

FARMERS AND MERCHANTS BANCSHARES, INC.

2020 Annual Report





◆ THE "COMMUNITY" BANK THAT PUTS PEOPLE FIRST ◆
Member FDIC

March 4, 2021

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, 2020 was \$2,682,003, or \$0.90 per common share, compared to \$4,560,804, or \$1.54 per common share, for the year ended December 31, 2019. On October 1, 2020, the Company consummated its previously-announced acquisition of Carroll Bancorp, Inc. and Carroll Community Bank (collectively "Carroll"). The Company incurred significant one-time costs of \$3,236,817 during the year ended December 31, 2020 related to this acquisition. The table below provides a comparison of the Company's results for the year ended December 31, 2020 and 2019, both with and without the acquisition costs. Net income excluding acquisition costs was the highest in the Company's history.

	Year Ended December 31,		
	2020		2019
	As Reported	Excluding Acquisition Costs	As Reported
Income before taxes	\$ 3,169,214	\$ 6,406,031	\$ 5,600,138
Income taxes	487,211	1,292,806	1,039,334
Net income	\$ 2,682,003	\$ 5,113,225	\$ 4,560,804
Earnings per share	\$ 0.90	\$ 1.71	\$ 1.54
Return on average assets	0.51%	0.97%	1.06%
Return on average equity	5.22%	9.96%	9.52%

Cash dividends paid to stockholders in 2020 increased to \$0.52 per common share from \$0.51 per common share in 2019. The book value of the common stock of Farmers and Merchants Bancshares, Inc. was \$17.18 per share at December 31, 2020, compared to \$16.63 per share at December 31, 2019.

Total assets increased to \$677 million at December 31, 2020 from \$442 million at December 31, 2019. Loans increased to \$522 million at December 31, 2020 from \$359 million at December 31, 2019. Deposits increased to \$573 million at December 31, 2020 from \$377 million at December 31, 2019. The acquisition of Carroll with \$176 million in assets was the primary driver of the significant increases in most assets and liabilities from the prior year end.

COVID-19 certainly played a significant role in 2020 as we continued our business while protecting the health and safety of our customers and employees. We are proud to have helped our community in these difficult times by originating over \$31 million in Paycheck Protection Program loans.

We are excited to have the Carroll acquisition completed and look forward to the positive impact it will have on our 2021 results. We sincerely appreciate all of your confidence in and your support of Farmers and Merchants Bancshares, Inc.

Sincerely yours,

Bruce L. Schindler
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, Route 140, and Route 26 corridors with branches in Owings Mills, Reisterstown, Upperco, Hampstead, Manchester, Westminster, and Eldersburg. The Insurance Subsidiary is a captive insurance entity that provides insurance coverage for Farmers and Merchants Bank.

Services of the Bank

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

Commercial Services

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

Consumer Services

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

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

Farmers and Merchants Bancshares, Inc.

MISSION STATEMENT

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

Farmers and Merchants Bank

LOCATIONS

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

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

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

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

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

Eldersburg Office
1321 Liberty Road
Eldersburg, MD 21784
410-795-1900

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

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

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

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

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

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

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

Commercial Loan Center
Eldersburg Office
1321 Liberty Road
Eldersburg, MD 21784
410-795-1900

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

Bruce L. Schindler, Chairman
 President

Bob Davidson Ford Lincoln

Ronald W. Hux, Vice-Chairman
 President
 Douron, 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.

J. Lawrence Mekulski
 Retired Principal KLNb, LLC

Louna S. Primm
 Retired Bank Executive

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

Teresa L. Smack
 President
 Terry's Tag & Title

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

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
 George W. Peck.....Commercial Banking
 Barry Luciani.....Branch Administration

Vice Presidents

Lynnette Kitzmiller.....Corporate Secretary
 Kevin P. Bankert.....Commercial Banking
 M. Eugene Bosley.....Commercial Banking
 J. Thomas Turner.....Mortgage Officer
 Susan K. Jaeger.....Business Development

Other Bank Officers

T. Jeffrey Horner.....Controller
 Mark W. Lutrey.....Auditor
 Suzette L. Covalt.....Commercial Banking
 Thomas E. Long.....Commercial Banking
 Tracey R. Diggs.....BSA
 Taylor R. Adamez.....Business Development

Assistant Vice Presidents

Loan Officers

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

Assistant Vice Presidents

Branch Managers

Abigail J. Antkowiak.....Eldersburg
 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

	As Reported 2020	Excluding Acquisition Costs 2020 (a)	2019	2018	2017	2016
OPERATING DATA						
Interest income	\$ 20,763,180	\$ 20,763,180	\$ 18,702,338	\$ 17,768,333	\$ 16,594,803	\$ 15,351,497
Interest expense	<u>3,458,677</u>	<u>3,458,677</u>	<u>3,679,953</u>	<u>2,507,241</u>	<u>1,707,240</u>	<u>1,346,120</u>
Net interest income	17,304,503	17,304,503	15,022,385	15,261,092	14,887,563	14,005,377
Provision for loan losses	<u>625,000</u>	<u>625,000</u>	<u>40,000</u>	<u>475,000</u>	<u>410,000</u>	<u>-</u>
Net interest income after provision						
for loan losses	16,679,503	16,679,503	14,982,385	14,786,092	14,477,563	14,005,377
Noninterest income	2,072,119	2,072,119	1,493,567	1,365,273	1,337,094	1,465,197
Acquisition costs	3,236,817	-	-	-	-	-
Noninterest expense	<u>12,345,591</u>	<u>12,345,591</u>	<u>10,875,814</u>	<u>10,332,480</u>	<u>10,023,102</u>	<u>9,534,625</u>
Income before income taxes	3,169,214	6,406,031	5,600,138	5,818,885	5,791,555	5,935,949
Income taxes	<u>487,211</u>	<u>1,292,806</u>	<u>1,039,334</u>	<u>1,106,209</u>	<u>2,002,314</u>	<u>2,026,820</u>
Net income	<u>\$ 2,682,003</u>	<u>\$ 5,113,225</u>	<u>\$ 4,560,804</u>	<u>\$ 4,712,676</u>	<u>\$ 3,789,241</u>	<u>\$ 3,909,129</u>

PER SHARE DATA

Net income (Basic)	\$0.90	\$1.71	\$1.54	\$1.61	\$1.30	\$1.35
Dividends	\$0.52		\$0.51	\$0.47	\$0.43	\$0.40
Book value	\$17.18		\$16.63	\$15.41	\$14.32	\$13.46

KEY RATIOS

Return on average assets	0.51%	0.97%	1.06%	1.14%	0.96%	1.08%
Return on average equity	5.22%	9.96%	9.52%	10.77%	9.26%	10.26%
Efficiency ratio	80.42%	63.71%	65.85%	62.15%	61.78%	61.63%
Dividend payout ratio	57.78%	30.41%	33.12%	29.43%	33.33%	29.58%
Net yield on interest-earning assets	3.67%		3.67%	3.88%	4.04%	4.21%
Tier 1 capital leverage ratio	9.05%		10.94%	10.86%	10.31%	10.39%

AT PERIOD END

Total assets	\$ 677,317,082	\$ 442,215,098	\$ 417,157,877	\$ 402,904,469	\$ 379,831,359
Gross loans	524,987,052	362,494,703	343,940,842	335,595,916	298,126,919
Cash and cash equivalents	40,975,670	9,121,352	14,618,237	7,237,385	13,312,915
Securities	77,555,805	56,041,792	44,719,058	46,133,692	52,373,567
Deposits	573,401,547	376,613,314	354,713,003	319,796,424	302,715,136
Borrowings	42,227,252	10,958,118	14,012,000	38,768,507	36,226,159
Stockholders' equity	51,729,483	49,453,516	45,394,707	41,798,932	39,012,277

SELECTED AVERAGE BALANCES

Total assets	\$ 526,539,417	\$ 431,595,287	\$ 412,586,954	\$ 396,454,271	\$ 361,005,005
Gross loans	421,010,433	344,793,736	343,573,784	319,825,707	284,804,975
Cash and cash equivalents	21,272,187	20,124,328	12,054,442	12,428,778	13,271,319
Securities	65,583,845	53,049,768	44,471,457	50,251,527	48,301,835
Deposits	369,504,859	367,570,825	339,624,630	315,159,559	284,921,811
Borrowings	18,638,621	11,975,017	26,524,352	38,627,588	36,175,989
Stockholders' equity	51,344,333	47,927,778	43,748,434	40,926,674	38,115,746

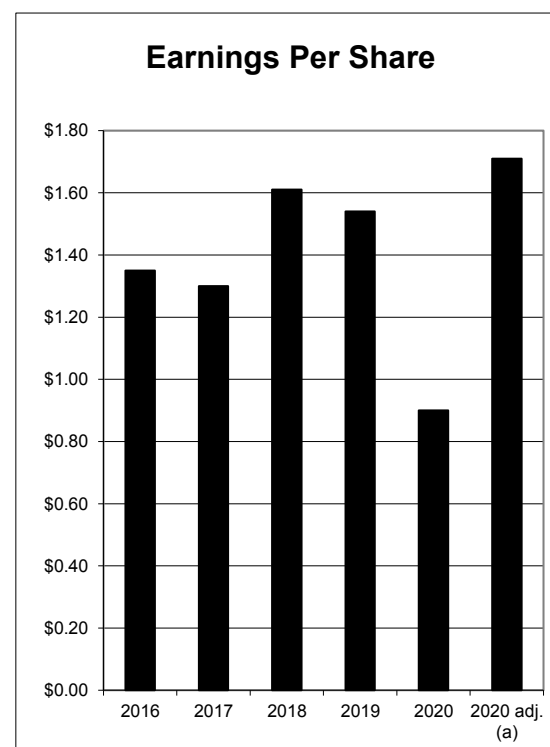
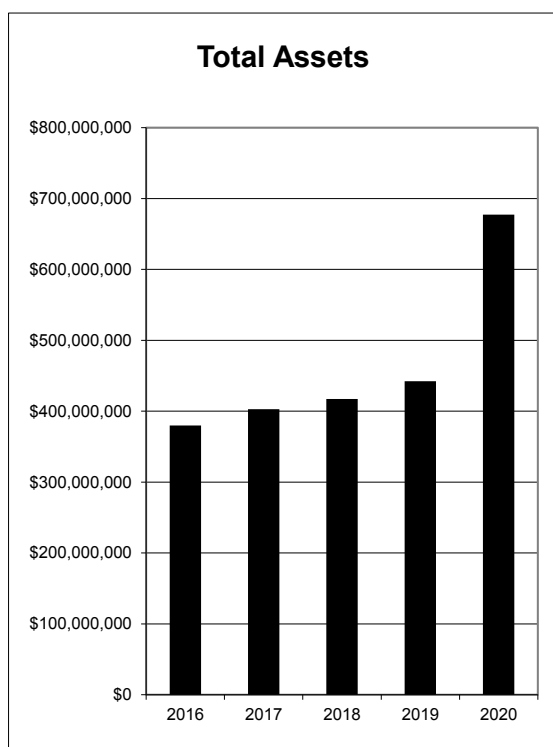
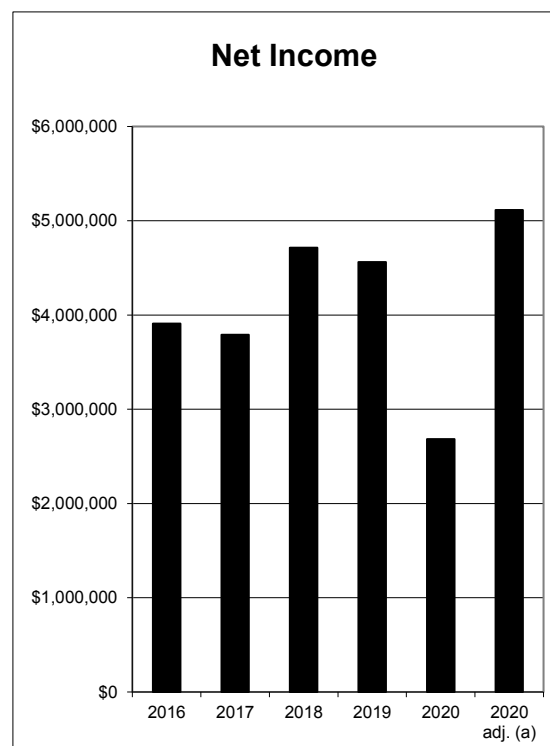
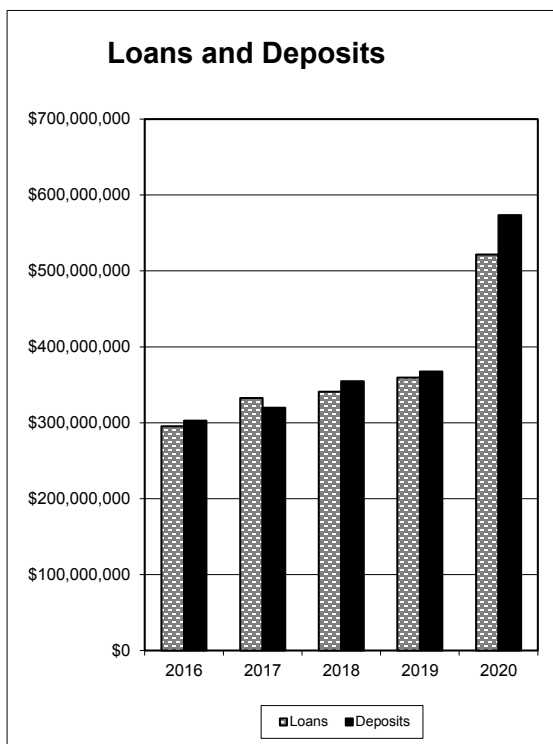
ASSET QUALITY

Nonperforming assets	\$ 6,048,577	\$ -	\$ 1,209,468	\$ 2,657,702	\$ 1,166,889
Nonperforming assets/total assets	0.89%	0.00%	0.29%	0.66%	0.31%
Allowance for loan losses/total loans	0.63%	0.72%	0.73%	0.73%	0.79%

(a) - Operating data and related ratios are presented for 2020 excluding the one-time costs incurred during the acquisition of Carroll Bancorp, Inc.

