland and surrounding areas of northern Maryland. The Insurance Subsidiary is a captive insurance entity that provides insurance coverage for Farmers and Merchants Bank. Reliable Community Financial Services, Inc. is licensed to provide a wide range of investment and insurance products to its customers, but is inactive.

Reclassifications

Certain reclassifications have been made to the 2017 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 losses 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. Discounts are accreted through maturity. Premiums are amortized through the earliest call date. 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 Company amortizes premiums and accretes discounts using the interest method.

Equity security at fair value

On January 1, 2018, the Company adopted the new accounting standard for financial instruments, which requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The adoption of this guidance resulted in a \$10,416 decrease to retained earnings and a \$10,416 increase to accumulated other comprehensive loss during the year ended December 31, 2018.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

Summary of Significant Accounting Policies (Continued)

Federal Home Loan Bank stock

As a member of the Federal Home Loan Bank of Atlanta (the “FHLB”), the Bank is required to purchase FHLB stock in an amount that is based on the Bank’s total assets. Additional stock is purchased and redeemed based on the outstanding FHLB advances to the Bank. The stock is recorded at cost on the balance sheet.

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.

Past due status is based on the contractual terms of the loan. Management may make an exception to reporting a loan as past due, if the past due status is solely due to the loan being past maturity, the Company intends to extend the loan, and the borrower is making principal and interest payments in accordance with the terms of the matured note. 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. If collection of principal is evaluated as doubtful, all payments are applied to principal. 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 the loans are included on the watch list.

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 Company’s allowance for loan losses consists of three elements: (i) specific valuation allowances determined based on probable losses on impaired loans; (ii) historical valuation allowances determined based on historical loan loss experience for impaired 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 Company.

The allowances established for probable losses on impaired 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 when the collateral value, if the loan is collateral dependent, or the discounted cash flows of the impaired loan is lower than the carrying value.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans. The Company 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 to twenty quarters. As of December 31, 2018 and 2017, management used a twenty quarter period for the historical loss ratio. 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 Company. 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 as well as changes to policies and

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

Summary of Significant Accounting Policies (Continued)

experience of loan personnel. 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.

Mortgage loans held for sale and mortgage banking income

Mortgage loans held for sale are carried at the lower of aggregate cost or fair value based on the current fair 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.

The Company sells its mortgage loans to third party investors servicing released. Upon sale and delivery, loans are legally isolated from the Company and the Company has no ability to restrict or constrain the ability of third party investors to pledge or exchange the mortgage loans. The Company does not have the entitlement or ability to repurchase the mortgage loans or unilaterally cause third party investors to put the mortgage loans back to the Company.

Premises and equipment

Land is carried at cost. 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 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 with any gains or losses on sale in noninterest income.

Bank owned life insurance

The Company has purchased life insurance policies on certain key executives. Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Revenue Recognition

On January 1, 2018, the Company adopted Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU") 2014-09 Revenue from Contracts with Customers and all subsequent amendments to the standard which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as other real estate owned. The majority of the Company's revenues come from interest income and other sources, including loans and securities, that are outside the scope of the standard. The Company's services that fall within the scope of standard are presented within noninterest revenue and are recognized as revenue as the Company satisfies its obligation to the customer. Services within the scope of the standard include service charges on deposits, interchange income, and the sale of other real estate owned. The implementation of the standard had no significant impact on our financial statements.

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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

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 1,671,789 and 1,658,384 for 2018 and 2017, respectively. Diluted earnings per share is derived by dividing net income available by the weighted-average number of shares outstanding, adjusted for the dilutive effect of outstanding common stock equivalents. There are no potentially dilutive stock equivalents outstanding at December 31, 2018 or 2017.

Subsequent events

The Company has evaluated events and transactions occurring subsequent to the statement of financial condition date of December 31, 2018 for items that should potentially be recognized or disclosed in these financial statements as prescribed by FASB Accounting Standards Codification Topic 855, Subsequent Events.

2. Cash and Cash Equivalents

The Company normally carries balances with other banks that exceed the federally insured limit. The average balance carried in excess of the limit, including unsecured federal funds sold to the same banks, was \$5,349,977 and \$5,991,573 during the years ended December 31, 2018 and 2017, respectively.

Deposits held in noninterest-bearing transaction accounts are aggregated with any interest-bearing deposits the owner may hold in the same category. The combined total is insured up to \$250,000.

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

3. Investment Securities

Investment securities are summarized as follows:

December 31, 2018	Amortized cost	Unrealized gains	Unrealized losses	Fair value
<i>Available for sale</i>				
State and municipal	\$ 1,506,011	\$ 11,161	\$ 10,667	\$ 1,506,505
SBA pools	2,779,411	-	60,039	2,719,372
Mortgage-backed securities	23,090,618	33,594	758,098	22,366,114
	<u>\$ 27,376,040</u>	<u>\$ 44,755</u>	<u>\$ 828,804</u>	<u>\$26,591,991</u>
<i>Held to maturity</i>				
State and municipal	<u>\$ 18,127,067</u>	<u>\$ 115,220</u>	<u>\$ 209,194</u>	<u>\$18,033,093</u>
December 31, 2017				
<i>Available for sale</i>				
State and municipal	\$ 1,510,848	\$ 38,494	\$ 10,135	\$ 1,539,207
SBA pools	3,212,771	75	13,000	3,199,846
Mortgage-backed securities	23,735,332	8,787	553,662	23,190,457
	<u>\$ 28,458,951</u>	<u>\$ 47,356</u>	<u>\$ 576,797</u>	<u>\$ 27,929,510</u>
<i>Held to maturity</i>				
State and municipal	<u>\$ 18,204,182</u>	<u>\$ 225,349</u>	<u>\$ 121,904</u>	<u>\$ 18,307,627</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

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.

