FARMERS AND MERCHANTS BANCSHARES, INC.

2019 Annual Report

100TH ANNIVERSARY

FARMERS & MERCHANTS BANK

1919 2019

THE "COMMUNITY" BANK THAT PUTS PEOPLE FIRST

100TH ANNIVERSARY
1919 FARMERS & MERCHANTS BANK 2019
THE "COMMUNITY" BANK THAT PUTS PEOPLE FIRST

Member FDIC

March 6, 2020

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, 2019 was $4,560,804, or $1.54 per common share, compared to $4,712,676, or $1.61 per common share per common share, in 2018. This was the second highest net income in the history of the Company and the Bank.

Return on average equity was 9.52% in 2019 compared to 10.77% in 2018. Return on average assets was 1.06% in 2019 compared to 1.14% in 2018. Cash dividends paid to stockholders in 2019 increased 9% to $0.51 per common share from $0.47 per common share in 2018. During 2019, the price of the Company's stock increased $0.99 per share or 5.7%, from $17.41 to $18.4. The total return for the year, including the cash dividends, was 8.6%.

Total assets increased 6% to $442 million at December 31, 2019 from $417 million at December 31, 2018. Loans increased 5% to $359 million at December 31, 2019 from $341 million at December 31, 2018. Investment in debt securities increased 25% to $56 million at December 31, 2019 from $45 million at December 31, 2018. Deposits increased 6% to $377 million at December 31, 2019 from $355 million at December 31, 2018. The book value of the common stock of Farmers and Merchants Bancshares, Inc. was $16.63 per share at December 31, 2019, compared to $15.41 per share at December 31, 2018.

On March 6, 2020, we announced that a definitive agreement had been signed whereby Carroll Bancorp, Inc. (Carroll), the parent of Carroll Community Bank, will be acquired by the Company. We are excited to expand our presence in the Carroll County market, especially in the Eldersburg/Sykesville area. Settlement is expected in the third quarter of 2020 subject to regulatory and other approvals. Based upon assets at December 31, 2019, the consolidated assets will be approximately $620 million.

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

We were pleased to celebrate our 100th Anniversary during 2019. We would like to thank all those who have made our longevity possible: our stockholders, customers, employees, and directors. We have been truly blessed to work in the fine communities that we serve. We sincerely appreciate all of your confidence in and your support of Farmers and Merchants Bancshares, Inc.

Sincerely yours,

Paul F. Wooden, Jr.
Chairman

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

The Bank offers 24 hour ATMs, including access to the Allpoint Network, 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 Beckleysville 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

Director Emeritus

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

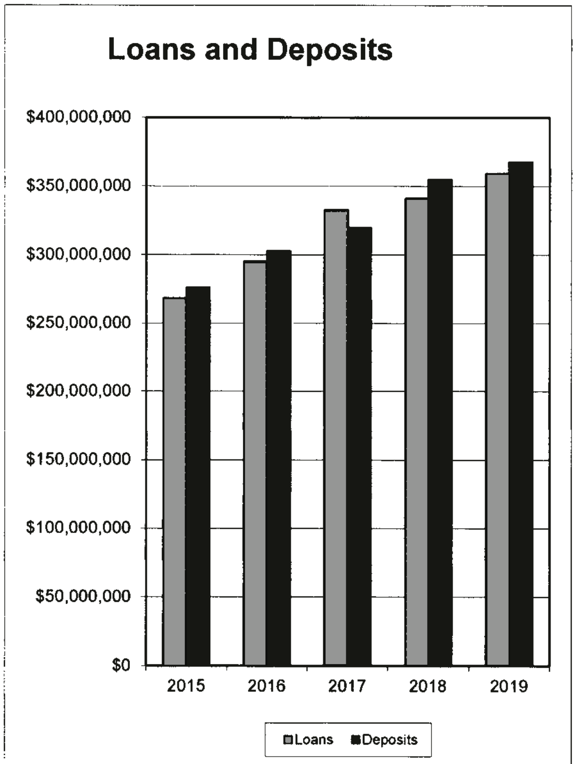
Assistant Vice Presidents
Branch Managers

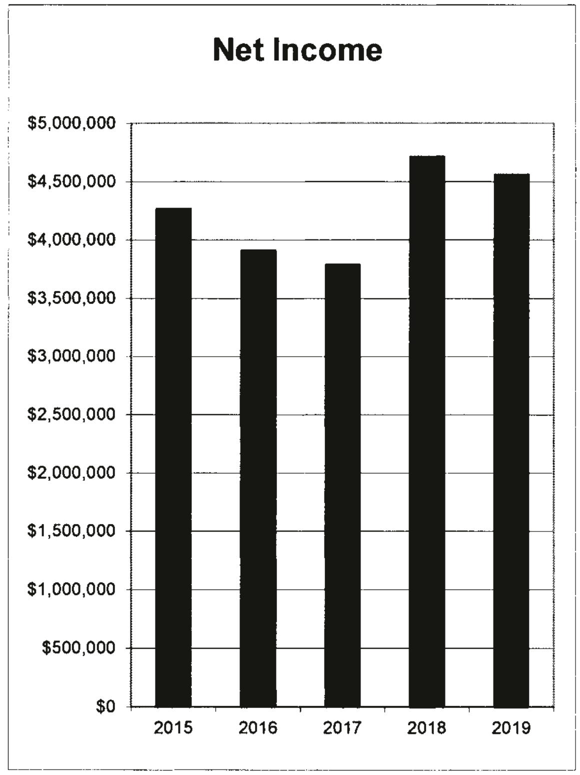
Jennifer R. Caines...................Westminster
Amy L. Collins..........................Greenmount
Rachel L. Heird.......................Owings Mills
Kelly P. Johnson.......................Hampstead
Wendy A. Panek.......................Reisterstown
Shannon M. Panek-Close...........Main Office

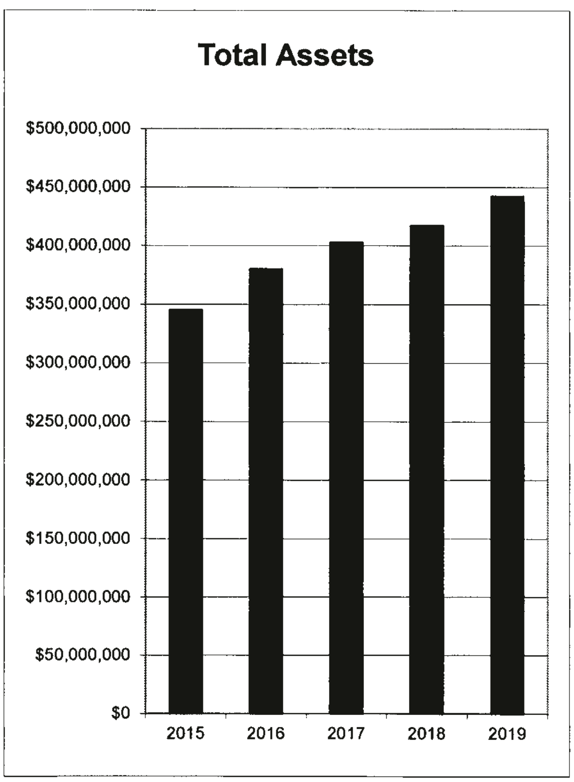
Farmers and Merchants Bancshares, Inc.
Selected Consolidated Financial Data

