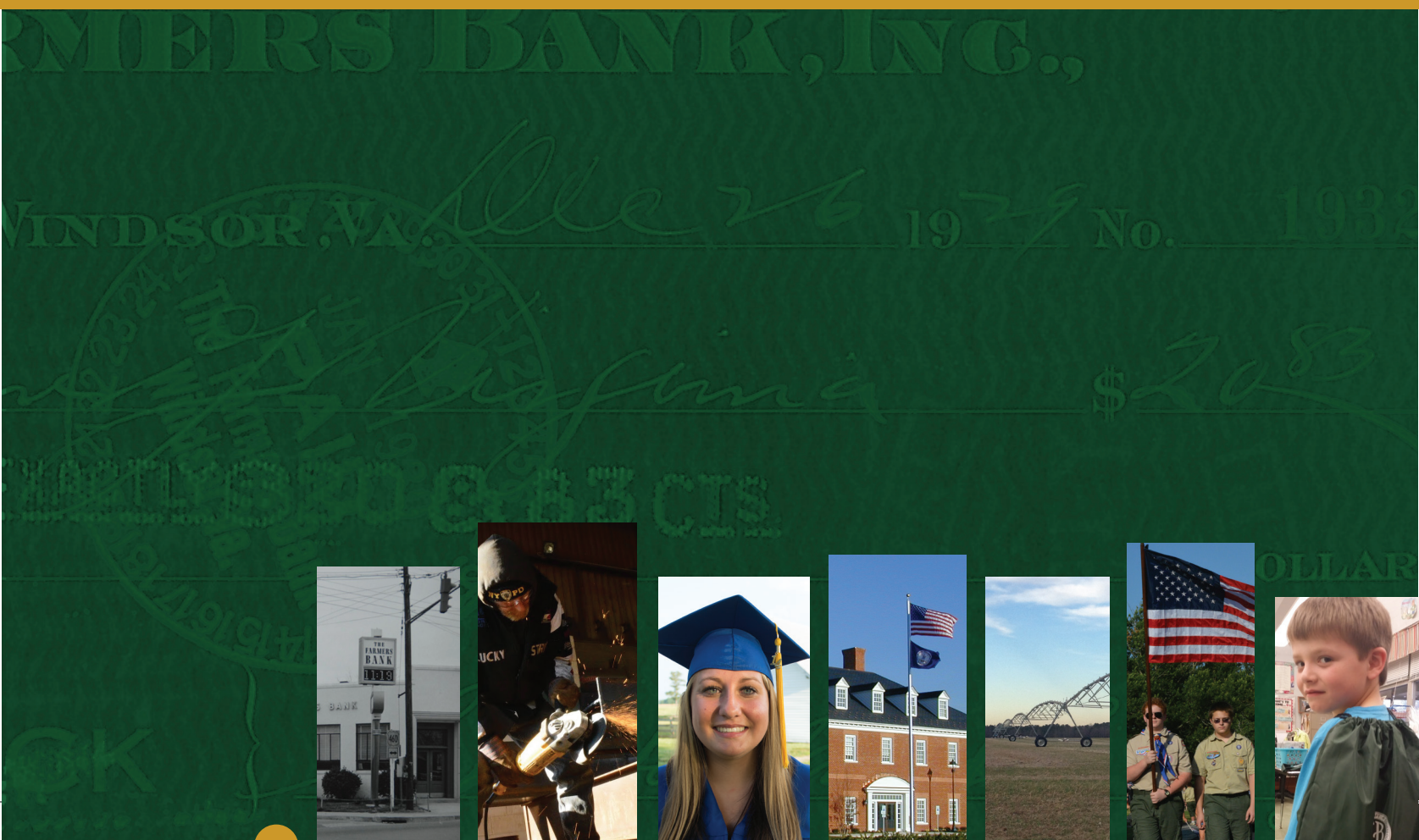


Cultivating Community



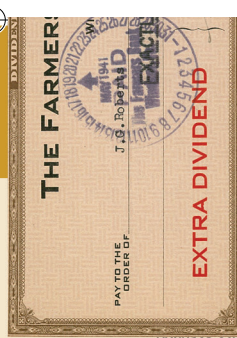
FARMERS BANK

Annual Report 2014

COURTEOUS | PROMPT | RELIABLE | SECURE

Statement showing increase of Net Earnings of Farmers Bank, Windsor, Virginia which have been added to Surplus & Profits after paying \$1300.00 in Dividends each year beginning with the year 1922.

Surplus & Profits	
Dec. 31, 1920	\$2,224.94
Dec. 31, 1921	5,253.34
Dec. 31, 1922	7,111.24
Dec. 31, 1923	8,549.66
Dec. 31, 1924	10,488.17
Dec. 31, 1925	12,034.81
Dec. 31, 1926	14,276.23
Dec. 31, 1927	15,586.08
Dec. 31, 1928	17,760.00
Dec. 31, 1929	20,228.00



STATEMENT OF CONDITION THE FARMERS BANK

WINDSOR, VIRGINIA
DECEMBER 31, 1953

ASSETS		LIABILITIES	
Accounts.....	\$ 849,111.50	Capital Stock.....	\$ 25,000.00
Investment Securities.....	1,636,626.13	Surplus.....	175,000.00
Bonds & Other Securities.....	155,317.81	Undivided Profits.....	27,215.16
Banking House and Lot.....	13,029.10	Contingent Fund.....	10,000.00
Furniture and Fixtures.....	8,881.11	Reserve for Interest and Taxes..	1,177.99
Cash and Due From Banks.....	1,225,135.22	Dividend Checks Outstanding..	743.75
		Deposits.....	3,648,963.97
	\$ 3,888,100.87		\$ 3,888,100.87



November 12, 1919 -
Bank incorporated by Shirley T. Holland
1922 - First dividend to shareholders

1946 - Assets exceeded \$2 million
1951 - Richard J. Holland, Sr. joins the Bank

1910

1920

1930

1940

1950

1960

Our Mission

It is the mission of Farmers Bank to be unique and distinct from all other financial institutions, set apart by excelling in the following areas:



State's largest employer - and certainly one of its best known - is Planters Peanuts.

The name "Planters" and "peanuts" are practically synonymous the world over today, but peanuts are just one of the many fine products processed here today by Planters Peanuts Division of Standard Brands, Inc.

Founded in 1906 by the late Amos C. Holt and Marco Pizzani in Wilkes-Barre, Pa., the first plant was opened here in 1912. The company merged with Standard Brands Incorporated in 1961.

Today, skilled peanuteers, all tree nuts, dry roasted peanut butter, chocolate coated nuts, peanut candy, roasted nuts and refined peanut oil all bearing the familiar "Planters" label - are shipped to practically every forest country in the world. Employing 1,900 workers, a plant among peanuteers, a yearly payroll of \$8,000,000 is far cry from Mr. Coker's initial.

The 1906 version of Planters occupied two floors of a mode building in Wilkes-Barre, Pa. It was the historic sum of \$1 a month and the business consisted of two large peanuteers and some crude machinery operated by five girls and a man.

In 1915, Coker came to this city because of its location in the midst of the peanut belt and made it "the peanut capital."

Only five years later, the distinguished top - hatted "Mr. Peanuteer" made his appearance on the scene and became internationally famous as the representative of quality in peanuteers and peanut products.

Today Planters Peanuts Division of Standard Brands is one of the largest and most successful of the nation's food processing plants.

Farmers Bank of Windsor Boasts Its Highest Assets

The Farmers Bank located on W. Windsor Blvd., Windsor, has served the local trade area for 48 years, being founded in 1919 by Shirley T. Holland and Dr. J. M. Raby. Today the bank has eight employees and assets of \$7,368,702.76 - the highest in its history.

During 1966 a modern parking lot was opened as another customer service. A building and additional land was purchased adjacent to the present bank property. This will be used for expansion.

Plans are now underway for additional parking facilities and a drive-in teller facility.

5 - Ruritan District; past president of the Tri-County Clearing House Bankers Association; past district deputy grand master of 31st Masonic District; past president of Windsor High School P.T.A.; member of Boy Scout Executive Board for Old Dominion Area Council; and member of Cedar Point Club.

Other Farmers Bank officers are: W. H. Johnson, Chairman

of the Board, Shirley T. Holland, President; C. E. Fulgham, Vice President; Betty J. Alphin, Assistant Vice President; Nancy W. Jones, Assistant Cashier.

Board of Directors are: W. H. Johnson, Shirley T. Holland, W. T. Joyce, William A. Cowles, E. Russell Laine, C. E. Fulgham, W. M. Edwards, Jr., Richard J. Holland.

Chamber Worked Hard For Redelopment Plan Here

Although the voters turned it down in a referendum November 1968, the Suffolk-Namemasand Chamber of Commerce worked

Organized in 1971, the Chamber has since offered community service in various phases through committees designed



AVAILABLE AT FARMERS BANK, WINDSOR

RESER OR ENDORSERS OF THIS NOTE SEVERALLY WAIVE ITS PRES... FURTHER WAIVE THE PROTEST OF THIS NOTE IN CASE OF NON-P... WE, THE MAKER OR MAKERS, AND ENDORSER OR EN... NKRUPT LAWS AS TO THIS DEBT AND FURTHER AG... ALL COURT COST WHICH MAY BE INCURRED, IN CAS...



1968 - First drive-in teller facility
1970 - Loans exceeded \$5 million

1984 - First Computer/Assignment of Account Numbers
1988 - Richard J. Holland, Sr. named President and Chairman of the Board
1989 - New Windsor Branch

1994 - Richard J. Holland, Jr. named President and CEO
1999 - Implemented Online Banking
2002 - Lakeside Branch Opened
2004 - Hillpoint Branch Opened

2009 - Harbourview Branch Opened
2013 - Courtland Branch Opened and Implemented Mobile Banking
2014 - Partnership with Manry Rawls, LLC

1970

1980

1990

2000

2010

- To offer a superior level of service that is responsive, courteous, cooperative and professional.
- To remain an independent financial institution close to the people of Isle of Wight County, Southampton County, the City of Suffolk and the surrounding communities, being sensitive to their financial needs and designing and offering products to specifically meet those needs.
- To be good corporate citizens, serving as leaders to strengthen our communities and promote their welfare.
- To employ men and women who are loyal to the bank and committed to our direction, policies and goals.
- To bring our shareholders a fair rate of return on their investments.

Dear Shareholder,



Richard J. Holland, Jr.

In November 2014 Farmers Bank celebrated ninety-five years of history and service to our customers, communities and shareholders. Though our past is deeply rooted in providing traditional banking services to the local community, your Board of Directors, Management and Staff have spent much of 2014 strategically planning for the future and focused on increasing your shareholder value. The collaboration and commitment from these people have brought you, our shareholders, increased dividends, improved asset quality, higher earnings and a better positioned financial institution.

We are proud to report the results enclosed in this annual report. Net income attributable to common shareholders increased by almost nineteen percent, which was reflected in the nine percent increase in the per share dividends declared during the year. Contributing to this success was net loan growth of \$17 million in an environment where economic growth and expansion remains muted. An increase of \$15 million, or 21 percent, in non-interest bearing deposits also significantly aided in lowering our cost of funds and offsetting loans that re-priced at lower rates. As discussed in our letter from January, diversifying revenue through our mortgage and insurance offerings led to improved non-interest income of \$425,000, or 31 percent.

In reporting these results, I remind you that our region, state and country remain in a very challenging economic position. Financial conditions have not improved enough to support meaningful progress. Regulatory oversight continues to be a burden on our earnings. Although, regulatory and compliance costs continue to rise, many of the efforts we put into place in late 2014 and reported to you in January, will help to offset these additional expenses.

Remaining a community bank of our size is becoming a novelty, however your Bank is armed with leadership that is prepared for the challenge. We enjoy being involved in our communities, where we strive to make a difference with our services and contributions. Our actions and daily decisions have the potential to impact lives, homes and businesses in a very meaningful and constructive way.

Thank you for your loyalty and continued support of the Company. May we as partners stamp Farmers Bank with a legacy that we can be proud of and endures for future generations over the next ninety-five years.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard J. Holland, Jr.".

Richard J. Holland, Jr.
Chairman and CEO

A handwritten signature in black ink, appearing to read "Vernon M. Towler".