December 31, 2018	Available for Sale		Held to Maturity	
	Amortized cost	Fair value	Amortized cost	Fair value
Within one year	\$ 375,000	\$ 375,653	\$ 1,009,284	\$ 1,011,165
Over one to five years	260,587	249,920	590,522	598,528
Over five to ten years	870,424	880,932	1,858,695	1,876,364
Over ten years	-	-	14,668,566	14,547,036
	<u>1,506,011</u>	<u>1,506,505</u>	<u>18,127,067</u>	<u>18,033,093</u>
Mortgage-backed securities and SBA pools, due in monthly installments	<u>25,870,029</u>	<u>25,085,486</u>	-	-
	<u>\$ 27,376,040</u>	<u>\$ 26,591,991</u>	<u>\$ 18,127,067</u>	<u>\$ 18,033,093</u>
December 31, 2017				
Within one year	\$ -	\$ -	\$ 165,677	\$ 168,260
Over one to five years	-	-	780,336	794,512
Over five to ten years	1,133,940	1,150,564	1,792,019	1,831,833
Over ten years	376,908	388,643	15,466,150	15,513,022
	<u>1,510,848</u>	<u>1,539,207</u>	<u>18,204,182</u>	<u>18,307,627</u>
Mortgage-backed securities and SBA pools, due in monthly installments	<u>26,948,103</u>	<u>26,390,303</u>	-	-
	<u>\$ 28,458,951</u>	<u>\$ 27,929,510</u>	<u>\$ 18,204,182</u>	<u>\$ 18,307,627</u>

Securities with a carrying value of **\$11,706,765** and \$31,982,381 as of December 31, 2018 and 2017, respectively, were pledged as collateral for securities sold under repurchase agreements, municipal deposits, and borrowings.

In 2018 and 2017, the Company had no security sales.

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

December 31, 2018	Less than 12 months		12 months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
State and municipal	\$ 3,435,052	\$ 42,080	\$ 3,740,467	\$ 177,781	\$ 7,175,519	\$ 219,861
SBA pools	443,288	6,707	2,276,084	53,332	2,719,372	60,039
Mortgage-backed securities	596,002	6,631	17,770,790	751,467	18,366,792	758,098
Total	<u>\$ 4,474,342</u>	<u>\$ 55,418</u>	<u>\$ 23,787,341</u>	<u>\$ 982,580</u>	<u>\$ 28,261,683</u>	<u>\$ 1,037,998</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

3. Investment Securities (Continued)

December 31, 2017	Less than 12 months		12 months or more		Total	
Description of investments	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
State and municipal	\$ 812,630	\$ 1,519	\$ 3,444,443	\$ 130,520	\$ 4,257,073	\$ 132,039
SBA pools	551,780	1,903	2,109,832	11,097	2,661,612	13,000
Mortgage-backed securities	2,871,597	41,413	19,571,511	512,249	22,443,108	553,662
Total	<u>\$ 4,236,007</u>	<u>\$ 44,835</u>	<u>\$ 25,125,786</u>	<u>\$ 653,866</u>	<u>\$ 29,361,793</u>	<u>\$ 698,701</u>

Management has the ability and intent to hold securities classified as held to maturity until they mature, at which time the Company should receive full value for the securities. As of December 31, 2018, management did not have the intent to sell any of the securities 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 these factors, as of December 31, 2018, management believes the unrealized losses detailed in the table above are temporary and, accordingly, none of these unrealized losses have been recognized in the Company's consolidated statement of income.

4. Related Party Transactions

Certain executive officers and directors of the Company, including members of their immediate families and companies in which they are significant owners (more than 10%), were indebted to the Company. 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 Company. During the years ended December 31, 2018 and 2017, the activity of these loans was as follows:

	2018	2017
Balance, beginning of year	\$ 15,577,316	\$ 12,782,233
Additions	2,069,000	5,921,920
Amounts collected	(2,669,653)	(3,126,837)
Change in related parties	(1,021,566)	-
Balance, end of year	<u>\$ 13,955,097</u>	<u>\$ 15,577,316</u>

Unused lines of credit to related parties totaled **\$634,724** and \$746,842 at December 31, 2018 and 2017, respectively. Letters of credit were issued to directors totaling **\$0** and \$6,534 at December 31, 2018 and 2017, respectively.

Deposits at the Company from related parties totaled **\$14,665,183** and \$18,592,732 at December 31, 2018 and 2017, respectively.

Payments to companies controlled by directors totaled **\$4,144** in 2018 and \$10,278 in 2017.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans

Major categories of loans at December 31, 2018 and 2017 are as follows:

	2018	2017
Real estate:		
Commercial	\$ 238,834,149	\$ 234,026,574
Construction and land development	18,265,505	18,160,366
Residential	63,024,106	59,241,416
Commercial	23,323,073	23,613,543
Consumer	494,009	554,017
	<u>343,940,842</u>	<u>335,595,916</u>
Less: Allowance for loan losses	2,509,334	2,458,911
Deferred origination fees net of costs	530,873	603,299
	<u>\$ 340,900,635</u>	<u>\$ 332,533,706</u>

The maturity and rate repricing distribution of the loan portfolio as of December 31, 2018 and 2017, is as follows:

	2018	2017
Variable rate, immediately	\$ 65,523,966	\$ 55,901,161
Due within one year	42,060,188	42,042,744
Due over one to five years	153,190,636	136,475,036
Due over five years	83,166,052	101,176,975
	<u>\$ 343,940,842</u>	<u>\$ 335,595,916</u>

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

	2018	2017
Commercial real estate	<u>\$ 988,811</u>	<u>\$ 2,245,743</u>

At December 31, 2018, the Company had **two** nonaccrual commercial real estate loans to the same borrower totaling **\$988,811**. The loans were secured by real estate and business assets and were personally guaranteed. Gross interest income of **\$115,168** would have been recorded in 2018 if these nonaccrual loans had been current and performing in accordance with the original terms. The Company allocated **\$0** of its allowance for loan losses to these nonaccrual loans. The balance of the nonaccrual loans was net of charge-offs of **\$690,000** at December 31, 2018.

