

# MOVING FORWARD



## FARMERS BANK

SERVING THE COMMUNITY SINCE 1919

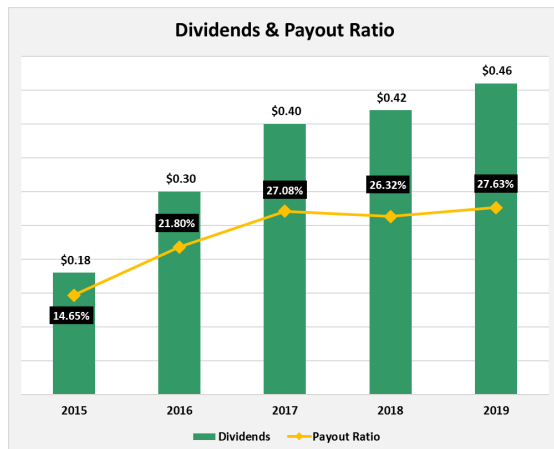
### 2019 ANNUAL REPORT



## Dear Shareholder,

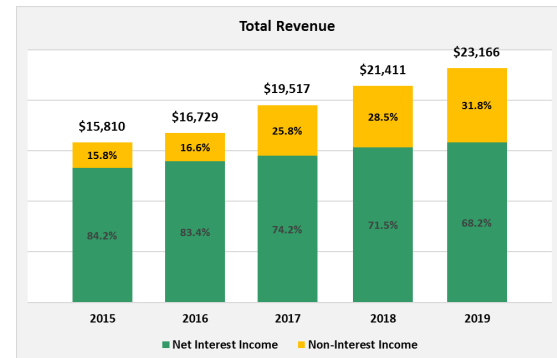
We are pleased to announce Farmers Bank ended its 100th year with strong results. The Company posted record earnings for the fifth consecutive year, which amounted to \$5,096,105 or \$1.65 per share, a 6.47% increase from the \$4,875,252 or \$1.59 per share, reported for 2018. Return on average assets of 1.10% for 2019 has improved from the 2018 results of 1.07%. Return on average equity as of December 31, 2019 was 9.49% as compared to 10.31% for the same period of the prior year. Return on average tangible common equity was 11.27% as of December 31, 2019 and compared to 12.51% as of December 31, 2018.

Given the growth in earnings, our Board of Directors voted to increase the dividend paid to shareholders. Dividends declared were \$.46 in 2019 compared to \$.42 in 2018. This represents a dividend payout ratio of 27.63% and a dividend yield of 2.82% based on our share price as of March 1, 2020.



Net interest income was positively impacted by the rise in interest rates during the first half of 2019 and increased 3.26% when compared to annualized results of 2018. Loan balances declined year over year as we received several large loan payoffs in the fourth quarter that occurred in the normal

course of business. This influx of cash and our growth in average non-interest bearing deposits has allowed us to control funding costs by prudently pricing interest bearing deposit accounts. It has also given us the ability to repay \$10 million in Federal Home Loan bank borrowings that were maturing with rates higher than current market rates.



One of our long-term strategic initiatives has been to diversify revenue streams. Our continued expansion into the insurance industry by investing in acquisitions through Manry Rawls Insurance has proven to be a consistently beneficial return. This, along with other non-interest bearing income components help to alleviate the pressure from the flat yield curve by reducing our reliance on net interest margin. Since 2015, non-interest income as a percent of total revenue has grown from 15.8% to 31.8% in 2019. We continue to explore non-interest income opportunities that will add value for our customers and contribute to the Bank's profitability.

Non-interest expenses remained relatively flat, with the exception of employee-related expense. The insurance acquisition through Manry Rawls and our investment in staff in the Chesapeake and Virginia Beach markets accounted for the majority of the increase in this expense. We are enthusiastic about the opportunity we see in the Virginia

Beach market, with an added focus on the southern end of the city. We have received regulatory approval and are on schedule to open a storefront location in the Pungo area by early second quarter. We believe this market has an unmet need and our brand of relationship banking is already being well received by consumers and businesses.

Throughout 2019, we celebrated our Bank's 100-year anniversary. We reminisced about all the good times and fond memories of customers and friends, times spent giving back to the community, and the robust economic cycles that ultimately helped pave the way for growth, prosperity and expansion. We reflected on the many challenges experienced during our first 100 years, and how those experiences and our actions helped solidify the Bank's foundation and shape our core values as an institution. We experienced a great deal during our first century of existence and in so doing, emerged a solid, stable and storied institution well positioned for the future.