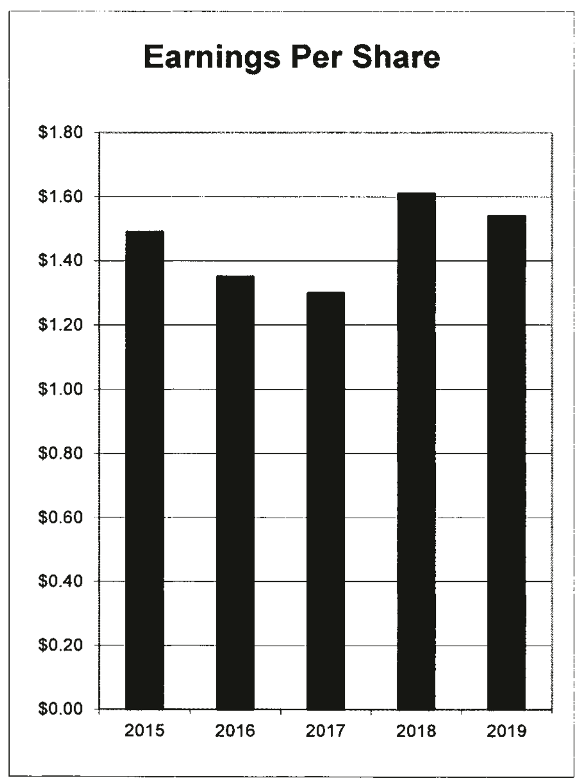
	2019	2018	2017	2016	2015
OPERATING DATA					
Interest income	$ 18,702,338	$ 17,768,333	$ 16,594,803	$ 15,351,497	$ 14,705,401
Interest expense	3,679,953	2,507,241	1,707,240	1,346,120	1,189,646
Net interest income	15,022,385	15,261,092	14,887,563	14,005,377	13,515,755
Provision for loan losses	40,000	475,000	410,000	-	-
Net interest income after provision for loan losses	14,982,385	14,786,092	14,477,563	14,005,377	13,515,755
Noninterest income	1,493,567	1,365,273	1,337,094	1,465,197	1,986,260
Noninterest expense	10,875,814	10,332,480	10,023,102	9,534,625	8,703,588
Income before income taxes	5,600,138	5,818,885	5,791,555	5,935,949	6,798,427
Income taxes	1,039,334	1,106,209	2,002,314	2,026,820	2,530,205
Net income	$ 4,560,804	$ 4,712,676	$ 3,789,241	$ 3,909,129	$ 4,268,222
PER SHARE DATA					
Net income (Basic)	$1.54	$1.61	$1.30	$1.35	$1.49
Dividends	$0.51	$0.47	$0.43	$0.40	$0.37
Book value	$16.63	$15.41	$14.32	$13.46	$12.57
KEY RATIOS					
Return on average assets	1.06%	1.14%	0.96%	1.08%	1.29%
Return on average equity	9.52%	10.77%	9.26%	10.26%	12.26%
Net yield on interest-earning assets	3.67%	3.88%	4.04%	4.21%	4.40%
Efficiency ratio	65.85%	62.15%	61.78%	61.63%	56.14%
Average equity to average assets	11.10%	10.60%	10.32%	10.56%	10.50%
Dividend payout ratio	33.12%	29.43%	33.33%	29.58%	24.52%
AT PERIOD END					
Total assets	$ 442,215,098	$ 417,157,877	$ 402,904,469	$ 379,831,359	$ 345,309,996
Gross loans	362,494,703	343,940,842	335,595,916	298,126,919	271,263,338
Cash and cash equivalents	9,121,352	14,618,237	7,237,385	13,312,915	20,192,839
Securities	56,041,792	44,719,058	46,133,692	52,373,567	40,248,651
Deposits	376,613,314	354,713,003	319,796,424	302,715,136	275,964,737
Borrowings	10,958,118	14,012,000	38,768,507	36,226,159	31,490,619
Stockholders' equity	49,453,516	45,394,707	41,798,932	39,012,277	36,223,361
SELECTED AVERAGE BALANCES					
Total assets	$ 431,595,287	$ 412,586,954	$ 396,454,271	$ 361,005,005	$ 331,522,302
Gross loans	344,793,736	343,573,784	319,825,707	284,804,975	273,626,511
Cash and cash equivalents	20,124,328	12,054,442	12,428,778	13,271,319	15,227,040
Securities	53,049,768	44,471,457	50,251,527	48,301,835	31,041,271
Deposits	367,570,825	339,624,630	315,159,559	284,921,811	265,634,314
Borrowings	11,975,017	26,524,352	38,627,588	36,175,989	29,363,070
Stockholders' equity	47,927,778	43,748,434	40,926,674	38,115,746	34,810,159
ASSET QUALITY					
Nonperforming assets	$ -	$ 1,209,468	$ 2,657,702	$ 1,166,889	$ 1,429,313
Nonperforming assets/total assets	0.00%	0.29%	0.66%	0.31%	0.41%
Allowance for loan losses/total loans	0.72%	0.73%	0.73%	0.79%	0.95%

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, 2019 and 2018, 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. Note 1 to the consolidated financial statements describes the methodology used to determine the allowance for loan losses.

FINANCIAL CONDITION

Total assets were $442,215,098 at December 31, 2019, an increase of $25,057,221, or 6.0%, over the $417,157,877 recorded at December 31, 2018. The increase was due primarily to an increase of $18,482,208 in loans and an increase of $9,939,783 in securities available for sale, offset by a decrease of $5,496,885 in cash and cash equivalents.

Total liabilities were $392,761,582 at December 31, 2019, an increase of $20,998,412, or 5.6%, over the $371,763,170 recorded at December 31, 2018. The increase was due primarily to an increase of $21,900,311 in deposits and an increase of $2,117,258 in other liabilities, offset by decreases of $3,000,000 in Federal Home Loan Bank ("FHLB") advances. The increase in deposits was comprised of a $23,958,816 increase in interest-bearing accounts, offset by a $2,058,505 decrease in noninterest-bearing accounts.

Stockholders' equity was $49,453,516 at December 31, 2019 compared to $45,394,707 at December 31, 2018, an increase of $4,058,809. The increase was due primarily to net income for 2019 of $4,560,804 and an increase in the after-tax unrealized gain on available for sale securities of $610,923, offset by dividends paid, net of reinvestments, of $1,021,471.

Loans

Major categories of loans at December 31, 2019, 2018, 2017, 2016, and 2015, are as follows:

	2019		2018		2017		2016		2015	
Real estate:										
Commercial	$ 240,938,149	67%	$ 238,834,149	70%	$ 234,026,574	70%	$ 206,145,076	69%	$ 186,703,868	69%
Construction/Land development	18,194,955	5%	18,265,505	5%	18,160,366	5%	14,392,992	5%	12,820,165	5%
Residential	76,122,069	21%	63,024,106	18%	59,241,416	18%	54,710,809	18%	51,290,828	19%
Commercial	26,947,503	7%	23,323,073	7%	23,613,543	7%	22,152,773	8%	19,562,302	7%
Consumer	292,027	0%	494,009	0%	554,017	0%	725,269	0%	886,175	0%
	362,494,703	100%	343,940,842	100%	335,595,916	100%	298,126,919	100%	271,263,338	100%
Less: Allowance for loan losses	2,593,715		2,509,334		2,458,911		2,363,086		2,583,445	
Deferred origination fees net of cost	518,145		530,873		603,299		477,261		430,491	
	$ 359,382,843		$ 340,900,635		$ 332,533,706		$ 295,286,572		$ 268,249,402	

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

Loans increased by $18,482,208, or 5.4%, to $359,382,843 at December 31, 2019 from $340,900,635 at December 31, 2018. The growth was due to increases in commercial real estate loans of $2,104,000, commercial loans of $3,624,430, and residential real estate loans of $13,097,963, offset by decreases in construction/land development loans of $70,550 and consumer loans of $201,982. The allowance for loan losses increased $84,381 to $2,593,715 at December 31, 2019 as compared to $2,509,334 at December 31, 2018.

The following table sets forth at December 31, 2019 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	$ 24,276,554	$ 122,440,313	$ 94,221,282	$ 240,938,149
Construction/Land development	6,569,860	11,532,904	92,191	18,194,955
Residential	10,893,629	43,869,381	21,359,059	76,122,069
Commercial	11,804,962	6,608,185	8,534,356	26,947,503
Consumer	26,316	229,231	36,480	292,027
	$ 53,571,321	$ 184,680,014	$ 124,243,368	$ 362,494,703
Classified by Sensitivity to Change In Interest Rates				
Fixed-Interest Rate Loans	$ 36,637,288	$ 155,832,490	$ 83,154,800	$ 275,624,578
Adjustable-Interest Rate Loans	16,934,033	28,847,524	41,088,568	86,870,125
	$ 53,571,321	$ 184,680,014	$ 124,243,368	$ 362,494,703

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
2019							
Real estate:							
Commercial	$ 224,794	$ -	$ -	$ 224,794	$ 240,713,355	$ 240,938,149	$ -
Construction/Land development	-	-	-	-	18,194,955	18,194,955	-
Residential	59,892	-	-	59,892	76,062,177	76,122,069	-
Commercial	-	-	-	-	26,947,503	26,947,503	-
Consumer	-	-	-	-	292,027	292,027	-
Total	$ 284,686	$ -	$ -	$ 284,686	$ 362,210,017	$ 362,494,703	$ -

	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	$ -	$ 25,000	$ 999,318	$ 1,024,318	$ 342,916,524	$ 343,940,842	$ 10,507

	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	$ -

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:

	2019	2018	2017	2016	2015
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, 2019, the Company had no nonaccrual loans.

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, 2019, the Company had no loans that were delinquent 90 days or greater. 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.

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

	2019	2018	2017	2016	2015
Impaired loans no valuation allowance	$ 2,135,045	$ 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
Total impaired loans	$ 2,135,045	$ 3,177,381	$ 5,183,182	$ 3,342,744	$ 3,400,494
Valuation allowance related to impaired loan:	$ -	$ -	$ 127,213	$ 24,167	$ 167,211

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, 2019, the Company had one commercial real estate loan totaling $2,084,988 and one residential loan totaling $50,057 classified as TDRs. The $50,057 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, 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.

	2019	2018	2017	2016	2015
Restructured loans (TDRs):					
Performing as agreed	$ 2,135,045	$ 2,188,570	$ 2,937,439	$ 2,348,275	$ 2,443,681
Not performing as agreed	-	-	-	241,580	-
Total TDRs	$ 2,135,045	$ 2,188,570	$ 2,937,439	$ 2,589,855	$ 2,443,681

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.

	2019	2018	2017	2016	2015
Special mention	$ -	$ -	$ 5,391,589	$ 8,962,940	$ 6,366,296
Substandard	11,399,425	11,448,021	4,625,568	6,399,618	7,843,897
Doubtful	19,192	78,467	2,274,162	29,742	25,525
Total	$ 11,418,617	$ 11,526,488	$ 12,291,319	$ 15,392,300	$ 14,235,718

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, 2019, 2018, 2017, 2016, and 2015. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

						Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
December 31, 2019	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	$ 1,754,372	$ (11,700)	$ -	$ 21,189	$ 1,763,861	$ -	$ 1,763,861	$ 2,084,988	$ 238,853,161
Construction and land development	196,374	(17,571)	-	14,025	192,828	-	192,828	-	18,194,955
Residential	401,626	76,498	-	-	478,124	-	478,124	50,057	76,072,012
Commercial	102,610	(3,995)	-	9,167	107,782	-	107,782	-	26,947,503
Consumer	10,428	(6,295)	-	-	4,133	-	4,133	-	292,027
Unallocated	43,924	3,063	-	-	46,987	-	46,987	-	-
	$ 2,509,334	$ 40,000	$ -	$ 44,381	$ 2,593,715	$ -	$ 2,593,715	$ 2,135,045	$ 360,359,658

Farmers and Merchants Bancshares, Inc.