Vernon M. Towler
President



Vernon M. Towler

Board of Directors



Richard J. Holland, Jr.
Chairman



William A. Gwaltney, Jr.
Vice Chairman
Indika Farms, Inc., President



G. Thomas Alphin, Jr.
Commonwealth Gin,
Co-Owner



E. Warren Beale, Jr.
Manry Rawls, LLC



Harold U. Blythe
Retired Bank CEO



William L. Chorey
Chorey & Associates Realty, Ltd.,
Owner/Broker



David T. Owen
Wakefield Farm Service, Inc.,
President



Peter D. Pruden, III
Taste Unlimited, Co-Owner



William H. Riddick, III
Attorney at Law - Smithfield



Kent B. Spain
Suffolk Insurance Corporation,
Executive Vice President



O. A. Spady
Retired Entrepreneur

Executive Management



Richard J. Holland, Jr.
*Chairman of the Board &
Chief Executive Officer*



Vernon M. Towler
President



Patricia T. Allen
*Senior Vice President, Director
of Loan & Deposit Operations*



Kathy C. Bryant
*Senior Vice President, Director of
Human Resources and Retail*



Norman F. Carr, Jr.
*Senior Vice President,
Smithfield Market*



Kristy E. DeJarnette
*Senior Vice President,
Chief Financial Officer*



Clayton N. Minter
*Vice President,
Chief Credit Officer*



Chad A. Rountree
*Vice President,
Windsor Market*



Thomas L. Woodward, III
*Vice President,
Chief Lending Officer*

Bank Officers

William N. Bailey
Vice President, Information Technology

Lauren P. Harper
Vice President, Loans

Elizabeth D. Jones
Vice President, Loans

James C. Saunders
Vice President, Loans

Andrea B. Curry
Assistant Vice President, Operations

Kelly D. Dewitt
*Assistant Vice President, BSA, AML,
OFAC & Security Officer*

C. Thomas Eure, Jr.
Assistant Vice President, Operations

Blanche E. Hecker
Assistant Vice President, Retail

Joanne F. Joyner
Assistant Vice President, Retail

Erin W. Park
Assistant Vice President, Controller

D. Renee Scott
Assistant Vice President, Retail

Meghan D. White
Assistant Vice President, Loan Operations



Suffolk Community Board

David E. Russell (Chairman)

President, Tile & Terrazzo, LLC

James C. Adams, III

President, Featherlite Coaches

Alison Dodson Anderson

Owner, A. Dodson's

Timothy K. Palmer

Attorney at Law & Certified Public Accountant

Roy A. Runyon, III

Director of Research and Development, The Gartman Letter, L.C.

H. Hadley Whitlock, Jr.

Retired Commercial Lender

Western Tidewater Community Board

Vincent Carollo (Chairman)

Anna's Ristorante & JVC Holdings, LLC

Christopher T. Alphin

Commonwealth Gin

Tammy W. Edwards

Windsor Hardware and Supply Company

Randolph H. Pack

Smithfield Station

V.S. Pittman, II

Manry Rawls, LLC

John T. Randall

Stallings & Randall, P.C.



Financial Highlights

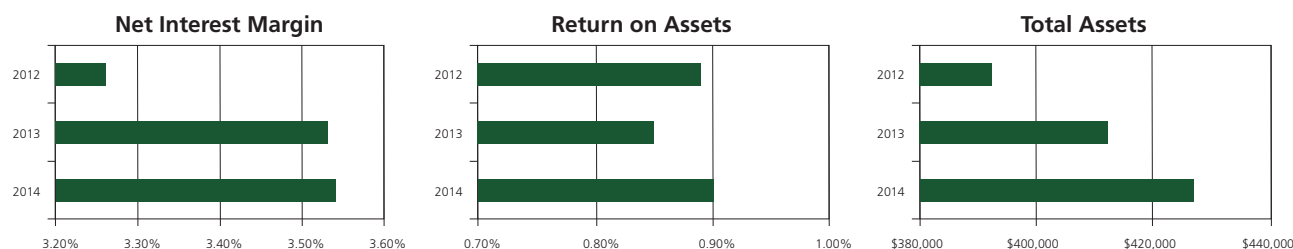
At or for the Years Ended December 31,	2014	2013	2012
(Dollars in thousands, except per share data)			
Summary of Operations			
Interest income	\$16,128	\$15,909	\$17,371
Interest expense	3,156	3,182	4,900
Net interest income	12,972	12,727	12,471
Provision for loan losses	(850)	(500)	-
Net interest income after provision for loan losses	13,822	13,227	12,471
Non-interest income	1,763	1,337	3,381
Non-interest expense	11,317	10,150	10,811
Income before income taxes	4,268	4,414	5,041
Income taxes	907	1,098	1,310
Net income	\$3,361	\$3,316	\$3,731
Per Share and Shares Outstanding (1)			
Basic net income	\$5.53	\$4.66	\$5.22
Book value at end of period	\$62.45	\$54.06	\$55.85
Basic weighted average shares outstanding	608,039	607,357	605,821
Shares outstanding at period end	612,156	608,020	607,366
Balance Sheet Data			
Total assets	\$426,791	\$412,162	\$392,343
Total loans, net	239,325	221,843	220,402
Total deposits	342,809	343,350	325,680
Borrowings	30,000	20,000	20,000
Selected Performance Ratios			
Return on average assets	0.90%	0.85%	0.89%
Return on average stockholders' equity	8.20%	8.30%	9.00%
Net interest margin (2)	3.54%	3.53%	3.26%
Non-interest income as a percentage of total revenue (3)	11.97%	9.50%	21.33%
Efficiency ratio (4)	71.24%	69.16%	70.89%
Asset Quality Ratios			
Nonperforming loans to period-end loans	2.39%	2.45%	2.13%
Allowance for loan losses to period-end loans	3.29%	3.22%	3.68%
Net charge-offs to average loans outstanding	-0.68%	0.23%	0.17%
Capital (Bank Only)			
Tier 1 leverage ratio	10.83%	10.37%	9.55%
Total risk-based capital ratio	17.92%	18.40%	17.51%
Stockholder's equity	\$48,037	\$43,104	\$42,992

(1) Computed based on the weighted average number of shares outstanding during each period.

(2) Net interest margin is net interest income divided by average interest earning assets.

(3) Total revenue consists of net interest income and non-interest income.

(4) Efficiency ratio is non-interest expense divided by the sum of net interest income and non-interest income.



Farmers Bankshares, Inc.

Consolidated Financial Statements for Years Ended December 31, 2014 and 2013

Contents

	Page
Independent Auditors' Report	2
Consolidated Balance Sheets	3
Consolidated Statements of Operations	4
Consolidated Statements of Comprehensive Income.....	5
Consolidated Statements of Changes in Stockholders' Equity	6
Consolidated Statements of Cash Flows	7 - 8
Notes to Consolidated Financial Statements	9 - 45



Independent Auditors' Report

To the Board of Directors and Shareholders
Farmers Bankshares, Inc.
Windsor, Virginia

We have audited the accompanying consolidated financial statements of Farmers Bankshares, Inc., which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operations, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Farmers Bankshares, Inc., as of December 31, 2014 and 2013, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Dixon Hughes Goodman LLP

Charlotte, North Carolina
February 19, 2015

Farmers Bankshares, Inc.
Consolidated Balance Sheets

	December 31,	
	2014	2013
Assets		
Cash and cash equivalents		
Cash and due from banks	\$ 18,946,788	\$ 20,986,999
Federal Funds sold	8,631,880	10,523,685
Total cash and cash equivalents	27,578,668	31,510,684
Available-for-sale securities (Note 3)	136,634,119	140,293,318
Mortgage loans held for sale	986,000	-
Loans held for investment, net of allowance for loan losses of \$8,181,827 and \$7,381,066, respectively (Note 4)	239,325,310	221,842,775
Premises and equipment, net (Note 5)	3,806,446	5,038,166
Other real estate owned	1,498,798	1,788,798
Accrued interest	1,725,181	1,796,866
Prepaid expenses	366,467	388,920
Income taxes receivable	666,602	213,466
Net deferred tax asset	-	1,056,385
Non-marketable equity securities (Note 6)	4,355,547	2,256,089
Bank-owned life insurance	9,584,982	5,844,964
Other assets	262,418	131,718
	399,211,870	380,651,465
Total assets	\$ 426,790,538	\$ 412,162,149
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing deposits	\$ 86,085,407	\$ 71,039,645
Interest-bearing deposits (Note 7)	256,723,297	272,310,842
Total deposits	342,808,704	343,350,487
Federal Home Loan Bank borrowings (Note 9)	30,000,000	20,000,000
Capital notes (Note 8)	11,253,475	11,253,475
Securities sold under agreements to repurchase (Note 9)	1,929,599	2,595,776
Deferred compensation plans	1,104,315	971,455
Net deferred tax liability	374,802	-
Other liabilities	1,095,387	886,085
Accrued interest	249,229	234,354
Total liabilities	388,815,511	379,291,632
Stockholders' equity		
Common stock, \$0.625 par value; 10,000,000 shares authorized; 612,156 and 608,020 shares issued and outstanding at December 31, 2014 and 2013, including nonvested shares of 3,450 and 0- shares, respectively	382,600	380,015
Capital surplus	2,723,028	2,695,613
Retained earnings	31,849,329	28,853,472
Accumulated other comprehensive income	3,020,070	941,417
Total stockholders' equity	37,975,027	32,870,517
Total liabilities and stockholders' equity	\$ 426,790,538	\$ 412,162,149

Farmers Bankshare, Inc.
Consolidated Statements of Operations

	Years Ended December 31,	
	2014	2013
Interest income		
Interest and fees on loans held for investment	\$ 11,917,161	\$ 12,103,930
Interest on mortgage loans held for sale	2,470	-
Interest on available-for-sale securities	2,815,959	2,559,424
Interest on tax exempt available-for-sale securities	1,269,922	1,163,005
Interest on federal funds sold	41,970	22,270
Other interest income	80,391	60,225
Total interest and dividend income	<u>16,127,873</u>	<u>15,908,854</u>
Interest expense		
Interest on deposits	1,966,110	2,690,428
Interest on Federal Home Loan Bank advances	614,693	485,607
Interest on capital notes	569,160	-
Interest on repurchase agreements	5,941	5,366
Interest on federal funds purchased	3	469
Total interest expense	<u>3,155,907</u>	<u>3,181,870</u>
Net interest income	12,971,966	12,726,984
Recovery of loan losses	<u>(850,000)</u>	<u>(500,000)</u>
Net interest income after provision for loan losses	<u>13,821,966</u>	<u>13,226,984</u>
Noninterest income		
Service charges	353,212	345,983
Income from automated teller machines and bank card interchange	450,090	434,007
Gain on disposition of securities	288,847	109,232
Income on bank owned life insurance	240,019	236,542
Gain on sale of premises and equipment	20,404	-
Other income	410,752	210,990
Total noninterest income	<u>1,763,324</u>	<u>1,336,754</u>
Noninterest expense		
Salaries and employee benefits	5,755,188	5,421,728
Equipment expense	731,347	657,278
Occupancy expense	615,749	594,080
Bank franchise tax	402,681	381,498
Advertising and marketing	547,556	381,409
Data processing	843,361	772,958
Loan related legal and other expenses	276,056	169,653
Federal Deposit Insurance Corporation assessment	286,513	291,640
Loss on sale and write-downs of other real estate owned	288,130	120,919
Other real estate owned	313,914	139,758
Other	1,256,677	1,219,103
Total noninterest expense	<u>11,317,172</u>	<u>10,150,024</u>
Income before income taxes	4,268,118	4,413,714
Income tax expense (Note 11)	<u>907,229</u>	<u>1,097,970</u>
Net income	3,360,889	3,315,744
Preferred stock dividend and accretion of discount	-	488,399
Net income attributable to common shareholders	<u>\$ 3,360,889</u>	<u>\$ 2,827,345</u>
Basic earnings per common share (Note 18)	<u>\$ 5.53</u>	<u>\$ 4.66</u>
Diluted earnings per common share	<u>\$ 5.52</u>	<u>\$ 4.66</u>
Cash dividends declared per common share	<u>\$ 0.60</u>	<u>\$ 0.55</u>

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

Farmers Bankshares, Inc.
Consolidated Statements of Comprehensive Income

	Years Ended December 31,	
	2014	2013
Net income	\$ 3,360,889	\$ 3,315,744
Other comprehensive income (loss):		
Unrealized holding gains (losses) on available-for-sale securities	3,438,321	(5,298,090)
Tax effect	(1,169,029)	1,801,351
Unrealized holding gains (losses) on available-for-sale securities, net of tax amount	2,269,292	(3,496,739)
Reclassification adjustment for realized gains	(288,847)	(109,232)
Tax effect	98,208	37,139
Reclassification adjustment for realized gains, net of tax amount	(190,639)	(72,093)
Other comprehensive income (loss), net of tax	2,078,653	(3,568,832)
Comprehensive income (loss)	\$ 5,439,541	\$ (253,088)

Farmers Bankshares, Inc.
Consolidated Statements of Changes in Stockholders' Equity

	Preferred Stock Series A	Preferred Stock Series B	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balances, December 31, 2012	8,632,556	457,271	379,323	2,652,804	26,360,240	4,510,249	42,992,443
Net income	-	-	-	-	3,315,744	-	3,315,744
Changes in net unrealized gain on securities available for sale, net of reclassification adjustment and tax effect	-	-	-	-	-	(3,568,832)	(3,568,832)
Repurchase of preferred stock	(8,752,400)	(437,600)	-	-	-	-	(9,190,000)
Issuance of common stock - stock compensation plan	-	-	263	14,738	-	-	15,001
Issuance of common stock - director stock plan	-	-	429	28,071	-	-	28,500
Preferred stock net accretion, (amortization) and costs	119,844	(19,671)	-	-	(100,173)	-	-
Cash dividends declared on preferred shares	-	-	-	-	(388,226)	-	(388,226)
Cash dividends declared on common shares, \$0.55 per share	-	-	-	-	(334,113)	-	(334,113)
Balances, December 31, 2013	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 380,015</u>	<u>\$ 2,695,613</u>	<u>\$ 28,853,472</u>	<u>\$ 941,417</u>	<u>\$ 32,870,517</u>
Net income	-	-	-	-	3,360,889	-	3,360,889
Changes in net unrealized gain on securities available for sale, net of reclassification adjustment and tax effect	-	-	-	-	-	2,078,653	2,078,653
Issuance of restricted common shares	-	-	2,156	(2,156)	-	-	-
Issuance of common stock - director stock plan	-	-	429	29,571	-	-	30,000
Cash dividends declared on common shares, \$0.60 per share	-	-	-	-	(365,032)	-	(365,032)
Balances, December 31, 2014	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 382,600</u>	<u>\$ 2,723,028</u>	<u>\$ 31,849,329</u>	<u>\$ 3,020,070</u>	<u>\$ 37,975,027</u>