Farmers and Merchants Bancshares, Inc.

Selected Consolidated Financial Data



(a) - Excluding the one-time costs incurred during the acquisition of Carroll Bancorp, Inc.

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, 2020 and 2019, 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.

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.

Management applies various valuation methodologies to assets and liabilities which often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets, such as most investment securities. However, for those items for which an observable liquid market does not exist, management utilizes significant estimates and assumptions to value such items. Examples of these items include loans, deposits, borrowings, goodwill, core deposit and other intangible assets, other assets and liabilities obtained or assumed in

Farmers and Merchants Bancshares, Inc.

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

business combinations. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on our results of operations, financial condition or disclosures of fair value information. In addition to valuation, we must assess whether there are any declines in value below the carrying value of assets that should be considered other than temporary or otherwise require an adjustment in carrying value and recognition of a loss in the consolidated statements of income. Examples include investment securities, goodwill and core deposit intangible, among others.

COVID-19 PANDEMIC

The COVID-19 pandemic has been wreaking havoc on the U.S. economy since the World Health Organization declared it a pandemic on March 11, 2020. The full impact and its effect on the banking industry, including the Company, will not be known for several quarters, but will be significant.

The U.S. and state governments reacted to the outbreak of the pandemic by issuing shelter-at-home orders and requiring that non-essential businesses be closed to prevent spread of the virus. The health crisis quickly turned into a financial crisis resulting in guidance and mandates regarding foreclosures and repossessions and accounting and regulatory changes designed to encourage banks to work with customers suffering detrimental financial impact.

Although states, including Maryland, have eased several of the COVID-19 restrictions, including stay-at-home orders and the required closure of non-essential businesses, there appears to be a resurgence of COVID-19 cases in many states, including Maryland. As a result, it is possible that states, including Maryland, will re-implement some or all of the COVID-19 related restrictions and again require some or all non-essential businesses to close or drastically alter their business operations, which could have a material adverse impact on our customers and, thus, our financial condition and results of operations.

PAYCHECK PROTECTION PROGRAM

The U.S. Government's Coronavirus Aid, Relief, and Economic Security Act, as amended (the "CARES Act") established the Small Business Administration ("SBA") Paycheck Protection Program ("PPP"), which provides small businesses with resources to maintain payroll, hire back employees who may have been laid off, and to cover applicable overhead expenses. Following the enactment of the CARES Act and the establishment of the PPP, we acted expeditiously to prepare our associates so they could guide our customers on the proper procedures necessary to enable them to take advantage of this program. We developed a PPP specific information site within our website that provided detailed information, links and materials for eligible customers to access. Internally, we reallocated resources to review, process and data enter customer applications, working tirelessly over extended hours to provide access to as many local business owners as possible. We were able to fund 172 loan applications for approximately \$25.3 million from the first tranche of PPP designated funds. Congress allocated additional funding to the PPP on April 23, 2020, and we were able to gain approval for an additional 101 loan applications for approximately \$5.8 million through December 31, 2020. During 2020, we gained approval for over \$31 million to 273 small businesses. Approximately 70% of the loans were under \$100,000 in size. All PPP loans are 100% guaranteed by the SBA, have up to a five-year maturity (the majority of our PPP originations have a two-year maturity), provide for a six-month deferral period, and have an interest rate of 1%. These loans may be forgiven by the SBA if the borrower meets certain conditions, including by using at least 75% of the loan proceeds for payroll costs. The SBA also established processing fees from 1% to 5%, depending on the loan amount. During 2020, we received \$1,285,719 in fees which, net of related origination costs, will be

Farmers and Merchants Bancshares, Inc.

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

amortized into interest income over the life of the loans. On December 27, 2020, Congress allocated additional funding to the PPP. Through February 24, 2021, we have gained approval for 121 loans applications for approximately \$18.4 million from the third tranche of PPP designated funds.

In April 2020, the Bank established eligibility to participate in the Paycheck Protection Program Liquidity Facility ("PPPLF"), which was established by Congress and administered by the Federal Reserve Bank. This facility uses the SBA guaranteed PPP loans as collateral, offering 100% collateral coverage with no recourse to the Bank. The majority of the PPP loan disbursements were to internal, non-interest-bearing accounts for use by borrowers. As a result, we have not yet accessed the PPPLF, but are prepared to utilize the fund when management determines the timing is appropriate.

FINANCIAL CONDITION

Effective on October 1, 2020, the Company consummated its previously-announced acquisition of Carroll Bancorp, Inc. and its wholly-owned subsidiary, Carroll Community Bank (collectively, "Carroll") in a series of merger transactions (the "Merger") pursuant to which the stockholders of Carroll Bancorp, Inc. received cash in the aggregate amount of \$24.8 million in exchange for their shares of common stock of Carroll Bancorp, Inc. The merger consideration was paid by the Company using \$7.8 million in cash and \$17 million in proceeds from a third-party term loan obtained in connection with the Merger. At the Effective Time of the Merger, Carroll had total assets of \$176,159,890, net loans of \$145,153,100, and total liabilities of \$157,992,286, of which \$144,896,990 represented deposits. The Merger was accounted for as a business combination using the acquisition method of accounting, and, accordingly, assets acquired and liabilities assumed were recorded at estimated fair values at the effective time of the Merger.

The following table presents the book values and fair values of the assets, liabilities, and equity of Carroll at the effective time of the Merger:

Farmers and Merchants Bancshares, Inc.

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

	Book value	Fair value
Cash	\$ 5,441,610	\$ 5,441,610
Certificates of deposit in other bar	750,000	750,000
Securities available for sale	12,863,795	12,922,620
Restricted stock, at cost	926,700	926,700
Loans held for sale	1,702,950	1,743,195
Loans	145,153,100	145,080,950
Premises and equipment	2,619,413	2,684,240
Other real estate owned	1,411,605	1,411,605
Other assets	5,290,717	5,388,546
Goodwill and other intangibles	-	7,061,490
Total assets	<u>\$ 176,159,890</u>	<u>\$ 183,410,956</u>
Deposits	\$ 144,896,990	\$ 145,513,085
FHLB advances	13,000,000	13,000,000
Other liabilities	95,296	90,143
Total liabilities	<u>157,992,286</u>	<u>158,603,228</u>
Stockholders' equity	18,167,604	24,807,728
Total liabilities and stockholders' equity	<u>\$ 176,159,890</u>	<u>\$ 183,410,956</u>

Total assets were \$667,317,082 at December 31, 2020, an increase of \$235,101,984, or 53.2%, over the \$442,215,098 recorded at December 31, 2019. The increase was due primarily to an increase of \$162,307,671 in loans, and increase of \$31,854,318 in cash and cash equivalents, and an increase of \$21,514,013 in securities available for sale and held for maturity. A significant portion of these increases was due to the Merger and the origination of the PPP loans.

Total liabilities were \$625,587,599 at December 31, 2020, an increase of \$232,826,017, or 59.3%, over the \$392,761,582 recorded at December 31, 2019. The increase was due primarily to an increase of \$196,788,233 in deposits, an increase of \$13,795,854 of securities sold under repurchase agreements, and an increase of \$16,973,280 in long-term debt. The increase in deposits was comprised of a \$42,496,098 increase in noninterest-bearing accounts and a \$154,292,135 increase in interest-bearing accounts. A significant portion of the increases in deposits was due to the Merger and the deposits generated from the PPP loans.

Stockholders' equity was \$51,729,483 at December 31, 2020 compared to \$49,453,516 at December 31, 2019, an increase of \$2,275,967. The increase was due primarily to net income for 2020 of \$2,682,003 and an increase in the after-tax unrealized gain on available for sale securities of \$663,653, offset by dividends paid, net of reinvestments, of \$1,069,689.

Loans

Major categories of loans at December 31, 2020, 2019, 2018, 2017, and 2016, are as follows:

Farmers and Merchants Bancshares, Inc.

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

	2020		2019		2018		2017		2016	
Real estate:										
Commercial	\$ 274,501,327	52%	\$ 240,938,149	67%	\$ 238,834,149	70%	\$ 234,026,574	70%	\$ 206,145,076	69%
Construction/Land development	33,641,916	6%	18,194,955	5%	18,265,505	5%	18,160,366	5%	14,392,992	5%
Residential	156,111,245	30%	76,122,069	21%	63,024,106	18%	59,241,416	18%	54,710,809	18%
Commercial	61,368,105	12%	26,947,503	7%	23,323,073	7%	23,613,543	7%	22,152,773	8%
Consumer	288,454	0%	292,027	0%	494,009	0%	554,017	0%	725,269	0%
	<u>525,911,047</u>	<u>100%</u>	<u>362,494,703</u>	<u>100%</u>	<u>343,940,842</u>	<u>100%</u>	<u>335,595,916</u>	<u>100%</u>	<u>298,126,919</u>	<u>100%</u>
Less: Allowance for loan losses	3,296,538		2,593,715		2,509,334		2,458,911		2,363,086	
Deferred origination fees net of costs	<u>923,995</u>		<u>518,145</u>		<u>530,873</u>		<u>603,299</u>		<u>477,261</u>	
	<u>\$ 521,690,514</u>		<u>\$ 359,382,843</u>		<u>\$ 340,900,635</u>		<u>\$ 332,533,706</u>		<u>\$ 295,286,572</u>	

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

Loans increased by \$162,307,671, or 45.2%, to \$521,690,514 at December 31, 2020 from \$359,382,843 at December 31, 2019. The growth was due primarily to increases in commercial real estate loans of \$33,563,178, commercial loans of \$34,420,602, residential real estate loans of \$79,989,176, and construction/land development loans of \$15,446,961. The allowance for loan losses increased \$702,823 to \$3,296,538 at December 31, 2020 as compared to \$2,593,715 at December 31, 2019.

Commercial loans in the table above include \$32,071,443 of Paycheck Protection Program ("PPP") loans at December 31, 2020, which are 100% guaranteed by the Small Business Administration ("SBA"). A substantial portion of the PPP loans in the Company's portfolio at December 31, 2020 are expected to be forgiven by the SBA. During the year-ended December 31, 2020, the Company collected approximately \$1,286,000 in fees from the SBA in connection with the originations of the PPP loans. The fees, net of related origination costs, are being recognized as interest income over the term of the loans using the straight-line method, with accelerated recognition when the loan pays off before maturity through SBA forgiveness or by other means.

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:

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	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
2020							
Real estate:							
Commercial	\$ 182,656	\$ -	\$ -	\$ 182,656	\$ 274,318,671	\$ 274,501,327	\$ -
Construction/Land development	-	-	-	-	33,641,916	33,641,916	-
Residential	24,591	-	220,967	245,558	155,865,687	156,111,245	-
Commercial	-	-	-	-	61,368,105	61,368,105	-
Consumer	-	-	-	-	288,454	288,454	-
Total	\$ 207,247	\$ -	\$ 220,967	\$ 428,214	\$ 525,482,833	\$ 525,911,047	\$ -
	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

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	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
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	\$ -

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 unless there are mitigating factors. 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:

	2020	2019	2018	2017	2016
Non-accrual loans					
Commercial real estate	\$ 4,407,829	\$ -	\$ 988,811	\$ 2,245,743	\$ -
Construction/Land development	-	-	-	-	752,889
Residential real estate	220,967	-	-	-	-
Total non-accrual loans	\$ 4,628,796	\$ -	\$ 988,811	\$ 2,245,743	\$ 752,889

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At December 31, 2020, the Company had one nonaccrual commercial real estate loan totaling \$4,407,829 and two nonaccrual residential real estate loans totaling \$220,967. The loans were secured by real estate, business assets and a personal guaranty. Gross interest income of \$13,395 would have been recorded in 2020 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 and a nonaccretable discount totaling \$8,176 at December 31, 2020.

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

At December 31, 2020, the Company had no loans that were delinquent 90 days or greater other than the nonaccrual loans listed above. At December 31, 2019, the Company had no loans that were delinquent 90 days or greater.

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

	2020	2019	2018	2017	2016
Impaired loans no valuation allowance	\$ 6,875,374	\$ 2,135,045	\$ 3,177,381	\$ 2,937,439	\$ 2,348,275
Impaired loans with a valuation allowance	2,313,161	-	-	2,245,743	994,469
Total impaired loans	<u>\$ 9,188,535</u>	<u>\$ 2,135,045</u>	<u>\$ 3,177,381</u>	<u>\$ 5,183,182</u>	<u>\$ 3,342,744</u>
Valuation allowance related to impaired loans	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 127,213</u>	<u>\$ 24,167</u>

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

At December 31, 2020, the Company had two commercial real estate loans totaling \$2,252,316 and one residential loan totaling \$44,733 classified as TDRs. One of the commercial real estate loans with a principal balance of \$182,656 was restructured as a TDR during 2020. All three loans are included in impaired loans above. Each loan is paying as agreed. There have been no charge-offs or allowances associated with these three loans.

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. 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.