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

December 31, 2018	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment: Individually	Allowance for loan losses ending balance evaluated for impairment: Collectively	Outstanding loan balances evaluated for impairment: Individually	Outstanding loan balances evaluated for impairment: 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

December 31, 2017	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment: Individually	Allowance for loan losses ending balance evaluated for impairment: Collectively	Outstanding loan balances evaluated for impairment: Individually	Outstanding loan balances evaluated for impairment: 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 for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment: Individually	Allowance for loan losses ending balance evaluated for impairment: Collectively	Outstanding loan balances evaluated for impairment: Individually	Outstanding loan balances evaluated for impairment: 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	-	-
	$ 2,583,445	$ -	$ (330,485)	$ 110,126	$ 2,363,086	$ 24,167	$ 2,338,919	$ 3,342,744	$ 294,784,175

December 31, 2015	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment: Individually	Collectively	Outstanding loan balances evaluated for impairment: 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

	2019	2018	2017	2016	2015
Allowance for loan losses to total loans outstanding	0.72%	0.73%	0.73%	0.79%	0.95%
Ratio of net charge-offs to average loans oustanding during the period	-0.01%	0.12%	0.10%	0.08%	0.07%

The Company recorded $44,381 in net recoveries in 2019 versus $424,577 in net charge-offs in 2018. The provision for loan losses was $40,000 in 2019 and $475,000 in 2018.

Other Real Estate Owned

Other real estate owned ("OREO") at December 31, 2019 and 2018 included one property with a carrying value of $0 and $210,150, 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 2020. Due to the length of time the property has been held, Maryland regulation required a write-down of the value to $0 in 2019.

	2019	2018	2017	2016	2015
Other Real Estate Owned	$ -	$ 210,150	$ 265,500	$ 414,000	$ 472,500

Investment Securities

Investment securities increased $11,322,734, or 25.3%, to $56,041,792 at December 31, 2019 from $44,719,058 at December 31, 2018. At December 31, 2019 and 2018, the Company had classified 65% and 59%, 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:

	2019	2018	2017
Available for sale			
State and municipal	$ 512,670	$ 1,506,505	$ 1,539,207
SBA pools	2,151,797	2,719,372	3,199,846
Mortgage-backed securities	33,867,307	22,366,114	23,190,457
	$ 36,531,774	$ 26,591,991	$ 27,929,510
Held to maturity			
State and municipal	$ 19,510,018	$ 18,127,067	$ 18,204,182

The following table sets forth the scheduled maturities of investment securities at December 31, 2019:

	Available for Sale			Held to Maturity		
	Amortized Cost	Fair Value	Yield	Amortized Cost	Fair Value	Yield
Within 1 year	$ -	$ -	0.00%	$ 257,150	$ 261,204	3.61%
Over 1 to 5 years	258,134	258,838	2.25%	562,587	565,140	3.17%
Over 5 to 10 years	250,000	253,832	3.10%	2,717,125	2,782,474	3.73%
Over 10 years	-	-	0.00%	15,973,156	16,489,113	3.19%
	508,134	512,670	2.67%	19,510,018	20,097,931	3.27%
SBA Pools	2,203,834	2,151,797	2.71%	-	-	-
Mortgage-backed securities	33,760,999	33,867,307	2.39%	-	-	-
	$ 36,472,967	$ 36,531,774	2.41%	$ 19,510,018	$ 20,097,931	3.27%

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

Deposits

Total deposits were $376,613,314 at December 31, 2019 compared to $354,713,003 at December 31, 2018, an increase of $21,900,311, or 6.2%. The increase was due to a $13,691,088 increase in time deposits, a $3,934,154 increase in savings accounts, and a $7,005,488 increase in interest bearing checking accounts, offset by a $671,914 decrease in money market accounts and a $2,058,505 decrease in noninterest-bearing accounts. The following table shows the average balances and average costs of deposits for the years ended December 31:

	2019		2018		2017	
	Average Balance	Cost	Average Balance	Cost	Average Balance	Cost
Noninterest bearing demand deposits	$ 59,374,960	0.00%	$ 61,972,038	0.00%	$ 60,346,388	0.00%
Interest bearing demand deposits	56,851,471	0.19%	48,070,664	0.22%	42,370,867	0.14%
Savings and money market deposits	101,375,083	0.40%	97,644,061	0.25%	104,943,540	0.23%
Time deposits	149,969,311	2.01%	131,937,867	1.42%	107,498,764	1.00%
	$ 367,570,825	0.96%	$ 339,624,630	0.65%	$ 315,159,559	0.44%

As of December 31, 2019, certificates of deposit of $100,000 or more mature as follows:

Period	Balance
3 months or less	$ 18,391,810
Over 3 months to 6 months	13,301,468
Over 6 months to 12 months	13,544,392
Over 12 months	22,711,878
Total	$ 67,949,548

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, 2019, the Company's off-balance sheet financial instruments were as follows:

Loan commitments	$ 13,755,488
Unused lines of credit	$ 25,929,499
Letters of credit	$ 1,935,613

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:

		At December 31,		
		2019	2018	2017
Amount oustanding at year-end:				
Securities sold under repurchase agreements		$ 10,958,118	$ 11,012,000	$ 21,768,507
Federal Home Loan Bank advances		-	3,000,000	17,000,000
Federal Home Loan Bank advances mature in:				
	2018	$ -	$ -	$ 14,000,000
	2019	-	3,000,000	3,000,000
Weighted average rate paid at December 31:				
Securites sold under repurchase agreements		1.49%	1.07%	0.65%
Federal Home Loan Bank advances		0.00%	1.50%	1.35%

	For years ended December 31,		
	2019	2018	2017
Maximum amount of borrowings outstanding at any month end:			
Securities sold under repurchase agreeents	$ 10,958,118	$ 22,173,010	$ 30,786,064
Federal Home Loan Bank advances	6,500,000	19,000,000	18,000,000
Average amount of borrowings oustanding with respect to:			
Securities sold under repurchase agreements	$ 9,273,092	$ 17,479,418	$ 24,702,931
Federal Home Loan Bank advances	2,610,959	8,795,890	13,846,575
Borrowings from FRB and commerical banks	90,966	249,044	78,082
Average rate paid for the year:			
Securities sold under repurchase agreements	1.24%	0.83%	0.66%
Federal Home Loan Bank advances	1.62%	1.50%	1.20%
Borrowings from FRB and commerical banks	2.91%	1.93%	1.64%

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 $4,560,804 for the year ended December 31, 2019 compared to $4,712,676 for the year ended December 31, 2018. The decrease of $151,872 from 2018 was due to a decrease in net interest income of $238,707 and an increase in noninterest expense of $543,334, offset by an increase in noninterest income of $128,294, a decrease in income taxes of $66,875, and a decrease in the provision for loan losses of $435,000.

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, 2019, the Company recorded net interest income of $15,022,385 compared to $15,261,092 for 2018, a decrease of $238,707. The decrease was attributable to a decline in the net yield on interest-earning assets, offset by an increase in the average balance of interest-earning assets. The net average tax equivalent yield on interest earning assets declined 21 basis points to 3.67% in 2019 when compared to the 3.88% recorded in 2018. Average interest earning assets increased $18,028,572 to $414,714,708 in 2019 from $396,686,136 in 2018.

Total interest income for the year ended December 31, 2019 increased by $934,005 to $18,702,338, compared to $17,768,333 for 2018. The increase was due primarily to the aforementioned increase in average interest earning assets and an increase of 4 basis points in the tax equivalent yield on interest earning assets to 4.55% in 2019 from 4.51% in 2018.

Interest income from loans was $16,894,567 in 2019 compared to $16,401,554 in 2018, an increase of $493,103. This increase was attributable to a $1,219,952 increase in the average balance of loans to $344,793,736 in 2019 from $343,573,784 in 2018 and a 13 basis point increase in the average yield on loans to 4.90% in 2019 from 4.77% in 2018.

For the year ended December 31, 2019, the Company recorded interest income on securities of $1,449,841. For the same period of 2018, interest income on securities was $1,181,480. The $268,361 increase in 2019 was attributable to a $8,578,311 increase in the average balance of securities to $53,049,768 in 2019 from $44,471,457 in 2018 and a 10 basis point increase in the average tax equivalent yield on securities to 3.05% in 2019 from 2.95% in 2018.

Interest income on federal funds sold and other interest-earning assets (FHLB stock and certificates of deposit) increased $172,541 to $357,840 in 2019 compared to $185,299 in 2018. The increase was due to a 3 basis point increase in the average tax equivalent yield to 2.21% in 2019 from 2.18% in 2018, and a $8,230,309 increase in the average balance of federal funds sold and other interest-earning assets to $16,871,204 in 2019 from $8,640,895 in 2018.

Total interest expense increased $1,172,712 to $3,679,953 in 2019 compared to $2,507,241 in 2018. The increase was primarily due to an increase of $15,993,938 in the average balance of interest-bearing liabilities to

$320,170,882 in 2019 from $304,176,944 in 2018 and a 33 basis point increase in the cost of interest-bearing liabilities to 1.15% in 2019 from 0.82% in 2018.