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

Farmers Bankshares, Inc.
Consolidated Statements of Cash Flows

	Years Ended December 31,	
	2014	2013
Cash flows from operating activities		
Net income	\$ 3,360,889	\$ 3,315,744
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	487,942	448,786
Recovery of loan losses	(850,000)	(500,000)
Provision for deferred income taxes	360,364	520,557
Amortization of investment securities premiums	884,280	1,239,767
Net gain on disposition of available-for-sale securities	(288,847)	(109,232)
Loss on sales and writedowns on other real estate owned	288,130	120,919
Capitalization of costs associated with other real estate owned	-	(16,801)
Gain on sale of premises and equipment	(20,404)	-
Increase in cash value of bank owned life insurance	(240,019)	(236,542)
Compensation expense for stock issuance	-	15,001
Director expense for stock issuance	30,000	28,500
Change in operating assets and liabilities		
Origination of mortgage loans held for sale	(2,091,950)	-
Proceeds from sale of mortgage loans held for sale	1,105,950	-
Interest receivable	71,685	34,329
Interest payable	14,875	(91,231)
Prepaid expenses	22,453	285,886
Income taxes receivable	(453,136)	132,830
Other assets	49,300	(3,062)
Deferred compensation	132,860	218,271
Other liabilities	184,764	133,457
Net cash provided by operating activities	<u>3,049,136</u>	<u>5,537,179</u>
Cash flows from investing activities		
Proceeds from sales, prepayments and maturities of available-for-sale securities	17,521,826	26,300,963
Purchase of available-for-sale securities	(11,308,586)	(37,584,280)
Purchase of bank owned life insurance	(3,500,000)	-
Proceeds from sale of non-marketable equity securities	-	254,200
Purchase of non-marketable equity securities	(2,099,458)	(3,450)
Proceeds from sale of other real estate owned	1,440,628	614,297
Loan originations, net of repayments	(18,251,293)	(2,350,434)
Proceeds from sale of premises and equipment	1,235,085	-
Purchases of premises and equipment	(470,903)	(737,872)
Net cash used in investing activities	<u>(15,432,701)</u>	<u>(13,506,576)</u>
Cash flows from financing activities		
Cash dividends paid on preferred shares	-	(388,226)
Cash dividends paid on common shares	(340,492)	(163,867)
Repurchase of preferred stock	-	(9,190,000)
Proceeds from issuance of capital notes	-	11,253,475
Proceeds from FHLB borrowings	10,000,000	5,000,000
Repayment of FHLB borrowings	-	(5,000,000)
Change in noninterest-bearing deposits	15,045,762	13,778,672
Change in interest-bearing deposits	(15,587,545)	3,891,408
Change in securities sold under agreements to repurchase	(666,177)	847,996
Net cash provided by financing activities	<u>8,451,548</u>	<u>20,029,458</u>
Net increase (decrease) in cash and cash equivalents	(3,932,017)	12,060,061
Cash and cash equivalents		
Beginning of the year	31,510,684	19,450,623
End of year	<u>\$ 27,578,667</u>	<u>\$ 31,510,684</u>

Farmers Bankshares, Inc.
Consolidated Statements of Cash Flow (concluded)

	Years Ended December 31,	
	2014	2013
Supplemental disclosure of cash flow information		
Cash paid for		
Income taxes	\$ 1,000,000	\$ 460,000
Interest on deposits and other borrowings	3,141,032	3,273,101
 Supplemental schedule of non-cash investing activities		
Change in unrealized gains on available-for-sale securities, net of income tax	\$ (2,078,653)	\$ (3,568,832)
Transfer of loans to other real estate owned	(1,618,758)	(1,410,000)
Contribution of other real estate owned	(180,000)	(81,000)

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 1 - Organization and nature of business

Farmers Bankshares, Inc. (the "Company") was organized and incorporated under the laws of the Commonwealth of Virginia on July 26, 2013. On December 31, 2013, the Company was consummated as the Bank Holding Company of Farmers Bank, Windsor, Virginia (the "Bank") through a reorganization plan, under the laws of the Commonwealth of Virginia. As of this date, the Bank became a wholly-owned subsidiary of Farmers Bankshares, Inc. The Bank was formed on November 12, 1919 and has offices in Windsor, Smithfield, Suffolk, and Courtland, Virginia. Through its banking subsidiary the Company provides a wide variety of banking services primarily in southeastern Virginia.

The Bank provides small and mid-sized businesses, professionals, corporate executives and entrepreneurs with banking services comparable to those of the large national and regional institutions. These services include loans that are priced on a deposit-based relationship, direct access to the Bank's decision makers, and quick, innovative response to customers' financial needs. If customers have credit requirements that exceed the Bank's credit limits, the Bank seeks to accommodate those customers by arranging loans on a participation basis with other financial institutions.

Note 2 - Summary of significant accounting policies

Basis of presentation and consolidation - The consolidated financial statements of the Company are prepared in conformity with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, the Bank and FB Properties of Virginia, L.L.C., which owns certain Bank assets. All significant intercompany balances and transactions have been eliminated in consolidation.

Cash and cash equivalents - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits with banks and federal funds sold, all of which mature within 90 days or less. The Company is required by the Federal Reserve to maintain average reserve balances. For the final quarterly reporting period in 2014 and 2013, the aggregate amount of daily-required balances was \$44,000 and \$46,000, respectively.

Investment securities - Investments in debt securities classified as held-to-maturity, if any, are stated at cost, adjusted for amortization of premiums and accretion of discounts using the interest method. The Company held no such securities during the periods reported in the financial statements.

Investments in debt securities classified as trading, if any, are stated at fair value. Such securities are purchased and held principally for the purpose of selling them in the near term. Unrealized holding gains and losses for trading securities are included in the statements of operations. The Company held no such securities during the periods reported on in the financial statements.

Investments not classified as either held-to-maturity or trading are classified as available-for-sale. Debt securities classified as available-for-sale are stated at fair value with unrealized holding gains and losses excluded from earnings and reported as a component of accumulated other comprehensive income until realized. The income statement line items impacted by the reclassification of realized gains (losses) on the sale of securities are the gains (losses) on disposition of securities and income tax expense line items in the income statement.

Gains and losses on the sale of securities are determined using the specific identification method and are recognized on a trade date basis. Other than temporary declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost, if any, are included in earnings as realized losses. In determining, whether other-than-temporary impairment exists, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) if the Company expects to recover the amortized cost basis in the security.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 2 - Summary of significant accounting policies (continued)

Loans - The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by commercial and consumer mortgage loans throughout Southeastern Virginia. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans held for investment that management has the intent and ability to hold for the foreseeable future or until maturity generally are stated at their outstanding unpaid principal balances. Loans held for sale are originated and intended for sale in the secondary market. These loans are carried at the lower of cost or market in the aggregate. Net unrealized losses, if any, are recognized through charges to income. Interest income is accrued on the unpaid principal balance for all loan classes. Discounts and premiums are amortized to income using the interest method. Net deferred fees and costs are amortized over the lives of the applicable loans using the effective interest rate method.

Allowance for loan losses - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of a specific, a historic and a qualitative, general component. The specific component relates to loans that are considered impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of an impaired loan are lower than the carrying value of that loan. The historic component covers non-classified and criticized loans and is based on historical loss experience adjusted for qualitative factors. The qualitative reserve of the allowance reflects adjustments to historical experience to account for current conditions impacting the loan portfolio.

For all classes, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The allowance model is applied to determine the specific allowance balance for impaired loans and the general allowance balance for unimpaired loans grouped by loan type.

The Bank's loan charge-off policy for all loan classes is to charge down loans to net realizable value once a portion of the loan is determined to be uncollectible, and the underlying collateral shortfall is assessed. Loans are moved to nonaccrual status when the loan becomes 90 days delinquent or a portion of the loan is determined to be uncollectible and supporting collateral is not considered to be sufficient to cover potential losses.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 2 - Summary of significant accounting policies (continued)

Allowance for loan losses (concluded) - Nonaccrual loans are reviewed monthly to determine if all or a portion of the loan is uncollectible. Nonaccrual loans that are determined to be solely collateral dependent are monitored for possible charge downs to net realizable value upon determination that they are impaired.

Income recognition on impaired and non-accrual loans - All classes of loans are generally classified as non-accrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. All classes of loans that are on a current payment status or past due less than 90 days may also be classified as non-accrual, if repayment in full of principal and/or interest is in doubt.

All classes of loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

When all classes of loans are classified as non-accrual and the future collectibility of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the future collectibility of the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a non-accrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Other real estate owned - Real estate acquired through, or in lieu of, foreclosure is held for sale and is initially recorded at fair value less estimated cost to sale at the date of foreclosure, establishing a new cost basis. Principal and interest losses existing at the time of acquisition of such assets are charged against the allowance for loan losses and interest income, respectively. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less estimated cost to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Revenue and expenses from operations associated with other real estate owned and the impact of any subsequent changes in the carrying value are included in other expenses.

Premises and equipment - Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. For financial reporting purposes, assets are depreciated over their estimated useful lives using the straight-line method. Useful lives for these assets are within the following ranges, buildings from 10-39 years, equipment, furniture and fixtures 3-15 years, computer equipment 3-7 years and software 3-5 years. For income tax purposes, the accelerated cost recovery system and the modified accelerated cost recovery system are used.

Non-marketable equity securities - Non-marketable equity securities are restricted securities, carried at cost, and periodically evaluated for impairment. These securities are restricted, do not have a readily determinable fair value, and lack a market. Because of the redemption provisions of the Federal Reserve Bank and Federal Home Loan Bank stock, the Bank estimated that the fair value equaled or exceeded the cost of these investments and the investments were not impaired. In April 2014, the Bank invested approximately \$1.4 million in return for a one-third ownership in Manry Rawls, LLC. Manry Rawls, LLC is a local and independent regional insurance agency offering a wide array of insurance products. The Bank's proportionate share of Manry Rawls' income is recorded as an increase in the investment and directly to other non-interest income. Any cash distributions made by Manry Rawls' would lower the recorded investment at the time of payment. Income recognized in 2014 was \$175,611. The difference between the carrying value of the investment and the underlying equity in net assets amounts to approximately \$923,000 and is considered equity method goodwill. Equity method investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment might not be recoverable. No such impairment was identified in 2014.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 2 - Summary of significant accounting policies (continued)

Income taxes - Income taxes are provided for the tax effects of transactions reported in the financial statements, and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of investment securities, deferred loan fees, allowance for loan losses, deferred compensation, interest on non-performing loans and accumulated depreciation for financial and income tax reporting.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered in income. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that the tax benefits will not be realized. Management has evaluated all other tax positions that could have a significant effect on the financial statements and determined the Company had no uncertain income tax positions at December 31, 2014 and 2013. The years ending on or after December 31, 2011 remain subject to examination by federal and state tax authorities. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

Deferred compensation plans - The Company maintains deferred compensation and retirement arrangements with certain officers. The Company's policy is to accrue the estimated amounts to be paid under the contracts over the expected period of active employment. The Company purchased life insurance contracts to fund the expected liabilities under the contracts.

Earnings per common share - Basic earnings per share (EPS) are computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted earnings per share reflect the potential dilution if restricted stock, or other common stock equivalents, would result in the issuance of additional shares of common stock that share in earnings. Potential common shares that may be issued by the Company relate solely to outstanding non-vested restricted stock.

Off-balance sheet financial instruments - In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commitments under credit card arrangements, commercial letters of credit, standby letters of credit, and financial guarantees written. Such financial instruments are generally recorded in the financial statements when they become payable. A reserve for these off-balance sheet financial instruments is considered immaterial as is the fair value of the financial guarantees.

Use of estimates - The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Estimation of fair values - The following notes summarize the major methods and assumptions used in estimating the fair value of financial instruments:

Short-term financial instruments are valued at their carrying amounts included in the Company's balance sheet, which are reasonable estimates of fair value due to the relatively short period to maturity of the instruments. This approach applies to cash and cash equivalents, deposits in other banks, federal funds sold, and short-term borrowings.

Loans are valued on the basis of estimated future receipts of principal and interest, discounted at various rates. Loan prepayments are assumed to occur at the same rate as in previous periods when interest rates were at levels similar to current levels. Future cash flows for homogeneous categories of consumer loans are estimated on a portfolio basis and discounted at current rates offered for similar loan terms to new borrowers with similar credit profiles.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 2 - Summary of significant accounting policies (continued)

Estimation of fair values (concluded) – A liquidity discount is not considered in determining the fair value of the loan portfolio.

Investment securities are valued at quoted market prices, if available. The fair value of equity investments in the restricted stock of the FRB and FHLB approximates the carrying value due to the redemptive provisions of these securities.