Looking ahead into 2020, management and the Board of Directors are laser focused on navigating the challenges of the current banking environment, not the least of which are margin compression and the need for economies of scale. A flat yield curve, historically low interest rates, an increasingly competitive landscape, together with less than robust loan demand, will continue to force downward pressure on the Bank's net interest margin. Also, during times of heightened competition with anemic loan demand, it is not unusual to see financial institutions relax underwriting standards in order to grow loan assets. History has shown that this path invariably leads to problems down the road. At Farmers Bank, we will remain prudent in our underwriting and strive to continue to demonstrate stable, positive asset quality trends. Our belief is that expansion into new markets such as

Chesapeake and Virginia Beach will offer profitable growth opportunities and yield the economies of scale necessary to return an attractive shareholder return. We remain committed to flexibility and promptness in serving the needs of our customers while taking the time to understand their financial needs with a goal of always bringing value-added solutions to the relationship. We understand that convenience is a top priority for our customers, and we remain committed to technology offerings, products and services that consistently provide a convenient and mutually beneficial outcome.

We know what has worked for the past one hundred years will need to evolve to remain relevant for the next one hundred, but the principals that have guided the Bank since its founding will continue to direct the way we interact with our customers and communities. Continued consolidation in the banking industry only serves to further distinguish the important role that small banks play in their communities.

We are immensely grateful to our customers, staff, Board of Directors and most importantly, you, our shareholders for your confidence and support.

Sincerely,



Richard J. Holland, Jr.  
*Chairman*



Vernon M. Towler  
*President and Chief Executive Officer*





## BOARD OF DIRECTORS

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*\* Denotes Farmers Bankshares, Inc. Board Member*



## OFFICERS

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Technology Officer*

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*Virginia Dermatology*

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Mullen*

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*Attorney at Law, Basnight,  
Kinser, Leftwich & Nuckols, P.C.*

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*President, Tymar  
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*Commonwealth Gin*

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*P. Milton Cook, Jr., P.C.*

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*President, Windsor Hardware  
and Supply Company*

Randolph H. Pack  
*President, Smithfield Station*

V.S. Pittman, II  
*President, Manry Rawls, LLC*

John T. Randall  
*Attorney at Law,  
Randall Page, P.C.*

Sharon C. Stallings  
*CEO, Hampton Roads  
Contracting, Inc.*

T. Craig Stallings  
*Certified Public Accountant,  
Craig Stallings and Associates*



# Financial Highlights

At or for the Years Ended December 31,

2019

2018

2017

## Summary of Operations

	2019	2018	2017
(Dollars in thousands, except per share data)			
Interest income	\$18,931	\$18,114	\$16,637
Interest expense	3,129	2,811	2,150
Net interest income	15,802	15,303	14,487
Provision for loan losses	-	-	-
Net interest income after provision for loan losses	15,802	15,303	14,487
Non-interest income	7,713	6,263	5,091
Non-interest expense	17,419	15,851	13,358
Income before income taxes	6,096	5,715	6,220
Income taxes	738	619	1,451
Net income attributable to noncontrolling interest	262	221	265
Net income	\$5,096	\$4,875	\$4,504

## Per Share and Shares Outstanding (1)

	2019	2018	2017
Basic net income	\$1.65	\$1.59	\$1.47
Book value at end of period, excluding minority interest	\$18.17	\$15.57	\$15.01
Basic weighted average shares outstanding	3,087,868	3,071,643	3,063,661
Dividends per share	\$0.46	\$0.42	\$0.40
Shares outstanding at period end	3,092,133	3,075,860	3,066,709

## Balance Sheet Data

	2019	2018	2017
Total assets	\$476,571	\$478,211	\$456,583
Total loans, net	261,064	269,520	266,753
Total deposits	385,517	386,682	370,891
Borrowings	15,000	25,000	25,000

## Selected Performance Ratios (Bank Only)

	2019	2018	2017
Return on average assets	1.14%	1.10%	1.10%
Return on average stockholders' equity	9.29%	10.05%	9.46%
Net interest margin (2)	3.83%	3.70%	3.87%
Non-interest income as a percentage of total revenue (3)	48.81%	29.05%	26.01%
Efficiency ratio (4)	72.79%	71.49%	65.21%

## Asset Quality Ratios

	2019	2018	2017
Nonperforming loans to period-end loans	0.28%	0.25%	0.31%
Allowance for loan losses to period-end loans	2.13%	2.15%	2.17%
Net charge-offs to average loans outstanding	0.08%	0.00%	-0.06%

## Capital (Bank Only)

	2019	2018	2017
Tier 1 leverage ratio	10.35%	9.68%	9.52%
Total risk-based capital ratio	15.09%	13.89%	14.04%
Stockholder's equity	\$60,395	\$52,139	\$50,312

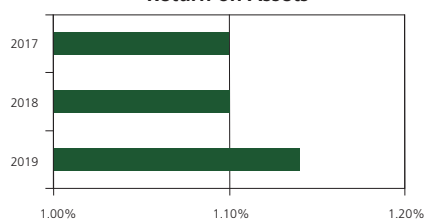
(1) Computed based on the weighted average number of shares outstanding during each period.