Interest paid on NOW, savings, and money market deposit accounts increased $158,969 to $507,385 in 2019 compared to $348,416 in 2018. The increase was due to a 8 basis point increase in the cost of funds to 0.32% in 2019 from 0.24% in 2018 and a $12,511,829 increase in the average balance of these deposits to $158,226,554 in 2019 from $145,714,725 in 2018.

Interest paid on time deposits increased $1,135,375 to $3,012,575 in 2019 compared to $1,877,200 in 2018. The increase in interest expense was due to an increase of 59 basis points in the average rate paid to 2.01% in 2019 from 1.42% in 2018 and an increase of $18,031,444 in the average balance to $149,969,311 in 2019 from $131,937,867 in 2018.

Interest paid on securities sold under repurchase agreements decreased $30,240 to $114,641 in 2019 compared to $144,881 in 2018. The decrease was attributable to a $8,206,326 decrease in the average balance of securities sold under repurchase agreements to $9,273,092 in 2019 from $17,479,418 in 2018, offset by an increase of 41 basis points in the average rate to 1.24% in 2019 from 0.83% in 2018.

Interest paid on FHLB advances and other borrowings decreased $91,392 to $45,352 in 2019 from $136,744 in 2018. The decrease was attributable to a $6,343,009 decrease in the average balance of FHLB advances and other borrowings to $2,701,925 in 2019 from $9,044,934 in 2018, offset by an increase of 17 basis points in the average rate to 1.68% in 2019 from 1.51% in 2018.

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.

	2019			2018			2017		
	Average Balance	Interest	Yield	Average Balance	Interest	Yield	Average Balance	Interest	Yield
Assets:									
Loans	$ 344,793,736	$ 16,894,657	4.90%	$ 343,573,784	$ 16,401,554	4.77%	$ 319,825,707	$ 15,189,238	4.75%
Securities, taxable	34,949,183	875,715	2.51%	26,807,959	617,249	2.30%	32,115,690	715,689	2.23%
Securities, tax exempt	18,100,585	740,077	4.09%	17,663,498	695,282	3.94%	18,135,837	883,901	4.87%
Federal funds sold and other interest earning assets	16,871,204	373,678	2.21%	8,640,895	188,479	2.18%	6,090,159	99,840	1.64%
Total interest-earning assets	414,714,708	18,884,127	4.55%	396,686,136	17,902,564	4.51%	376,167,393	16,888,668	4.49%
Noninterest-earning assets	16,880,579			15,900,818			20,286,878		
Total assets	$ 431,595,287			$ 412,586,954			$ 396,454,271		
Liabilities and Stockholders' Equity:									
NOW, savings, and money market	$ 158,226,554	507,385	0.32%	$ 145,714,725	348,416	0.24%	$ 147,314,407	299,586	0.20%
Certificates of deposit	149,969,311	3,012,575	2.01%	131,937,867	1,877,200	1.42%	107,498,764	1,078,722	1.00%
Securities sold under repurchase agreements	9,273,092	114,641	1.24%	17,479,418	144,881	0.83%	24,702,931	161,914	0.66%
FHLB advances and other borrowings	2,701,925	45,352	1.68%	9,044,934	136,744	1.51%	13,924,657	167,018	1.20%
Total interest-bearing deposits	320,170,882	3,679,953	1.15%	304,176,944	2,507,241	0.82%	293,440,759	1,707,240	0.58%
Noninterest-bearing deposits	59,374,960			61,972,038			60,346,388		
Noninterest-bearing liabilities	4,121,667			2,689,538			1,740,450		
Total liabilities	383,667,509			368,838,520			355,527,597		
Stockholders' equity	47,927,778			43,748,434			40,926,674		
Total liabilities and stockholders' equity	$ 431,595,287			$ 412,586,954			$ 396,454,271		
Net interest income		$ 15,204,174			$ 15,395,323			$ 15,181,428	
Interest rate spread			3.40%			3.69%			3.91%
Net yield on interest-earning assets			3.67%			3.88%			4.04%
Ratio of average interest-earning assets to average interest-bearing liabilities			129.53%			130.41%			128.19%

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

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, 2019 compared to 2018 Change due to variance in			Year ended December 31, 2018 compared to 2017 Change due to variance in		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Loans	$ 58,420	$ 434,683	$ 493,103	$ 1,133,307	$ 79,009	$ 1,212,316
Securities, taxable	200,268	58,198	258,466	(121,552)	23,112	(98,440)
Securities, tax exempt	17,465	27,330	44,795	(22,493)	(166,126)	(188,619)
Federal funds sold and other interest-earning assets	182,248	2,951	185,199	49,541	39,098	88,639
Total interest-earning assets	458,401	523,162	981,563	1,038,803	(24,907)	1,013,896
Interest expense:						
NOW, savings, and money market	31,969	127,000	158,969	(3,286)	52,116	48,830
Certificates of deposit	282,876	852,499	1,135,375	281,349	517,129	798,478
Securities sold under repurchase agreements	(84,353)	54,113	(30,240)	(53,923)	36,890	(17,033)
FHLB advances and other borrowings	(105,032)	13,640	(91,392)	(67,274)	37,000	(30,274)
Total interest-bearing liabilities	125,460	1,047,252	1,172,712	156,866	643,135	800,001
Change in net interest income	$ 332,941	$ (524,090)	$ (191,149)	$ 881,937	$ (668,042)	$ 213,895

Noninterest Income

Total noninterest income increased by $128,294, or 9.4%, to $1,493,567 in 2019 from $1,365,273 in 2018. The increase was primarily a result of a $202,965 increase in bank owned life insurance income due to proceeds received from a policy, a $125,943 increase in mortgage banking income due to an increase in volume originated, and a $27,661 increase in the unrealized gain on equity security, offset by a $154,800 increase in the write-down of other real estate owned required by regulation and a $86,491 lower gain on the sale of SBA loans.

Noninterest Expense

Total noninterest expense increased by $543,334, or 5.3%, to $10,875,814 in 2019 from $10,332,480 in 2018. The increase was due primarily to an increase in salary and employee benefit expenses of $316,548, or 4.9%, to $6,824,811 in 2019 compared to $6,508,263 in 2018, an increase in occupancy expenses of $65,724, or 9.3%, and an increase in other expenses of $178,849, or 7.2%. The increase in salaries and benefits was due primarily to merit increases in salaries paid to existing staff, incentives, and higher payroll taxes and benefits. Occupancy increased primarily as a result of the new lease accounting that was implemented in 2019 along with an increase in actual rent paid. The increase in other expenses was due primarily to an increase of $130,774 in insurance claims reserve, an increase of $54,793 in advertising, and an increase in professional fees of $47,945, offset by a decrease of $94,572 in FDIC assessments. Note 11 to the consolidated financial statements provides additional information about the Company's other expenses.

Income Taxes

Income taxes decreased $66,875 to $1,039,334 in 2019 from $1,106,209 in 2018. Lower income before taxes was the primary driver of the decrease.

The Company's effective tax rate decreased to 18.6% in 2019, from 19.0% in 2018. The decrease was due to higher percentage of tax-exempt revenue. 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 21%.

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:

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, 2019 and 2018, management estimated the following changes in NII, assuming the indicated rate changes:

Change in Rate	2019	2018
400 basis point increase	$ (854,000)	$(623,000)
300 basis point increase	(547,000)	(384,000)
200 basis point increase	(310,000)	(204,000)
100 basis point increase	(136,000)	(80,000)
100 basis point decrease	115,000	193,000
200 basis point decrease	74,000	48,000
300 basis point decrease	84,000	(41,000)

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 $59.1 million under a secured line of credit with the FHLB. The Bank also has a facility with the Federal Reserve Bank of Richmond (the "Reserve Bank") under which the Bank can borrow approximately $21.2 million. Finally, the Bank has $18,500,000 ($9,500,000 unsecured and $9,000,000 secured) overnight federal funds lines of credit available from commercial banks. FHLB advances of $0 and $3,000,000 were outstanding as of December 31, 2019 and 2018, respectively. There were no borrowings from the Reserve Bank or our commercial bank lenders at December 31, 2019 and 2018. 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 Note 13 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, 2019 and 2018, 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, 2019 and 2018, 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.

(Dollars in thousands)	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
December 31, 2019	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)	$ 51,274	13.88%	$ 38,775	10.50%	$ 36,928	10.00%
Tier 1 capital (to risk-weighted assets)	48,681	13.18%	31,389	8.50%	29,543	8.00%
Common equity tier 1 (to risk-weighted assets)	48,681	13.18%	25,850	7.00%	24,003	6.50%
Tier 1 leverage (to average assets)	48,681	10.94%	17,798	4.00%	22,247	5.00%
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%

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, 2019, 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 adopted the provisions of ASU 2016-02, effective January 1, 2019, by recording an asset of $1,400,855, a liability of $1,527,019, a $91,447 adjustment to retained earnings, and a $34,717 adjustment to deferred income taxes.

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. ASU 2019-10 "Financial Instruments – Credit Losses (Topic 326), Derivatives and hedging (Topic 815), and Leases (Topic 842): Effective Dates" extended the implementation date to 2023 for SEC registered smaller reporting companies and private companies. The Company is considered a smaller reporting company. The Company has engaged a third-party vendor to assist in the implementation of this ASU.

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.