For unquoted securities, the fair value is estimated by the Company on the basis of financial and other information.

The carrying amounts of accrued interest approximate fair value.

The fair value of demand deposits and deposits with no defined maturity is taken to be the amount payable on demand at the reporting date. The fair value of fixed-maturity deposits is estimated using discounted cash flow analyses and rates currently offered for deposits of similar remaining maturities. The intangible value of long-term relationships with depositors is not taken into account in estimating the fair values disclosed.

Fair values of capital notes are based on market prices for debt securities having similar maturity and interest rate characteristics. The impact of the Company's assessment of its own credit risk is not factored into the fair value of the notes.

The carrying amounts of federal funds purchased and borrowings under repurchase agreements approximate their fair values.

The fair values of the Company's Federal Home Loan Bank advances are estimated using discounted cash flow analyses based on current rates offered on similar debt instruments.

It is not practicable to separately estimate the fair values for off-balance-sheet credit commitments, including standby letters of credit and guarantees written, due to the lack of cost-effective, reliable measurement methods for these instruments.

Certain significant estimates - Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans and the valuation of other real estate owned. Management uses available information to recognize losses on loans and other real estate owned. Future additions to the allowances may be necessary based on changes in local economic conditions and other factors. Management believes the allowances recorded at December 31, 2014 and 2013 are sufficient to cover inherent losses in the portfolio.

Recent accounting pronouncements - In January 2014, the FASB issued ASU 2014-04, "Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure". The amendments in this update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 2 - Summary of significant accounting policies (concluded)

Recent accounting pronouncements (concluded) - Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments are effective for fiscal years beginning after December 31, 2014. The adoption of this standard is not expected to have a material impact on the consolidated financial statements of the Company.

In June 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606". This ASU applies to any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the revenue recognition requirements in Topic 605, "Revenue Recognition", most industry-specific guidance, and some cost guidance Table of Contents 10 included in Subtopic 605-35, "Revenue Recognition-Construction-Type and Production-Type Contracts". The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2017 for nonpublic companies. Early adoption is not permitted. The adoption of this standard is not expected to have a material impact on the consolidated financial statements of the Company.

In August 2014, the FASB issued ASU No. 2014-14, "Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure". The amendments in this ASU apply to creditors that hold government-guaranteed mortgage loans and is intended to eliminate the diversity in practice related to the classification of these guaranteed loans upon foreclosure. The new guidance stipulates that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if (1) the loan has a government guarantee that is not separable from the loan prior to foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the other receivable should be measured on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2014. Entities may adopt the amendments on a prospective basis or modified retrospective basis as of the beginning of the annual period of adoption; however, the entity must apply the same method of transition as elected under ASU 2014-04. Early adoption is permitted provided the entity has already adopted ASU 2014-04. The adoption of this standard is not expected to have a material impact on the consolidated financial statements of the Company.

Reclassifications - Certain reclassifications have been made to prior period balances to conform to the current year presentation.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 3 - Available-for-sale securities

At December 31, 2014 and 2013, securities are as follows:

December 31, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
State and municipal	\$ 34,040,522	\$ 2,010,653	\$ 4,050	\$ 36,047,125
Residential mortgage-backed securities	19,048,941	403,228	28,123	19,424,046
Collateralized mortgage obligations	46,442,057	804,844	443,032	46,803,869
Small Business Administration Pools	32,526,739	1,832,340	-	34,359,079
	<u>\$ 132,058,259</u>	<u>\$ 5,051,065</u>	<u>\$ 475,205</u>	<u>\$ 136,634,119</u>

December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
State and municipal	\$ 35,063,849	\$ 871,128	\$ 276,408	\$ 35,658,569
Residential and mortgage-backed securities	19,433,360	225,046	584,986	19,073,420
Collateralized mortgage obligations	46,669,105	408,420	786,817	46,290,708
Small Business Administration Pools	37,700,613	1,570,008	-	39,270,621
	<u>\$ 138,866,927</u>	<u>\$ 3,074,602</u>	<u>\$ 1,648,211</u>	<u>\$ 140,293,318</u>

At December 31, 2014 and 2013, gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position, are as follows:

December 31, 2014	Approximate Market Value	Continuous Unrealized Losses Existing for:		Total Losses
		Less than 12 Months	More than 12 Months	
Available-for-sale securities:				
State and municipal	\$ 400,388	\$ -	\$ 4,050	\$ 4,050
Residential mortgage-backed securities	7,007,611	-	28,123	28,123
Collateralized mortgage obligations	14,639,068	-	443,032	443,032
Total temporarily impaired investment securities	<u>\$ 22,047,067</u>	<u>\$ -</u>	<u>\$ 475,205</u>	<u>\$ 475,205</u>

December 31, 2013	Approximate Market Value	Continuous Unrealized Losses Existing for:		Total Losses
		Less than 12 Months	More than 12 Months	
Available-for-sale securities:				
State and municipal	\$ 10,648,954	\$ 276,408	\$ -	\$ 276,408
Residential mortgage-backed securities	11,044,258	584,986	-	584,986
Collateralized mortgage obligations	20,991,354	776,449	10,368	786,817
Total temporarily impaired investment securities	<u>\$ 42,684,566</u>	<u>\$ 1,637,843</u>	<u>\$ 10,368</u>	<u>\$ 1,648,211</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 3 - Available-for-sale securities (concluded)

State and municipal - The Company's unrealized losses on state and municipal securities were caused by the interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because of the Company's intent to hold the securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell these securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Residential and mortgage-backed securities and collateralized mortgage obligations- The Company's unrealized losses on residential and mortgage-backed securities and collateralized mortgage obligations were caused by the interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Because our mortgage-related securities are backed by FNMA and FHLMC, which are GSEs, or are collateralized by securities backed by these agencies, and because of the Company's intent to hold the securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell these securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

At December 31, 2014 and 2013, securities with a carrying value of approximately \$24,085,310 and \$17,016,641, respectively, are pledged to the Commonwealth of Virginia to secure public deposits. In addition, at December 31, 2014 and 2013, securities with a carrying value of \$19,123,648 and \$4,792,267, respectively, are pledged to the Federal Home Loan Bank to secure advances. Investment securities with carrying values of \$2,869,847 and \$3,213,431 are pledged to secure repurchase agreements at December 31, 2014 and 2013, respectively.

At December 31, 2014, the amortized cost and fair value of debt securities by maturity date are as follows:

	Amortized Cost	Fair Value
Due in one year or less	\$ -	\$ -
Due from one to five years	-	-
Due from five to ten years	15,509,753	16,426,280
Due after ten years	116,548,506	120,207,839
Total debt securities	<u>\$ 132,058,259</u>	<u>\$ 136,634,119</u>

Gross realized gains on available-for-sale securities were:

	2014	2013
Residential mortgage-backed securities	\$ -	\$ 109,074
State and municipals	288,847	158
Total gross realized gains	<u>\$ 288,847</u>	<u>\$ 109,232</u>

There were no gross realized losses on available-for-sale securities during 2014 or 2013.

Proceeds from the sale of available-for-sale securities totaled \$3,757,225 and \$4,878,319 for the years ended December 31, 2014 and 2013, respectively.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses

General - The Bank provides to its customers a full range of short- to medium-term commercial, agricultural, Small Business Administration guaranteed, mortgage, home equity, and personal loans, both secured and unsecured. The Bank also makes real estate mortgage and construction loans. At December 31, 2014 and 2013, loans held for investment consisted of the following:

	2014	2013
Mortgage loans on real estate:		
Construction	\$ 32,212,181	\$ 31,261,147
Commercial Real Estate:		
Non-owner occupied	33,355,157	34,726,441
Owner occupied	59,344,528	58,036,590
Residential 1-4 family	44,829,015	41,339,445
Multifamily	7,283,745	7,377,067
Equity lines of credit	12,517,764	11,425,387
Total mortgage loans on real estate	189,542,390	184,166,077
Commercial and industrial	35,342,391	23,072,880
Agricultural	20,733,384	19,659,415
Individuals	1,873,436	2,240,940
Total loans	247,491,601	229,139,312
Less: Allowance for loan losses	(8,181,827)	(7,381,066)
Net deferred loan fees and costs	15,536	84,529
Loans, net	\$ 239,325,310	\$ 221,842,775

Real Estate Loans - Real estate loans include construction and land development loans, commercial real estate loans, home equity lines of credit and residential mortgages.

Construction/development lending totaled \$32.2 million and \$31.3 million at December 31, 2014 and 2013, respectively. The Bank originates one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower) and provides financing to builders and consumers for the construction of pre-sold homes. The Bank generally receives a pre-arranged permanent financing commitment from an outside banking entity prior to financing the construction of pre-sold homes. The Bank also makes commercial real estate construction loans, primarily for owner-occupied properties. The Bank limits its construction lending risk through adherence to established underwriting procedures. Residential one-to-four family loans amounted to \$44.8 million and \$41.3 million at December 31, 2014 and 2013, respectively.

Commercial real estate loans totaled \$92.7 million and \$92.8 million at December 31, 2014 and 2013, respectively. This lending has involved loans secured by owner-occupied commercial buildings for office, storage and warehouse space, as well as non-owner occupied commercial buildings. The Bank generally requires the personal guaranty of borrowers and a demonstrated cash flow capability sufficient to service the debt. Loans secured by commercial real estate may be larger in size and may involve a greater degree of risk than one-to-four family residential mortgage loans. Payments on such loans are often dependent on successful operation or management of the properties.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 – Loans and Allowance for Loan Losses (continued)

Commercial and Industrial Loans - At December 31, 2014 and 2013, the Bank's commercial loan portfolio totaled \$35.3 million and \$23.1 million, respectively. Commercial loans include both secured and unsecured loans for working capital, expansion, and other business purposes. Short-term working capital loans are secured by accounts receivable, inventory and/or equipment. The Bank also makes term commercial loans secured by equipment and real estate. Lending decisions are based on an evaluation of the financial strength, cash flow, management and credit history of the borrower, and the quality of the collateral securing the loan. With few exceptions, the Bank requires personal guarantees and secondary sources of repayment. Commercial loans generally provide greater yields and re-price more frequently than other types of loans, such as real estate loans.

Agricultural Loans - Agricultural loans totaled \$20.7 million and \$19.7 million at December 31, 2014 and 2013, respectively and include loans secured by farm equipment, inventory and farm land. Lending decisions are based on an evaluation of the financial strength, cash flow, management and credit history of the borrower, and the quality of the collateral securing the loan. Payments on such loans are often dependent on successful operation or management of the farming operation.

Loans to Individuals - Loans to individuals (consumer loans) include automobile loans, boat and recreational vehicle financing, and miscellaneous secured and unsecured personal loans and totaled \$1.9 million and \$2.2 million at December 31, 2014 and 2013, respectively. Consumer loans generally can carry significantly greater risks than other loans, even if secured, if the collateral consists of rapidly depreciating assets such as automobiles and equipment. Repossessed collateral securing a defaulted consumer loan may not provide an adequate source of repayment of the loan. Consumer loan collections are sensitive to job loss, illness and other personal factors. The Bank manages the risks inherent in consumer lending by following established credit guidelines and underwriting practices designed to minimize risk of loss.

Loan Approvals - The Bank's loan policies and procedures establish the basic guidelines governing its lending operations. The guidelines address the type of loans that the Bank seeks, target markets, underwriting and collateral requirements, terms, interest rate and yield considerations and compliance with laws and regulations. All loans or credit lines are subject to approval procedures and amount limitations. These limitations apply to the borrower's total outstanding indebtedness to the Bank, including any indebtedness as a guarantor. The policies are reviewed and approved at least annually by the Board of Directors of the Bank. The Bank supplements its own supervision of the loan underwriting and approval process with periodic loan reviews by independent, outside professionals experienced in loan review. Responsibility for loan review and loan underwriting resides with the Chief Credit Officer position. This position is responsible for loan underwriting and approval. On an annual basis, the Board of Directors of the Bank determines officers lending authority. Authorities may include loans, letters of credit, overdrafts, uncollected funds and such other authorities as determined by the Board of Directors.

Substantially all of the Bank's loans have been granted to customers in the Hampton Roads area of Virginia.

Credit Review and Evaluation - The Bank outsources the credit risk review function which reports to the Board of Directors. The focus of the engagement is on policy compliance and proper grading of higher credit risk loans as well as new and existing loans on a sample basis. Additional reporting for problem/criticized assets has been developed along with an after-the-fact loan review.

The Bank uses a risk grading program to facilitate the evaluation of probable inherent loan losses and the adequacy of the allowance for loan losses. In this program, risk grades are initially assigned by loan officers, reviewed by the Chief Credit Officer and reviewed by credit review analysts on a test basis. The Bank strives to maintain the loan portfolio in accordance with conservative loan underwriting policies that result in loans specifically tailored to the needs of the Bank's market area. Every effort is made to identify and minimize the credit risks associated with such lending strategies.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Credit Review and Evaluation (concluded) - All loans are risk graded on a scale from 1 (highest quality) to 9 (loss). Acceptable loans at inception are grades 1 through 5. These grades have underwriting requirements that at least meet the minimum requirements of a secondary market source. If borrowers do not meet credit history requirements, other mitigating criteria such as substantial liquidity and low loan-to-value ratios could be considered and would generally have to be met in order to make the loan. The Bank's loan policy states that a guarantor may be necessary if reasonable doubt exists as to the borrower's ability to repay.