At December 31, 2017, the Company had one nonaccrual commercial real estate loan totaling \$2,245,743. The loan was secured by real estate and business assets, and was personally guaranteed. Gross interest income of \$82,070 would have been recorded in 2017 if this nonaccrual loan had been current and performing in accordance with the original terms. The Company allocated \$127,213 of its allowance for loan losses to this nonaccrual loan. The balance of the nonaccrual loan was net of charge-offs of \$275,000 at December 31, 2017. This nonaccrual loan was paid off in 2018 with a recovery of \$197,660.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

An age analysis of past due loans, segregated by class of loans, as of year-end, 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 90 Days or More and Accruing
December 31, 2018							
Real estate:							
Commercial	\$ -	\$ -	\$ 988,811	\$ 988,811	\$ 237,845,338	\$ 238,834,149	\$ -
Construction and land development	-	-	-	-	18,265,505	18,265,505	-
Residential	-	-	10,507	10,507	63,013,599	63,024,106	10,507
Commercial	-	25,000	-	25,000	23,298,073	23,323,073	-
Consumer	-	-	-	-	494,009	494,009	-
Total	<u>\$ -</u>	<u>\$ 25,000</u>	<u>\$ 999,318</u>	<u>\$ 1,024,318</u>	<u>\$ 342,916,524</u>	<u>\$ 343,940,842</u>	<u>\$ 10,507</u>
December 31, 2017							
Real estate:							
Commercial	\$ -	\$ -	\$ 2,245,743	\$ 2,245,743	\$ 231,780,831	\$ 234,026,574	\$ -
Construction and land development	-	-	-	-	18,160,366	18,160,366	-
Residential	-	-	146,459	146,459	59,094,957	59,241,416	146,459
Commercial	-	-	-	-	23,613,543	23,613,543	-
Consumer	-	-	-	-	554,017	554,017	-
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,392,202</u>	<u>\$ 2,392,202</u>	<u>\$ 333,203,714</u>	<u>\$ 335,595,916</u>	<u>\$ 146,459</u>

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	Interest Recognized
December 31, 2018							
Commercial real estate	<u>\$ 3,867,381</u>	<u>\$ 3,177,381</u>	<u>\$ -</u>	<u>\$ 3,177,381</u>	<u>\$ -</u>	<u>\$ 4,180,282</u>	<u>\$ 120,193</u>
December 31, 2017							
Commercial real estate	<u>\$ 5,458,182</u>	<u>\$ 2,937,439</u>	<u>\$ 2,245,743</u>	<u>\$ 5,183,182</u>	<u>\$ 127,213</u>	<u>\$ 2,591,591</u>	<u>\$ 268,652</u>

Impaired loans include certain loans that have been modified in troubled debt restructurings (“TDRs”) where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

At December 31, 2018, the Company had **one** commercial real estate loan totaling **\$2,134,570** and **one** residential loan totaling **\$54,000** classified as TDRs. The **\$54,000** loan was restructured as a TDR during 2018. All are included in impaired loans above. Each loan is paying as agreed. There have been no charge-offs or allowances associated with these **two** loans.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

At December 31, 2017, the Company had three commercial real estate loans totaling \$2,937,439 classified as TDRs. Two loans totaling \$774,274 were restructured as TDRs during 2017. All are included in impaired loans above. Two of the loans paid off in 2018. There have been no charge-offs or allowances associated with these three loans.

As part of our portfolio risk management, the Company assigns a risk grade to each loan. 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, Average and Acceptable grades are assigned to loans with limited or no delinquent payments and more than sufficient collateral and/or cash flow.

A description of the general characteristics of loans characterized as watch list or classified is as follows:

Pass/Watch

Loans graded as Pass/Watch are secured by generally acceptable assets which reflect above-average risk. The loans warrant closer scrutiny by management than is routine, due to circumstances affecting the borrower, the borrower's industry, or the overall economic environment. Borrowers may reflect weaknesses such as inconsistent or weak earnings, break even or moderately deficit cash flow, thin liquidity, minimal capacity to increase leverage, or volatile market fundamentals or other industry risks. Such loans are typically secured by acceptable collateral, at or near appropriate margins, with realizable liquidation values.

Special Mention

A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. Special mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification. This classification is intended to be temporary while the Bank learns more about the condition of the borrower and the collateral.

Borrowers may exhibit poor liquidity and leverage positions resulting from generally negative cash flow or negative trends in earnings. Access to alternative financing may be limited to finance companies for business borrowers and may be unavailable for commercial real estate borrowers.

Substandard

A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard loans have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Borrowers may exhibit recent or unexpected unprofitable operations, an inadequate debt service coverage ratio, or marginal liquidity and capitalization. These loans require more intense supervision by Bank management.

Doubtful

A doubtful loan has all the weaknesses inherent as a substandard loan with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

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

December 31, 2018	Excellent	Above average	Average	Acceptable	Pass watch	Special mention	Substandard	Doubtful	Total
Real estate:									
Commercial	\$ -	\$ 3,632,231	\$101,633,803	\$104,454,812	\$ 20,356,642	\$ -	\$ 8,756,661	\$ -	\$ 238,834,149
Construction and land development	-	-	8,190,212	7,871,642	2,203,651	-	-	-	18,265,505
Residential	35,926	1,178,899	26,856,131	30,169,305	2,093,825	-	2,690,020	-	63,024,106
Commercial	977,054	24,180	12,373,503	7,130,122	2,818,214	-	-	-	23,323,073
Consumer	3,668	80,670	266,704	63,160	-	-	1,340	78,467	494,009
	<u>\$ 1,016,648</u>	<u>\$ 4,915,980</u>	<u>\$149,320,353</u>	<u>\$149,689,041</u>	<u>\$ 27,472,332</u>	<u>\$ -</u>	<u>\$ 11,448,021</u>	<u>\$ 78,467</u>	<u>\$ 343,940,842</u>