Year-end TDRs are set forth in the following table:

	2020	2019	2018	2017	2016
Restructured loans (TDRs):					
Performing as agreed	\$ 2,297,049	\$ 2,135,045	\$ 2,188,570	\$ 2,937,439	\$ 2,348,275
Not performing as agreed	-	-	-	-	241,580
Total TDRs	<u>\$ 2,297,049</u>	<u>\$ 2,135,045</u>	<u>\$ 2,188,570</u>	<u>\$ 2,937,439</u>	<u>\$ 2,589,855</u>

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Section 4013 of the U.S. Government's Coronavirus Aid, Relief, and Economic Security Act allows financial institutions to suspend application of certain current TDR accounting guidance under ASC 310-40 for loan modifications related to the COVID-19 pandemic made between March 1, 2020 and the earlier of December 31, 2020 or 60 days after the end of the COVID-19 national emergency, provided certain criteria are met. This relief can be applied to loan modifications for borrowers that were not more than 30 days past due as of December 31, 2019 and to loan modifications that defer or delay the payment of principal or interest, or change the interest rate on the loan. In April 2020, federal and state banking regulators issued the Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus to provide further interpretation of when a borrower is experiencing financial difficulty, specifically indicating that if the modification is either short-term (e.g., six months) or mandated by a federal or state government in response to the COVID-19 pandemic, the borrower is not experiencing financial difficulty under Accounting Standards Codification ("ASC") 310-40. The Company continues to prudently work with borrowers who have been negatively impacted by the COVID-19 pandemic while managing credit risks and recognizing appropriate allowance for loan losses on its loan portfolio. During the second quarter of 2020, the Company modified loans, due to the pandemic and at the borrower's request, with an aggregate principal balance of \$109.2 million, or 30% of its loan portfolio. During the third quarter of 2020, \$21.8 million of these previously-deferred loans were granted additional three-month deferrals, which amount represented 6% of the Company's loan portfolio. At December 31, 2020, five of these previously-deferred loans along with two loans acquired in the Merger totaling \$14.7 million in the aggregate, or 3% of the portfolio, had been granted additional payment deferrals. None of these loans were classified as TDRs as of December 31, 2020 because they met the criteria discussed above.

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.

Year-end loans graded special mention, substandard and doubtful are set forth in the following table:

	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Special mention	\$ 5,951,177	\$ -	\$ -	\$ 5,391,589	\$ 8,962,940
Substandard	13,732,062	11,399,425	11,448,021	4,625,568	6,399,618
Doubtful	11,265	19,192	78,467	2,274,162	29,742
Total	<u>\$ 19,694,504</u>	<u>\$ 11,418,617</u>	<u>\$ 11,526,488</u>	<u>\$ 12,291,319</u>	<u>\$ 15,392,300</u>

The allowance for loan losses is a reserve established through a provision for loan losses and is charged to expense. The allowance for loan losses represents an amount which, in management's judgment, will be adequate to absorb probable losses on existing loans and other extensions of credit that may become uncollectible. The Company's allowance for loan loss methodology includes allowance allocations calculated in accordance with 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

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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 currently available information, 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, 2020, 2019, 2018, 2017, and 2016. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

December 31, 2020	Beginning balance	Provision		Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
		for loan losses	Charge offs			Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,763,861	\$ 418,806	\$ -	\$ 47,462	\$ 2,230,129	\$ -	\$ 2,230,129	\$ 6,811,698	\$ 267,689,629
Construction and									
land development	192,828	(5,536)	-	14,400	201,692	-	201,692	1,566,174	32,075,742
Residential	478,124	166,515	-	-	644,639	-	644,639	810,633	155,300,582
Commercial	107,782	(12,353)	-	15,961	111,390	-	111,390	-	61,368,105
Consumer	4,133	(1,995)	-	-	2,138	-	2,138	-	288,454
Unallocated	46,987	59,563	-	-	106,550	-	106,550	-	-
	<u>\$ 2,593,715</u>	<u>\$ 625,000</u>	<u>\$ -</u>	<u>\$ 77,823</u>	<u>\$ 3,296,538</u>	<u>\$ -</u>	<u>\$ 3,296,538</u>	<u>\$ 9,188,505</u>	<u>\$ 516,722,512</u>

December 31, 2019	Provision					Allowance for loan losses		Outstanding loan	
	Beginning balance	for loan losses	Charge offs	Recoveries	Ending balance	ending balance evaluated		balances evaluated	
						for impairment:		for impairment:	
						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

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December 31, 2018	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated		Outstanding loan balances evaluated	
						for impairment:		for impairment:	
						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	-	-
	<u>\$ 2,458,911</u>	<u>\$ 475,000</u>	<u>\$ (702,115)</u>	<u>\$ 277,538</u>	<u>\$ 2,509,334</u>	<u>\$ -</u>	<u>\$ 2,509,334</u>	<u>\$ 3,177,381</u>	<u>\$ 340,763,461</u>

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

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

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

	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Allowance for loan losses to total loans outstanding	<u>0.63%</u>	<u>0.72%</u>	<u>0.73%</u>	<u>0.73%</u>	<u>0.79%</u>
Ratio of net charge-offs to average loans outstanding during the period	<u>-0.02%</u>	<u>-0.01%</u>	<u>0.12%</u>	<u>0.10%</u>	<u>0.08%</u>

The Company recorded net recoveries of \$77,823 and \$44,381 for 2020 and 2019, respectively. The provision for loan losses was \$625,000 in 2020 and \$40,000 in 2019.

Other Real Estate Owned

Other real estate owned ("OREO") at December 31, 2020 included two properties with an aggregate carrying value of \$1,411,605. The first property is an apartment building in Baltimore, Maryland with a carrying value of \$1,411,605 that was obtained in the Merger. The property is under an optional sales contract with no projected closing date. The other property is land in Cecil County, Maryland with a carrying value of \$0. It was acquired through foreclosure in 2007. The latter property consists of 10.43 acres and is currently under contract for a gross sales price of \$295,000 with closing expected in 2021. Due to the length of time the property has been held, Maryland banking law required a write-down of the value to \$0 in 2019.

	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Other Real Estate Owned	<u>\$ 1,411,605</u>	<u>\$ -</u>	<u>\$ 210,150</u>	<u>\$ 265,500</u>	<u>\$ 414,000</u>

Investment Securities

Investment securities increased \$21,514,013, or 38.4%, to \$77,555,805 at December 31, 2020 from \$56,041,792 at December 31, 2019. At December 31, 2020 and 2019, the Company had classified 70% and 65%, respectively, of the investment portfolio as available for sale. The remaining balance of the portfolio was classified as held to maturity.

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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:

	2020	2019	2018
<u>Available for sale</u>			
State and municipal	\$ 986,532	\$ 512,670	\$ 1,506,505
SBA pools	1,783,807	2,151,797	2,719,372
Corporate bonds	6,797,431	-	-
Mortgage-backed securities	44,909,516	33,867,307	22,366,114
	<u>\$ 54,477,286</u>	<u>\$ 36,531,774</u>	<u>\$ 26,591,991</u>
<u>Held to maturity</u>			
State and municipal	<u>\$ 23,078,519</u>	<u>\$ 19,510,018</u>	<u>\$ 18,127,067</u>

The following table sets forth the scheduled maturities of investment securities at December 31, 2020:

	<u>Available for Sale</u>			<u>Held to Maturity</u>		
	Amortized Cost	Fair Value	Yield	Amortized Cost	Fair Value	Yield
Within 1 year	\$ 505,372	\$ 502,475	3.73%	\$ 487,741	\$ 496,463	4.24%
Over 1 to 5 years	4,646,388	4,755,483	2.78%	793,876	813,523	2.93%
Over 5 to 10 years	2,300,591	2,323,451	4.62%	2,476,827	2,687,063	3.47%
Over 10 years	202,243	202,554	0.97%	19,320,075	20,247,737	3.01%
	7,654,594	7,783,963	3.35%	23,078,519	24,244,786	3.08%
SBA Pools	1,822,226	1,783,807	1.27%	-	-	-
Mortgage-backed securities	44,026,055	44,909,516	1.59%	-	-	-
	<u>\$ 53,502,875</u>	<u>\$ 54,477,286</u>	<u>1.83%</u>	<u>\$ 23,078,519</u>	<u>\$ 24,244,786</u>	<u>3.08%</u>

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

Deposits

Total deposits were \$573,401,547 at December 31, 2020 compared to \$376,613,314 at December 31, 2019, an increase of \$196,788,233, or 52.3%. The increase was due to a \$47,092,893 increase in certificates of deposit, a \$33,318,417 increase in savings accounts, a \$44,464,294 increase in interest bearing checking accounts,

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

a \$29,416,531 increase in money market accounts and a \$42,496,098 increase in noninterest-bearing accounts. The following table shows the average balances and average costs of deposits for the years ended December 31:

	2020		2019		2018	
	Average Balance	Cost	Average Balance	Cost	Average Balance	Cost
Noninterest bearing demand deposits	\$ 82,514,991	0.00%	\$ 59,374,960	0.00%	\$ 61,972,038	0.00%
Interest bearing demand deposits	83,893,984	0.28%	56,851,471	0.19%	48,070,664	0.22%
Savings and money market deposits	119,532,831	0.24%	101,375,083	0.40%	97,644,061	0.25%
Certificates of deposit	166,078,044	1.57%	149,969,311	2.01%	131,937,867	1.42%
	<u>\$ 452,019,850</u>	<u>0.69%</u>	<u>\$ 367,570,825</u>	<u>0.96%</u>	<u>\$ 339,624,630</u>	<u>0.65%</u>

As of December 31, 2020, certificates of deposit of \$100,000 or more mature as follows:

Period	Balance
3 months or less	\$ 25,139,310
Over 3 months to 6 months	16,412,064
Over 6 months to 12 months	22,724,193
Over 12 months	29,151,118
Total	<u>\$ 93,426,685</u>

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, 2020, the Company's off-balance sheet financial instruments were as follows:

Loan commitments	\$ 26,109,020
Unused lines of credit	\$ 37,713,573
Letters of credit	\$ 1,891,428

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.

Farmers and Merchants Bancshares, Inc.

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

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.

On September 30, 2020, the Company borrowed \$17,000,000 from First Horizon Bank ("FHN") to be used in the Merger on October 1, 2020. Net of issuance costs of \$28,126, the proceeds of the net long-term debt was \$16,971,874. The loan matures on September 30, 2025. The interest rate on the loan is fixed at 4.10%. The Company is required to make quarterly interest-only payments through October 1, 2021. The Company expects that the amount of these quarterly interest-only payments will be \$174,250. During the remaining term of the loan, the Company is required to make quarterly interest and principal payments of approximately \$646,472, which will be based on a nine-year straight-line amortization schedule. The remaining balance of approximately \$9,916,667 will be due at maturity. To secure its obligations under this loan, the Company pledged all of its shares of common stock of the Bank to the lender.

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

	At December 31,		
	<u>2020</u>	<u>2019</u>	<u>2018</u>
Amount outstanding at year-end:			
Securities sold under repurchase agreements	\$ 24,753,972	\$ 10,958,118	\$ 11,012,000
Federal Home Loan Bank advances	5,000,000		3,000,000
Federal Home Loan Bank advances mature in:			
2020	\$ -	\$ -	\$ 3,000,000
2025	5,000,000	-	-
Long-term debt (net of issuance costs) matures in	2025	16,973,280	-
Weighted average rate paid at December 31:			
Securities sold under repurchase agreements	0.61%	1.49%	1.07%
Federal Home Loan Bank advances	1.00%	0.00%	1.50%
Long-term debt	4.10%	0.00%	0.00%

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

	For years ended December 31,		
	<u>2020</u>	<u>2019</u>	<u>2018</u>
Maximum amount of borrowings outstanding at any month end:			
Securities sold under repurchase agreements	\$ 24,753,972	\$ 10,958,118	\$ 22,173,010
Federal Home Loan Bank advances	10,000,000	6,500,000	19,000,000
Long-term debt (net of issuance costs)	16,973,280	-	-
Average amount of borrowings outstanding with respect to:			
Securities sold under repurchase agreements	\$ 9,355,593	\$ 9,273,092	\$ 17,479,418
Federal Home Loan Bank advances	4,877,052	2,610,959	8,795,890
Borrowings from FRB and commercial banks	-	90,966	249,044
Long-term debt (net of issuance costs)	4,425,976	-	-
Average rate paid for the year:			
Securities sold under repurchase agreements	1.15%	1.24%	0.83%
Federal Home Loan Bank advances	0.84%	1.62%	1.50%
Borrowings from FRB and commercial banks	0.00%	2.91%	1.93%
Long-term debt	4.10%	0.00%	0.00%

The terms of the Company's operating leases, including the future minimum payments under those leases, are disclosed in Note 9 to the consolidated financial statements.

RESULTS OF OPERATIONS

Overview

The Company reported net income of \$2,682,003 for the year ended December 31, 2020 compared to \$4,560,804 for the year ended December 31, 2019. The decrease of \$1,878,801 from 2019 was due to an increase in noninterest expense of \$4,706,594 and an increase in the provision for loan losses of \$585,000, offset by an increase in net interest income of \$2,282,118, an increase in noninterest income of \$578,552, and a decrease in income taxes of \$552,123. Included in noninterest expense was \$3,236,817 of one-time expenses incurred in connection with the Merger. Without these acquisition costs, net income would have been \$5,113,225 for the year ended December 31, 2020. The table below provides a comparison of the Company's results for the year ended December 31, 2020 and 2019, both with and without the acquisition costs.

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

	Year Ended December 31,		
	2020		2019
	As Reported	Excluding Acquisition Costs	As Reported
Income before taxes	\$ 3,169,214	\$ 6,406,031	\$ 5,600,138
Income taxes	487,211	1,292,806	1,039,334
Net income	<u>\$ 2,682,003</u>	<u>\$ 5,113,225</u>	<u>\$ 4,560,804</u>
Earnings per share	\$ 0.90	\$ 1.71	\$ 1.54
Return on average assets	0.51%	0.97%	1.06%
Return on average equity	5.22%	9.96%	9.52%

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, 2020, the Company recorded net interest income of \$17,304,503 compared to \$15,022,385 for 2019, an increase of \$2,282,118. The increase was attributable to an increase in the average balance of interest-earning assets of \$85,331,237 to \$500,045,945 in 2020 from \$414,714,708 in 2019, offset by a decline in the net yield on interest-earning assets of 17 basis points to 3.50% in 2020 from 3.67% in 2019.