The Board of Directors has authorized the loan officers to have individual approval authority for risk grade 1 through 5 loans up to maximum exposure limits for each customer. New or renewed loans that are graded 6 (special mention) or lower must have approval from the Chief Credit Officer and Chief Lending Officer. Any changes in risk assessments as determined by loan officers, credit administrators, regulatory examiners and management are also considered.

The risk grades, normally assigned by the loan officers when the loan is originated and reviewed by the Chief Credit Officer, are based on several factors including historical data, current economic factors, composition of the portfolio, and evaluations of the total loan portfolio and assessments of credit quality within specific loan types. In some cases the risk grades are assigned by the Chief Credit Officer or the Chief Lending Officer, depending upon dollar exposure. Because these factors are dynamic, the provision for loan losses can fluctuate. Credit quality reviews are based primarily on analyses of borrowers' cash flows, with asset values considered only as a second source of payment. Credit analysts work with lenders in underwriting, structuring and risk grading the Bank's credits. The Chief Lending Officer and the Chief Credit Officer focus on lending policy compliance, credit risk grading, and credit risk reviews on larger dollar exposures. Management uses the information developed from the procedures above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in determining the appropriate levels of the allowance for loan losses. The following is a summary of the credit risk grade definitions for all loan types:

"1" – Prime - Credits in this category are virtually risk-free and are well-collateralized by cash or cash-equivalent instruments held by the Bank. The repayment program is well-defined and achievable, and repayment sources are numerous. No material documentation deficiencies or exceptions exist.

"2" – Good - This grade is reserved for loans secured by readily marketable collateral, or loans within guidelines to borrowers with liquid financial statements. A liquid financial statement is generally a financial statement with substantial liquid assets, particularly relative to the debts. These loans have excellent sources of repayment, with no significant identifiable risk of collection, and conform in all respects to Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).

"3" – Acceptable 1 - This grade is reserved for the Bank's top quality loans. These loans have excellent sources of repayment, with no significant identifiable risk of collection. Generally, loans assigned this risk grade will demonstrate the following characteristics:

- Conformity in all respects with Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

“4” – Acceptable 2 - This grade is given to acceptable loans. These loans have adequate sources of repayment, with little identifiable risk of collection. Loans assigned this risk grade will demonstrate the following characteristics:

- General conformity to the Bank's underwriting requirements, with limited exceptions to the Bank's policy, product or underwriting guidelines. All exceptions noted have documented mitigating factors that offset any additional risk associated with the exceptions noted.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

“5” – Weak Pass - This grade is given to acceptable loans that show signs of weakness in either adequate sources of repayment or collateral, but have demonstrated mitigating factors that minimize the risk of delinquency or loss. Loans assigned this grade may demonstrate some or all of the following characteristics:

- Additional exceptions to the Bank's policy requirements, product guidelines or underwriting standards that present a higher degree of risk to the Bank. Although the combination and/or severity of identified exceptions is greater for this risk grade, the exceptions may be properly mitigated by other documented factors that offset any additional risks.
- Unproved, insufficient or marginal primary sources of repayment that appear sufficient to service the debt at this time. Repayment weaknesses may be due to minor operational issues, financial trends, or reliance on projected (not historic) performance.
- Marginal or unproven secondary sources to liquidate the debt, including combinations of liquidation of collateral and liquidation value to the net worth of the borrower or guarantor.

“6” – Special Mention - Special Mention loans include the following characteristics:

- Loans with underwriting guideline tolerances and/or exceptions and with no mitigating factors;
- Extending loans that are currently performing satisfactorily but with potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Bank's position at some future date. Potential weaknesses are the result of deviations from prudent lending practices; or
- Loans where adverse economic conditions have developed subsequent to the loan origination that do not jeopardize liquidation of the debt, but do substantially increase the level of risk, may also warrant this rating.

“7” – Substandard - A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Loans consistently not meeting the repayment schedule should be downgraded to substandard. Loans in this category are characterized by deterioration in quality exhibited by any number of well-defined weaknesses requiring corrective action. The weaknesses may include, but are not limited to:

- High debt to worth ratios
- Declining or negative earnings trends
- Declining or inadequate liquidity
- Questionable repayment sources
- Lack of well-defined secondary repayment source, and
- Unfavorable competitive comparisons.

Such loans are no longer considered to be adequately protected due to the borrower's declining net worth, lack of earnings capacity, declining collateral margins and/or unperfected collateral positions. A possibility of loss of a portion of the loan balance cannot be ruled out. The repayment ability of the borrower is marginal or weak and the loan may have exhibited excessive overdue status or extensions and/or renewals.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

“8” – Doubtful – Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus 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. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Among these events are:

- Injection of capital
- Alternative financing
- Liquidation of assets or the pledging of additional collateral.

The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status, and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

“9” – Loss – Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan even though partial recovery may be effected in the future. Probable Loss portions of problem assets should be charged against the Reserve for Loan Losses. Loans may reside in this classification for administrative purposes for a period not to exceed the earlier of thirty (30) days or calendar quarter-end.

The following is a summary of credit quality indicators by class at December 31, 2014 and 2013:

Real Estate Credit Exposure as of December 31, 2014

	Commercial Real Estate						Equity lines of credit
	Construction	Non-owner occupied	Owner occupied	Residential 1-4 Family	Multifamily		
	(in thousands)						
Prime	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Good	-	205	111	80	-	-	237
Acceptable 1	5,015	4,931	9,958	12,034	69	-	7,289
Acceptable 2	10,387	12,496	21,740	16,979	5,242	-	3,780
Weak Pass	13,224	11,128	16,581	10,681	1,164	-	975
Special Mention	2,945	4,511	3,060	2,681	-	-	-
Substandard	641	84	7,061	2,374	809	-	237
Doubtful	-	-	834	-	-	-	-
Loss	-	-	-	-	-	-	-
	<u>\$ 32,212</u>	<u>\$ 33,355</u>	<u>\$ 59,345</u>	<u>\$ 44,829</u>	<u>\$ 7,284</u>	<u>\$ -</u>	<u>\$ 12,518</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Other Credit Exposures as of December 31, 2014

	Commerical and industrial	Agricultural	Individuals	Total
	(in thousands)			
Prime	\$ -	\$ -	\$ -	\$ -
Good	-	-	-	633
Acceptable 1	2,161	3,907	599	45,963
Acceptable 2	20,179	11,281	654	102,738
Weak Pass	11,155	4,127	232	69,267
Special Mention	1,179	873	388	15,637
Substandard	668	546	-	12,420
Doubtful	-	-	-	834
Loss	-	-	-	-
	<u>\$ 35,342</u>	<u>\$ 20,734</u>	<u>\$ 1,873</u>	<u>\$ 247,492</u>

Real Estate Credit Exposure as of December 31, 2013

	Commercial Real Estate			Residential		Equity lines
	Construction	Non-owner occupied	Owner occupied	1-4 Family	Multifamily	of credit
	(in thousands)					
Prime	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Good	-	298	175	103	-	537
Acceptable 1	2,840	5,071	9,944	12,875	115	5,664
Acceptable 2	7,327	12,937	22,092	13,271	5,164	3,869
Weak Pass	8,362	13,677	17,573	10,428	1,643	1,064
Special Mention	8,735	161	872	3,208	-	21
Substandard	3,997	2,583	7,381	1,454	455	270
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
	<u>\$ 31,261</u>	<u>\$ 34,727</u>	<u>\$ 58,037</u>	<u>\$ 41,339</u>	<u>\$ 7,377</u>	<u>\$ 11,425</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Other Credit Exposures as of December 31, 2013

	Commerical and industrial	Agricultural	Individuals	Total
	(in thousands)			
Prime	\$ -	\$ -	\$ -	\$ -
Good	-	-	-	1,113
Acceptable 1	2,067	3,088	545	42,209
Acceptable 2	12,186	12,998	993	90,837
Weak Pass	7,774	2,302	302	63,125
Special Mention	911	465	401	14,774
Substandard	135	806	-	17,081
Doubtful	-	-	-	-
Loss	-	-	-	-
	<u>\$ 23,073</u>	<u>\$ 19,659</u>	<u>\$ 2,241</u>	<u>\$ 229,139</u>

Nonaccrual loans and past due loans - Nonperforming assets include loans classified as nonaccrual, foreclosed bank-owned property and loans past due 90 days or more on which interest is still being accrued. There were no financing receivables past due over 90 days accruing interest as of December 31, 2014. There were two financing receivables with total current principal balance of \$352,822 past due over 90 days accruing interest as of December 31, 2013. These two loans were in the process of collection at December 31, 2013 and were expected to be repaid in full. Nonaccrual loans as of December 31, 2014 totaled \$5.9 million, or 2.39% of total loans, compared with \$5.6 million, or 2.45% of total loans, as of December 31, 2013. The Bank aggressively pursues the collection and repayment of all loans. Other nonperforming assets, such as repossessed and foreclosed collateral are aggressively liquidated by the Bank's management. The total number of loans on nonaccrual status as of December 31, 2014 and 2013 was 24 and 18, respectively.

For the years ended December 31, 2014 and 2013, the Bank recognized \$9,621 and \$0- in interest income on nonaccrual loans. If interest on those loans had been accrued in accordance with the original terms, interest income would have increased by approximately \$175,472 and \$181,249 for the years ended December 31, 2014 and 2013, respectively.

The following is a breakdown of nonaccrual loans as of December 31, 2014 and 2013:

	2014	2013
Mortgage loans on real estate:		
Construction	\$ 323,067	\$ 2,896,720
Commercial real estate:		
Non-owner occupied	-	126,654
Owner occupied	2,588,564	1,688,240
Residential 1-4 family	1,606,145	372,204
Multifamily	808,547	455,300
Equity lines of credit	43,609	76,954
Commerical and industrial	-	-
Agricultural	546,046	-
Individuals	-	-
Total	<u>\$ 5,915,978</u>	<u>\$ 5,616,072</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Nonaccrual loans and past due loans (concluded) - All classes of loans are considered past due if the required principal and interest income have not been received as of the date such payments were due. The following tables present the Bank's aged analysis of past due loans as of December 31, 2014 and 2013:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Greater Than 90 Days Still Accruing	Total Past Due	Current	Total Loans
(in thousands)							
December 31, 2014							
Mortgage loans on real estate:							
Construction	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 32,212	\$ 32,212
Commercial real estate:							
Non-owner occupied	-	-	-	-	-	33,355	33,355
Owner occupied	-	-	834	-	834	58,511	59,345
Residential 1-4 family	208	483	-	-	691	44,138	44,829
Multifamily	-	-	408	-	408	6,876	7,284
Equity lines of credit	-	-	17	-	17	12,501	12,518
Commercial and industrial	-	-	-	-	-	35,342	35,342
Agricultural	-	-	546	-	546	20,188	20,734
Individuals	-	-	-	-	-	1,873	1,873
Total	\$ 208	\$ 483	\$ 1,805	\$ -	\$ 2,496	\$ 244,996	\$ 247,492

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Greater Than 90 Days Still Accruing	Total Past Due	Current	Total Loans
(in thousands)							
December 31, 2013							
Mortgage loans on real estate:							
Construction	\$ 162	\$ -	\$ 2,133	\$ -	\$ 2,295	\$ 28,966	\$ 31,261
Commercial real estate:							
Non-owner occupied	-	-	127	-	127	34,600	34,727
Owner occupied	-	179	-	254	433	57,604	58,037
Residential 1-4 family	200	-	-	-	200	41,139	41,339
Multifamily	-	-	455	-	455	6,922	7,377
Equity lines of credit	-	-	25	-	25	11,400	11,425
Commercial and industrial	40	-	-	-	40	23,033	23,073
Agricultural	-	-	-	99	99	19,560	19,659
Individuals	-	-	-	-	-	2,241	2,241
Total	\$ 402	\$ 179	\$ 2,740	\$ 353	\$ 3,674	\$ 225,465	\$ 229,139

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Troubled Debt Restructurings - In order to maximize the collection of loan balances, the Bank evaluates troubled loan accounts on a case-by-case basis to determine if a loan modification would be appropriate. Loan modifications may be utilized where there is a reasonable chance that an appropriate modification would allow the Bank's customers to continue servicing debt. A loan is a troubled debt restructuring ("TDR") if both of the following exist: 1) a creditor has granted a concession to the debtor, and, 2) the debtor is experiencing financial difficulties. Non-accruing loans that are modified can be placed back on accrual status when both principal and interest are current and it is probable that the Bank will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement and a sustained period of payment performance is demonstrated. Interest on troubled debt restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur and a sustained payment performance period is obtained. For the years ended December 31, 2014 and 2013, the following table presents a breakdown of the types of concession made by loan class:

	Year ended December 31, 2014			Year ended December 31, 2013		
	Pre-Modification Outstanding Number of loans	Post- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Pre-Modification Outstanding Number of loans	Post- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Extended payment terms						
Mortgage loans on real estate:						
Construction	-	\$ -	\$ -	-	\$ -	\$ -
Commercial real estate:						
Non-owner occupied	1	47,144	47,394	1	1,414,426	1,390,611
Owner occupied	2	880,858	884,915	2	1,712,802	1,701,451
Residential 1-4 family	1	435,000	433,621	1	115,200	111,110
Multifamily	-	-	-	-	-	-
Equity lines of credit	-	-	-	-	-	-
Commercial and industrial	-	-	-	-	-	-
Agricultural	-	-	-	1	750,000	636,008
Individuals	-	-	-	-	-	-
Total	4	\$ 1,363,002	\$ 1,365,930	5	\$ 3,992,428	\$ 3,839,180

The restructured loans generally include terms to reduce the interest rate and extend payment terms. The Bank did not forgive any principal associated with any of the above loans during 2014. Within the last 12 months, two loans that were restructured in 2013, with a total principal balance of \$2.1 million subsequently defaulted and were foreclosed upon. Two loans that were restructured within the last 12 months during 2012 with a total principal balance of \$919,100 at December 31, 2012 subsequently defaulted and were foreclosed upon during 2013. These modifications resulted in specific reserves in the Bank's allowance for loan losses of \$0- and \$195,008 as of December 31, 2014 and 2013, respectively.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Troubled Debt Restructurings (concluded) - There are two TDRs that are on non-accrual status and have a total current principal balance of \$871,859 as of December 31, 2014. There were three TDRs that were on non-accrual status and had a total current principal balance of \$2.5 million as of December 31, 2013. Nineteen TDRs with a current principal balance of \$9.7 million and twenty TDRs with current principal balance of \$9.8 million were considered performing loans and are accruing interest based on their sustained payment performance as of December 31, 2014 and 2013, respectively.