December 31, 2017	Excellent	Above average	Average	Acceptable	Pass watch	Special mention	Substandard	Doubtful	Total
Real estate:									
Commercial	\$ -	\$ 6,115,925	\$127,639,361	\$ 79,619,726	\$ 9,041,882	\$ 5,391,589	\$ 3,972,348	\$ 2,245,743	\$ 234,026,574
Construction and land development	-	173,633	9,288,372	4,978,964	3,719,397	-	-	-	18,160,366
Residential	53,948	1,260,128	35,254,016	18,659,174	3,363,570	-	650,580	-	59,241,416
Commercial	1,581,878	121,919	16,225,350	5,545,562	138,834	-	-	-	23,613,543
Consumer	5,210	96,484	351,093	70,171	-	-	2,640	28,419	554,017
	<u>\$ 1,641,036</u>	<u>\$ 7,768,089</u>	<u>\$188,758,192</u>	<u>\$108,873,597</u>	<u>\$ 16,263,683</u>	<u>\$ 5,391,589</u>	<u>\$ 4,625,568</u>	<u>\$ 2,274,162</u>	<u>\$ 335,595,916</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

5. Loans (Continued)

The following tables detail activity in the allowance for loan losses by portfolio for the years ended December 31, 2018 and 2017. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

		Provision				Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
December 31, 2018	Beginning balance	for loan losses	Charge offs	Recoveries	Ending balance	Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,867,397	\$ 372,315	\$ (690,000)	\$ 204,660	\$ 1,754,372	\$ -	\$ 1,754,372	\$ 3,177,381	\$235,656,768
Construction and									
land development	223,274	(78,496)	(12,115)	63,711	196,374	-	196,374	-	18,265,505
Residential	247,953	153,673	-	-	401,626	-	401,626	-	63,024,106
Commercial	87,353	6,090	-	9,167	102,610	-	102,610	-	23,323,073
Consumer	7,027	3,401	-	-	10,428	-	10,428	-	494,009
Unallocated	25,907	18,017	-	-	43,924	-	43,924	-	-
	\$ 2,458,911	\$ 475,000	\$ (702,115)	\$ 277,538	\$ 2,509,334	\$ -	\$ 2,509,334	\$ 3,177,381	\$340,763,461

		Provision				Allowance for loan losses		Outstanding loan	
	Beginning	for loan	Charge		Ending	ending balance evaluated		balances evaluated	
						for impairment:		for impairment:	
December 31, 2017	balance	losses	offs	Recoveries	balance	Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,717,749	\$ 419,868	\$ (275,000)	\$ 4,780	\$ 1,867,397	\$ 127,213	\$ 1,740,184	\$ 5,183,182	\$ 228,843,392
Construction and									
land development	204,860	65,850	(47,436)	-	223,274	-	223,274	-	18,160,366
Residential	247,437	368	-	148	247,953	-	247,953	-	59,241,416
Commercial	125,260	(41,240)		3,333	87,353	-	87,353		23,613,543
Consumer	8,826	(1,799)	-	-	7,027	-	7,027	-	554,017
Unallocated	58,954	(33,047)	-	-	25,907	-	25,907	-	-
	\$ 2,363,086	\$ 410,000	\$ (322,436)	\$ 8,261	\$ 2,458,911	\$ 127,213	\$ 2,331,698	\$ 5,183,182	\$ 330,412,734

Loans with a balance of approximately \$63 million were pledged as collateral to the FHLB as of December 31, 2018. Loans with a balance of approximately \$51 million were pledged as collateral to the Federal Reserve Bank of Richmond (the "FRB") as of December 31, 2018. At December 31, 2018 and 2017, the Company serviced participation loans for others totaling \$30.0 and \$31.7 million, respectively.

The Company 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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

6. Premises and Equipment

A summary of premises and equipment is as follows:

	Useful lives	2018	2017
Land and improvements	-	\$ 1,952,998	\$ 1,952,998
Buildings and improvements	15-39 years	5,659,635	5,659,635
Furniture and equipment	3-10 years	3,796,514	3,604,769
		<u>11,409,147</u>	<u>11,217,402</u>
Accumulated depreciation and amortization		<u>6,333,837</u>	<u>6,011,131</u>
		<u>\$ 5,075,310</u>	<u>\$ 5,206,271</u>
Depreciation and amortization expense		<u>\$ 322,705</u>	<u>\$ 357,650</u>

Software with a net book value of **\$73,022** and \$126,538 as of December 31, 2018 and 2017, respectively, is included in other assets. Amortization expense of **\$57,756** and \$61,631 was recorded in 2018 and 2017, respectively.

7. Commitments and Contingencies

Lease Commitments

The Company 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 has been renewed for two five year terms with an expiration date of September 30, 2019. The lease has options to renew for six additional consecutive five-year terms. Effective in July 2012, the Company entered into an operating lease for certain facilities where the Greenmount branch is located. The initial term of the lease was for five years and, effective January 2018, the lease has been renewed for one five-year term with an option to renew for an additional five-year term. The Company 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 2018 for another year. The Company entered into an operating lease for the corporate headquarters in September 2015. The lease expires in September 2020 with options to renew for four additional consecutive five year terms. In May 2018, the Company entered into a lease for its Carroll Lutheran Village branch with a term of five years and the option to renew for two additional five year terms.

Future minimum payments under the agreements including those option years for which the Company is reasonably certain to renew are as follows:

Year	Amount
2019	\$ 137,383
2020	141,680
2021	146,120
2022	150,707
2023	155,447
Thereafter	<u>911,769</u>
	<u>\$ 1,643,106</u>

Rent expense was **\$138,778** and \$130,608 in 2018 and 2017, respectively.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

7. Commitments and Contingencies (continued)

Credit Commitments

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

	2018	2017
Loan commitments		
Construction and land development	\$ 6,800,240	\$ -
Commercial	1,143,217	1,295,000
Commercial real estate	2,853,913	7,478,500
Residential	1,557,500	660,000
	<u>\$12,354,870</u>	<u>\$ 9,433,500</u>
Unused lines of credit		
Home-equity lines	\$ 3,594,847	\$ 3,390,515
Commercial lines	23,389,326	36,614,548
	<u>\$26,984,173</u>	<u>\$ 40,005,063</u>
Letters of credit	<u>\$ 1,905,553</u>	<u>\$ 1,827,513</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.