Total interest income for the year ended December 31, 2020 increased by \$2,060,842 to \$20,763,180, from \$18,702,338 for 2019. The increase was due primarily to the aforementioned increase in average interest earning assets, offset by a decrease of 36 basis points in the tax equivalent yield on interest earning assets to 4.19% in 2020 from 4.55% in 2019.

Interest income from loans was \$19,291,162 in 2020 compared to \$16,894,657 in 2019, an increase of \$2,396,505. This increase was attributable to a \$76,216,697 increase in the average balance of loans to \$421,010,433 in 2020 from \$344,793,736 in 2019, offset by a 32 basis point decrease in the average yield on loans to 4.58% in 2020 from 4.90% in 2019.

For the year ended December 31, 2020, the Company recorded interest income on securities of \$1,395,493. For the same period of 2019, interest income on securities was \$1,449,841. The \$54,348 decrease in 2020 was attributable to a 65 basis point decrease in the average tax equivalent yield on securities to 2.40% in 2020 from 3.05% in 2019, offset by a \$12,534,077 increase in the average balance of securities to \$65,583,845 in 2020 from \$53,049,768 in 2019.

Interest income on federal funds sold and other interest-earning assets (FHLB stock and certificates of deposit) decreased \$281,315 to \$76,525 in 2020 compared to \$357,840 in 2019. The decrease was due to a 1.62% decrease in the average tax equivalent yield to 0.59% in 2020 from 2.21% in 2019, and a \$3,419,537 decrease in the average balance of federal funds sold and other interest-earning assets to \$13,451,667 in 2020 from \$16,871,204 in 2019.

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

Total interest expense decreased \$221,276 to \$3,458,677 in 2020 compared to \$3,679,953 in 2019. The decrease was due to a 26 basis point decrease in the cost of interest-bearing liabilities to 0.89% in 2020 from 1.15% in 2019, offset by an increase of \$67,972,598 in the average balance of interest-bearing liabilities to \$388,143,480 in 2020 from \$320,170,882 in 2019.

Interest paid on NOW, savings, and money market deposit accounts increased \$11,633 to \$519,018 in 2020 compared to \$507,385 in 2019. The increase was due to a \$45,200,261 increase in the average balance of these deposits to \$203,426,815 in 2020 from \$158,226,554 in 2019, offset by a 6 basis point decrease in the cost of funds to 0.26% in 2020 from 0.32% in 2019.

Interest paid on time deposits decreased \$402,599 to \$2,609,976 in 2020 compared to \$3,012,575 in 2019. The decrease was due to a decrease of 44 basis points in the average rate paid to 1.57% in 2020 from 2.01% in 2019, offset by an increase of \$16,108,733 in the average balance to \$166,078,044 in 2020 from \$149,969,311 in 2019.

Interest paid on securities sold under repurchase agreements decreased \$7,323 to \$107,318 in 2020 compared to \$114,641 in 2019. The decrease was attributable to a decrease of 9 basis points in the average rate to 1.15% in 2020 from 1.24% in 2019, offset by a \$62,501 increase in the average balance of securities sold under repurchase agreements to \$9,335,593 in 2020 from \$9,273,092 in 2019.

Interest paid on long-term debt that was \$181,465 in 2020 compared to \$0 in 2019. This debt relates to the \$17 million term loan obtained in 2020 to finance a portion of the cash paid to the former stockholders of Carroll Bancorp, Inc. in the Merger.

Interest paid on FHLB advances and other borrowings decreased \$4,452 to \$40,900 in 2020 from \$45,352 in 2019. The decrease was attributable to a decrease of 84 basis points in the average rate to 0.84% in 2020 from 1.68% in 2019, offset by a \$2,175,127 increase in the average balance of FHLB advances and other borrowings to \$4,877,052 in 2020 from \$2,701,925 in 2019.

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.

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

	2020			2019			2018		
	Average Balance	Interest	Yield	Average Balance	Interest	Yield	Average Balance	Interest	Yield
Assets:									
Loans	\$ 421,010,433	\$ 19,291,162	4.58%	\$ 344,793,736	\$ 16,894,657	4.90%	\$ 343,573,784	\$ 16,401,554	4.77%
Securities, taxable	44,207,230	774,582	1.75%	34,949,183	875,715	2.51%	26,807,959	617,249	2.30%
Securities, tax exempt	21,376,615	799,841	3.74%	18,100,585	740,077	4.09%	17,663,498	695,282	3.94%
Federal funds sold and other interest earning assets	13,451,667	79,846	0.59%	16,871,204	373,678	2.21%	8,640,895	188,479	2.18%
Total interest-earning assets	500,045,945	20,945,431	4.19%	414,714,708	18,884,127	4.55%	396,686,136	17,902,564	4.51%
Noninterest-earning assets	26,493,472			16,880,579			15,900,818		
Total assets	<u>\$ 526,539,417</u>			<u>\$ 431,595,287</u>			<u>\$ 412,586,954</u>		
Liabilities and Stockholders' Equity:									
NOW, savings, and money market	\$ 203,426,815	519,018	0.26%	\$ 158,226,554	507,385	0.32%	\$ 145,714,725	348,416	0.24%
Certificates of deposit	166,078,044	2,609,976	1.57%	149,969,311	3,012,575	2.01%	131,937,867	1,877,200	1.42%
Securities sold under repurchase agreements	9,335,593	107,318	1.15%	9,273,092	114,641	1.24%	17,479,418	144,881	0.83%
Long-term debt	4,425,976	181,465	4.10%	-	-	0.00%	-	-	0.00%
FHLB advances and other borrowings	4,877,052	40,900	0.84%	2,701,925	45,352	1.68%	9,044,934	136,744	1.51%
Total interest-bearing deposits	388,143,480	3,458,677	0.89%	320,170,882	3,679,953	1.15%	304,176,944	2,507,241	0.82%
Noninterest-bearing deposits	82,514,991			59,374,960			61,972,038		
Noninterest-bearing liabilities	4,536,613			4,121,667			2,689,538		
Total liabilities	475,195,084			383,667,509			368,838,520		
Stockholders' equity	51,344,333			47,927,778			43,748,434		
Total liabilities and stockholders' equity	<u>\$ 526,539,417</u>			<u>\$ 431,595,287</u>			<u>\$ 412,586,954</u>		
Net interest income		<u>\$ 17,486,754</u>			<u>\$ 15,204,174</u>			<u>\$ 15,395,323</u>	
Interest rate spread			<u>3.30%</u>			<u>3.40%</u>			<u>3.69%</u>
Net yield on interest-earning assets			<u>3.50%</u>			<u>3.67%</u>			<u>3.88%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities			<u>128.83%</u>			<u>129.53%</u>			<u>130.41%</u>

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.

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

RATE/VOLUME ANALYSIS

	Year ended December 31, 2020 compared to 2019 Change due to variance in			Year ended December 31, 2019 compared to 2018 Change due to variance in		
	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>
Interest income:						
Loans	\$ 3,547,286	\$ (1,150,781)	\$ 2,396,505	\$ 58,420	\$ 434,683	\$ 493,103
Securities, taxable	199,306	(300,439)	(101,133)	200,268	58,198	258,466
Securities, tax exempt	126,207	(66,443)	59,764	17,465	27,330	44,795
Federal funds sold and other interest-earning assets	<u>(63,716)</u>	<u>(230,116)</u>	<u>(293,832)</u>	<u>182,248</u>	<u>2,951</u>	<u>185,199</u>
Total interest-earning assets	<u>3,809,083</u>	<u>(1,747,779)</u>	<u>2,061,304</u>	<u>458,401</u>	<u>523,162</u>	<u>981,563</u>
Interest expense:						
NOW, savings, and money market	127,676	(116,043)	11,633	31,969	127,000	158,969
Certificates of deposit	300,318	(702,917)	(402,599)	282,876	852,499	1,135,375
Securities sold under repurchase agreements	768	(8,091)	(7,323)	(84,353)	54,113	(30,240)
Long-term debt	181,465	-	181,465	-	-	-
FHLB advances and other borrowings	<u>25,243</u>	<u>(29,695)</u>	<u>(4,452)</u>	<u>(105,032)</u>	<u>13,640</u>	<u>(91,392)</u>
Total interest-bearing liabilities	<u>635,470</u>	<u>(856,746)</u>	<u>(221,276)</u>	<u>125,460</u>	<u>1,047,252</u>	<u>1,172,712</u>
Change in net interest income	<u>\$ 3,173,613</u>	<u>\$ (891,033)</u>	<u>\$ 2,282,580</u>	<u>\$ 332,941</u>	<u>\$ (524,090)</u>	<u>\$ (191,149)</u>

Noninterest Income

Noninterest income was \$2,072,119 in 2020 compared to \$1,493,567 in 2019, an increase of \$578,552 or 38.7%. The increase resulted primarily from a \$627,227 increase in mortgage banking income and a \$210,150 lower write down of OREO, offset by decreases of \$176,586 in bank owned life insurance income and \$88,245 in service charges on deposit accounts. Our mortgage banking division has experienced strong mortgage origination activity during 2020 as a result of historically low interest rates. Lower service charges are a result of less customer transaction activity due to the COVID-19 pandemic.

Noninterest Expense

Total noninterest expense increased by \$4,706,594, or 43.3%, to \$15,582,408 in 2020 from \$10,875,814 in 2019. The increase was due primarily to \$3,236,817 in acquisition-related costs in 2020, an increase in salary and employee benefit expenses of \$970,890, or 14.2%, to \$7,795,701 in 2020, an increase in furniture and equipment expenses of \$226,347, or 36.8%, and an increase in other expenses of \$286,100, or 10.7%. All of these increases resulted from the Merger that was effective on October 1, 2020, which added employees, locations, and related expenses. Note 13 to the consolidated financial statements provides additional information about the Company's other expenses.

Income Taxes

Income taxes decreased \$552,123 to \$487,211 in 2020 from \$1,039,334 in 2019. Lower income before taxes was the primary driver of the decrease.

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

The Company's effective tax rate decreased to 15.4% in 2020, from 18.6% in 2019. The decrease was due to a higher percentage of tax-exempt revenue. Note 14 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

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

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, 2020 and 2019, management estimated the following changes in NII, assuming the indicated rate changes:

<u>Change in Rate</u>	<u>2020</u>	<u>2019</u>
400 basis point increase	\$ (157,000)	\$(854,000)
300 basis point increase	17,000	(547,000)
200 basis point increase	116,000	(310,000)
100 basis point increase	139,000	(136,000)
100 basis point decrease	(95,000)	115,000
200 basis point decrease	(124,000)	74,000
300 basis point decrease	(124,000)	84,000

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 \$89.3 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 could borrow approximately \$33.2 million. Finally, the Bank has \$23,500,000 (\$14,500,000 unsecured and \$9,000,000 secured) overnight federal funds lines of credit available from commercial banks. FHLB advances of \$5,000,000 and \$0 were outstanding as of December 31, 2020 and 2019, respectively. There were no borrowings from the Reserve Bank or from the commercial banks' lines of credit at December 31, 2020 and 2019. On September 30, 2020, the Company borrowed \$17,000,000 from a commercial bank, which was used on October 1, 2020 to fund a portion of the cash consideration paid to the former stockholders of Carroll Bancorp, Inc. in the Merger. The outstanding balance at December 31, 2020, net of unamortized issuance costs, was \$16,973,280. 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.

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

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 15 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, 2020 and 2019, 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, 2020 and 2019, 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	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2020						
Total capital (to risk-weighted assets)	\$ 63,400	12.62%	\$ 52,732	10.50%	\$ 50,221	10.00%
Tier 1 capital (to risk-weighted assets)	60,104	11.97%	42,688	8.50%	40,177	8.00%
Common equity tier 1 (to risk-weighted assets)	60,104	11.97%	35,155	7.00%	32,644	6.50%
Tier 1 leverage (to average assets)	60,104	9.05%	26,569	4.00%	33,211	5.00%
December 31, 2019						
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%

Farmers and Merchants Bancshares, Inc.

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

(continued)

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 June 2016, the FASB issued Accounting Standards Update ("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 2018-14, "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 became 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 December 2019, FASB released ASU 2019-12 - Income Taxes (Topic 740), which simplifies the accounting for income taxes by removing multiple exceptions to the general principals in Topic 740. ASU 2019-12 is effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2020. The Company is in the process of reviewing the impact of adopting this standard on the Company's financial statements.

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

Report of Independent Registered Public Accounting Firm

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

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Farmers and Merchants Bancshares, Inc. (the Company) as of December 31, 2020 and 2019, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2020, 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, 2020 and 2019, and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2020, 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.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the Audit Committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgements. The communication of the critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing a separate opinion on the critical audit matters or on the accounts or disclosures to which they relate.

Report of Independent Registered Public Accounting Firm (Continued)

Critical Audit Matters (Continued)

Allowance for Loan Losses

Description of the Matter

The Company's loan portfolio totaled \$521.7 million as of December 31, 2020, and the related allowance for loan losses ("allowance") was \$3.3 million. As discussed in Note 1 and Note 6 to the financial statements, the Company estimates an allowance representing an amount which, in management's judgement, is appropriate to absorb probable losses in the loan portfolio. The Company's method for estimating the allowance includes (1) segregating the loan portfolio into pools based upon similar characteristics and risk profiles and applying a loss factor to the pools, based on historical losses within those pools, (2) applying qualitative factors to the loan pools that consider economic and other factors, both internal and external, affecting the Company and the pools, and (3) determining specific reserves based on individual evaluation of impaired loans that are not included in the pools discussed above.

Auditing management's estimate of the allowance involved a high degree of subjectivity due to the nature of the factors included in the allowance and its potential impact on the allowance.