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

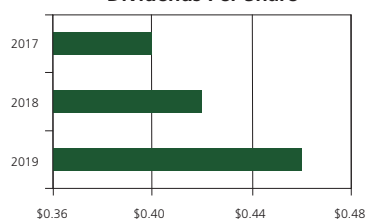
(3) Total revenue consists of net interest income and non-interest income.

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

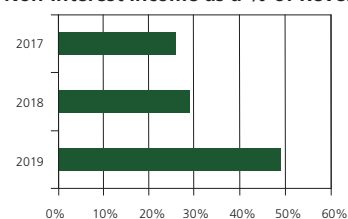
Return on Assets



Dividends Per Share



Non-Interest Income as a % of Revenue



# Farmers Bankshares, Inc.

## Consolidated Financial Statements for Years Ended December 31, 2019 and 2018

### Contents

	Page
Independent Auditor's 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 - 52



## Independent Auditor's Report

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

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Farmers Bankshares, Inc. and Subsidiary (the Company), which comprise the consolidated balance sheets as of December 31, 2019 and 2018, 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 (collectively, the financial statements).

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these 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 financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's Responsibility

Our responsibility is to express an opinion on these 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 financial statements.

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

### Emphasis of Matter

As discussed in Note 21 to the financial statements, the Company adopted, effective January 1, 2019, new accounting guidance related to Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers*. Our opinion is not modified with respect to this matter.

### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Farmers Bankshares, Inc. and Subsidiary as of December 31, 2019 and 2018, 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.

Elliott Davis  
PLLC

Raleigh, North Carolina  
March 9, 2020

# Farmers Bankshares, Inc.

## Consolidated Balance Sheets

	December 31,	
	2019	2018
<b>Assets</b>		
Cash and cash equivalents		
Cash and due from banks	\$ 28,232,969	\$ 15,353,150
Federal funds sold	1,776,842	1,137,152
<b>Total cash and cash equivalents</b>	<b>30,009,811</b>	<b>16,490,302</b>
Available-for-sale securities (Note 3)	145,299,630	157,015,508
Non-marketable equity securities (Note 8)	5,264,989	4,130,699
Loans held for investment, net of allowance for loan losses of \$5,676,680 and \$5,916,359, respectively (Note 4)	261,064,409	269,520,306
Premises and equipment, net (Note 5)	5,795,900	2,934,749
Goodwill (Note 7)	6,027,286	4,807,857
Other intangible assets, net (Note 7)	4,582,184	3,811,185
Other real estate owned	672,404	672,404
Accrued interest receivable	1,806,986	1,978,401
Prepaid expenses	508,766	560,160
Net deferred tax asset (Note 13)	16,460	759,987
Income taxes receivable	54,235	3,022
Bank-owned annuity contract	2,913,142	2,961,521
Bank-owned life insurance	11,156,635	10,851,328
Other assets	1,397,742	1,713,116
	<b>446,560,768</b>	<b>461,720,243</b>
<b>Total assets</b>	<b>\$ 476,570,579</b>	<b>\$ 478,210,545</b>
<b>Liabilities and Stockholders' Equity</b>		
Deposits		
Noninterest-bearing deposits	\$ 116,234,905	\$ 115,871,109
Interest-bearing deposits (Note 9)	269,282,155	270,811,346
<b>Total deposits</b>	<b>385,517,060</b>	<b>386,682,455</b>
Federal Home Loan Bank borrowings (Note 11)	15,000,000	25,000,000
Capital notes (Note 10)	6,000,000	6,000,000
Securities sold under agreements to repurchase (Note 11)	5,141,855	3,848,904
Deferred compensation plans (Note 12)	1,623,228	1,520,980
Accrued interest payable	298,985	336,608
Other liabilities	4,703,525	4,910,053
<b>Total liabilities</b>	<b>418,284,653</b>	<b>428,299,000</b>
<b>Stockholders' equity</b>		
Common stock, \$0.125 par value; 50,000,000 shares authorized; 3,092,133 and 3,075,860 shares issued and outstanding at December 31, 2019 and 2018, including nonvested shares of 27,853 and 17,806 shares, respectively	386,518	384,484
Capital surplus	3,000,031	2,895,515
Retained earnings	50,175,584	44,991,893
Accumulated other comprehensive income (loss)	2,621,878	(383,711)
<b>Total Farmers Bankshares, Inc. stockholders' equity</b>	<b>56,184,011</b>	<b>47,888,181</b>
Noncontrolling interest	2,101,915	2,023,364
<b>Total stockholders' equity</b>	<b>58,285,926</b>	<b>49,911,545</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 476,570,579</b>	<b>\$ 478,210,545</b>