Insurance Reserves

The Insurance Subsidiary insures risks of the Bank (primarily professional liability) that are not available in typical commercially available policies. In addition, the Insurance Subsidiary, as one protected cell of a protected cell captive insurance company ("CIC"), is responsible for a portion of all claims filed by the other protected cells in the CIC. The Company records liabilities for claims incurred but not reported based on historical loss information and claim emergence patterns. Total liabilities related to Insurance Subsidiary claims at December 31, 2018 and 2017 were \$48,618 and \$27,413, respectively, and are included in other liabilities in the Consolidated Balance Sheet.

8. Retirement Plans

The Company 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 are eligible for participation in the plan. The Company 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 Company's contributions to this plan were \$173,848 and \$170,142 for 2018 and 2017, respectively.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

8. Retirement Plans (Continued)

The Company 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 Company. Each of the agreements provides for the amount of death insurance benefits to be paid to beneficiaries of the insured. For this plan, the Company expensed **\$5,673** and \$5,228 in 2018 and 2017, respectively.

The Company adopted supplemental executive retirement plans for three of its executives. The plans provide cash compensation to the executive officers under certain circumstances, including a separation of service. The benefits vest over the period from adoption to a specified age for each executive. The Company recorded expenses, including interest, of **\$240,609** and \$255,859 in 2018 and 2017, respectively, for these plans.

Retirement plan expenses are included in employee benefits on the Consolidated Statements of Income.

9. Interest-Bearing Deposits

Major classifications of interest-bearing deposits are as follows:

	2018	2017
NOW	\$ 56,293,730	\$ 43,536,401
Money market	54,995,415	53,750,747
Savings	43,638,363	43,903,240
Certificates of deposit, \$250,000 or more	23,335,007	15,896,054
Other time deposits	113,732,968	98,306,849
	<u>\$291,995,483</u>	<u>\$ 255,393,291</u>

As of December 31, 2018, certificates of deposit mature as follows:

<u>Year</u>	<u>Amount</u>
2019	\$ 84,831,543
2020	30,056,739
2021	13,382,329
2022	2,477,962
2023	6,302,390
Thereafter	17,012
	<u>\$137,067,975</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

10. Borrowed Funds

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

	2018	2017
Amounts outstanding at year-end:		
Securities sold under repurchase agreements	\$ 11,012,000	\$ 21,768,507
Federal Home Loan Bank advances are summarized as follows:		
	<u>Maturity date</u>	<u>Interest Rate</u>
	1/16/2018	1.13%
	1/30/2018	1.25%
	2/12/2018	1.14%
	3/15/2018	1.17%
	5/24/2018	1.26%
	6/28/2018	1.69%
	8/13/2018	1.32%
	9/23/2019	1.25%
	11/22/2019	1.99%
	Total	
	\$ 3,000,000	\$ 17,000,000
Weighted average rate paid at December 31:		
Securities sold under repurchase agreements	1.07%	0.65%
Federal Home Loan Bank advances	1.50%	1.35%
Maximum month-end amount outstanding during the year ended December 31:		
Securities sold under repurchase agreements	\$ 22,173,010	\$ 30,786,064
Federal Home Loan Bank advances	19,000,000	18,000,000
Average amount outstanding during the year ended December 31:		
Securities sold under repurchase agreements	\$ 17,479,418	\$ 24,702,931
Federal Home Loan Bank advances	8,795,890	13,846,575
Borrowings from FRB and commercial banks	249,047	78,082
Average rate paid during the year ended December 31:		
Securities sold under repurchase agreements	0.83%	0.66%
Federal Home Loan Bank advances	1.50%	1.20%
Borrowings from FRB and commercial banks	1.93%	1.64%
Investment securities underlying the repurchase agreements at December 31:		
Carrying value	\$ 11,706,765	\$ 22,363,793
Estimated fair value	11,710,458	22,484,092
Loans and investment securities pledged to the Federal Home Loan Bank at December 31:		
Carrying value - loans	\$ 63,305,452	\$ 68,406,154
Carrying value - investment securities	-	4,749,970
Loans pledged to the Federal Reserve Bank at December 31:		
Carrying value	\$ 50,682,236	\$ 40,717,623

The Company is approved to borrow approximately \$46.4 million against eligible pledged single family residential loans, eligible pledged multi-family loans, eligible pledged commercial loans, and eligible pledged securities under a secured line of credit with the FHLB. In addition, the Company has a facility with the FRB whereby the Company can borrow up to \$25.6 million. The Company also has available an unsecured federal funds line of credit of \$9.5 million and a secured federal funds line of credit of \$9 million from commercial banks.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

11. Other Noninterest Expenses

Other noninterest expenses include the following:

	2018	2017
Professional services	\$ 400,759	\$ 452,846
Advertising	237,508	236,564
Automated teller machine and debit card expenses	210,644	285,912
Directors fees	197,116	178,796
Telephone	193,631	179,329
Stationery, printing, and supplies	190,057	170,301
Postage, delivery, and armored carrier	179,677	172,607
Internet banking fees	155,208	157,962
Federal Deposit Insurance Corporation premiums	125,143	125,943
Correspondent bank services	94,763	84,119
Travel and conferences	50,553	51,509
Maryland state regulatory assessment	47,967	44,897
Insurance claims	47,726	27,413
Dues and subscriptions	44,603	39,574
Liability insurance	43,414	49,332
Other real estate owned	42,762	24,441
Remote deposit expenses	31,923	30,895
Credit reports	26,860	23,450
Payroll preparation	21,652	19,406
Other	143,728	118,362
	<u>\$ 2,485,694</u>	<u>\$ 2,473,658</u>