The specific reserve portion of the allowance for loan losses on TDRs is determined by discounting the restructured cash flows at the original effective rate of the loan before modification or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio.

Impaired Loans - Management considers certain loans graded “doubtful” (loans graded 8) or “loss” (loans graded 9) to be individually impaired and may consider “substandard” loans (loans graded 7) individually impaired depending on the borrower’s payment history. Any loans classified as troubled debt restructurings regardless of loan grade are also classified as impaired loans. The Bank measures impairment based upon discounted expected cash flows or the value of the collateral. Collateral value is assessed based on collateral value trends, liquidation value trends, and other liquidation expenses to determine logical and credible discounts that may be needed. Updated appraisals are required for all impaired loans and typically at renewal or modification of larger loans if the appraisal is more than 12 months old.

Impaired loans for all classes of loans typically include nonaccrual loans, loans over 90 days past due still accruing, troubled debt restructured loans and other potential problem loans considered impaired based on other underlying factors. Potential problem loans totaled \$15.6 million and \$14.8 million as of December 31, 2014 and 2013, respectively. These totals include loans which are currently performing and are not included in nonaccrual or restructured loans above, but about which we have serious doubts as to the borrower’s ability to comply with present repayment terms. These loans are likely to be included later in nonaccrual, past due or troubled debt restructured loans, so they are considered by management in assessing the adequacy of the allowance for loan losses. No additional funds are committed to be advanced in connection with impaired loans.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

The following tables present the Bank's investment in loans considered to be impaired and related information on those impaired loans as of December 31, 2014 and 2013:

	Recorded Investment	Unpaid Principal Balance	Related Allowance (in thousands)	Year to Date	
				Average Recorded Investment	Interest Income Recognized
December 31, 2014					
Impaired loans without a related allowance for loan losses					
Mortgage loans on real estate:					
Construction	\$ 318	\$ 318	\$ -	\$ 323	\$ 20
Commercial real estate:					
Non-owner occupied	131	131	-	187	13
Owner occupied	3,224	3,224	-	3,256	178
Residential 1-4 family	540	540	-	250	13
Multifamily	73	73	-	73	-
Equity lines of credit	17	17	-	21	-
Commercial and industrial	-	-	-	-	-
Agricultural	-	-	-	-	-
Individuals	-	-	-	-	-
Impaired loans with a related allowance for loan losses					
Mortgage loans on real estate:					
Construction	1,342	1,342	31	1,373	67
Commercial real estate:					
Non-owner occupied	1,349	1,349	28	1,369	74
Owner occupied	4,863	4,863	1,493	4,981	212
Residential 1-4 family	2,181	2,181	959	2,229	95
Multifamily	736	963	283	986	22
Equity lines of credit	27	27	27	28	1
Commercial and industrial	250	250	9	208	8
Agricultural	546	546	236	583	25
Individuals	-	-	-	-	-
Total impaired loans					
Mortgage loans on real estate:					
Construction	\$ 1,660	\$ 1,660	\$ 31	\$ 1,696	\$ 87
Commercial real estate:					
Non-owner occupied	1,480	1,480	28	1,556	87
Owner occupied	8,087	8,087	1,493	8,237	390
Residential 1-4 family	2,721	2,721	959	2,479	108
Multifamily	809	1,036	283	1,059	22
Equity lines of credit	44	44	27	49	1
Commercial and industrial	250	250	9	208	8
Agricultural	546	546	236	583	25
Individuals	-	-	-	-	-
Total impaired loans	\$ 15,597	\$ 15,824	\$ 3,066	\$ 15,867	\$ 728

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

	Recorded Investment	Unpaid Principal Balance	Related Allowance (in thousands)	Year to Date	
				Average Recorded Investment	Interest Income Recognized
December 31, 2013					
Impaired loans without a related allowance for loan losses					
Mortgage loans on real estate:					
Construction	\$ 1,431	\$ 1,504	\$ -	\$ 1,942	\$ 107
Commercial real estate:					
Non-owner occupied	2,583	2,583	-	2,623	168
Owner occupied	3,504	3,504	-	3,709	193
Residential 1-4 family	897	897	-	929	45
Multifamily	455	682	-	700	8
Equity lines of credit	239	239	-	244	8
Commercial and industrial	-	-	-	-	-
Agricultural	170	170	-	172	13
Individuals	-	-	-	-	-
Impaired loans with a related allowance for loan losses					
Mortgage loans on real estate:					
Construction	2,567	2,567	659	2,584	92
Commercial real estate:					
Non-owner occupied	-	-	-	-	-
Owner occupied	3,877	3,877	568	3,942	186
Residential 1-4 family	557	557	113	572	30
Multifamily	-	-	-	-	-
Equity lines of credit	30	30	30	31	-
Commercial and industrial	135	135	4	84	3
Agricultural	636	636	195	711	44
Individuals	-	-	-	-	-
Total impaired loans					
Mortgage loans on real estate:					
Construction	\$ 3,998	\$ 4,071	\$ 659	\$ 4,526	\$ 199
Commercial real estate:					
Non-owner occupied	2,583	2,583	-	2,623	168
Owner occupied	7,381	7,381	568	7,651	379
Residential 1-4 family	1,454	1,454	113	1,501	75
Multifamily	455	682	-	700	8
Equity lines of credit	269	269	30	275	8
Commercial and industrial	135	135	4	84	3
Agricultural	806	806	195	883	57
Individuals	-	-	-	-	-
Total impaired loans	\$ 17,081	\$ 17,381	\$ 1,569	\$ 18,243	\$ 897

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Allowance for Loan Losses - The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate for probable losses that have been incurred within the existing portfolio of loans. The primary risks inherent in the Bank's loan portfolio, including the adequacy of the allowance or reserve for loan losses, are based on management's assumptions regarding, among other factors, general and local economic conditions, which are difficult to predict and are beyond the Bank's control. In estimating these risks, and the related loss reserve levels, management also considers the financial conditions of specific borrowers and credit concentrations with specific borrowers, groups of borrowers, and industries.

The allowance for loan losses is adjusted by direct charges to provision expense. Losses on loans are charged against the allowance for loan losses in the accounting period in which they are determined by management to be uncollectible. Recoveries during the period are credited to the allowance for loan losses. The Bank realized negative provisions of \$850,000 and \$500,000 for the years ended December 31, 2014 and 2013, respectively. During 2014 and 2013 the Bank received several large recoveries, which were credited to the allowance. The recoveries and the continued improvement in our credit related trends were the main contributors to the negative provisions in 2014 and 2013. The provision expense is determined by the Bank's allowance for loan losses model. The components of the model are specific reserves for impaired loans and a general allocation for unimpaired loans. The general allocation has three components, an estimate based on historical loss experience, an additional estimate based on internal and external environmental factors due to the uncertainty of historical loss experience in predicting current embedded losses in the portfolio that will be realized in the future and an unallocated portion to cover uncertainties that could affect management's estimate of probable losses.

In determining the general allowance allocation, the ratios from the actual loss history for the various categories are applied to the homogeneous pools of loans in each category.

The portion of the general allocation on environmental factors includes estimates of losses related to the following:

- Current national and local economic conditions
- Composition of the nature and volume of the portfolio
- Changes in the trend or volume of past due, watch list and classified loans
- The existence and effect of concentrations or changes in concentrations upon the portfolio
- The existence and effect of granularity in the size of credits in the portfolio
- The existence and effect of loan to values in excess of regulatory guidance - percentage of loans in each category with Reg H exceptions
- Cumulative effect of other factors such as loan portfolio quality, underwriting strength and general determinations about the portfolio held by executive management.

Markets served by the Bank continue to experience softening from the general economy and declines in real estate values. Other factors impacting the allowance at December 31, 2014 were watch list trends, unemployment rate trends, government spending expectations and underwriting and servicing assessments.

During 2010 and 2011 the Bank charged-off approximately \$2.4 million of principal of a \$3.6 million construction loan due to the deteriorating financial condition of the borrower and a current ruling on a related court case. In 2014 this court ruling was overturned. The borrower's payment as a result of the court ruling resulted in a recovery of approximately \$2.2 million which increased the Bank's allowance for loan losses and is included in recoveries on construction loans in the 2014 table below.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (continued)

Allowance for Loan Losses (continued) - The following tables present changes in the allowance for loan losses for the years ended December 31, 2014 and 2013:

	December 31, 2013	Charge-offs	Recoveries	Provision	December 31, 2014
	(Amounts in thousands)				
Mortgage loans on real estate:					
Construction	\$ 1,598	\$ 757	\$ 2,197	\$ (1,930)	\$ 1,108
Commercial real estate:					
Non-owner occupied	893	-	449	(658)	684
Owner occupied	1,728	247	-	1,139	2,620
Residential 1-4 family	1,500	32	54	417	1,939
Multifamily	190	-	-	118	308
Equity lines of credit	292	-	17	(101)	208
Commercial and industrial	590	34	3	154	713
Agricultural	550	-	-	25	575
Individuals	40	2	3	(14)	27
	<u>\$ 7,381</u>	<u>\$ 1,072</u>	<u>\$ 2,723</u>	<u>\$ (850)</u>	<u>\$ 8,182</u>

	December 31, 2012	Charge-offs	Recoveries	Provision	December 31, 2013
	(Amounts in thousands)				
Mortgage loans on real estate:					
Construction	\$ 2,137	\$ 250	\$ 23	\$ (312)	\$ 1,598
Commercial real estate:					
Non-owner occupied	925	-	-	(32)	893
Owner occupied	1,227	-	-	501	1,728
Residential 1-4 family	1,962	129	37	(370)	1,500
Multifamily	354	227	-	63	190
Equity lines of credit	301	5	17	(21)	292
Commercial and industrial	1,138	18	7	(537)	590
Agricultural	335	-	-	215	550
Individuals	44	2	5	(7)	40
	<u>\$ 8,423</u>	<u>\$ 631</u>	<u>\$ 89</u>	<u>\$ (500)</u>	<u>\$ 7,381</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 4 - Loans and Allowance for Loan Losses (concluded)

Allowance for Loan Losses (concluded) - The activity in the allowance for loan loss for 2014 and 2013 are summarized by loan class as follows:

As of December 31, 2014	Reserves for loans individually evaluated for impairment	Loans individually evaluated for impairment	Reserves for loans collectively evaluated for impairment	Loans collectively evaluated for impairment
	(Amounts in thousands)			
Mortgage loans on real estate:				
Construction	\$ 31	\$ 1,660	\$ 1,077	\$ 30,552
Commercial real estate:				
Non owner occupied	28	1,480	656	31,875
Owner occupied	1,493	8,087	1,127	51,257
Residential 1-4 family	959	2,721	980	42,108
Multifamily	283	809	25	6,475
Equity lines of credit	27	44	181	12,474
Commercial and industrial	9	250	704	35,092
Agricultural	236	546	339	20,187
Individuals	-	-	27	1,875
	<u>\$ 3,066</u>	<u>\$ 15,597</u>	<u>\$ 5,116</u>	<u>\$ 231,895</u>

As of December 31, 2013	Reserves for loans individually evaluated for impairment	Loans individually evaluated for impairment	Reserves for loans collectively evaluated for impairment	Loans collectively evaluated for impairment
	(Amounts in thousands)			
Mortgage loans on real estate:				
Construction	\$ 659	\$ 3,998	\$ 939	\$ 27,263
Commercial real estate:				
Non owner occupied	-	2,583	893	32,144
Owner occupied	568	7,381	1,160	50,656
Residential 1-4 family	113	1,454	1,387	39,885
Multifamily	-	455	190	6,922
Equity lines of credit	30	269	262	11,156
Commercial and industrial	4	135	586	22,938
Agricultural	195	806	355	18,853
Individuals	-	-	40	2,241
	<u>\$ 1,569</u>	<u>\$ 17,081</u>	<u>\$ 5,812</u>	<u>\$ 212,058</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 5 - Premises and equipment

At December 31, 2014 and 2013, premises and equipment consist of the following:

	2014	2013
Land	\$ 456,450	\$ 1,666,727
Buildings	5,837,763	5,594,344
Equipment, furniture and fixtures	2,643,475	2,685,561
Computer equipment	213,776	302,841
Software	455,235	463,176
	<u>9,606,699</u>	<u>10,712,649</u>
Less accumulated depreciation	(5,800,253)	(5,696,414)
Construction in progress	-	21,931
Total premises and equipment, net	<u>\$ 3,806,446</u>	<u>\$ 5,038,166</u>

For 2014 and 2013, depreciation charged to operating expense was \$487,942 and \$448,786, respectively.