ROWLES
& Company, LLP
Certified Public Accountants

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, 2019 and 2018, 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, 2019, 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, 2019 and 2018, and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2019, 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
March 6, 2020

8100 Sandpiper Circle, Suite 308, Baltimore, Maryland 21236
443-725-5395 Fax 443-725-5074
Website: www.Rowles.com

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Consolidated Balance Sheets

December 31,	2019	2018
Assets		
Cash and due from banks	$ **6,664,307**	$ 11,480,608
Federal funds sold and other interest-bearing deposits	**2,457,045**	3,137,629
Cash and cash equivalents	**9,121,352**	14,618,237
Certificate of deposit in other bank	**100,000**	100,000
Securities available for sale	**36,531,774**	26,591,991
Securities held to maturity	**19,510,018**	18,127,067
Equity security at fair value	**532,321**	503,827
Federal Home Loan Bank stock, at cost	**376,200**	575,800
Mortgage loans held for sale	**242,000**	573,638
Loans, less allowance for loan losses of **$2,593,715** and $2,509,334	**359,382,843**	340,900,635
Premises and equipment	**5,036,851**	5,075,310
Accrued interest receivable	**1,019,540**	990,529
Deferred income taxes	**1,036,078**	1,179,454
Other real estate owned	**-**	210,150
Bank owned life insurance	**7,145,477**	7,053,354
Other assets	**2,180,644**	657,885
	$ **442,215,098**	$ 417,157,877
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing	$ **60,659,015**	$ 62,717,520
Interest-bearing	**315,954,299**	291,995,483
Total deposits	**376,613,314**	354,713,003
Securities sold under repurchase agreements	**10,958,118**	11,012,000
Federal Home Loan Bank of Atlanta advances	**-**	3,000,000
Accrued interest payable	**346,214**	311,489
Other liabilities	**4,843,936**	2,726,678
	392,761,582	371,763,170
Stockholders' equity		
Common stock, par value $.01 per share, authorized 5,000,000 shares; issued and outstanding 2,974,019 shares in 2019 and 1,682,997 shares in 2018	**29,740**	16,830
Additional paid-in capital	**27,812,991**	27,324,794
Retained earnings	**21,568,161**	18,621,382
Accumulated other comprehensive income (loss)	**42,624**	(568,299)
	49,453,516	45,394,707
	$ **442,215,098**	$ 417,157,877

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,	2019	2018
Interest income		
Loans, including fees	$ 16,894,657	$ 16,401,554
Investment securities - taxable	869,457	610,951
Investment securities - tax exempt	580,384	570,529
Federal funds sold and other interest earning assets	357,840	185,299
Total interest income	18,702,338	17,768,333
Interest expense		
Deposits	3,519,960	2,225,616
Securities sold under repurchase agreements	114,641	144,881
Federal Home Loan Bank advances and other borrowings	45,352	136,744
Total interest expense	3,679,953	2,507,241
Net interest income	15,022,385	15,261,092
Provision for loan losses	40,000	475,000
Net interest income after provision for loan losses	14,982,385	14,786,092
Noninterest income		
Service charges on deposit accounts	663,675	670,653
Mortgage banking income	397,710	271,767
Bank owned life insurance income	364,729	161,764
Unrealized gain (loss) on equity security	16,232	(11,429)
Write down of other real estate owned	(210,150)	(55,350)
Gain on sale of SBA loans	139,535	226,026
Other fees and commissions	121,836	101,842
Total noninterest income	1,493,567	1,365,273
Noninterest expense		
Salaries	5,472,609	5,194,871
Employee benefits	1,352,202	1,313,392
Occupancy	771,917	706,193
Furniture and equipment	614,543	632,330
Other	2,664,543	2,485,694
Total noninterest expense	10,875,814	10,332,480
Income before income taxes	5,600,138	5,818,885
Income taxes	1,039,334	1,106,209
Net income	$ 4,560,804	$ 4,712,676
Earnings per share - basic and diluted	$ 1.54	$ 1.61

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,	2019	2018
Net income	**$ 4,560,804**	$ 4,712,676
Other comprehensive income (loss), net of income taxes:		
Securities available for sale		
Net unrealized gain (loss) arising during the period	**842,856**	(254,609)
Income tax (expense) benefit	**(231,933)**	70,061
Total other comprehensive loss	**610,923**	(184,548)
Total comprehensive income	**$ 5,171,727**	$ 4,528,128

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 paid-in	Retained	Accumulated other comprehensive	Total stockholders'
	Shares	Par value	capital	earnings	income (loss)	equity
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, $0.47 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**
Net income	-	-	-	**4,560,804**	-	**4,560,804**
Unrealized loss on securities available for sale net of income tax expense of **$231,933**	-	-	-	-	**610,923**	**610,923**
Reclassification due to adoption of ASU No. 2016-02	-	-	-	**(91,447)**	-	**(91,447)**
Cash dividends, **$0.51** per share	-	-	-	**(1,509,895)**	-	**(1,509,895)**
Dividends reinvested	**22,705**	**227**	**488,197**	-	-	**488,424**
Stock Dividend	**1,268,317**	**12,683**	-	**(12,683)**	-	-
Balance, December 31, 2019	**2,974,019**	**$ 29,740**	**$27,812,991**	**$ 21,568,161**	**$ 42,624**	**$ 49,453,516**

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,	2019	2018
Cash flows from operating activities		
Interest received	**$ 18,648,337**	$ 17,714,259
Fees and commissions received	**1,455,827**	1,044,262
Interest paid	**(3,645,228)**	(2,376,372)
Proceeds from sale of mortgage loans held for sale	**20,046,955**	13,093,197
Origination of mortgage loans held for sale	**(19,715,317)**	(13,339,135)
Cash paid to suppliers and employees	**(10,019,091)**	(9,372,508)
Income taxes paid	**(1,055,967)**	(1,399,920)
Cash provided by operating activities	**5,715,516**	5,363,783
Cash flows from investing activities		
Proceeds from maturity and call of securities		
Available for sale	**8,507,098**	4,943,748
Held to maturity	**1,101,420**	223,000
Purchase of securities		
Available for sale	**(17,761,884)**	(4,007,664)
Held to maturity	**(2,457,087)**	(122,313)
Loans made to customers, net of principal collected	**(19,952,309)**	(11,427,440)
Proceeds from sale of SBA loans	**1,582,364**	2,883,963
Redemption of stock in FHLB of Atlanta	**199,600**	487,800
Purchases of premises and equipment	**(256,561)**	(191,744)
Cash used by investing activities	**(29,037,359)**	(7,210,650)
Cash flows from financing activities		
Net increase (decrease) in		
Noninterest-bearing deposits	**(2,058,505)**	(1,685,613)
Interest-bearing deposits	**23,958,816**	36,602,192
Securities sold under repurchase agreements	**(53,882)**	(10,756,507)
Federal Home Loan Bank of Atlanta advances	**(3,000,000)**	(14,000,000)
Dividends paid, net of reinvestments	**(1,021,471)**	(933,903)
Common stock issued	**-**	1,550
Cash provided by financing activities	**17,824,958**	9,227,719
Net increase (decrease) in cash and cash equivalents	**(5,496,885)**	7,380,852
Cash and cash equivalents at beginning of period	**14,618,237**	7,237,385
Cash and cash equivalents at end of period	**$ 9,121,352**	$ 14,618,237

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,	2019	2018
Reconciliation of net income to net cash provided by operating activities		
Net income	**$ 4,560,804**	$ 4,712,676
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	**344,171**	380,461
Provision for loan losses	**40,000**	475,000
Lease expense in excess of rent paid	**40,912**	-
Write down of other real estate owned	**210,150**	55,350
Write down of other assets	**-**	4,500
Equity security dividends reinvested	**(12,262)**	(11,375)
Unrealized (gain) loss on equity security	**(16,232)**	11,429
Gain on sale of SBA loans	**(139,535)**	(226,026)
Deferred income taxes	**(53,841)**	(111,360)
Amortization of premiums and accretion of discounts, net	**130,575**	123,253
Increase (decrease) in		
Deferred loan fees	**(12,728)**	(72,426)
Accrued interest payable	**34,725**	130,869
Other liabilities	**557,902**	366,692
Decrease (increase) in		
Mortgage loans held for sale	**331,638**	(245,938)
Accrued interest receivable	**(29,011)**	29,727
Bank owned life insurance cash surrender value	**(92,123)**	(161,764)
Other assets	**(179,629)**	(97,285)
Cash provided by operating activities	**$ 5,715,516**	$ 5,363,783

The accompanying notes are an integral part of these 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

The 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 the 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 2018 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 income (loss) during the year ended December 31, 2018.

1. **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, 2019 and 2018, 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

1. **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.

Operating Leases

On January 1, 2019, the Company adopted FASB ASU 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees are 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

1. **Summary of Significant Accounting Policies** (Continued)

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. The Company adopted the provisions of ASU 2016-02, effective January 1, 2019, by recording an asset of $1,400,855, a liability of $1,527,019, a $91,447 adjustment to retained earnings, and a $34,717 adjustment to deferred income taxes.

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.

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. In September 2019, the Company's Board of Directors' declared a 75% stock dividend that was paid on October 31, 2019. Weighted average shares were **2,952,904** and 2,925,631 for 2019 and 2018, 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. No potentially dilutive stock equivalents were outstanding at December 31, 2019 or 2018.