**Farmers Bankshare, Inc.**  
**Consolidated Statements of Operations**

	Years Ended December 31,	
	2019	2018
<b>Interest income</b>		
Interest and fees on loans held for investment	\$ 14,508,086	\$ 13,289,563
Interest on taxable available-for-sale securities	2,450,927	2,593,586
Interest on tax-exempt available-for-sale securities	1,854,664	1,993,818
Interest on federal funds sold	83,310	111,489
Other interest income	34,656	125,788
<b>Total interest and dividend income</b>	<b>18,931,643</b>	<b>18,114,244</b>
<b>Interest expense</b>		
Interest on deposits	2,509,219	2,087,106
Interest on Federal Home Loan Bank advances	360,806	505,981
Interest on capital notes	195,000	195,000
Interest on repurchase agreements	27,366	14,523
Interest on federal funds purchased	36,549	8,501
<b>Total interest expense</b>	<b>3,128,940</b>	<b>2,811,111</b>
<b>Net interest income</b>	<b>15,802,703</b>	<b>15,303,133</b>
<b>Provision of loan losses</b>	-	-
<b>Net interest income after provision for loan losses</b>	<b>15,802,703</b>	<b>15,303,133</b>
<b>Noninterest income</b>		
Service charges	577,856	598,380
Income from automated teller machines and bank card interchange	576,109	560,452
Insurance commissions	5,554,730	4,452,749
Net gain on disposition of available-for-sale securities	336,269	154,773
Income on bank owned life insurance	305,307	306,814
Other income	363,080	190,168
<b>Total noninterest income</b>	<b>7,713,351</b>	<b>6,263,336</b>
<b>Noninterest expense</b>		
Salaries and employee benefits	10,281,452	8,955,428
Equipment expense	1,117,945	937,945
Occupancy expense	1,080,292	931,434
Bank franchise tax	383,393	546,656
Advertising and marketing	629,307	453,971
Data processing	1,503,977	1,623,519
Loan related legal and other expenses	119,542	100,636
Federal Deposit Insurance Corporation assessment	49,183	168,164
Net loss on sale and write-downs of other real estate owned	-	8,318
Net loss on sale of premises and equipment	14,577	-
Other	2,239,762	2,116,497
<b>Total noninterest expense</b>	<b>17,419,430</b>	<b>15,842,568</b>
<b>Income before income taxes &amp; noncontrolling interest</b>	<b>6,096,624</b>	<b>5,714,901</b>
<b>Income tax expense (Note 13)</b>	<b>738,359</b>	<b>619,132</b>
<b>Net income</b>	<b>\$ 5,358,265</b>	<b>\$ 5,095,769</b>
<b>Net income attributable to noncontrolling interest</b>	<b>262,160</b>	<b>220,518</b>
<b>Net income attributable to Farmers Bankshares, Inc.</b>	<b>\$ 5,096,105</b>	<b>\$ 4,875,251</b>
<b>Basic earnings per common share (Note 19)</b>	<b>\$ 1.65</b>	<b>\$ 1.59</b>
<b>Diluted earnings per common share</b>	<b>\$ 1.65</b>	<b>\$ 1.59</b>

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

**Farmers Bankshares, Inc.**  
**Consolidated Statements of Comprehensive Income**

	Years Ended December 31,	
	2019	2018
<b>Net income</b>	\$ 5,358,265	\$ 5,095,769
<b>Other comprehensive loss:</b>		
Net unrealized holding (losses) gains on available-for-sale securities	4,140,813	(2,096,584)
Tax effect	(869,571)	440,283
Unrealized holding gains (losses) on available-for-sale securities, net of tax amount	3,271,242	(1,656,301)
Reclassification adjustment for net realized gains	(336,269)	(154,773)
Tax effect	70,616	32,502
Reclassification adjustment for net realized gains, net of tax amount	(265,653)	(122,271)
Other comprehensive gain (loss), net of tax	3,005,589	(1,778,572)
<b>Comprehensive income</b>	\$ 8,363,854	\$ 3,317,197