Note 6 - Non-marketable equity securities

Non-marketable equity securities consist of the following at December 31, 2014 and 2013:

	2014	2013
Federal Home Loan Bank stock	\$ 1,721,200	\$ 1,371,300
Federal Reserve Bank stock	397,350	273,900
Community Bankers' Bank stock	61,300	61,300
Bankers Title, LLC	99,178	49,589
Manry Rawls, LLC	1,576,519	-
Senior Housing Crime Prevention Foundation stock	500,000	500,000
Total non-marketable equity securities	<u>\$ 4,355,547</u>	<u>\$ 2,256,089</u>

Note 7 - Interest-bearing deposits

Interest-bearing deposits consist of the following:

	2014	2013
NOW accounts	\$ 30,262,637	\$ 31,415,299
Money market accounts	88,955,844	89,663,359
Savings accounts	22,848,756	21,580,454
Certificates of deposits and IRAs \$250,000 and over	15,900,016	16,232,003
Certificates of deposits and IRAs under \$250,000	98,756,044	113,419,727
Total interest-bearing deposits	<u>\$ 256,723,297</u>	<u>\$ 272,310,842</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 7 - Interest-bearing deposits (concluded)

At December 31, 2014, the scheduled maturities of time deposits are as follows:

2015	\$	47,725,228
2016		22,273,100
2017		13,402,487
2018		19,505,366
2019		11,749,879
Thereafter		-
Total time deposits	\$	<u>114,656,060</u>

Note 8 - Capital notes

During the fourth quarter of 2013, the Company closed the private placement of unregistered debt securities (the "2013 Offering") pursuant to which the Company issued approximately \$11.3 million in principal of notes (the "2013 Notes"). The 2013 Notes have not been and will not be registered under the Securities Act of 1933 and may not be offered or sold in the United States absent registration or an applicable exemption from registration requirements. The 2013 Notes bear interest at the rate of 5% per year with interest payable quarterly in arrears. The 2013 Notes mature on December 31, 2018, but are subject to prepayment in whole or in part on or after December 31, 2014 at the Company's sole discretion on 30 days written notice to the holders. There are no assets pledged as collateral for the 2013 Notes. The Company used approximately \$6.2 million of the proceeds from the 2013 Offering in December to repay the funds associated with the United States Treasury's Capital Purchase Program (see Note 20).

Of these capital notes, \$900,000 is due to executive officers and board members of the Bank as of December 31, 2014 and 2013, respectively. Interest expense of \$45,125 and \$0- was paid to these related parties on the capital notes for the years ended December 31, 2014 and 2013, respectively.

Note 9 - Securities sold under agreements to repurchase and other borrowings

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one day from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction.

Information concerning securities sold under agreements to repurchase is summarized, as follows:

	<u>2014</u>	<u>2013</u>
Balance at December 31,	\$ 1,929,599	\$ 2,595,776
Average balance during the year	\$ 2,390,632	\$ 2,160,045
Average interest rate during the year	0.25%	0.25%
Maximum month-end balance during the year	\$ 3,457,523	\$ 3,148,511

The Bank has arrangements with various banks which enables the Bank to borrow up to \$30,000,000 in federal funds on an unsecured basis, at a variable rate. At December 31, 2014 and 2013, the Bank had outstanding federal funds purchased in the amount of \$0-.

The Bank also has arrangements with the Federal Home Loan Bank which enables the Bank to borrow up to twenty-five percent of total assets.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 9 - Securities sold under agreements to repurchase and other borrowings (concluded)

At December 31, 2014 and 2013, Federal Home Loan Bank advances were as follows:

December 31, 2014

Maturity date	Call Feature	Amount	Rate
August 31, 2015	-	\$ 5,000,000	3.080%
January 9, 2017	-	5,000,000	0.990%
May 29, 2018	One-time call	5,000,000	3.690%
January 8, 2019	-	5,000,000	1.977%
September 3, 2019	-	5,000,000	1.999%
April 15, 2020	-	2,500,000	2.040%
October 13, 2020	-	2,500,000	2.176%
Total FHLB borrowings/weighted average rate		<u>\$ 30,000,000</u>	2.310%

December 31, 2013

Maturity date	Call Feature	Amount	Rate
September 2, 2014	-	\$ 5,000,000	1.963%
August 31, 2015	-	5,000,000	3.080%
May 29, 2018	One-time call	5,000,000	3.690%
January 8, 2014	-	5,000,000	0.280%
Total FHLB borrowings/weighted average rate		<u>\$ 20,000,000</u>	2.253%

The carrying value of loans pledged as collateral to the Federal Home Loan Bank were \$21,447,533 and \$31,964,545 at December 31, 2014 and 2013, respectively.

Note 10 - Employee benefit plans

Profit sharing plan - The Company has a profit sharing plan covering substantially all employees. Contributions to the plan are determined annually by the Compensation Committee and are the lesser of 10% of the participants' base compensation or 10% of the net income of the Bank. Employee benefits expense included \$337,000 and \$335,000 for the plan for 2014 and 2013, respectively.

Post-retirement benefits - The Company has entered into deferred compensation arrangements with certain key personnel which call for the payment of benefits upon the retirement or death of the individuals. These arrangements are funded through life insurance policies on the individuals, with the intent that the proceeds from the life insurance policies approximate amounts payable under the deferred compensation arrangements. The liabilities associated with these deferred compensation arrangements were \$1,104,315 and \$971,455 as of December 31, 2014 and 2013, respectively. Salaries and employee benefits expense included \$136,400 and \$221,811 of expense related to these arrangements for 2014 and 2013, respectively.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 11 - Income taxes

The principal components of the income tax expense as of December 31, 2014 and 2013 are as follows:

	2014	2013
Federal - current tax provision	\$ 546,865	\$ 577,413
Federal - deferred (benefit)	360,364	520,557
	<u>\$ 907,229</u>	<u>\$ 1,097,970</u>

The differences between expected federal income taxes at statutory rates and actual income tax expense are summarized as follows:

	2014	2013
Income tax expense computed at federal statutory rate (34%)	\$ 1,451,160	\$ 1,500,663
Tax effects of:		
Tax-exempt interest	(473,721)	(448,919)
Non-taxable bank owned life insurance	(73,670)	-
Non-deductible expenses	16,170	20,776
Other	(12,710)	25,450
	<u>\$ 907,229</u>	<u>\$ 1,097,970</u>

The Bank's deferred tax assets and liabilities and their components are included in other assets and liabilities on the balance sheets. The components of these deferred tax assets and liabilities are as follows:

	2014	2013
Deferred tax assets:		
Allowance for loan losses	\$ 1,074,456	\$ 1,363,456
Deferred compensation	384,624	338,248
Interest on non-performing loans	652	26,246
Write-down of value related to other real estate owned	42,160	296,570
Other	172,440	43,416
Total deferred tax asset	<u>1,674,332</u>	<u>2,067,936</u>
Deferred tax liabilities:		
Accumulated accretion on available-for-sale investment securities	(136,987)	(130,727)
Accumulated depreciation	(352,450)	(366,845)
Net unamortized deferred fees and expenses	(3,904)	(29,006)
Net unrealized gain on available-for-sale securities	(1,555,793)	(484,973)
Total deferred tax liability	<u>(2,049,134)</u>	<u>(1,011,551)</u>
Net deferred tax asset (liability)	<u>\$ (374,802)</u>	<u>\$ 1,056,385</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 12 - Commitments and contingencies

The Company leases banking premises and various equipment for periods extending through December 2020. Total rental expense was \$189,521 and \$187,351 for 2014 and 2013, respectively.

Pursuant to the terms of non-cancelable lease agreements in effect at December 31, 2014, pertaining to bank premises and equipment, future minimum rental commitments under various operating leases are as follows:

2015	\$	128,861
2016		67,734
2017		12,131
2018		6,876
2019		6,876
Thereafter		2,292
	\$	<u>224,770</u>

Various legal claims also arise from time to time in the normal course of business which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

Note 13 - Related party transactions

In the ordinary course of business, the Bank has loan and deposit transactions with its executive officers and directors, and with companies in which the officers and directors have a significant financial interest. These transactions are at substantially the same rates as similarly situated customers. A summary of related party loan activity during 2014 and 2013 is as follows:

	2014	2013
Beginning balance, January 1	\$ 3,593,573	\$ 2,508,622
Originations	1,216,723	1,649,450
Repayments	(730,743)	(564,499)
Ending balance, December 31,	<u>\$ 4,079,553</u>	<u>\$ 3,593,573</u>

Commitments to extend credit to related parties amounted to \$7,451,081 and \$7,557,701 at December 31, 2014 and 2013, respectively.

Deposits from related parties held by the Bank amounted to \$4,478,645 and \$8,212,635 at December 31, 2014 and 2013, respectively.

The Bank currently has a loan outstanding to Mary Rawls, LLC with a current principal balance of \$2,844,624 as of December 31, 2014. This loan is at substantially the same terms as similarly situated customers.

See Note 8 for additional disclosures of related party transactions.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 14 - Credit commitments and concentrations of credit risk

Commitments to extend credit are agreements to lend funds to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer. Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized, usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year.

The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary.

The amounts of loan commitments, guarantees and standby letters of credit are set out in the following table as of December 31, 2014 and 2013. Because many commitments and almost all standby letters of credit and guarantees expire without being funded in whole or in part, the contract amounts are not estimates of future cash flows. A summary of loan commitments and standby letters of credit is as follows:

	2014	2013
Loan commitments	\$ 49,689,725	\$ 51,266,040
Standby letters of credit and guarantees written	\$ 300,038	\$ 400,566

Standby letters of credit outstanding at December 31, 2014 expire during 2015 and 2016.

Loan commitments, standby letters of credit and written guarantees have off-balance sheet credit risk because only origination fees and accruals for probable losses, if any, are recognized in the statements of financial position until the commitments are fulfilled or the standby letters of credit or guarantees expire. Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. The credit risk amounts are equal to the contractual amounts, assuming that the amounts are fully advanced and collateral or other security is of no value. The Bank's policy is to require customers to provide collateral prior to the disbursement of approved loans. For retail loans, the Bank usually retains a security interest in the property or products financed, which provides repossession rights in the event of default by the customer. For business loans and financial guarantees, collateral is usually in the form of inventory or marketable securities (held in trust) or property (notations on title).

Concentrations of credit risk (whether on or off-balance sheet) arising from financial instruments exist in relation to certain groups of customers. A group concentration arises when a number of counterparties have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. A group concentration exists as most of the Bank's customers are located within southeastern Virginia.

The credit risk amounts represent the maximum accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted and any collateral or security proved to be of no value. The Bank has experienced little difficulty in accessing collateral when required.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 15 - Regulatory matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).

Management believes, as of December 31, 2014, the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2014, the most recent notification from the Board of Governors of the Federal Reserve Board categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Bank's actual capital amounts (dollars in thousands) and ratios are presented in the table below:

	Actual		For Capital Adequacy Purposes		Under Prompt Corrective Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(Dollars in thousands)</i>						
As of December 31, 2014:						
Total Capital						
(to Risk-Weighted Assets)	\$ 48,402	17.9%	\$ 21,602	8%	\$ 27,002	10%
Tier I Capital						
(to Risk-Weighted Assets)	45,017	16.7%	10,801	4%	16,201	6%
Tier I Capital						
(to Average Assets)	45,017	10.8%	16,623	4%	20,779	5%
As of December 31, 2013:						
Total Capital						
(to Risk-Weighted Assets)	\$ 45,294	18.4%	\$ 19,697	8%	\$ 24,622	10%
Tier I Capital						
(to Risk-Weighted Assets)	42,163	17.1%	9,849	4%	14,773	6%
Tier I Capital						
(to Average Assets)	42,163	10.4%	16,270	4%	20,338	5%

The above tables set forth the capital position and analysis for the Bank only. Because total assets on a consolidated basis are less than \$500 million, the Company is not subject to the consolidated capital requirements imposed by the Bank Holding Company Act. Consequently, the Company does not calculate its financial ratios on a consolidated basis. If calculated, the capital ratios for the Company on a consolidated basis would no longer be comparable to the capital ratios of the Bank because the proceeds of the capital notes do not qualify as equity capital on a consolidated basis.

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 16 - Fair value measurements

The Company refers to the *Fair Value Measurements and Disclosures* Topic of the FASB Accounting Standards Codification (ASC 820) to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. This guidance clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

The fair market value measurement specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions.