Subsequent events

The Company has evaluated events and transactions occurring subsequent to the statement of financial condition date of December 31, 2019 for items that should potentially be recognized or disclosed in these financial statements as prescribed by FASB Accounting Standards Codification Topic 855, Subsequent Events.

On March 6, 2020, the Company issued a press release in which it announced the execution of an Agreement and Plan of Merger (the "Merger Agreement") with Carroll Bancorp, Inc. ("Carroll") pursuant to which Carroll will be merged with and into the Company, with the Company as the surviving corporation (the "Merger") and, as soon as possible thereafter, Carroll Community Bank, a Maryland commercial bank and wholly-owned subsidiary of Carroll ("Carroll Bank"), will be merged with and into the Bank, with the Bank as the surviving insured depository institution (the "Bank Merger"). Based on financial results as of December 31, 2019, the combined company would have pro forma total assets of $620 million, total deposits of $521 million, and total loans of $512 million. The Merger has been unanimously approved by the boards of directors of both companies. The closing of the Merger is subject to various conditions, including approval of the Merger Agreement by Carroll's stockholders, the companies' receipt of regulatory approvals, and other customary closing conditions. Currently, the Merger is expected to close in the third quarter of 2020, after all such conditions are met. The Merger Agreement provides that Carroll's stockholders will receive cash merger consideration in the aggregate amount of $25 million, subject to a dollar-for-dollar reduction if and to the extent that Carroll's tangible book value prior to the closing does not equal or exceed $18,200,000. Item 1A of Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2019 contains, under the heading "**Risks Relating to Our Pending Merger with Carroll Bancorp, Inc.**", a discussion of the most significant risks relating to the Merger.

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 **$8,500,311** and $5,349,977 during the years ended December 31, 2019 and 2018, 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, 2019	Amortized cost	Unrealized gains	Unrealized losses	Fair value
Available for sale				
State and municipal	**$ 508,134**	**$ 4,536**	**$ -**	**$ 512,670**
SBA pools	**2,203,834**	**-**	**52,037**	**2,151,797**
Mortgage-backed securities	**33,760,999**	**255,843**	**149,535**	**33,867,307**
	$ 36,472,967	**$ 260,379**	**$ 201,572**	**$36,531,774**
Held to maturity				
State and municipal	**$ 19,510,018**	**$ 588,393**	**$ 480**	**$20,097,931**
December 31, 2018				
Available for sale				
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
	$ 27,376,040	$ 44,755	$ 828,804	$ 26,591,991
Held to maturity				
State and municipal	$ 18,127,067	$ 115,220	$ 209,194	$ 18,033,093

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

	Available for Sale		Held to Maturity	
December 31, 2019	Amortized cost	Fair value	Amortized cost	Fair value
Within one year	**$ -**	**$ -**	**$ 257,150**	**$ 261,204**
Over one to five years	**258,134**	**258,838**	**562,587**	**565,140**
Over five to ten years	**250,000**	**253,832**	**2,717,125**	**2,782,474**
Over ten years	**-**	**-**	**15,973,156**	**16,489,113**
	508,134	**512,670**	**19,510,018**	**20,097,931**
Mortgage-backed securities and SBA pools, due in monthly installments	**35,964,833**	**36,019,104**	**-**	**-**
	$36,472,967	**$ 36,531,774**	**$ 19,510,018**	**$ 20,097,931**

3. **Investment Securities** (Continued)

	Available for Sale		Held to Maturity	
December 31, 2018	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
	1,506,011	1,506,505	18,127,067	18,033,093
Mortgage-backed securities and SBA pools, due in monthly installments	25,870,029	25,085,486	-	-
	$ 27,376,040	$ 26,591,991	$ 18,127,067	$ 18,033,093

Securities with a carrying value of **$11,441,474** and $11,706,765 as of December 31, 2019 and 2018, respectively, were pledged as collateral for securities sold under repurchase agreements.

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, 2019	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	**$ 251,618**	**$ 480**	**$ -**	**$ -**	**$ 251,618**	**$ 480**
SBA pools	**-**	**-**	**2,151,797**	**52,037**	**2,151,797**	**52,037**
Mortgage-backed securities	**10,643,624**	**58,063**	**7,295,788**	**91,472**	**17,939,412**	**149,535**
Total	**$ 10,895,242**	**$ 58,543**	**$ 9,447,585**	**$ 143,509**	**$ 20,342,827**	**$ 202,052**

December 31, 2018	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	$ 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	$ 4,474,342	$ 55,418	$ 23,787,341	$ 982,580	$ 28,261,683	$ 1,037,998

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, 2019, 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 the these factors, as of December 31, 2019, 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.

In 2019 and 2018, the Company had no security sales.

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, 2019 and 2018, the activity of these loans was as follows:

	2019	2018
Balance, beginning of year	**$ 13,955,097**	$ 15,577,316
Additions	**5,934,975**	2,069,000
Amounts collected	**(5,338,836)**	(2,669,653)
Change in related parties	**-**	(1,021,566)
Balance, end of year	**$ 14,551,236**	$ 13,955,097

Unused lines of credit to related parties totaled **$337,000** and $634,724 at December 31, 2019 and 2018, respectively.

Deposits at the Company from related parties totaled **$16,237,540** and $14,665,183 at December 31, 2019 and 2018, respectively.

Payments to companies controlled by directors totaled **$22,469** in 2019 and $4,144 in 2018.

5. **Loans**

Major categories of loans at December 31, 2019 and 2018 are as follows:

	2019	2018
Real estate:		
Commercial	**$ 240,938,149**	$ 238,834,149
Construction and land development	**18,194,955**	18,265,505
Residential	**76,122,069**	63,024,106
Commercial	**26,947,503**	23,323,073
Consumer	**292,027**	494,009
	362,494,703	343,940,842
Less: Allowance for loan losses	**2,593,715**	2,509,334
Deferred origination fees net of costs	**518,145**	530,873
	$ 359,382,843	$ 340,900,635

The maturity and rate repricing distribution of the loan portfolio as of December 31, 2019 and 2018, is as follows:

	2019	2018
Variable rate, immediately	**$ 80,832,310**	$ 65,523,966
Due within one year	**42,583,270**	42,060,188
Due over one to five years	**155,924,323**	153,190,636
Due over five years	**83,154,800**	83,166,052
	$ 362,494,703	$ 343,940,842

5. **Loans** (Continued)

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

	2019	2018
Commercial real estate	$ -	$ 988,811

At December 31, 2019, the Company had no nonaccrual loans.

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.

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, 2019							
Real estate:							
Commercial	**$ 224,794**	**$ -**	**$ -**	**$ 224,794**	**$ 240,713,355**	**$ 240,938,149**	**$ -**
Construction and land development	**-**	**-**	**-**	**-**	**18,194,955**	**18,194,955**	**-**
Residential	**59,892**	**-**	**-**	**59,892**	**76,062,177**	**76,122,069**	**-**
Commercial	**-**	**-**	**-**	**-**	**26,947,503**	**26,947,503**	**-**
Consumer	**-**	**-**	**-**	**-**	**292,027**	**292,027**	**-**
Total	**$ 284,686**	**$ -**	**$ -**	**$ 284,686**	**$ 362,210,017**	**$ 362,494,703**	**$ -**
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	$ -	$ 25,000	$ 999,318	$ 1,024,318	$ 342,916,524	$ 343,940,842	$ 10,507

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, 2019							
Commercial real estate	**$ 2,084,988**	**$ 2,084,988**	**$ -**	**$ 2,084,988**	**$ -**	**$ 2,631,185**	**$ 106,874**
Residential real estate	**50,057**	**50,057**	**-**	**50,057**	**-**	**25,029**	**2,876**
	$ 2,135,045	**$ 2,135,045**	**$ -**	**$ 2,135,045**	**$ -**	**$ 2,656,214**	**$ 109,750**
December 31, 2018							
Commercial real estate	$ 3,867,381	$ 3,177,381	$ -	$ 3,177,381	$ -	$ 3,177,381	$ 120,193

5. **Loans** (Continued)

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, 2019, the Company had **one** commercial real estate loan totaling **$2,084,988** and **one** residential loan totaling **$50,057** classified as TDRs. The **$50,057** loan was restructured as a TDR during 2018. Both 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, 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. Both 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.

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.

5. **Loans** (Continued)

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.

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

December 31, 2019	Excellent	Above average	Average	Acceptable	Pass watch	Special mention	Substandard	Doubtful	Total
Real estate:									
Commercial	$ -	$ 2,769,944	$ 91,274,940	$110,566,629	$ 27,438,005	$ -	$ 8,888,631	$ -	$ 240,938,149
Construction and land development	-	216,000	4,737,737	8,572,151	4,669,067	-	-	-	18,194,955
Residential	39,817	1,633,783	30,767,418	34,784,120	6,386,377	-	2,510,554	-	76,122,069
Commercial	153,848	20,000	11,682,299	11,995,143	3,096,213	-	-	-	26,947,503
Consumer	2,327	99,385	91,620	60,049	19,214	-	240	19,192	292,027
	$ 195,992	$ 4,739,112	$138,554,014	$165,978,092	$ 41,608,876	$ -	$ 11,399,425	$ 19,192	$ 362,494,703

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
	$ 1,016,648	$ 4,915,980	$149,320,353	$149,689,041	$ 27,472,332	$ -	$ 11,448,021	$ 78,467	$ 343,940,842

5. **Loans** (Continued)

The following tables detail activity in the allowance for loan losses by portfolio for the years ended December 31, 2019 and 2018. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

						Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
December 31, 2019	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	$ 1,754,372	$ (11,700)	$ -	$ 21,189	$ 1,763,861	$ -	$ 1,763,861	$ 2,084,988	$238,853,161
Construction and land development	196,374	(17,571)	-	14,025	192,828	-	192,828	-	18,194,955
Residential	401,626	76,498	-	-	478,124	-	478,124	50,057	76,072,012
Commercial	102,610	(3,995)	-	9,167	107,782	-	107,782	-	26,947,503
Consumer	10,428	(6,295)	-	-	4,133	-	4,133	-	292,027
Unallocated	43,924	3,063	-	-	46,987	-	46,987	-	-
	$ 2,509,334	$ 40,000	$ -	$ 44,381	$ 2,593,715	$ -	$ 2,593,715	$ 2,135,045	$360,359,658

						Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
December 31, 2018	Beginning balance	Provision 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

Loans with a balance of approximately **$80** million were pledged as collateral to the FHLB as of December 31, 2019. Loans with a balance of approximately **$46** million were pledged as collateral to the Federal Reserve Bank of Richmond (the "FRB") as of December 31, 2019. At December 31, 2019 and 2018, the Company serviced participation loans for others totaling **$24.2** 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.