12. Income Taxes

The components of income tax expense are as follows:

	2018	2017
Current		
Federal	\$ 834,327	\$ 1,532,959
State	383,242	406,410
	<u>1,217,569</u>	<u>1,939,369</u>
Revaluation of deferred tax asset due to change in corporate tax rate	-	410,391
Deferred	<u>(111,360)</u>	<u>(347,446)</u>
	<u>\$ 1,106,209</u>	<u>\$ 2,002,314</u>

The Tax Cuts and Jobs Act reduced the Company's federal corporate income tax rate from 34% to 21% beginning in 2018. Because the legislation was passed in 2017, the Company was required to revalue its net deferred tax asset in 2017 using the 21% rate resulting in additional income tax expense in 2017. The Company recorded net income tax expense of \$410,391 related to this revaluation. Of this amount, \$64,801 was attributable to the Company's net deferred tax asset for unrealized losses on available for sale securities. In addition to adjusting the deferred tax asset for this item, the Company recorded an adjustment to accumulated other comprehensive income with a transfer to retained earnings.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

12. Income Taxes (Continued)

The components of the deferred tax expense are as follows:

	2018	2017
Depreciation	\$ (6,049)	\$ (62,449)
Provision for loan losses	287	(132,991)
Other real estate owned allowance for loss	(15,231)	(58,576)
Nonaccrual interest	(8,888)	(3,633)
Prepaid captive insurance premium	(9,325)	13,781
Write-down of equity securities	(4,383)	(592)
Post-retirement benefits	(67,771)	(102,986)
	<u>\$(111,360)</u>	<u>\$ (347,446)</u>

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

Deferred tax assets		
Allowance for loan losses	\$ 626,841	\$ 627,127
Other real estate owned allowance for loss	228,354	213,123
Write-down of equity securities	12,631	4,265
Nonaccrual interest	31,692	22,804
Post-retirement benefits	502,661	434,891
Unrealized loss on securities available for sale	215,751	149,671
	<u>1,617,930</u>	<u>1,451,881</u>
Deferred tax liabilities		
Prepaid captive insurance premium	273,665	282,990
Depreciation	164,811	170,859
	<u>438,476</u>	<u>453,849</u>
Net deferred tax asset	<u>\$1,179,454</u>	<u>\$ 998,032</u>

The differences between the federal income tax rate in effect each year and the effective tax rate for the Company are reconciled as follows:

Statutory federal income tax rate	21.0 %	34.0 %
Increase (decrease) resulting from:		
Federal tax-exempt income	(6.5)	(10.8)
State income taxes, net of federal income tax benefit	4.7	3.9
Nondeductible expenses	0.1	0.1
Revaluation of deferred tax asset due to change in corporate tax rate	-	7.1
Other	(0.3)	0.3
	<u>19.0 %</u>	<u>34.6 %</u>

Included in Federal tax-exempt income is the insurance premium revenue of the Insurance Subsidiary.

The Company does not have material uncertain tax positions and did not recognize any adjustments for unrecognized tax benefits. The Company remains subject to examination of income tax returns for the years ending after December 31, 2014.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

13. Capital Standards

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

The Basel III Capital Rules became effective for the Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of Common Equity Tier 1 capital, Tier 1 capital, and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

In connection with the adoption of the Basel III Capital Rules, the Bank elected to opt-out of the requirement to include accumulated other comprehensive income in Common Equity Tier 1 capital. Common Equity Tier 1 capital for the Bank is reduced by goodwill and other intangible assets, net of associated deferred tax liabilities and subject to transition provisions.

Under the revised prompt corrective action requirements, as of January 1, 2015, insured depository institutions are required to meet the following in order to qualify as "well capitalized:" (1) a Common Equity Tier 1 risk-based capital ratio of 6.5%; (2) a Tier 1 risk-based capital ratio of 8%; (3) a total risk-based capital ratio of 10%; and (4) a Tier 1 leverage ratio of 5%.

The implementation of the capital conservation buffer began on January 1, 2016, at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have current applicability to the Bank. Management believes that, as of December 31, 2018, the Bank met all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

The following table presents actual and required capital ratios as of December 31, 2018 and 2017, for the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2018 and 2017, based on the phase-in provisions of the Basel III Capital Rules. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

As of December 31, 2018, the most recent notification from the FDIC has categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain ratios as set forth in the table. There have been no conditions or events since that notification that management believes have changed the Bank's category.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

13. Capital Standards (Continued)

The FDIC, through formal or informal agreement, has the authority to require an institution to maintain higher capital ratios than those provided by statute, to be categorized as well capitalized under the regulatory framework for prompt corrective action. The following table presents actual and required capital ratios as of December 31, 2018 and 2017, for the Bank under the Basel III Capital Rules.

(Dollars in thousands) December 31, 2018	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)	\$ 47,857	13.50%	\$ 34,996	9.88%	\$ 35,439	10.00%
Tier 1 capital (to risk-weighted assets)	45,348	12.80%	27,908	7.88%	28,351	8.00%
Common equity tier 1 (to risk-weighted assets)	45,348	12.80%	22,593	6.38%	23,036	6.50%
Tier 1 leverage (to average assets)	45,348	10.86%	16,698	4.00%	20,872	5.00%
(Dollars in thousands) December 31, 2017	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)	\$ 44,039	12.54%	\$ 32,477	9.25%	\$ 35,110	10.00%
Tier 1 capital (to risk-weighted assets)	41,580	11.84%	25,455	7.25%	28,088	8.00%
Common equity tier 1 (to risk-weighted assets)	41,580	11.84%	20,188	5.75%	22,822	6.50%
Tier 1 leverage (to average assets)	41,580	10.31%	16,135	4.00%	20,169	5.00%

14. Fair Value

Accounting standards define fair value as the price that would be received upon the sale of an asset or paid upon the transfer of 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 is not 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.