How We Addressed the Matter in Our Audit

We obtained an understanding of the Company's process for establishing the allowance for loan losses, including the determination of the historical loss factors and the qualitative factor adjustments of the allowance for loan losses. We tested the accuracy of the data used to calculate and estimate the various components of the allowance for loan losses, the accuracy of the calculation of the allowance for loan losses, management's review and approval methods used to establish the allowance, analysis of changes in the various components of the allowance for loan losses relative to changes in the Company's loan portfolio and economy, and evaluation of the overall reasonableness and appropriateness of the allowance. We also tested management's evaluation of impaired loans, including the assumptions used to determine any specific reserves in the allowance for those loans.

Acquisition of Carroll Bancorp, Inc.

Description of the Matter

The Company completed its acquisition of Carroll Bancorp, Inc. ("Carroll") on October 1, 2020, in a transaction valued at approximately \$24.8 million. As discussed in Note 1 and Note 2 to the financial statements, the transaction was accounted for as a business combination using the acquisition method of accounting and, accordingly, assets acquired and liabilities assumed were recorded at estimated fair values on the acquisition date.

How We Addressed the Matter in Our Audit

Auditing the Company's accounting for its acquisition of Carroll involved assessing assumptions used in the valuation of the acquired loan and deposit portfolios and in the valuation of the core deposit intangible. We obtained an understanding of the valuation of the loans and deposits and the core deposit intangible and evaluated the key assumptions and inputs used in the measurement by a third-party valuation specialist. Our procedures included testing the inputs used in the valuation and evaluating the reasonableness of assumptions used by comparison with third party market sources.

Rowles & Company, LLP

We have served as the Company's auditor since 1997.
Baltimore, Maryland
March 2, 2021

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

December 31,	2020	2019
Assets		
Cash and due from banks	\$ 39,898,557	\$ 6,664,307
Federal funds sold and other interest-bearing deposits	<u>1,077,113</u>	<u>2,457,045</u>
Cash and cash equivalents	40,975,670	9,121,352
Certificates of deposit in other banks	850,000	100,000
Securities available for sale	54,477,286	36,531,774
Securities held to maturity	23,078,519	19,510,018
Equity security at fair value	552,566	532,321
Restricted stock, at cost	900,500	376,200
Mortgage loans held for sale	1,673,350	242,000
Loans, less allowance for loan losses of \$3,296,538 and \$2,593,715	521,690,514	359,382,843
Premises and equipment	7,736,556	5,036,851
Accrued interest receivable	2,057,491	1,019,540
Deferred income taxes	1,219,668	1,036,078
Other real estate owned	1,411,605	-
Bank owned life insurance	11,297,342	7,145,477
Goodwill and other intangibles	7,059,408	-
Other assets	<u>2,336,607</u>	<u>2,180,644</u>
	<u>\$ 677,317,082</u>	<u>\$ 442,215,098</u>
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing	\$ 103,155,113	\$ 60,659,015
Interest-bearing	<u>470,246,434</u>	<u>315,954,299</u>
Total deposits	573,401,547	376,613,314
Securities sold under repurchase agreements	24,753,972	10,958,118
Federal Home Loan Bank of Atlanta advances	5,000,000	-
Long-term debt	16,973,280	-
Accrued interest payable	409,622	346,214
Other liabilities	<u>5,049,178</u>	<u>4,843,936</u>
	<u>625,587,599</u>	<u>392,761,582</u>
Stockholders' equity		
Common stock, par value \$.01 per share, authorized 5,000,000 shares; issued and outstanding 3,011,255 shares in 2020 and 2,974,019 shares in 2019	30,113	29,740
Additional paid-in capital	28,294,139	27,812,991
Retained earnings	22,698,954	21,568,161
Accumulated other comprehensive income	<u>706,277</u>	<u>42,624</u>
	<u>51,729,483</u>	<u>49,453,516</u>
	<u>\$ 677,317,082</u>	<u>\$ 442,215,098</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Consolidated Statements of Income

Years Ended December 31,	2020	2019
Interest income		
Loans, including fees	\$ 19,291,162	\$ 16,894,657
Investment securities - taxable	770,394	869,457
Investment securities - tax exempt	625,099	580,384
Federal funds sold and other interest earning assets	76,525	357,840
Total interest income	<u>20,763,180</u>	<u>18,702,338</u>
Interest expense		
Deposits	3,128,994	3,519,960
Securities sold under repurchase agreements	107,318	114,641
Federal Home Loan Bank advances and other borrowings	222,365	45,352
Total interest expense	<u>3,458,677</u>	<u>3,679,953</u>
Net interest income	17,304,503	15,022,385
Provision for loan losses	<u>625,000</u>	<u>40,000</u>
Net interest income after provision for loan losses	<u>16,679,503</u>	<u>14,982,385</u>
Noninterest income		
Service charges on deposit accounts	575,430	663,675
Mortgage banking income	1,024,937	397,710
Bank owned life insurance income	188,143	364,729
Unrealized gain on equity security	10,513	16,232
Write down of other real estate owned	-	(210,150)
Gain on sale of SBA loans	125,520	139,535
Other fees and commissions	147,576	121,836
Total noninterest income	<u>2,072,119</u>	<u>1,493,567</u>
Noninterest expense		
Salaries	6,137,050	5,472,609
Employee benefits	1,658,651	1,352,202
Occupancy	758,357	771,917
Furniture and equipment	840,890	614,543
Acquisition	3,236,817	-
Other	2,950,643	2,664,543
Total noninterest expense	<u>15,582,408</u>	<u>10,875,814</u>
Income before income taxes	3,169,214	5,600,138
Income taxes	<u>487,211</u>	<u>1,039,334</u>
Net income	<u>\$ 2,682,003</u>	<u>\$ 4,560,804</u>
 Earnings per share - basic and diluted	 <u>\$ 0.90</u>	 <u>\$ 1.54</u>

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

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

Years Ended December 31,	2020	2019
Net income	\$ 2,682,003	\$ 4,560,804
Other comprehensive income, net of income taxes:		
Securities available for sale		
Net unrealized gain arising during the period	915,604	842,856
Income tax expense	<u>(251,951)</u>	<u>(231,933)</u>
Total other comprehensive gain	<u>663,653</u>	<u>610,923</u>
Total comprehensive income	<u>\$ 3,345,656</u>	<u>\$ 5,171,727</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity

	Common stock		Additional	Retained	Accumulated other	Total
	Shares	Par value	paid-in capital	earnings	comprehensive income (loss)	stockholders' equity
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 gain 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	<u>1,268,317</u>	<u>12,683</u>	<u>-</u>	<u>(12,683)</u>	<u>-</u>	<u>-</u>
Balance, December 31, 2019	2,974,019	29,740	27,812,991	21,568,161	42,624	49,453,516
Net income	-	-	-	2,682,003	-	2,682,003
Unrealized gain on securities available for sale net of income tax expense of \$251,951	-	-	-	-	663,653	663,653
Cash dividends, \$0.52 per share	-	-	-	(1,551,210)	-	(1,551,210)
Dividends reinvested	<u>37,236</u>	<u>373</u>	<u>481,148</u>	<u>-</u>	<u>-</u>	<u>481,521</u>
Balance, December 31, 2020	<u>3,011,255</u>	<u>\$ 30,113</u>	<u>\$28,294,139</u>	<u>\$ 22,698,954</u>	<u>\$ 706,277</u>	<u>\$ 51,729,483</u>

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

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

Years Ended December 31,	2020	2019
Cash flows from operating activities		
Interest received	\$ 21,071,658	\$ 18,648,337
Fees and commissions received	1,747,943	1,455,827
Interest paid	(3,521,625)	(3,645,228)
Proceeds from sale of mortgage loans held for sale	51,397,979	20,046,955
Origination of mortgage loans held for sale	(51,086,134)	(19,715,317)
Cash paid to suppliers and employees	(14,227,116)	(10,019,091)
Income taxes paid	(930,435)	(1,055,967)
Cash provided by operating activities	<u>4,452,270</u>	<u>5,715,516</u>
Cash flows from investing activities		
Proceeds from maturity and call of securities		
Available for sale	22,224,763	8,507,098
Held to maturity	1,956,420	1,101,420
Proceeds from sale of securities		
Available for sale	2,025,000	-
Purchase of securities		
Available for sale	(28,841,213)	(17,761,884)
Held to maturity	(5,470,258)	(2,457,087)
Cash paid for the acquisition of Carroll Bancorp, Inc., net of cash acquired	(19,366,118)	-
Loans made to customers, net of principal collected	(19,478,136)	(19,952,309)
Proceeds from sale of SBA loans	1,233,270	1,582,364
Redemption of restricted stock	402,400	199,600
Purchases of premises and equipment	(387,111)	(256,561)
Cash used by investing activities	<u>(45,700,983)</u>	<u>(29,037,359)</u>
Cash flows from financing activities		
Net increase (decrease) in		
Noninterest-bearing deposits	21,273,083	(2,058,505)
Interest-bearing deposits	30,131,909	23,958,816
Securities sold under repurchase agreements	13,795,854	(53,882)
Federal Home Loan Bank of Atlanta advances	(8,000,000)	(3,000,000)
Long-term debt	16,971,874	-
Dividends paid, net of reinvestments	(1,069,689)	(1,021,471)
Cash provided by financing activities	<u>73,103,031</u>	<u>17,824,958</u>
Net increase (decrease) in cash and cash equivalents	31,854,318	(5,496,885)
Cash and cash equivalents at beginning of period	<u>9,121,352</u>	<u>14,618,237</u>
Cash and cash equivalents at end of period	<u><u>\$ 40,975,670</u></u>	<u><u>\$ 9,121,352</u></u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Years Ended December 31,	2020	2019
Reconciliation of net income to net cash provided by operating activities		
Net income	\$ 2,682,003	\$ 4,560,804
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	415,781	344,171
Provision for loan losses	625,000	40,000
Lease expense in excess of rent paid	34,058	40,912
Write down of other real estate owned	-	210,150
Equity security dividends reinvested	(9,732)	(12,262)
Unrealized (gain) loss on equity security	(10,513)	(16,232)
Gain on sale of SBA loans	(125,520)	(139,535)
Deferred income taxes	(151,331)	(53,841)
Amortization of debt issuance costs	1,406	
Amortization of premiums and accretion of discounts, net	288,961	130,575
Increase (decrease) in		
Deferred loan fees	531,441	(12,728)
Accrued interest payable	63,408	34,725
Other liabilities	163,897	557,902
Decrease (increase) in		
Mortgage loans held for sale	311,845	331,638
Accrued interest receivable	(200,455)	(29,011)
Bank owned life insurance cash surrender value	(188,143)	(92,123)
Other assets	20,164	(179,629)
Cash provided by operating activities	\$ 4,452,270	\$ 5,715,516

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

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

Principles of consolidation

The consolidated financial statements include the accounts of Farmers and Merchants Bancshares, Inc. and its wholly owned subsidiaries, Farmers and Merchants Bank (the “Bank”), and Series Protected Cell FCB-4 (the “Insurance Subsidiary”), and one subsidiary of the Bank, Reliable Community Financial Services, Inc. (collectively the “Company”, “we”, “us”, or “our”). The Insurance Subsidiary is a series investment, 100% owned by the Company, in First Community Bankers Insurance Co., LLC, a Tennessee “series” limited liability company and licensed property and casualty insurance company. Intercompany balances and transactions have been eliminated. This includes the insurance premium paid by the Bank to the Insurance Subsidiary through an intermediary. Effective October 1, 2020, the Company acquired Carroll Bancorp, Inc. and its wholly-owned subsidiary, Carroll Community Bank (collectively, “Carroll”), both of which were based in Eldersburg, Maryland, through a series of merger transactions (the “Merger”). The results of operations and assets acquired and liabilities assumed from Carroll are included only from the effective date of the Merger. The comparability of the Company's results of operations for the years ended December 31, 2020, and 2019 have been impacted by the Merger.

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 2019 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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

Equity security at fair value

The Company owns a mutual fund that is measured at fair value with changes in fair value recognized in noninterest income.

Restricted stock, at cost

Restricted stock consists of Federal Home Loan Bank of Atlanta (the “FHLB”) stock, Community Bankers Bank (“CBB”) stock, and Atlantic Community Bankers Bank (“ACBB”) stock. As a member of 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. CBB and ACBB require its correspondent banking institutions to hold stock as a condition of membership. The restricted investment in bank stocks is carried at cost. On a quarterly basis, management evaluates the bank stocks for impairment based on assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as operating performance, liquidity, funding and capital positions, stock repurchase history, dividend history, and impact of legislative and regulatory changes.

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) segregating the loan portfolio into pools based upon similar characteristics and risk profiles and applying a loss factor to the pools, based on historical losses within those pools, (ii) applying qualitative factors to the loan pools that consider economic and other factors, both internal and external, affecting the Company and the pools, and (iii) determining specific reserves based on individual evaluation of impaired loans that are not included in the pools discussed above.

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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

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, 2020 and 2019, 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 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.

Loans acquired in connection with business combinations are recorded at fair value with no carryover of any allowance for loan losses. Fair value of the loans involves estimating the amount and timing of principal and interest cash flows expected to be collected on the loans and discounting those cash flows at a market rate of interest.

The excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loan. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable discount. These loans are accounted for under ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality ("ASC 310-30"). The nonaccretable discount includes estimated future credit losses expected to be incurred over the life of the loan. Subsequent decreases in expected cash flows will require us to evaluate the need for an addition to the allowance for loan losses. Subsequent improvement in expected cash flows will result in the reversal of a corresponding amount of the nonaccretable discount, which we will then reclassify as accretable discount to be recognized into interest income over the remaining life of the loan.

Loans acquired through business combinations that meet the specific criteria of ASC 310-30 are individually evaluated each period to analyze expected cash flows. To the extent that the expected cash flows of a loan have decreased due to credit deterioration, the Company establishes an allowance.