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

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non- controlling Interest	Total
<b>Balances, December 31, 2017</b>	<u>\$ 383,340</u>	<u>\$ 2,841,759</u>	<u>\$ 41,399,842</u>	<u>\$ 1,394,861</u>	<u>\$ 2,022,164</u>	<u>\$ 48,041,966</u>
Net income	-	-	4,875,251	-	220,518	5,095,769
Changes in net unrealized loss on securities available for sale, net of reclassification adjustment and tax effect	-	-	-	(1,778,572)	-	(1,778,572)
Distribution of interest in Manry Rawls, LLC	-	-	-	-	(219,318)	(219,318)
Issuance of common stock - director stock plan	187	24,314	-	-	-	24,501
Stock based compensation	957	29,442	-	-	-	30,399
Cash dividends declared on common shares, \$0.42 per share	-	-	(1,283,200)	-	-	(1,283,200)
<b>Balances, December 31, 2018</b>	<u>\$ 384,484</u>	<u>\$ 2,895,515</u>	<u>\$ 44,991,893</u>	<u>\$ (383,711)</u>	<u>\$ 2,023,364</u>	<u>\$ 49,911,545</u>
Adoption of ASU 2016-02	-	-	39,600	-	-	39,600
Adoption of ASC 606	-	-	1,456,160	-	-	1,456,160
Net income	-	-	5,096,105	-	262,160	5,358,265
Changes in net unrealized loss on securities available for sale, net of reclassification adjustment and tax effect	-	-	-	3,005,589	-	3,005,589
Distribution of interest in Manry Rawls, LLC	-	-	-	-	(107,664)	(107,664)
Issuance of common stock - director stock plan	519	70,456	-	-	-	70,975
Stock based compensation	1,515	34,060	-	-	-	35,575
Purchase of additional interest in Manry Rawls, LLC	-	-	-	-	(75,945)	(75,945)
Cash dividends declared on common shares, \$0.46 per share	-	-	(1,408,174)	-	-	(1,408,174)
<b>Balances, December 31, 2019</b>	<u>\$ 386,518</u>	<u>\$ 3,000,031</u>	<u>\$ 50,175,584</u>	<u>\$ 2,621,878</u>	<u>\$ 2,101,915</u>	<u>\$ 58,285,926</u>

**Farmers Bankshares, Inc.**  
**Consolidated Statements of Cash Flows**

	Years Ended December 31,	
	2019	2018
<b>Cash flows from operating activities</b>		
Net income	\$ 5,358,265	\$ 5,095,769
Adjustments to reconcile net income to net cash provided by operating activities		
Distribution of interest in Manry Rawls, LLC	(107,664)	(219,318)
Depreciation	560,701	511,307
Amortization of intangible assets	360,002	290,945
Deferred income tax expense (benefit)	(55,428)	52,637
Amortization of investment securities premiums	616,618	660,668
Net gain on disposition of available-for-sale securities	(336,269)	(154,773)
Loss on sales and writedowns on other real estate owned	-	8,318
Increase in cash value of bank owned life insurance and annuity	(305,307)	(306,814)
Decrease in cash value of annuity	48,379	67,168
Stock based compensation	35,575	30,399
Issuance of stock to directors	70,975	24,501
Change in operating assets and liabilities:		
Interest receivable	171,415	(190,725)
Interest payable	(37,623)	86,583
Prepaid expenses	51,394	15,458
Income taxes receivable	(51,213)	109,495
Other assets	(88,238)	(559,982)
Deferred compensation	102,248	86,926
Other liabilities	885,634	1,228,721
<b>Net cash provided by operating activities</b>	<b>7,279,464</b>	<b>6,837,283</b>
<b>Cash flows from investing activities</b>		
Proceeds from sales, prepayments and maturities of available-for-sale securities	39,370,295	21,890,718
Purchase of available-for-sale securities	(24,130,223)	(43,859,532)
Proceeds from sale of non-marketable equity securities	425,100	10,863
Purchase of non-marketable equity securities	(1,431,350)	(571,850)
Purchase of other equity investments, net	(128,040)	-
Proceeds from sale of other real estate owned	-	61,494
Loan originations, net of repayments	8,455,897	(2,767,593)
Purchases of premises and equipment	(2,978,639)	(565,025)
Acquisition of business, net of cash acquired	(2,093,385)	(200,000)
<b>Net cash provided (used) in investing activities</b>	<b>17,489,655</b>	<b>(26,000,925)</b>
<b>Cash flows from financing activities</b>		
Cash dividends paid on common shares	(1,377,166)	(1,283,200)
Repayment of FHLB borrowings	(10,000,000)	-
Net increase in noninterest-bearing deposits	363,796	8,514,241
Net increase (decrease) in interest-bearing deposits	(1,529,191)	7,277,577
Net increase in securities sold under agreements to repurchase	1,292,951	2,231,138
<b>Net cash provided (used) by financing activities</b>	<b>(11,249,610)</b>	<b>16,739,756</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>13,519,509</b>	<b>(2,423,886)</b>
<b>Cash and cash equivalents</b>		
Beginning of the year	16,490,302	18,914,188
End of year	<b>\$ 30,009,811</b>	<b>\$ 16,490,302</b>



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

	Years Ended December 31,	
	2019	2018
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for		
Income taxes	\$ 845,000	\$ 457,000
Interest	3,166,563	2,724,528
<b>Supplemental schedule of non-cash investing activities</b>		
Net, right of use asset and right of use liability	\$ 39,600	\$ -
<b>Supplemental schedule of non-cash investing activities</b>		
Change in unrealized gains on available-for-sale securities, net of income tax	\$ 3,005,589	\$ (1,778,572)
<b>Acquisitions</b>		
Assets acquired	\$ 165,597	\$ 568,351
Liabilities assumed	-	-
Net assets	\$ 165,597	\$ 568,351
Goodwill and fair value acquisition adjustments, net	\$ 1,219,429	\$ 296,111

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### 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. Through its banking subsidiary, formed on November 12, 1919, 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.