The standards require 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. The standards establish 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) for 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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

14. Fair Value (Continued)

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

The Company uses the following methods and significant assumptions to estimate the fair values of the following assets:

- Securities available for sale: The fair values of securities available for sale are 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.
- Equity security at fair value: The Company's investment in an equity mutual fund is valued based on the net asset value of the fund, which is classified as Level 1.
- Other real estate owned ("OREO"): Nonrecurring fair value adjustments to OREO reflect full or partial write-downs that are based on the OREO's observable market price or current appraised value of the real estate. Since the market for OREO is not active, OREO subjected to nonrecurring fair value adjustments based on the current appraised value of the real estate are classified as Level 3. The appraised value is obtained annually from an independent third party appraiser and is reduced by expected sales costs, which has historically been 10% of the appraised value.
- 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 3. The appraised value is obtained annually from an independent third party appraiser and is reduced by expected sales costs, which has historically been 10% of the appraised value.

The following table summarizes financial assets measured at fair value on a recurring and nonrecurring basis as of December 31, 2018 and 2017, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	Carrying Value:			
	Level 1	Level 2	Level 3	Total
December 31, 2018				
Recurring				
Available for sale securities				
State and municipal	\$ -	\$ 1,506,505	\$ -	\$ 1,506,505
SBA pools	-	2,719,372	-	2,719,372
Mortgage-backed securities	-	22,366,114	-	22,366,114
	<u>\$ -</u>	<u>\$ 26,591,991</u>	<u>\$ -</u>	<u>\$ 26,591,991</u>
Equity security at fair value	\$ 503,827	\$ -	\$ -	\$ 503,827
Nonrecurring				
Other real estate owned	\$ -	\$ -	\$ 210,150	\$ 210,150
Impaired loans	-	-	3,177,381	3,177,381
December 31, 2017				
Recurring				
Available for sale securities				
State and municipal	\$ -	\$ 1,539,207	\$ -	\$ 1,539,207
SBA pools	-	3,199,846	-	3,199,846
Mortgage-backed securities	-	23,190,457	-	23,190,457
	<u>\$ -</u>	<u>\$ 27,929,510</u>	<u>\$ -</u>	<u>\$ 27,929,510</u>
Equity security at fair value	\$ 503,881	\$ -	\$ -	\$ 503,881
Nonrecurring				
Other real estate owned	\$ -	\$ -	\$ 265,500	\$ 265,500
Impaired loans	-	-	5,055,969	5,055,969

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

14. Fair Value (continued)

Reconciliation of Level 3 Inputs

	Other Real Estate Owned	Impaired Loans
December 31, 2017 fair value	\$ 265,500	\$ 5,055,969
Additions	-	1,747,826
Advances	-	19,086
Write-downs/charge-offs	(55,350)	(690,000)
Recoveries	-	197,660
Loan loss provision	-	127,213
Principal payments received	-	(3,280,373)
December 31, 2018 fair value	<u>\$ 210,150</u>	<u>\$ 3,177,381</u>

The estimated fair value of financial instruments that are reported at amortized cost in the Company's consolidated balance sheets, segregated by the level of the valuation inputs were as follows:

	December 31, 2018		December 31, 2017	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 2 inputs				
Securities held to maturity	18,127,067	18,033,093	18,204,182	18,307,627
Mortgage loans held for sale	573,638	582,248	327,700	332,558
Federal Home Loan Bank stock	575,800	575,800	1,063,600	1,063,600
Level 3 inputs				
Loans, net	340,900,635	337,385,842	332,533,706	332,689,848
Financial liabilities				
Level 1 inputs				
Noninterest-bearing deposits	\$ 62,717,520	\$ 62,717,520	\$ 64,403,133	\$ 64,403,133
Securities sold under repurchase agreements	11,012,000	11,012,000	21,768,507	21,768,507
Level 2 inputs				
Interest-bearing deposits	291,995,483	281,761,483	255,393,291	244,403,291
Federal Home Loan Bank advances	3,000,000	2,971,000	17,000,000	16,957,000

The fair value of mortgage loans held for sale is determined by the expected sales price. Beginning in the first quarter of 2018, the fair value of loans were determined using an exit price methodology as prescribed by FASB Accounting Standards Update 2016-01, which became effective in the first quarter of 2018. The exit price estimation of fair value is based on the present value of the expected cash flows. The projected cash flows are based on the contractual terms of the loans, adjusted for prepayments and use of a discount rate based on the relative risk of the cash flows, taking into account the loan type, maturity of the loan, liquidity risk, servicing costs, and a required return on debt and capital (Level 3).

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

14. Fair Value (continued)

In addition, an incremental liquidity discount is applied to certain loans, using historical sales of loans during periods of similar economic conditions as a benchmark. In comparison, loan fair values as of December 31, 2017 were estimated based on an entrance price methodology. As a result, the fair value adjustments as of December 31, 2018 and December 31, 2017 are not comparable.

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.

The fair value of credit commitments are considered to be the same as the contractual amounts, and are not included in the table above. These commitments generate fees that approximate those currently charged to originate similar commitments.