6. Premises and Equipment

A summary of premises and equipment is as follows:

	Useful lives	2019	2018
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	**4,053,075**	3,796,514
		11,665,708	11,409,147
Accumulated depreciation and amortization		**6,628,857**	6,333,837
		$ 5,036,851	$ 5,075,310
Depreciation and amortization expense		**$ 295,020**	$ 322,705

Software with a net book value of **$47,802** and $73,022 as of December 31, 2019 and 2018, respectively, is included in other assets. Amortization expense of **$49,151** and $57,756 was recorded in 2019 and 2018, 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 three five year terms with an expiration date of September 30, 2024. The lease has options to renew for five 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 2019 for another year. The Company entered into an operating lease for the corporate headquarters in June 2015. In July 2019, the lease was amended to increase the amount of space. The lease expires in June 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.

The following table shows operating lease right of use assets and operating lease liabilities as of December 31, 2019:

	Consolidated Balance Sheet classification	December 31, 2019
Operating lease right of use asset	Other assets	$ 1,392,281
Operating lease liabilities	Other liabilities	$ 1,559,356

Operating lease cost included in occupancy expense in the statement of income was $195,039 during 2019 and $138,778 during 2018.

Future undiscounted lease payments for operating leases with initial terms of one year or more as of December 31, 2019 are as follows:

7. **Commitments and Contingencies** (continued)

Year	Amount
2020	$ 165,099
2021	175,784
2022	185,622
2023	191,939
2024	197,586
Thereafter	911,190
Total lease payments	1,827,220
Less imputed interest	(267,864)
Present value of operating lease liabilities	$ 1,559,356

For operating leases as of December 31, 2019, the weighted average remaining lease term is 9.51 years and the weighted average discount rate is 3.25%. During 2019, cash paid for amounts included in the measurement of lease liabilities was $154,127.

Credit Commitments

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

	2019	2018
Loan commitments		
Construction and land development	**$ 1,322,275**	$ 6,800,240
Commercial	**4,102,000**	1,143,217
Commercial real estate	**7,560,714**	2,853,913
Residential	**770,499**	1,557,500
	$13,755,488	$ 12,354,870
Unused lines of credit		
Home-equity lines	**$ 3,700,404**	$ 3,594,847
Commercial lines	**22,229,095**	23,389,326
	$25,929,499	$ 26,984,173
Letters of credit	**$ 1,935,613**	$ 1,905,553

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.

7. **Commitments and Contingencies** (continued)

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, 2019 and 2018 were **$191,951** and $48,618, 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 **$193,109** and $173,848 for 2019 and 2018, respectively.

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 **$5,873** and $5,673 in 2019 and 2018, 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 **$145,964** and $240,609 in 2019 and 2018, 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:

	2019	2018
NOW	**$ 63,299,218**	$ 56,293,730
Money market	**54,323,501**	54,995,415
Savings	**47,572,517**	43,638,363
Certificates of deposit, $250,000 or more	**33,251,181**	23,335,007
Other time deposits	**117,507,882**	113,732,968
	$315,954,299	$ 291,995,483

As of December 31, 2019, certificates of deposit mature as follows:

Year	Amount
2020	**$ 96,757,612**
2021	**34,086,443**
2022	**12,142,807**
2023	**5,993,296**
2024	**1,778,905**
	$ 150,759,063

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:

			2019	2018
Amounts outstanding at year-end:				
Securities sold under repurchase agreements			**$ 10,958,118**	$ 11,012,000
Federal Home Loan Bank advances are summarized as follows:				
	Maturity date	Interest Rate	Amount	
	9/23/2019	1.25%	-	2,000,000
	11/22/2019	1.99%	-	1,000,000
		Total	$ -	$ 3,000,000
Weighted average rate paid at December 31:				
Securities sold under repurchase agreements			**1.49%**	1.07%
Federal Home Loan Bank advances			**0.00%**	1.50%
Maximum month-end amount outstanding during the year ended December 31:				
Securities sold under repurchase agreements			**$ 10,958,118**	$ 22,173,010
Federal Home Loan Bank advances			**6,500,000**	19,000,000
Average amount outstanding during the year ended December 31:				
Securities sold under repurchase agreements			**$ 9,273,092**	$ 17,479,418
Federal Home Loan Bank advances			**2,610,959**	8,795,890
Borrowings from FRB and commercial banks			**90,966**	249,044
Average rate paid during the year ended December 31:				
Securities sold under repurchase agreements			**1.24%**	0.83%
Federal Home Loan Bank advances			**1.62%**	1.50%
Borrowings from FRB and commercial banks			**2.91%**	1.93%
Investment securities underlying the repurchase agreements at December 31:				
Carrying value			**$ 11,441,474**	$ 11,706,765
Estimated fair value			**11,859,595**	11,710,458
Loans and investment securities pledged to the Federal Home Loan Bank at December 31:				
Carrying value - loans			**$ 80,432,808**	$ 63,305,452
Loans pledged to the Federal Reserve Bank at December 31:				
Carrying value			**$ 46,086,041**	$ 50,682,236

The Company is approved to borrow approximately $59.1 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 $21.2 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.

11. Other Noninterest Expenses

Other noninterest expenses include the following:

	2019	2018
Professional services	$ 448,704	$ 400,759
Advertising	292,301	237,508
Automated teller machine and debit card expenses	254,792	210,644
Directors fees	212,161	197,116
Telephone	204,486	193,631
Stationery, printing, and supplies	181,823	190,057
Insurance claims	178,500	47,726
Postage, delivery, and armored carrier	154,583	179,677
Internet banking fees	152,750	155,208
Correspondent bank services	128,622	94,763
Travel and conferences	52,152	50,553
Liability insurance	49,447	43,414
Maryland state regulatory assessment	48,794	47,967
Dues and subscriptions	41,261	44,603
Remote deposit expenses	31,278	31,923
Federal Deposit Insurance Corporation premiums	30,571	125,143
Credit reports	29,825	26,860
Payroll preparation	21,406	21,652
Other real estate owned	13,408	42,762
Other	137,679	143,728
	$ 2,664,543	$ 2,485,694

12. Income Taxes

The components of income tax expense are as follows:

	2019	2018
Current		
Federal	$ 756,984	$ 834,327
State	336,191	383,242
	1,093,175	1,217,569
Deferred	(53,841)	(111,360)
	$ 1,039,334	$ 1,106,209

12. **Income Taxes** (Continued)

The components of the deferred tax expense are as follows:

	2019	2018
Depreciation	$ 10,501	$ (6,049)
Provision for loan losses	(11,007)	287
Other real estate owned allowance for loss	(57,828)	(15,231)
Nonaccrual interest	31,691	(8,888)
Prepaid captive insurance premium	21,373	(9,325)
Write-down of equity securities	9,767	(4,383)
Capitol loss carryover	(5,300)	-
Lease liability, net of right of use asset	(11,258)	-
Post-retirement benefits	(41,780)	(67,771)
	$ (53,841)	$ (111,360)

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

	2019	2018
Deferred tax assets		
Allowance for loan losses	$ 637,848	$ 626,841
Other real estate owned allowance for loss	286,182	228,354
Write-down of equity securities	2,864	12,631
Capital loss carryover	5,300	-
Nonaccrual interest	-	31,692
Post-retirement benefits	544,442	502,661
Unrealized loss on securities available for sale	-	215,751
Lease liability, net of right of use asset	45,975	-
	1,522,611	1,617,930
Deferred tax liabilities		
Prepaid captive insurance premium	295,039	273,665
Unrealized gain on securities available for sale	16,182	-
Depreciation	175,312	164,811
	486,533	438,476
Net deferred tax asset	$1,036,078	$ 1,179,454

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

	2019	2018
Statutory federal income tax rate	21.0 %	21.0 %
Increase (decrease) resulting from:		
Federal tax-exempt income	(7.0)	(6.5)
State income taxes, net of federal income tax benefit	4.4	4.7
Nondeductible expenses	0.1	0.1
Other	0.1	(0.3)
	18.6 %	19.0 %

12. **Income Taxes** (Continued)

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

Our fiscal year 2016 U.S. consolidated federal tax return is under audit by the IRS. As part of its audit, the IRS is reviewing the deductions related to, and the income generated by, the Insurance Subsidiary. The IRS has not completed its audit and has not communicated its position with respect to our tax treatment of the Insurance Subsidiary. If the IRS were to disagree with our tax treatment of the Insurance Subsidiary and we do not prevail in any challenge to this decision, then we could be required to pay taxes, interest, and penalties totaling approximately $2.1 million as of December 31, 2019. Management believes that it is more than likely that the Company would prevail in any challenge to our tax treatment of the Insurance Subsidiary and, therefore, a reserve for uncertain tax positions has not been recorded.