Loans acquired through business combinations that do not meet the specific criteria of ASC 310-30 are accounted for under ASC 310-20, Receivables - Nonrefundable Fees and Other Costs. These loans are initially recorded at fair value, and include credit and interest rate marks associated with acquisition accounting adjustments. Purchase premiums or discounts are subsequently amortized as an adjustment to yield over the estimated contractual lives of the loans. There is no allowance for loan losses established at the acquisition date for acquired performing loans. An allowance for loan losses is recorded for any credit deterioration in these loans subsequent to acquisition.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

Acquired loans that meet the criteria for impairment or nonaccrual of interest prior to the acquisition may be considered performing upon acquisition, regardless of whether the client is contractually delinquent if the Company expects to fully collect the new carrying value (i.e., fair value) of the loans. As such, the Company may no longer consider the loan to be nonperforming and may accrue interest on these loans, including the impact of any accretable discount. In addition, charge-offs on such loans would be first applied to the nonaccretable discount.

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.

Goodwill and other intangible assets

Goodwill is calculated as the purchase premium, if any, after adjusting for the fair value of net assets acquired in purchase transactions. Goodwill is not amortized but is reviewed for potential impairment on at least an annual basis, with testing between annual tests if an event occurs or circumstances change that could potentially reduce the fair value of a reporting unit. Other intangible assets represent purchased assets that can be distinguished from goodwill because of contractual or other legal rights. The Company's other intangible asset, core deposit intangible ("CDI") has a finite life and is amortized over 10 years on a straight line basis.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

1. Summary of Significant Accounting Policies (Continued)

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 income 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 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. Weighted average shares were 2,983,972 and 2,952,904 for 2020 and 2019, 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, 2020 or December 31, 2019.

Subsequent events

The Company has evaluated events and transactions occurring subsequent to the statement of financial condition date of December 31, 2020 for items that should potentially be recognized or disclosed in these financial statements as prescribed by FASB Accounting Standards Codification Topic 855, “Subsequent Events.”

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

2. Acquisition of Carroll Bancorp, Inc.

Carroll was acquired for approximately \$24.8 million. The Merger consideration was funded using \$7.8 million in cash and \$17 million in proceeds from a term loan obtained by Farmers and Merchants Bancshares, Inc. from a third-party. At the Effective Time of the Merger, Carroll had total assets of \$176,159,890, net loans of \$145,153,100, and total liabilities of \$157,992,286, of which \$144,896,990 represented deposits. The Merger was accounted for as a business combination using the acquisition method of accounting, and, accordingly, assets acquired and liabilities assumed are recorded at estimated fair values at the effective time of the Merger.

The following table presents the book values and fair values of the assets, liabilities, and equity of Carroll at the effective time of the Merger:

	Book value	Fair value
Cash	\$ 5,441,610	\$ 5,441,610
Certificates of deposit in other banks	750,000	750,000
Securities available for sale	12,863,795	12,922,620
Restricted stock, at cost	926,700	926,700
Loans held for sale	1,702,950	1,743,195
Loans	145,153,100	145,080,950
Premises and equipment	2,619,413	2,684,240
Other real estate owned	1,411,605	1,411,605
Other assets	5,290,717	5,388,546
Goodwill and other intangibles	-	7,061,490
Total assets	<u>\$ 176,159,890</u>	<u>\$ 183,410,956</u>
Deposits	\$ 144,896,990	\$ 145,513,085
FHLB advances	13,000,000	13,000,000
Other liabilities	95,296	90,143
Total liabilities	<u>157,992,286</u>	<u>158,603,228</u>
Stockholders' equity	18,167,604	24,807,728
Total liabilities and stockholders' equity	<u>\$ 176,159,890</u>	<u>\$ 183,410,956</u>

The determination of fair values of the acquired loans required the Company to make certain estimates about discount rates, future expected cash flows, market conditions and other future events that are highly subjective in nature. Based on such factors as past due status, nonaccrual status, bankruptcy status, and credit risk ratings, the acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 (purchased credit impaired or "PCI"), and loans that do not meet this criteria, which are accounted for under ASC 310-20 (purchased non-impaired). Expected cash flows, both

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

2. Acquisition of Carroll Bancorp, Inc. (continued)

principal and interest, were estimated based on key assumptions covering such factors as prepayments, default rates and severity of loss given default. These assumptions were developed using both Carroll's historical experience and the portfolio characteristics as of the acquisition date as well as available market research. The fair value estimates for acquired loans were based on the amount and timing of expected principal, interest and other cash flows, including expected prepayments, discounted at prevailing market interest rates applicable to the types of acquired loans, which the Company considered to be level 3 fair value measurements. Deposit liabilities assumed in the Merger were segregated into two categories: time-deposits (i.e., deposit accounts with a stated maturity) and demand deposits, both using level 2 fair value measurements. In determining fair value of time deposits, the Company discounted the contractual cash flows of the deposit accounts using prevailing market interest rates for time deposit accounts of similar type and duration. For demand deposits, the acquisition date outstanding balance of the assumed demand deposit accounts approximates fair value. Acquisition date fair values for securities available for sale were determined using Level 1 or Level 2 inputs consistent with the methods discussed further in Note 16 - Fair Value. The remaining acquisition date fair values represent either Level 2 or Level 3 fair value measurements (premises and equipment and core deposit intangible).

The Company recognized a core deposit intangible of \$83,282, which is being amortized using a straight-line method over a 10-year amortization period, consistent with expected future cash flows.

Loans acquired from Carroll were measured at fair value at the acquisition date with no carryover of any allowance for loan losses.

3. 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 **\$8,703,983** and **\$8,500,311** during the years ended December 31, 2020 and 2019, 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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

4. Investment Securities

Investment securities are summarized as follows:

December 31, 2020	Amortized cost	Unrealized gains	Unrealized losses	Fair value
<i>Available for sale</i>				
State and municipal	\$ 962,438	\$ 24,094	\$ -	\$ 986,532
SBA pools	1,822,226	-	38,419	1,783,807
Corporate bonds	6,692,156	108,172	2,897	6,797,431
Mortgage-backed securities	44,026,055	941,987	58,526	44,909,516
	<u>\$ 53,502,875</u>	<u>\$ 1,074,253</u>	<u>\$ 99,842</u>	<u>\$54,477,286</u>
<i>Held to maturity</i>				
State and municipal	<u>\$ 23,078,519</u>	<u>\$ 1,177,125</u>	<u>\$ 10,858</u>	<u>\$24,244,786</u>
December 31, 2019				
<i>Available for sale</i>				
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
	<u>\$ 36,472,967</u>	<u>\$ 260,379</u>	<u>\$ 201,572</u>	<u>\$ 36,531,774</u>
<i>Held to maturity</i>				
State and municipal	<u>\$ 19,510,018</u>	<u>\$ 588,393</u>	<u>\$ 480</u>	<u>\$ 20,097,931</u>

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

December 31, 2020	Available for Sale		Held to Maturity	
	Amortized cost	Fair value	Amortized cost	Fair value
Within one year	\$ 505,372	\$ 502,475	\$ 487,741	\$ 496,463
Over one to five years	4,646,388	4,755,483	793,876	813,523
Over five to ten years	2,300,591	2,323,451	2,476,827	2,687,063
Over ten years	202,243	202,554	19,320,075	20,247,737
	<u>7,654,594</u>	<u>7,783,963</u>	<u>23,078,519</u>	<u>24,244,786</u>
Mortgage-backed securities and SBA pools, due in monthly installments	<u>45,848,281</u>	<u>46,693,323</u>	<u>-</u>	<u>-</u>
	<u>\$ 53,502,875</u>	<u>\$ 54,477,286</u>	<u>\$ 23,078,519</u>	<u>\$ 24,244,786</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

4. Investment Securities (Continued)

December 31, 2019	Available for Sale		Held to Maturity	
	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
	<u>508,134</u>	<u>512,670</u>	<u>19,510,018</u>	<u>20,097,931</u>
Mortgage-backed securities and SBA pools, due in monthly installments	<u>35,964,833</u>	<u>36,019,104</u>	<u>-</u>	<u>-</u>
	<u>\$ 36,472,967</u>	<u>\$ 36,531,774</u>	<u>\$ 19,510,018</u>	<u>\$ 20,097,931</u>

Securities with a carrying value of **\$34,958,212** and \$11,441,474 as of December 31, 2020 and 2019, 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, 2020	Less than 12 months		12 months or more		Total	
	Unrealized		Unrealized		Unrealized	
Description of investments	Fair value	losses	Fair value	losses	Fair value	losses
State and municipal	\$ 719,430	\$ 10,858	\$ -	\$ -	\$ 719,430	\$ 10,858
SBA pools	-	-	1,783,807	38,419	1,783,807	38,419
Corporate bonds	502,754	2,897	-	-	502,754	2,897
Mortgage-backed securities	<u>9,286,525</u>	<u>57,987</u>	<u>96,652</u>	<u>539</u>	<u>9,383,177</u>	<u>58,526</u>
Total	<u>\$ 10,508,709</u>	<u>\$ 71,742</u>	<u>\$ 1,880,459</u>	<u>\$ 38,958</u>	<u>\$ 12,389,168</u>	<u>\$ 110,700</u>

December 31, 2019	Less than 12 months		12 months or more		Total	
	Unrealized		Unrealized		Unrealized	
Description of investments	Fair value	losses	Fair value	losses	Fair value	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	<u>10,643,624</u>	<u>58,063</u>	<u>7,295,788</u>	<u>91,472</u>	<u>17,939,412</u>	<u>149,535</u>
Total	<u>\$ 10,895,242</u>	<u>\$ 58,543</u>	<u>\$ 9,447,585</u>	<u>\$ 143,509</u>	<u>\$ 20,342,827</u>	<u>\$ 202,052</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

4. Investment Securities (Continued)

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, 2020, management did not have the intent to sell any of the securities before a recovery of cost. The unrealized losses are due to increases in market interest rates over the yields available at the time the underlying securities were purchased as well as other market conditions for each particular security based upon the structure and remaining principal balance. The fair values of the investment securities are expected to recover as the securities approach their maturity dates or repricing dates or if market yields for such investments decline. Based on these factors, as of December 31, 2020, 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 2020, the Company sold three available for sale securities totalling \$2,025,000 with no gain or loss realized on the sale.

In 2019, the Company had no security sales.

5. 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 during 2020 and 2019. 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, 2020 and 2019, the activity of these loans was as follows:

	2020	2019
Balance, beginning of year	\$ 14,551,236	\$ 13,955,097
Additions	1,771,200	5,934,975
Amounts collected	(1,763,554)	(5,338,836)
Balance, end of year	<u>\$ 14,558,882</u>	<u>\$ 14,551,236</u>

Unused lines of credit to related parties totaled **\$330,315** and \$337,000 at December 31, 2020 and 2019, respectively.

Deposits at the Company from related parties totaled **\$20,611,092** and \$16,237,540 at December 31, 2020 and 2019, respectively.

Payments to companies controlled by directors totaled **\$54,544** in 2020 and \$22,469 in 2019.

In February 2021, the Bank and a company of which one of the Bank's directors is a co-owner entered into a contract of sale pursuant to which the Bank intends to sell to such company for \$1,370,000 real property that was acquired in the Merger and on which Carroll Community Bank previously operated a branch. To finance the purchase of this real property, the Bank intends to make a loan to the buyer in the principal amount of approximately \$1.1 million.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

6. Loans

Major categories of loans at December 31, 2020 and 2019 are as follows:

	<u>2020</u>	<u>2019</u>
Real estate:		
Commercial	\$ 274,501,327	\$ 240,938,149
Construction and land development	33,641,916	18,194,955
Residential	156,111,245	76,122,069
Commercial	61,368,105	26,947,503
Consumer	<u>288,454</u>	<u>292,027</u>
	525,911,047	362,494,703
Less: Allowance for loan losses	3,296,538	2,593,715
Deferred origination fees net of costs	<u>923,995</u>	<u>518,145</u>
	<u>\$ 521,690,514</u>	<u>\$ 359,382,843</u>

Commercial loans in the table above include \$32,071,443 of Paycheck Protection Program (“PPP”) loans, which are 100% guaranteed by the Small Business Administration (“SBA”). A substantial portion of the PPP loans in the Company’s portfolio as of December 31, 2020 are expected to be forgiven by the SBA. During the year ended December 31, 2020, the Company collected approximately \$1,286,000 in fees from the SBA in connection with the originations of the PPP loans. The fees, net of related origination costs, are being recognized as interest income over the term of the loans using the straight-line method, with accelerated recognition when the loan pays off before maturity through SBA forgiveness or other means.

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

	<u>2020</u>	<u>2019</u>
Real estate:		
Commercial	\$ 4,407,829	\$ -
Residential	<u>220,967</u>	<u>-</u>
	<u>\$ 4,628,796</u>	<u>\$ -</u>

At December 31, 2020, the Company had one nonaccrual commercial real estate loan totaling \$4,407,829 and two nonaccrual residential real estate loans totaling \$220,967. The loans were secured by real estate and business assets and were personally guaranteed. Gross interest income of \$13,395 would have been recorded in 2020 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 and a nonaccretable discount totaling \$8,176 at December 31, 2020.