15. Parent Company Financial Information

The condensed financial statements for the Company (parent only) are presented below:

Balance Sheets

December 31,	2018	2017
Assets		
Cash and cash equivalents	\$ 64,243	\$ 48,384
Investment in subsidiaries	45,330,464	41,743,068
Other assets	-	7,480
	<u>\$ 45,394,707</u>	<u>\$ 41,798,932</u>
Liabilities and Stockholders' Equity		
Stockholders' equity		
Common stock, par value \$.01 per share, authorized 5,000,000 shares; issued and outstanding 1,682,997 shares in 2018 and 1,667,813 shares in 2017	\$ 16,830	\$ 16,678
Additional paid-in capital	27,324,794	26,869,796
Retained earnings	18,621,382	15,306,625
Accumulated other comprehensive income	(568,299)	(394,167)
	<u>45,394,707</u>	<u>41,798,932</u>
	<u>\$ 45,394,707</u>	<u>\$ 41,798,932</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

15. Parent Company Financial Information (continued)

Statements of Income

Years Ended December 31,	2018	2017
Income		
Cash dividends from subsidiary	\$ 1,541,225	\$ 1,250,278
Total income	1,541,225	1,250,278
Noninterest expense	492	455
Income before before income taxes and equity in undistributed income of subsidiaries	1,540,733	1,249,823
Income taxes (benefit)	-	-
Income before before equity in undistributed income of subsidiaries	1,540,733	1,249,823
Equity in undistributed income of subsidiaries	3,171,943	2,539,418
	<u>\$ 4,712,676</u>	<u>\$ 3,789,241</u>

Statements of Cash Flows

Years Ended December 31,	2018	2017
Cash flows from operating activities		
Net Income	\$ 4,712,676	\$ 3,789,241
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of subsidiaries	(3,171,943)	(2,539,418)
Other	7,479	-
Cash provided by operating activities	<u>1,548,212</u>	<u>1,249,823</u>
Cash flows from investing activities		
Contribution of capital to subsidiaries	(600,000)	(300,000)
Cash used by investing activities	<u>(600,000)</u>	<u>(300,000)</u>
Cash flows from financing activities		
Proceeds form sale of common stock	1,550	-
Dividends paid, net of reinvestments	(933,903)	(953,525)
Cash provided by financing activities	<u>(932,353)</u>	<u>(953,525)</u>
Net increase (decrease) in cash and cash equivalents	15,859	(3,702)
Cash and cash equivalents at beginning of period	48,384	52,086
Cash and cash equivalents at end of period	<u>\$ 64,243</u>	<u>\$ 48,384</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

16. Quarterly Results of Operations

	Three Months Ended			
	Unaudited			
2018	December 31	September 30	June 30	March 31
Interest income	\$4,599,891	\$ 4,525,190	\$4,385,506	\$4,257,746
Interest expense	726,549	664,018	580,913	535,761
Net interest income	3,873,342	3,861,172	3,804,593	3,721,985
Provision for loan losses	450,000	(100,000)	75,000	50,000
Net income	1,136,805	1,308,688	1,145,065	1,122,118
Earnings per share - basic and diluted	\$ 0.68	\$ 0.78	\$ 0.69	\$ 0.67
2017	December 31	September 30	June 30	March 31
Interest income	\$ 4,264,414	\$ 4,232,017	\$ 4,121,760	\$ 3,976,612
Interest expense	466,104	442,805	412,618	385,713
Net interest income	3,798,310	3,789,212	3,709,142	3,590,899
Provision for loan losses	60,000	225,000	75,000	50,000
Net income	656,339	1,014,456	1,134,889	983,557
Earnings per share - basic and diluted	\$ 0.39	\$ 0.61	\$ 0.69	\$ 0.59

17. Litigation

In the ordinary course of its business, the Company 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 Company.

Farmers and Merchants Bancshares, Inc.

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

The Company's Articles of Incorporation authorize the Company to issue up to 5,000,000 shares of common stock, par value \$.01 per share (the "Common Stock"). As of February 28, 2018 there were 1,682,997 shares of Common Stock issued and outstanding held by approximately 551 stockholders of record.

Although many trades occur through privately-negotiated transactions, the shares of the Company's common stock are traded in the over-the-counter market by certain broker-dealers and price quotations are available through the OTC Markets Group's OTC Pink Market (the "Pink Market") under the symbol "FMFG". The following table sets forth, for the periods indicated, high and low bid information for the common stock as reported through the Pink Market. These prices do not include retail mark-ups, markdowns or commissions, and may not necessarily represent actual transactions. The table also shows the per share cash dividends declared during these periods.

	<u>High</u>	<u>Low</u>	<u>Dividend Per Share</u>
2018			
Quarter ended December 31	\$32.99	\$29.00	\$0.43
Quarter ended September 30	32.00	31.40	0.00
Quarter ended June 30	31.45	30.40	0.40
Quarter ended March 31	34.50	29.30	0.00
2017			
Quarter ended December 31	\$33.00	\$27.85	\$0.39
Quarter ended September 30	28.50	27.15	0.00
Quarter ended June 30	28.25	27.00	0.37
Quarter ended March 31	27.50	25.25	0.00

The Company's ability to declare and pay dividends is limited by federal banking laws and Maryland corporation laws. Subject to these laws, the payment of dividends are at the discretion of the Company's board of directors, who considers such factors as operating results, financial condition, capital adequacy, regulatory requirements, and stockholder return. The Company's ability to pay dividends will be largely dependent on its receipt of dividends from the Bank and/or the Insurance Subsidiary. Like the Company, the Bank's ability to declare and pay dividends is subject to limitations imposed by federal and Maryland banking and Maryland corporation laws, and the Insurance Subsidiary's ability to declare and pay dividends is subject to limitations imposed by Tennessee insurance laws. Accordingly, there can be no assurance that dividends will be declared on the shares of the common stock in any future fiscal quarter.

Farmers and Merchants Bancshares, Inc.

Stockholder Information

Corporate Headquarters

4510 Lower Beckleysville Road, Suite H
Hampstead, MD 21074
410-374-1510

Annual Meeting

The annual meeting of stockholders will be held
April 23, 2019 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 Bancshares, Inc.
are publicly traded on the NASDAQ Stock Market's Over-the-Counter
Bulletin Board under the trading symbol "FMFG."

Janney Montgomery Scott, LLC. makes a market in Farmers and
Merchants Bancshares Inc. common stock.
For information, please contact Douglas Velnoskey at 443-201-2088

Transfer Agent

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Independent Accountants

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Website

www.fmb1919.com

**A copy of the Farmers and Merchants Bancshares, Inc. annual report, including
financial statements, may be obtained without charge upon written request to:**

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