The Company does not have other 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, 2015.

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, 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%.

13. Capital Standards

The implementation of the capital conservation buffer began on January 1, 2016, at the 0.625% level and was phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reached 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.

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, 2019 and 2018, 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, 2019 and 2018, 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, 2019 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. Capital ratios of the Company are substantially the same as the Bank's.

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, 2019 and 2018, for the Bank under the Basel III Capital Rules.

(Dollars in thousands)	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
December 31, 2019	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)	**$ 51,274**	**13.88%**	**$38,775**	**10.50%**	**$36,928**	**10.00%**
Tier 1 capital (to risk-weighted assets)	**48,681**	**13.18%**	**31,389**	**8.50%**	**29,543**	**8.00%**
Common equity tier 1 (to risk-weighted assets)	**48,681**	**13.18%**	**25,850**	**7.00%**	**24,003**	**6.50%**
Tier 1 leverage (to average assets)	**48,681**	**10.94%**	**17,798**	**4.00%**	**22,247**	**5.00%**

(Dollars in thousands)	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
December 31, 2018	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%

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.
- 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. State of Maryland regulations require that OREO is written down to $0 after a certain period of time.

14. **Fair Value** (Continued)

- 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, 2019 and 2018, 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, 2019				
Recurring				
Available for sale securities				
State and municipal	$ -	$ 512,670	$ -	$ 512,670
SBA pools	-	2,151,797	-	2,151,797
Mortgage-backed securities	-	33,867,307	-	33,867,307
	$ -	$ 36,531,774	$ -	$ 36,531,774
Equity security at fair value	$ 532,321	$ -	$ -	$ 532,321
Nonrecurring				
Other real estate owned	$ -	$ -	$ -	$ -
Impaired loans	-	-	2,135,045	2,135,045
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
	$ -	$ 26,591,991	$ -	$ 26,591,991
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

Reconciliation of Level 3 Inputs

	Other Real Estate Owned	Impaired Loans
December 31, 2018 fair value	$ 210,150	$ 3,177,381
Additions	-	-
Advances	-	-
Write-downs/charge-offs	(210,150)	-
Recoveries	-	15,299
Loan loss provision	-	(15,299)
Principal payments received	-	(1,042,336)
December 31, 2019 fair value	$ -	$ 2,135,045

14. **Fair Value (continued)**

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, 2019		December 31, 2018	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 2 inputs				
Securities held to maturity	**$ 19,510,018**	**$ 20,097,931**	$ 18,127,067	$ 18,033,093
Mortgage loans held for sale	**242,000**	**245,857**	573,638	582,248
Federal Home Loan Bank stock	**376,200**	**376,200**	575,800	575,800
Level 3 inputs				
Loans, net	**359,382,843**	**359,346,031**	340,900,635	337,385,842
Financial liabilities				
Level 1 inputs				
Noninterest-bearing deposits	**$ 60,659,015**	**$ 60,659,015**	$ 62,717,520	$ 62,717,520
Securities sold under repurchase agreements	**10,958,118**	**10,958,118**	11,012,000	11,012,000
Level 2 inputs				
Interest-bearing deposits	**315,954,299**	**313,622,299**	291,995,483	281,761,483
Federal Home Loan Bank advances	**-**	**-**	3,000,000	2,971,000

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).

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.

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,	2019	2018
Assets		
Cash and cash equivalents	$ 64,152	$ 64,243
Investment in subsidiaries	49,389,364	45,330,464
	$ 49,453,516	$ 45,394,707
Liabilities and Stockholders' Equity		
Stockholders' equity		
Common stock, par value $.01 per share, authorized 5,000,000 shares; issued and outstanding 2,974,019 shares in 2019 and 1,682,997 shares in 2018	$ 29,740	$ 16,830
Additional paid-in capital	27,812,991	27,324,794
Retained earnings	21,568,161	18,621,382
Accumulated other comprehensive income	42,624	(568,299)
	49,453,516	45,394,707
	$ 49,453,516	$ 45,394,707

Statements of Income

Years Ended December 31,	2019	2018
Income		
Cash dividends from subsidiary	$ 1,331,917	$ 1,541,225
Total income	1,331,917	1,541,225
Noninterest expense	537	492
Income before before income taxes and equity in undistributed income of subsidiaries	1,331,380	1,540,733
Income taxes (benefit)	-	-
Income before before equity in undistributed income of subsidiaries	1,331,380	1,540,733
Equity in undistributed income of subsidiaries	3,229,424	3,171,943
Net Income	$ 4,560,804	$ 4,712,676

15. **Parent Company Financial Information (continued)**

Statements of Cash Flows

Years Ended December 31,	2019	2018
Cash flows from operating activities		
Net Income	$ 4,560,804	$ 4,712,676
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of subsidiaries	(3,229,424)	(3,171,943)
Other	-	7,479
Cash provided by operating activities	1,331,380	1,548,212
Cash flows from investing activities		
Contibution of capital to subsdiaries	(310,000)	(600,000)
Cash used by investing activities	(310,000)	(600,000)
Cash flows from financing activities		
Proceeds from sale of common stock	-	1,550
Dividends paid, net of reinvestments	(1,021,471)	(933,903)
Cash provided by financing activities	(1,021,471)	(932,353)
Net increase (decrease) in cash and cash equivalents	(91)	15,859
Cash and cash equivalents at beginning of period	64,243	48,384
Cash and cash equivalents at end of period	$ 64,152	$ 64,243

16. Quarterly Results of Operations

	Three Months Ended Unaudited			
2019	December 31	September 30	June 30	March 31
Interest income	**$ 4,776,334**	**$ 4,719,012**	**$ 4,659,456**	**$ 4,547,536**
Interest expense	**977,295**	**956,411**	**924,864**	**821,383**
Net interest income	**3,799,039**	**3,762,601**	**3,734,592**	**3,726,153**
Provision for loan losses	**40,000**	**(13,000)**	**-**	**13,000**
Net income	**1,060,786**	**1,177,910**	**1,225,821**	**1,096,287**
Earnings per share - basic and diluted	**$ 0.36**	**$ 0.40**	**$ 0.42**	**$ 0.37**
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	$ 0.39	$ 0.45	$ 0.39	$ 0.38

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, 2019 there were 2,974,019 shares of Common Stock issued and outstanding held by approximately 477 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.

	High	Low	Dividend Per Share
2019			
Quarter ended December 31	$19.50	$17.01	$0.26
Quarter ended September 30	17.71	17.21	0.00
Quarter ended June 30	17.71	17.18	0.25
Quarter ended March 31	19.43	17.20	0.00
2018			
Quarter ended December 31	$18.85	$16.57	$0.25
Quarter ended September 30	18.28	17.94	0.00
Quarter ended June 30	17.97	17.37	0.23
Quarter ended March 31	19.71	16.74	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 28, 2020 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
American Stock Transfer & Trust Company
6201 15th Avenue
Brooklyn, NY 12219
(800) 937-5449

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Robert S. Glushakow, Esq.
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Hunt Valley, Maryland 21031

Securities Counsel
Andrew D. Bulgin, Esq.
Gordon, Feinblatt, Rothman
Hoffberger & Hollander, LLC
233 East Redwood Street
Baltimore, Maryland 21202

Independent Accountants
Rowles & Company, LLP
8100 Sandpiper Circle, Suite 308
Baltimore, Maryland 21236

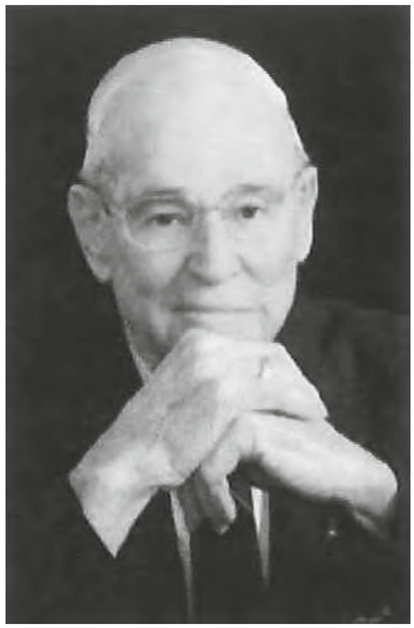
Website
www.fmb1919.bank

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
25 Westminster Pike
Reisterstown, Maryland 21136

In Memory of

W. Ralph Wisner



October 3, 1925 – Friday, August 16, 2019

It is with saddened hearts that we report to you the passing of director W. Ralph Wisner. Ralph served the bank faithfully, as a bank director, for over 40 years. His distinguished service included membership on our Executive Committee, Facilities Committee, and Loan Committee. He was a loyal bank customer for over 50 years. He was an esteemed businessman retiring as Vice President of Crest Contracting Company. He was a devoted family man and member of the community as a lifetime member of Mount Zion United Methodist Church, charter member of the American Legion Hampstead Post 200, and longtime member of Piney Branch Golf Club.

His guidance, kindness and friendship will be missed by all.

We express our sincerest condolences to his family.