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

6. Loans (Continued)

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

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	Past Due 90 Days or More and Accruing
December 31, 2020							
Real estate:							
Commercial	\$ 182,656	\$ -	\$ -	\$ 182,656	\$ 274,318,671	\$ 274,501,327	\$ -
Construction and land development	-	-	-	-	33,641,916	33,641,916	-
Residential	24,591	-	220,967	245,558	155,865,687	156,111,245	-
Commercial	-	-	-	-	61,368,105	61,368,105	-
Consumer	-	-	-	-	288,454	288,454	-
Total	<u>\$ 207,247</u>	<u>\$ -</u>	<u>\$ 220,967</u>	<u>\$ 428,214</u>	<u>\$ 525,482,833</u>	<u>\$ 525,911,047</u>	<u>\$ -</u>
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	<u>\$ 284,686</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 284,686</u>	<u>\$ 362,210,017</u>	<u>\$ 362,494,703</u>	<u>\$ -</u>

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

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized
December 31, 2020							
Commercial real estate	\$ 7,246,478	\$ 6,660,145	\$ 151,553	\$ 6,811,698	\$ -	\$ 4,448,343	\$ 352,938
Construction and land development	1,719,010	-	1,566,174	1,566,174	-	783,087	22,520
Residential real estate	1,121,649	215,229	595,434	810,663	-	430,360	10,656
	<u>\$ 10,087,137</u>	<u>\$ 6,875,374</u>	<u>\$ 2,313,161</u>	<u>\$ 9,188,535</u>	<u>\$ -</u>	<u>\$ 5,661,790</u>	<u>\$ 386,114</u>
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
	<u>\$ 2,135,045</u>	<u>\$ 2,135,045</u>	<u>\$ -</u>	<u>\$ 2,135,045</u>	<u>\$ -</u>	<u>\$ 2,656,214</u>	<u>\$ 109,750</u>

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

6. Loans (Continued)

At December 31, 2020, the Company had **two** commercial real estate loans totaling **\$2,252,316** and **one** residential loan totaling **\$44,733** classified as TDRs. One of the commercial real estate loans with a principal balance of **\$182,656** was restructured as a TDR during 2020. All three loans are included in impaired loans above. Each loan is paying as agreed. There have been no charge-offs or allowances associated with these **three** loans.

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. 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.

Section 4013 of the U.S. Government's Coronavirus Aid, Relief, and Economic Security Act allows financial institutions to suspend application of certain current TDRs accounting guidance under ASC 310-40 for loan modifications related to the COVID-19 pandemic made between March 1, 2020 and the earlier of December 31, 2020 or 60 days after the end of the COVID-19 national emergency, provided certain criteria are met. This relief can be applied to loan modifications for borrowers that were not more than 30 days past due as of December 31, 2019 and to loan modifications that defer or delay the payment of principal or interest, or change the interest rate on the loan. In April 2020, federal and state banking regulators issued the Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus to provide further interpretation of when a borrower is experiencing financial difficulty, specifically indicating that if the modification is either short-term (e.g., six months) or mandated by a federal or state government in response to the COVID-19 pandemic, the borrower is not experiencing financial difficulty under ASC 310-40. The Company continues to prudently work with borrowers negatively impacted by the COVID-19 pandemic while managing credit risks and recognizing appropriate allowance for loan losses on its loan portfolio. During the second quarter of 2020, the Company modified loans, due to the pandemic and at the borrower's request, with an aggregate principal balance of \$109.2 million, or 30% of its loan portfolio. During the third quarter of 2020, \$21.8 million of these previously-deferred loans were granted additional three-month deferrals, which amount represented 6% of the Company's loan portfolio. At December 31, 2020, five of these previously-deferred loans along with two loans acquired in the Merger totaling \$14.7 million in the aggregate, or 3% of the portfolio, had been granted additional payment deferrals. None of these loans were classified as TDRs as of December 31, 2020 because they met the criteria discussed above.

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

6. Loans (Continued)

not expose the Bank to sufficient risk to warrant adverse classification. This classification is intended to be temporary while the Bank learns more about the condition of the borrower and the collateral.

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

Substandard

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

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

Doubtful

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

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

December 31, 2020	Excellent	Above average	Average	Acceptable	Pass watch	Special mention	Substandard	Doubtful	Total
Real estate:									
Commercial	\$ -	\$ 2,010,472	\$ 80,782,360	\$ 83,504,722	\$ 93,013,211	\$ 5,951,177	\$ 9,239,385	\$ -	\$ 274,501,327
Construction and land development	-	-	2,962,300	15,944,499	13,168,844	-	1,566,273	-	33,641,916
Residential	36,285	1,026,824	79,207,040	45,302,862	27,611,830	-	2,926,404	-	156,111,245
Commercial	32,088,058	-	10,037,516	13,532,170	5,710,361	-	-	-	61,368,105
Consumer	13,729	109,955	131,171	6,671	15,663	-	-	11,265	288,454
	<u>\$ 32,138,072</u>	<u>\$ 3,147,251</u>	<u>\$ 173,120,387</u>	<u>\$ 158,290,924</u>	<u>\$ 139,519,909</u>	<u>\$ 5,951,177</u>	<u>\$ 13,732,062</u>	<u>\$ 11,265</u>	<u>\$ 525,911,047</u>
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
	<u>\$ 195,992</u>	<u>\$ 4,739,112</u>	<u>\$ 138,554,014</u>	<u>\$ 165,978,092</u>	<u>\$ 41,608,876</u>	<u>\$ -</u>	<u>\$ 11,399,425</u>	<u>\$ 19,192</u>	<u>\$ 362,494,703</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

6. Loans (Continued)

The following tables detail activity in the allowance for loan losses by portfolio for the years ended December 31, 2020 and 2019. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

December 31, 2020	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
						Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,763,861	\$ 418,806	\$ -	\$ 47,462	\$ 2,230,129	\$ -	\$ 2,230,129	\$ 6,811,698	\$267,689,629
Construction and land development	192,828	(5,536)	-	14,400	201,692	-	201,692	1,566,174	32,075,742
Residential	478,124	166,515	-	-	644,639	-	644,639	810,663	155,300,582
Commercial	107,782	(12,353)	-	15,961	111,390	-	111,390	-	61,368,105
Consumer	4,133	(1,995)	-	-	2,138	-	2,138	-	288,454
Unallocated	46,987	59,563	-	-	106,550	-	106,550	-	-
	<u>\$ 2,593,715</u>	<u>\$ 625,000</u>	<u>\$ -</u>	<u>\$ 77,823</u>	<u>\$ 3,296,538</u>	<u>\$ -</u>	<u>\$ 3,296,538</u>	<u>\$ 9,188,535</u>	<u>\$516,722,512</u>

December 31, 2019	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated for impairment:		Outstanding loan balances evaluated for impairment:	
						Individually	Collectively	Individually	Collectively
Real estate:									
Commercial	\$ 1,754,372	\$ (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	-	-
	<u>\$ 2,509,334</u>	<u>\$ 40,000</u>	<u>\$ -</u>	<u>\$ 44,381</u>	<u>\$ 2,593,715</u>	<u>\$ -</u>	<u>\$ 2,593,715</u>	<u>\$ 2,135,045</u>	<u>\$360,359,658</u>

The following table provides activity for the accretable yield of purchased loans:

	2020
Balance at beginning of the year	\$ -
Acquired during the year	2,478,000
Accretion	227,768
Adjustments	-
Balance at end of year	<u>\$ 2,250,232</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

6. Loans (Continued)

At December 31, 2020, the nonaccretable discount on purchased impaired loans was \$927,000. At December 31, 2020, the remaining yield premium on purchased loans was \$2,124,008. At December 31, 2020, the principal balance of purchased loans was \$135,413,180 and the carrying value was \$134,347,454.

Loans having an aggregate balance of approximately **\$115.3** million were pledged as collateral to the FHLB as of December 31, 2020. Loans having an aggregate balance of approximately **\$76** million were pledged as collateral to the Federal Reserve Bank of Richmond (the “FRB”) as of December 31, 2020. At December 31, 2020 and 2019, the Company serviced participation loans for others totaling **\$21.0** and \$24.2 million, respectively.

The Company makes loans primarily to customers located primarily in Baltimore County and Carroll County, Maryland and in surrounding areas of northern Maryland. Although management believes that 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.

7. Premises and Equipment

A summary of premises and equipment is as follows:

	Useful lives	2020	2019
Land and improvements	-	\$ 3,237,998	\$ 1,952,998
Buildings and improvements	15-39 years	6,989,622	5,659,635
Furniture and equipment	3-10 years	4,509,439	4,053,075
		<u>14,737,059</u>	<u>11,665,708</u>
Accumulated depreciation and amortization		<u>7,000,503</u>	<u>6,628,857</u>
		<u>\$ 7,736,556</u>	<u>\$ 5,036,851</u>
Depreciation and amortization expense		<u>\$ 371,646</u>	<u>\$ 295,020</u>

The Bank has entered into a contract to sell for \$1,370,000 one of the two parcels of real property that were acquired from Carroll in the Merger. The carrying value of the land, building, and furniture and equipment at December 31, 2020 was \$1,322,000, which is the expected net sale proceeds. The sale is expected to be completed by March 31, 2021.

Software with a net book value of **\$155,122** and \$47,802 as of December 31, 2020 and 2019, respectively, is included in other assets. Amortization expense of **\$44,135** and \$49,151 was recorded in 2020 and 2019, respectively.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

8. Goodwill and Other Intangibles

The acquisition of Carroll in October of 2020 resulted in the recording of goodwill and core deposit intangible ("CDI"). The following table presents the changes in both assets:

	<u>Goodwill</u>	<u>CDI</u> 2020	<u>Total</u>
Balance at beginning of the year	\$ -	\$ -	\$ -
Acquired during the year	6,978,208	83,282	7,061,490
Amortization	-	(2,082)	(2,082)
Adjustments	-	-	-
Balance at end of year	<u>\$ 6,978,208</u>	<u>\$ 81,200</u>	<u>\$ 7,059,408</u>

The CDI is being amortized over 10 years on a straight line basis. Annual amortization will be \$8,328 for the next 9 years and \$6,246 in year 10. Since the acquisition was a tax-free reorganization, goodwill and CDI are not deductible for income tax purposes.

9. 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 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 was renewed in June 2020 with options to renew for three 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, 2020:

	Consolidated Balance <u>Sheet classification</u>	<u>December 31, 2020</u>	<u>December 31, 2019</u>
Operating lease right of use asset	Other assets	\$ 1,242,832	\$ 1,392,281
Operating lease liabilities	Other liabilities	1,443,966	1,559,356

Operating lease cost included in occupancy expense in the statement of income was \$195,106 during 2020 and \$195,039 during 2019.

Future undiscounted lease payments for operating leases with initial terms of one year or more as of December 31, 2020 are as follows:

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

9. Commitments and Contingencies (continued)

<u>Year</u>	<u>Amount</u>
2021	\$ 210,956
2022	221,497
2023	228,531
2024	234,910
2025	241,483
Thereafter	<u>899,195</u>
Total lease payments	2,036,572
Less imputed interest	<u>(592,606)</u>
Present value of operating lease liabilities	<u>\$ 1,443,966</u>

For operating leases as of December 31, 2020, the weighted average remaining lease term is 8.51 years and the weighted average discount rate is 3.25%. During the years ended December 31, 2020 and 2019, cash paid for amounts included in the measurement of lease liabilities was \$161,046 and \$154,127, respectively.

Credit Commitments

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

	<u>2020</u>	<u>2019</u>
Loan commitments		
Construction and land development	\$ 4,668,250	\$ 1,322,275
Commercial	1,000,000	4,102,000
Commercial real estate	15,772,020	7,560,714
Residential	<u>4,668,750</u>	<u>770,499</u>
	<u>\$26,109,020</u>	<u>\$ 13,755,488</u>
Unused lines of credit		
Home-equity lines	\$13,716,894	\$ 3,700,404
Commercial lines	<u>23,996,679</u>	<u>22,229,095</u>
	<u>\$37,713,573</u>	<u>\$ 25,929,499</u>
Letters of credit	<u>\$ 1,891,428</u>	<u>\$ 1,935,613</u>

Loan commitments and lines of credit are agreements to lend to a customer as long as there is no violation of any condition to the contract. Loan commitments generally have interest rates at current market amounts, fixed expiration dates, and may require payment of a fee. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at any time. Letters of credit are commitments issued to guarantee the performance of a customer to a third party.

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

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

9. 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, 2020 and 2019 were **\$315,419** and \$191,951, respectively, and are included in other liabilities in the Consolidated Balance Sheet.

10. 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 **\$237,612** and \$193,109 for 2020 and 2019, 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. Some of the policies provide benefits subsequent to the employee's employment with the Company. For this plan, the Company expensed **\$6,356** and \$5,873 in 2020 and 2019, 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 **\$207,858** and \$145,964 in 2020 and 2019, respectively, for these plans.

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

11. Interest-Bearing Deposits

Major classifications of interest-bearing deposits are as follows:

	2020	2019
NOW	\$107,763,512	\$ 63,299,218
Money market	83,740,032	54,323,501
Savings	80,890,934	47,572,517
Certificates of deposit, \$250,000 or more	38,700,152	33,251,181
Other time deposits	159,151,804	117,507,882
	<u>\$470,246,434</u>	<u>\$ 315,954,299</u>

As of December 31, 2020, certificates of deposit mature as follows:

Year	Amount
2021	\$133,669,557
2022	38,374,714
2023	21,959,383
2024	2,152,623
2025	1,695,679
	<u>\$197,851,956</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

12. 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.

On September 30, 2020, Farmers and Merchants Bancshares, Inc. borrowed \$17,000,000 from First Horizon Bank ("FHN") to be used, on October 1, 2020, to fund a portion of the merger consideration paid in the Merger. Net of issuance costs of \$28,126, the proceeds of the net long-term debt was \$16,971,874. The loan matures on September 30, 2025. The interest rate on the loan is fixed at 4.10%. The Company is required to make quarterly interest-only payments through October 1, 2021. The Company expects that the amount of these quarterly interest-only payments will be \$174,250. During the remaining term of the loan, the Company is required to make quarterly interest and principal payments of approximately \$646,472, which will be based on a nine-year straight-line amortization schedule. The remaining balance of approximately \$9,916,667 will be due at maturity. To secure its obligations under this loan, the Company pledged all of its shares of common stock of the Bank to the lender.