The Bank purchased a 66% ownership interest in Manry Rawls, LLC ("Manry Rawls") in May 2017. Manry Rawls is a local and independent regional insurance agency offering a wide array of insurance products. In January 2019, the Bank purchased an additional five percent interest in Manry Rawls. This additional interest made the Bank's total ownership approximately 72%. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 805, *Business Combinations*. As such, the assets acquired and liabilities assumed in the transactions were recorded at their respective fair values as of the acquisition date.

During 2018, the Company acquired The Lankford Agency, an independent insurance agency, which was merged with the operations of Manry Rawls. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired were recorded at their respective fair values as of the acquisition date. There were no liabilities assumed with this purchase. The results of operations of the acquired business are included in the Company's Consolidated Statements of Operations commencing October 1, 2018. The total purchase price for the transaction was \$200,000 in cash and contingent future payments with a net present value of \$332,989. The allocation of the purchase price results in goodwill of \$296,111 and other intangible assets including customer lists of \$236,879.

During 2019, the Company acquired Carolina East Insurance, an independent insurance agency, which was merged with the operations of Manry Rawls. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and as such, the assets acquired were recorded at their respective fair values as of the acquisition date. There was no liabilities assumed with this purchase. The results of operations of the acquired business are included in the Company's Consolidated Statements of Operations commencing January 2, 2019. The total purchase price for the transaction was \$1,150,000 in cash and contingent future payments with a net present value of \$1,200,429 million. The allocation of the purchase price results in goodwill of \$1,219,429 and other intangible assets including customer lists of \$1,131,000.

### 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, its wholly-owned subsidiary, the Bank and Manry Rawls. All significant intercompany balances and transactions have been eliminated in consolidation.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

*Reclassification* – Certain amounts in the 2018 consolidated financial statements have been reclassified to conform to the 2019 presentation. The reclassifications had no effect on net income or stockholders' equity as previously reported.

*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 2019 and 2018, the aggregate amount of daily-required balances was \$82,000 and \$63,000, respectively.

*Investment securities* - Investments in debt securities classified as held-to-maturity, if any, are stated at cost, and 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 Consolidated Statements of Operations. The Company held no such securities during the periods reported on in the financial statements.

Debt securities 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 Consolidated Statement of Operations. 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 debt securities below their cost, if any, are included in earnings as realized losses. Other than temporarily impaired ("OTTI") guidance for investments states that an impairment is OTTI if any of the following conditions exist: the entity intends to sell the security; it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis; or, the entity does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell).

*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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

*Allowance for loan losses (concluded)* - 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 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 less selling costs) 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 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 less selling costs 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.

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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

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 sell 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.

*Leases* - On January 1, 2019, the Company adopted ASU No. 2016-02 "Leases (Topic 842)" and all subsequent ASUs that modified Topic 842. The Company elected the optional transition method provided by ASU 2018-11 and did not adjust prior periods for ASC 842. The Company also elected certain practical expedients within the standard and consistent with such elections did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases, and did not reassess any initial direct costs for existing leases. The implementation of the new standard resulted in recognition of a right-of-use asset of \$657,157 and lease liability of \$618,887 at the date of adoption, which is related to the Company's lease of premises used in operations. The right-of-use asset and lease liability are included in other assets and other liabilities, respectively, in the consolidated balance sheets.

Lease liabilities represent the Company's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Company's incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Company's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

The Company's long-term lease agreements are classified as operating leases. Certain of these leases offer the option to extend the lease term and the Company has included such extensions in its calculation of the lease liabilities to the extent the options are reasonably assured of being exercised. The lease agreements do not provide for residual value guarantees and have no restrictions or covenants that would impact dividends or require incurring additional financial obligations. Note 6 provides additional information related to leases.

*Goodwill and other intangibles* - Goodwill is not subject to amortization, but is subject to an annual assessment for impairment by applying a fair-value-based test as required by ASC 350, *Goodwill and Other Intangible Assets*. Additionally, under ASC 350, acquired intangible assets are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful life.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

Goodwill is tested for impairment at the reporting unit level on an annual basis as of September 30, or more often if events or circumstances indicate there may be impairment. Testing is conducted in two steps: identifying the potential impairment and then, if necessary, identifying the amount of impairment. The first step (step 1) compares the fair value of the reporting unit to its carrying amount. If the fair value is less than the carrying amount, a second test is conducted by comparing the implied fair value of goodwill with the carrying amount of that goodwill. If the carrying amount exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess. For our annual impairment testing conducted during 2019, we identified one reporting unit with goodwill: Manry Rawls. For purposes of performing step 1 of the goodwill impairment test, the Company primarily uses the qualitative approach to value the reporting unit. An initial qualitative evaluation is made to assess the likelihood of impairment and determine whether further quantitative testing to calculate the fair value is necessary. When the qualitative evaluation indicates that impairment is more likely than not, quantitative testing is required whereby the fair value of each reporting unit is calculated and compared to the recorded book value. Based on our analysis, we determined there is no goodwill impairment, since the fair value for the reporting unit was in excess of the respective reporting unit's carrying value as of September 30, 2019.