The three levels of the fair value hierarchy are based on these two types of inputs are as follows:

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 - Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 - Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the consolidated financial statements:

Securities available for sale - Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2).

The following table presents the balances of available-for-sale securities measured at fair value on a recurring basis as of December 31, 2014 and 2013:

Description	Balance as of			
	December 31, 2014	Level 1	Level 2	Level 3
State and municipal	\$ 36,047,125	\$ -	\$ 36,047,125	\$ -
Residential mortgage-backed securities	19,424,046	-	19,424,046	-
Collateralized mortgage obligations	46,803,869	-	46,803,869	-
Small Business Administration Pools	34,359,079	-	34,359,079	-
	<u>\$ 136,634,119</u>	<u>\$ -</u>	<u>\$ 136,634,119</u>	<u>\$ -</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 16 - Fair value measurements (continued)

Description	Balance as of December 31, 2013	Level 1	Level 2	Level 3
State and municipal	\$ 35,658,569	\$ -	\$ 35,658,569	\$ -
Residential mortgage-backed securities	19,073,420	-	19,073,420	-
Collateralized mortgage obligations	46,290,708	-	46,290,708	-
Small Business Administration Pools	39,270,621	-	39,270,621	-
	<u>\$ 140,293,318</u>	<u>\$ -</u>	<u>\$ 140,293,318</u>	<u>\$ -</u>

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain financial assets recorded at fair value on a nonrecurring basis in the consolidated financial statements:

Impaired Loans - Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on the observable market price of the loan, the fair value of the collateral or by using the discounted cash flow method. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate.

The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company. The Company records impaired loans secured by real estate as Level 3 assets. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports are recorded as Level 3 assets. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Operations.

Other real estate owned - Other real estate owned is considered held for sale and is adjusted to fair value less estimated selling costs upon transfer of the loan to foreclosed assets. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. The Company considers the other real estate owned as nonrecurring Level 3.

The following table summarizes the Company's financial assets that were measured at fair value on a nonrecurring basis during the periods.

Description	Balance as of December 31, 2014	Level 1	Level 2	Level 3
Assets				
Other real estate owned	\$ 486,000	\$ -	\$ -	\$ 486,000
Impaired loans	8,227,915	-	-	8,227,915
Total assets	<u>\$ 8,713,915</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 8,713,915</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 16 - Fair value measurements (concluded)

Description	Balance as of December 31, 2013	Level 1	Level 2	Level 3
Assets				
Other real estate owned	\$ 616,000	\$ -	\$ -	\$ 616,000
Impaired loans	6,232,267	-	-	6,232,267
Total assets	\$ 6,848,267	\$ -	\$ -	\$ 6,848,267

The following table summarized quantitative information about Level 3 fair value measurements:

Description	Fair Value at December 31, 2014	Valuation Technique	Unobservable Input	Range (Weighted Average)
Assets				
Other real estate owned	\$ 486,000	Discounted appraisals	Collateral discounts	10-20%
Impaired loans	8,227,915	Discounted appraisals	Collateral discounts	10-30%
		Discounted cash flows	Discount rate	6%
Total assets	\$ 8,713,915			

Description	Fair Value at December 31, 2013	Valuation Technique	Unobservable Input	Range (Weighted Average)
Assets				
Other real estate owned	\$ 616,000	Discounted appraisals	Collateral discounts	10-20%
Impaired loans	6,232,267	Discounted appraisals	Collateral discounts	10-30%
		Discounted cash flows	Discount rate	6%
Total assets	\$ 6,848,267			

The following table presents the carrying amounts and fair value of the Company's financial instruments as of December 31, 2014 and 2013. FASB Accounting Standards Codification's *Financial Instruments* (ASC 825), defines the fair value of financial instruments as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The carrying amounts in the table are included in the balance sheets under the indicated captions.

	2014		2013	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
<i>(Dollars in thousands)</i>				
Financial assets:				
Cash and cash equivalents	\$ 27,579	\$ 27,579	\$ 31,511	\$ 31,511
Investment securities, available-for-sale	136,634	136,634	140,293	140,293
Loans held for sale	986	986	-	-
Loans held for investment, net	239,325	238,620	221,843	221,561
Accrued interest receivable	1,725	1,725	1,797	1,797
Financial liabilities:				
Demand deposits, NOW, savings and money market accounts	228,153	228,153	213,699	213,699
Time deposits	114,656	115,801	129,652	131,899
Accrued interest payable	249	249	234	234
FHLB Advances	30,000	30,668	20,000	20,751
Capital notes	11,253	11,253	11,253	11,253
Securities sold under agreement to repurchase	1,930	1,930	2,596	2,596

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 17 - Stock incentive plan

The Board approved a stock incentive plan effective January 1, 2007. The plan authorizes the grant of awards for a period of ten years. The number of shares authorized for issuance under the plan is limited to 2.25% of the total authorized and unissued shares of common stock. Three types of awards may be granted under the plan: Incentive Stock Options, Nonqualified Stock Options and Restricted Stock. The Bank granted restricted stock awards during 2014. The Bank accounts for this plan in accordance with the *Stock Compensation* Topic of the FASB Accounting Standards Codification (ASC 718). The non-vested equity share or non-vested equity share unit awarded to an employee is measured at its fair value on the grant date. The compensation expense is recognized over the requisite service period.

The fair value of the shares of restricted stock was determined by an outside appraisal. The vesting requirements are five years. The compensation expense recognized for the years ended December 31, 2014 and 2013 was \$30,000 and \$15,001, respectively. Members of the Board of Directors of the Bank can elect to receive a portion or all of their director's fees in the form of common stock. During the year ended December 31, 2014 and 2013, the expense related to these issuances was \$30,000 and \$28,500, respectively.

A summary of the status of the non-vested shares in relation to our restricted stock awards as of December 31, 2014 and 2013, and changes during the years ended December 31, 2014 and 2013, is presented below; the weighted average price is the weighted average fair value at the date of grant:

Restricted Share Awards	2014		2013	
	Shares	Weighted Average Price	Shares	Weighted Average Price
Nonvested - Beginning of the year	-	\$ -	420	\$ 35.75
Granted	3,450	43.51	-	-
Vested	-	-	(420)	35.75
Forfeited	-	-	-	-
Nonvested - End of year	3,450	\$ 43.51	-	\$ -

Note 18 - Earnings per share

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of diluted potential common stock. Potential dilutive common stock had no effect on income attributable to common shareholders.

	2014	2013
Basic		
Net income, as reported	\$ 3,360,889	\$ 3,315,744
Preferred stock dividends and accretion of discount	-	488,399
Net income attributable to common shareholders	<u>\$ 3,360,889</u>	<u>\$ 2,827,345</u>
Average common shares outstanding	<u>608,039</u>	<u>607,357</u>
Basic earnings per share amount	<u>\$ 5.53</u>	<u>\$ 4.66</u>
Diluted		
Net income attributable to common shareholders	<u>\$ 3,360,889</u>	<u>\$ 2,827,345</u>
Average common shares outstanding	608,039	607,357
Effect of dilutive unvested restricted stock awards	345	-
Average diluted shares outstanding	<u>608,384</u>	<u>607,357</u>
Diluted earnings per share	<u>\$ 5.52</u>	<u>\$ 4.66</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 19 – Condensed financial statements of parent company

On July 26, 2013, the Board of Directors of the Bank approved an Agreement and Plan of Reorganization and Share Exchange (the “Agreement”) whereby the Bank would become a subsidiary of Farmers Bankshares, Inc., a company incorporated in Virginia on July 26, 2013 for the purpose of becoming a holding company for the Bank. The Agreement provided for the statutory share exchange of all of the Bank’s common stock held by stockholders for the common stock of Farmers Bankshares, Inc., on a one-for-one basis.

The Agreement was approved by the Bank’s stockholders at a special meeting of the Bank’s stockholders held on September 26, 2013 (the “Special Stockholders’ Meeting”). The holding company reorganization was consummated on December 31, 2013 (see Note 1). Prior to the holding company reorganization, Farmers Bankshares, Inc. conducted no operations other than obtaining regulatory approval for the holding company reorganization. As this event is considered reorganization under common control, the consolidated financial statements, discussion of the statements and all other information presented herein for the years ending December 31, 2014 and 2013 are presented for the Company as a consolidated entity.

Financial information pertaining only to Farmers Bankshares, Inc. is as follows:

Balance Sheets

	December 31,	
	2014	2013
Assets		
Cash	\$ 954,727	\$ 1,042,892
Taxes receivable	216,758	14,348
Investment in Farmers Bank	48,037,325	43,104,139
Other assets	214,477	190,863
Total assets	\$ 49,423,287	\$ 44,352,242
Liabilities and Stockholders' Equity		
Liabilities		
Capital notes, 5% due December 31, 2018	\$ 11,253,475	\$ 11,253,475
Other liabilities	194,785	228,250
Total liabilities	11,448,260	11,481,725
Stockholders' equity		
Common stock, \$0.625 par value	382,600	380,015
Capital surplus	2,723,028	2,695,613
Retained earnings	31,849,329	28,853,472
Accumulated other comprehensive income	3,020,070	941,417
Total stockholders' equity	37,975,027	32,870,517
Total liabilities and stockholders' equity	\$ 49,423,287	\$ 44,352,242

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 19 – Condensed financial statements of parent company (concluded)

Statements of Operations

	Years Ended December 31,	
	2014	2013
Income	\$ 929,268	\$ 170,246
Operating expenses		
Interest expense	569,159	42,201
Legal and professional fees	26,131	23,125
Other expenses	34	14,260
Total expenses	<u>595,324</u>	<u>79,586</u>
Allocated income tax benefits	(202,410)	(14,348)
Income before equity in undistributed income of subsidiary	<u>536,354</u>	<u>105,008</u>
Equity in undistributed income - Farmers Bank	2,824,535	3,210,736
Net income	<u>\$ 3,360,889</u>	<u>\$ 3,315,744</u>

Statements of Cash Flows

	Years Ended December 31,	
	2014	2013
Cash flows from operating activities		
Net income	\$ 3,360,889	\$ 3,315,744
Adjustments to reconcile net income to net cash provided by operating activities		
Taxes receivable	(202,410)	(14,348)
Other assets	(23,614)	(190,863)
Other liabilities	(58,003)	58,004
Equity in undistributed net income of Farmers Bank	(2,824,535)	(3,210,736)
Net cash provided by (used in) operating activities	<u>252,327</u>	<u>(42,199)</u>
Cash flows from investing activities		
Investment in Farmers Bank	-	(4,000,000)
Net cash used in investing activities	<u>-</u>	<u>(4,000,000)</u>
Cash flows from financing activities		
Proceeds from issuance of 5% capital notes due December 31, 2018	-	11,253,475
Repurchase of preferred stock	-	(6,127,000)
Cash dividends paid on common shares	(340,492)	-
Cash dividends paid on preferred shares	-	(41,384)
Net cash provided by (used in) financing activities	<u>(340,492)</u>	<u>5,085,091</u>
Increase in cash and cash equivalents	(88,165)	1,042,892
Cash and cash equivalents		
Beginning of the year	<u>1,042,892</u>	<u>-</u>
End of year	<u>\$ 954,727</u>	<u>\$ 1,042,892</u>

Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements For Years Ended December 31, 2014 and 2013

Note 20 – Capital Purchase Program (“CPP”)

On January 23, 2009, the Bank issued 8,752 shares of non-cumulative perpetual preferred stock (“Series A”) for \$9.2 million and 438 warrants to the U.S Treasury as a condition to its participation in the Capital Purchase Program (“CPP”). The warrants were exercised immediately upon the issuance of the Series A preferred stock, which resulted in the issuance of 438 shares of non-cumulative perpetual preferred stock (“Series B”). Proceeds from this sale of preferred stock are used for general corporate purposes, including supporting the continued, anticipated growth of the Bank.

On January 9, 2013, the Bank redeemed thirty-five percent, or 3,063 of the total 8,752 shares of its Series A Preferred Stock. The Bank paid \$3,085,973 to redeem this portion of the Series A Preferred Stock, consisting of \$3,063,000 in liquidation value and \$22,973 of accrued and unpaid dividends associated with the preferred stock being redeemed.

During the fourth quarter of 2013, the Company received approval from the Treasury and its federal regulator to redeem the Preferred Stock issued to the Treasury. On December 31, 2013, the Bank redeemed the remaining preferred stock, or 5,689 shares of Series A Preferred Stock and 438 shares of Series B Preferred Stock. The Bank paid \$6,168,383 to redeem this portion of the Series A and Series B Preferred Stock, consisting of \$6,127,000 in liquidation value and \$41,383 of accrued and unpaid dividends associated with the preferred stock being redeemed.

Note 21 – Subsequent events

The Company has evaluated subsequent events through February 19, 2015, in connection with the preparation of these financial statements which is the date the financial statements were available to be issued.

Branch Locations

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28319 Southampton Parkway, Suite D



Harbour View – Suffolk
6255 College Drive, Suite L



Hillpoint – Suffolk
3100 Godwin Boulevard



Lakeside – Suffolk
1008 West Washington Street



Smithfield
1119 South Church Street, PO Box 888



Windsor
50 East Windsor Boulevard, PO Box 285

FARMERS BANK, INC.,

WINDSOR, VA.

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No.

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