Additional information is as follows:

		2020	2019
Amounts outstanding at year-end:			
Securities sold under repurchase agreements		\$ 24,753,972	\$ 10,958,118
Federal Home Loan Bank advances:			
<u>Maturity date</u>	<u>Interest Rate</u>	<u>Amount</u>	
3/30/2025	1.00%	5,000,000	-
Long-term debt (net of issuance costs):			
<u>Maturity date</u>	<u>Interest Rate</u>	<u>Amount</u>	
9/30/2025	4.10%	16,973,280	-
Weighted average rate paid at December 31:			
Securities sold under repurchase agreements		0.61%	1.49%
Federal Home Loan Bank advances		1.00%	0.00%
Long-term debt		4.10%	0.00%
Maximum month-end amount outstanding during the year ended December 31:			
Securities sold under repurchase agreements		\$ 24,753,972	\$ 10,958,118
Federal Home Loan Bank advances		10,000,000	6,500,000
Long-term debt (net of issuance costs)		16,973,280	-
Average amount outstanding during the year ended December 31:			
Securities sold under repurchase agreements		\$ 9,355,593	\$ 9,273,092
Federal Home Loan Bank advances		4,877,052	2,610,959
Borrowings from FRB and commercial banks		-	90,966
Long-term debt (net of issuance costs)		4,425,976	-
Average rate paid during the year ended December 31:			
Securities sold under repurchase agreements		1.15%	1.24%
Federal Home Loan Bank advances		0.84%	1.62%
Borrowings from FRB and commercial banks		0.00%	2.91%
Long-term debt		4.10%	0.00%
Investment securities underlying the repurchase agreements at December 31:			
Carrying value		\$ 34,958,212	\$ 11,441,474
Estimated fair value		35,880,915	11,859,595
Loans pledged to the Federal Home Loan Bank at December 31:			
Carrying value - loans		\$ 115,282,801	\$ 80,432,808

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

12. Borrowed Funds (continued)

	2020	2019
Loans pledged to the Federal Reserve Bank at December 31:		
Carrying value	\$ 76,027,628	\$ 46,086,041

The Company is approved to borrow approximately \$89.3 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 \$33.2 million. The Company also has available an unsecured federal funds line of credit of \$14.5 million and a secured federal funds line of credit of \$9 million from commercial banks.

13. Other Noninterest Expenses

Other noninterest expenses include the following:

	2020	2019
Professional services	\$ 424,813	\$ 448,704
Automated teller machine and debit card expenses	278,989	254,792
Advertising	237,909	292,301
Telephone	224,805	204,486
Stationery, printing, and supplies	208,510	181,823
Directors fees	203,335	212,161
Federal Deposit Insurance Corporation premiums	201,714	30,571
Insurance claims	200,000	178,500
Internet banking fees	185,815	152,750
Postage, delivery, and armored carrier	145,544	154,583
Correspondent bank services	135,621	128,622
Liability insurance	54,251	49,447
Other taxes	52,544	-
Maryland state regulatory assessment	51,310	48,794
Dues and subscriptions	48,517	41,261
Credit reports	42,592	29,825
Remote deposit expenses	37,298	31,278
Other real estate owned	34,861	13,408
Travel and conferences	27,141	52,152
Payroll processing	25,830	21,406
Other	129,244	137,679
	<u>\$ 2,950,643</u>	<u>\$ 2,664,543</u>

14. Income Taxes

The components of income tax expense are as follows:

	2020	2019
Current		
Federal	\$ 387,193	\$ 756,984
State	251,349	336,191
	638,542	1,093,175
Deferred	(151,331)	(53,841)
	<u>\$ 487,211</u>	<u>\$ 1,039,334</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

14. Income Taxes (Continued)

The components of the deferred tax expense are as follows:

	2020	2019
Depreciation	\$ 18,006	\$ 10,501
Provision for loan losses	171,984	(11,007)
Other real estate owned allowance for loss	-	(57,828)
Nonaccrual interest	2,752	31,691
Prepaid captive insurance premium	(76,855)	21,373
Write-down of equity securities	(2,893)	9,767
Capitol loss carryover	-	(5,300)
Lease liability, net of right of use asset	9,372	(11,258)
Purchase accounting adjustments	(29,982)	-
Post-retirement benefits	58,947	(41,780)
	<u>\$ 151,331</u>	<u>\$ (53,841)</u>

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

Deferred tax assets		
Allowance for loan losses	\$ 809,860	\$ 637,848
Other real estate owned allowance for loss	388,066	286,182
Write-down of equity securities	-	2,864
Capital loss carryover	5,300	5,300
Nonaccrual interest	4,620	-
Post-retirement benefits	603,390	544,442
Purchase accounting adjustments	392,341	-
Lease liability, net of right of use asset	55,347	45,975
	<u>2,258,924</u>	<u>1,522,611</u>
Deferred tax liabilities		
Prepaid captive insurance premium	371,894	295,039
Write-down of equity securities	15,606	-
Unrealized gain on securities available for sale	328,986	16,182
Depreciation	322,770	175,312
	<u>1,039,256</u>	<u>486,533</u>
Net deferred tax asset	<u>\$1,219,668</u>	<u>\$ 1,036,078</u>

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

Statutory federal income tax rate	21.0 %	21.0 %
Increase (decrease) resulting from:		
Federal tax-exempt income	(12.3)	(7.0)
State income taxes, net of federal income tax benefit	4.5	4.4
Nondeductible expenses	2.2	0.1
Other	-	0.1
	<u>15.4 %</u>	<u>18.6 %</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

14. **Income Taxes** (Continued)

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

Our fiscal year 2016, 2017, and 2018 U.S. consolidated federal tax returns are 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 \$2.6 million as of December 31, 2020. 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, 2016.

15. **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%.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

15. 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, 2020). 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, 2020 and 2019, 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, 2020 and 2019, 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, 2020 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, 2020 and 2019, for the Bank under the Basel III Capital Rules.

(Dollars in thousands) December 31, 2020	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)	\$ 63,400	12.62%	\$ 52,732	10.50%	\$ 50,221	10.00%
Tier 1 capital (to risk-weighted assets)	60,104	11.97%	42,688	8.50%	40,177	8.00%
Common equity tier 1 (to risk-weighted assets)	60,104	11.97%	35,155	7.00%	32,644	6.50%
Tier 1 leverage (to average assets)	60,104	9.05%	26,569	4.00%	33,211	5.00%
(Dollars in thousands) December 31, 2019	Actual		Minimum Capital Adequacy		To Be Well Capitalized	
	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%

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

16. 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 Company 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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

16. 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, 2020 and 2019, 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
<u>December 31, 2020</u>				
Recurring				
Available for sale securities				
State and municipal	\$ -	\$ 986,532	\$ -	\$ 986,532
SBA pools	-	1,783,807	-	1,783,807
Corporate bonds	-	6,797,431	-	6,797,431
Mortgage-backed securities	-	44,909,516	-	44,909,516
	<u>\$ -</u>	<u>\$ 54,477,286</u>	<u>\$ -</u>	<u>\$ 54,477,286</u>
Equity security at fair value	\$ 552,566	\$ -	\$ -	\$ 552,566
Nonrecurring				
Other real estate owned	\$ -	\$ -	\$ 1,411,605	\$ 1,411,605
Impaired loans	-	-	9,188,535	9,188,535
<u>December 31, 2019</u>				
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
	<u>\$ -</u>	<u>\$ 36,531,774</u>	<u>\$ -</u>	<u>\$ 36,531,774</u>
Equity security at fair value	\$ 532,321	\$ -	\$ -	\$ 532,321
Nonrecurring				
Other real estate owned	\$ -	\$ -	\$ -	\$ -
Impaired loans	-	-	2,135,045	2,135,045

Reconciliation of Level 3 Inputs

	Other Real Estate Owned	Impaired Loans
December 31, 2019 fair value	\$ -	\$ 2,135,045
Additions	1,411,605	7,141,460
Advances	-	26,499
Write-downs/charge-offs	-	-
Recoveries	-	-
Loan loss provision	-	-
Yield premium accretion	-	(4,139)
Principal payments received	-	(110,330)
December 31, 2020 fair value	<u>\$ 1,411,605</u>	<u>\$ 9,188,535</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

16. 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, 2020		December 31, 2019	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 2 inputs				
Securities held to maturity	\$ 23,078,519	\$ 24,244,786	\$ 19,510,018	\$ 20,097,931
Mortgage loans held for sale	1,673,350	1,705,781	242,000	245,857
Restricted stock, at cost	900,500	900,500	376,200	376,200
Level 3 inputs				
Loans, net	521,690,514	527,132,047	359,382,843	359,346,031
Financial liabilities				
Level 1 inputs				
Noninterest-bearing deposits	\$ 103,155,113	\$ 103,155,113	\$ 60,659,015	\$ 60,659,015
Securities sold under repurchase agreements	24,753,972	24,753,972	10,958,118	10,958,118
Level 2 inputs				
Interest-bearing deposits	470,246,434	474,096,434	315,954,299	313,622,299
Federal Home Loan Bank advances	5,000,000	5,136,000	-	-
Long-term debt	16,973,280	17,018,416	-	-

The fair value of mortgage loans held for sale was determined by the expected sales price. The fair value of loans was determined using an exit price methodology as prescribed by FASB Accounting Standards Update 2016-01. 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.

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

17. Parent Company Financial Information

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

Balance Sheets

December 31,	2020	2019
Assets		
Cash and cash equivalents	\$ 200,925	\$ 64,152
Investment in subsidiaries	68,645,516	49,389,364
Other assets	36,380	-
	<u>\$ 68,882,821</u>	<u>\$ 49,453,516</u>
Liabilities and Stockholders' Equity		
Long-term debt	\$ 16,973,280	\$ -
Accrued interest payable	180,058	-
	<u>17,153,338</u>	<u>-</u>
Stockholders' equity		
Common stock, par value \$.01 per share, authorized 5,000,000 shares; issued and outstanding 3,011,255 shares in 2020 and 2,974,019 shares in 2019	30,113	29,740
Additional paid-in capital	28,294,139	27,812,991
Retained earnings	22,698,954	21,568,161
Accumulated other comprehensive income	706,277	42,624
	<u>51,729,483</u>	<u>49,453,516</u>
	<u>\$ 68,882,821</u>	<u>\$ 49,453,516</u>

Statements of Income

Years Ended December 31,	2020	2019
Income		
Cash dividends from subsidiaries	\$ 9,452,045	\$ 1,331,917
Total income	9,452,045	1,331,917
Interest expense - long-term debt	(181,465)	-
Noninterest expense	(521)	(537)
Income before income taxes and equity in undistributed income of subsidiaries	9,270,059	1,331,380
Income taxes (benefit)	(37,812)	-
Income before equity in undistributed income of subsidiaries	9,307,871	1,331,380
Dividends in excess of income of bank subsidiary	(6,759,815)	-
Equity in undistributed income of insurance subsidiary	133,947	3,229,424
Net Income	<u>\$ 2,682,003</u>	<u>\$ 4,560,804</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

17. Parent Company Financial Information (continued)

Statements of Cash Flows

Years Ended December 31,	2020	2019
Cash flows from operating activities		
Net Income	\$ 2,682,003	\$ 4,560,804
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of insurance subsidiary	(133,947)	(3,229,424)
Accrued interest payable	180,058	-
Amortization of debt issuance costs	1,406	-
Income tax receivable	(37,812)	-
Dividend received in excess of income of bank subsidiary	6,759,815	-
Cash provided by operating activities	<u>9,451,523</u>	<u>1,331,380</u>
Cash flows from investing activities		
Contribution of capital to subsidiaries	(690,000)	(310,000)
Acquisition of Carroll Bancorp, Inc. net of cash acquired	(24,526,935)	-
Cash used by investing activities	<u>(25,216,935)</u>	<u>(310,000)</u>
Cash flows from financing activities		
Long-term debt	16,971,874	-
Dividends paid, net of reinvestments	(1,069,689)	(1,021,471)
Cash provided by financing activities	<u>15,902,185</u>	<u>(1,021,471)</u>
Net increase (decrease) in cash and cash equivalents	136,773	(91)
Cash and cash equivalents at beginning of period	64,152	64,243
Cash and cash equivalents at end of period	<u>\$ 200,925</u>	<u>\$ 64,152</u>

Farmers and Merchants Bancshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Continued)

18. Quarterly Results of Operations

	Three Months Ended			
	Unaudited			
2020	December 31	September 30	June 30	March 31
Interest income	\$ 6,475,562	\$ 4,822,354	\$ 4,755,228	\$ 4,710,036
Interest expense	907,745	721,605	884,825	944,502
Net interest income	5,567,817	4,100,749	3,870,403	3,765,534
Provision for loan losses	150,000	-	350,000	125,000
Net income	417,394	385,247	1,036,055	843,307
Earnings per share - basic and diluted	\$ 0.14	\$ 0.13	\$ 0.35	\$ 0.28
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

19. 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, 2021 there were 3,011,255 shares of Common Stock issued and outstanding held by approximately 468 stockholders of record.

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

	<u>High</u>	<u>Low</u>	<u>Dividend Per Share</u>
<u>2020</u>			
Quarter ended December 31	\$13.30	\$12.75	\$0.26
Quarter ended September 30	14.00	13.00	0.00
Quarter ended June 30	16.00	12.52	0.26
Quarter ended March 31	18.50	11.10	0.00
<u>2019</u>			
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

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 27, 2021 at 3:00 p.m. at the Corporate Headquarters.
Due to COVID -19 restrictions, shareholders are
encouraged to attend via conference call.
See our website at www.fmb1919.bank for instructions.

Securities Markets

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

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

Transfer Agent

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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:**

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Farmers and Merchants Bank
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Reisterstown, Maryland 21136