The second step (step 2) of impairment testing is necessary only if the reporting unit does not pass step 1. Step 2 compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination. Significant judgment and estimates are involved in estimating the fair value of the assets and liabilities of the reporting unit. Since the reporting unit did not fail step 1, step 2 was not applicable during 2019 testing. The Company monitored events and circumstances during the fourth quarter of 2019, and it determined that there were no triggering events requiring an updated impairment test as of December 31, 2019.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions, and selecting an appropriate control premium. Selection and weighting of the various fair value techniques may result in a higher or lower fair value. Judgment is applied in determining the weightings most representative of fair value.

Intangible assets are amortized or tested for impairment based on whether they have finite or indefinite lives. Intangibles that have finite lives are amortized on a straight-line basis over their useful life and tested for impairment whenever events or circumstances indicate the carrying amount of the assets may not be recoverable. The useful life applied to amortize the customer list intangible, which was created from the acquisition of Manry Rawls, is 15 years. Note 7 provides additional information related to goodwill and other intangibles.

*Non-marketable equity securities* - Equity securities are carried at fair value, with changes in fair value reported in net income. Equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment. On January 1, 2018, the Company adopted a new accounting standard for Financial Instruments (ASU 2016-01), which requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. Upon adoption, equity securities previously classified as available for sale are presented separately on the balance sheet as Equity securities. The amount of unrealized gain (loss), net of tax, related to these securities was reclassified from accumulated other comprehensive to retained earnings as of January 1, 2018. Upon adoption, the amendments related to equity securities without readily determinable fair values (including disclosure requirements) are being applied prospectively to equity investments that existed at January 1, 2018. Because of the redemption provisions of the Federal Reserve Bank (FRB) and Federal Home

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

Loan Bank (FHLB) stock, the Bank estimated that the fair value equaled or exceeded the cost of these investments and the investments were not impaired. 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 2019 or 2018.

*Mergers and acquisitions* - Mergers and acquisitions are accounted for using the acquisition method, as required by ASC 805, *Business Combinations*. Under this method, the cost of the acquired entity will be allocated to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. The excess of the cost over the fair value of the acquired net assets is recognized as goodwill.

*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 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, 2019 and 2018. The years ending on or after December 31, 2016 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 and annuity contracts to fund the expected liabilities under the contracts.

*Revenue recognition on insurance contracts* - Insurance commission income is recorded as of the effective date of insurance coverage or the billing date, whichever is later. Contingent commissions are recognized when determinable, which is generally when such commissions are received or when the Company receives data from the insurance companies that allows the reasonable estimation of these amounts. The income effects of subsequent premium and fee adjustments are recorded when the adjustments become known.

*Earnings per common share* - Basic earnings per share (EPS) is computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted earnings per share reflects 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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

*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.

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 FHLB 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 allowance may be necessary based on changes in local economic conditions and other factors. Management believes the allowance recorded at December 31, 2019 and 2018 is sufficient to cover inherent losses in the portfolio.

*Recent accounting pronouncements* - In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. At the FASB's October 16, 2019 meeting, the Board affirmed its decision to amend the effective date of this ASU for many companies. As a result of this meeting FASB issued ASU 2019-10 in November 2019. This ASU provides guidance to defer the effective dates for private companies, non-for-profit organizations, and certain smaller reporting companies applying standards on current expected credit losses, leases, and hedging. Public business entities that are SEC filers, excluding those meeting the smaller reporting company definition, will retain the initial required implementation date of fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. All other entities will be required to apply the guidance for fiscal years, and interim periods within those years, beginning after December 15, 2022. Based on the ASU, the Company expects this ASU will be effective for the Company beginning on January 1, 2023. The Company has engaged a third party to assist with implementation and is continuing to evaluate the impact that ASU 2016-13 will have on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the test for Goodwill Impairment. This ASU is intended to simplify goodwill impairment testing by eliminating the second step of the analysis under which the implied fair value of goodwill is determined as if the reporting unit were being acquired in a business combination. The update instead requires entities to compare the fair value of a reporting unit with its carrying amount and recognize an impairment charge for any amount by which the carrying amount exceeds the reporting unit's fair value, to the extent that the loss recognized does not exceed the amount of goodwill allocated to that reporting unit. The amendments are effective for fiscal years beginning after December 15, 2021. Early adoption is permitted. The Company does not expect the amendments to the standard to have a material effect on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement." The amendments modify the disclosure requirements in Topic 820 to add disclosures regarding changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty. Certain disclosure requirements in Topic 820 are also removed or modified. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Certain of the amendments are to be applied prospectively while others are to be applied retrospectively. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-13 to have a material impact on its consolidated financial statements.

In April 2019, the FASB issued ASU 2019-04, "Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments." This ASU clarifies and improves areas of guidance related to the recently issued standards on credit losses, hedging, and recognition and measurement including improvements resulting from various Transition Resource Group (or TRG) Meetings. The amendments related to credit losses will be effective for the Company for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The amendments related to recognition and measurement of financial instruments will be effective for the Company for fiscal year beginning after December 15, 2019, including interim period within those fiscal years. Early adoption is permitted. The Company is currently assessing the impact that ASU 2019-04 will have on its consolidated financial statements.

In May 2019, the FASB issued ASU 2019-05, "Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief." The amendments in this ASU provide entities that have certain instruments within the scope of Subtopic 326-20 with an option to irrevocably elect the fair value option in Subtopic 825-10, applied on an instrument-by-instrument basis for eligible instruments, upon the adoption of Topic 326. The fair value option election does not apply to held-to-maturity debt securities. An entity that elects the fair value option should subsequently measure those instruments at fair value with changes in fair value flowing through earnings. The amendments are effective for fiscal years beginning after December 15,

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (continued)

2021, and interim periods within those fiscal years. The amendments should be applied on a modified-retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings balance in the consolidated balance sheet. Early adoption is permitted. The Company is currently assessing the impact that ASU 2019-05 will have on its consolidated financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

### Accounting Standards Adopted in 2019

In August 2015, the FASB issued Accounting Standards Updated ("ASU") No. 2015-14, "Revenue from Contracts with Customers: Topic 606". This ASU is an update to the original ASU No. 2014-09 and the deferral of the effective date. Both ASU's apply 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 current revenue recognition requirements in Topic 605, "Revenue Recognition." 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 became effective for the Company on January 1, 2019. The Company applied the guidance using a modified retrospective approach. See Note 21 for additional information.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach does not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The FASB made subsequent amendments to Topic 842 in July 2018 through ASU 2018-10 ("Codification Improvements to Topic 842, Leases") and ASU 2018-11 ("Leases (Topic 842): Targeted Improvements"). Among these amendments is the provision in ASU 2018-11 that provides entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with current U.S. GAAP (Topic 840, Leases). The Company adopted ASU 2018-11 on January 1, 2019 using modified retrospective method and practical expedients for transition. As the Company owns the majority of its buildings, the adoption of this ASU did not have a material impact on its consolidated financial statements. Refer to Note 6 for further discussion.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 2 - Summary of significant accounting policies (concluded)

In March 2017, the FASB issued ASU No. 2017-08, "Receivables-Nonrefundable Fees and Other Costs (Topic 310-20), Premium Amortization on Purchased Callable Debt Securities." The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of assessing the impact that ASU 2017-08 will have on its consolidated financial statements. The adoption of this standard did not have a material impact to the consolidated financial statements, and as a result, a cumulative effects adjustment was not necessary.

### Note 3 - Available-for-sale securities

At December 31, 2019 and 2018, securities are as follows:

December 31, 2019	Amortized Cost	Gross	Gross	Fair Value
		Unrealized Gains	Unrealized Losses	
State and municipal securities	\$ 51,650,646	\$ 2,494,430	\$ 8,196	\$ 54,136,880
Residential mortgage-backed securities	38,469,234	315,947	27,075	38,758,106
Collateralized mortgage obligations	41,039,760	248,957	87,863	41,200,854
Small Business Administration loan securities	10,821,156	384,566	1,932	11,203,790
Total	<u>\$ 141,980,796</u>	<u>\$ 3,443,900</u>	<u>\$ 125,066</u>	<u>\$ 145,299,630</u>

December 31, 2018	Amortized Cost	Gross	Gross	Fair Value
		Unrealized Gains	Unrealized Losses	
State and municipal securities	\$ 65,906,841	\$ 698,572	\$ 441,306	\$ 66,164,107
Residential mortgage-backed securities	24,754,971	71,749	467,297	24,359,423
Collateralized mortgage obligations	52,982,245	65,203	827,298	52,220,150
Small Business Administration loan securities	13,857,161	417,665	2,998	14,271,828
Total	<u>\$ 157,501,218</u>	<u>\$ 1,253,189</u>	<u>\$ 1,738,899</u>	<u>\$ 157,015,508</u>

At December 31, 2019 and 2018, 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, 2019	Fair Value	Losses Existing for:		Total Losses
		Less than 12 Months	More than 12 Months	
Available-for-sale securities:				
State and municipal securities	\$ 977,050	\$ 8,196	\$ -	\$ 8,196
Residential mortgage-backed securities	4,881,392	78	26,997	27,075
Collateralized mortgage obligations	13,858,900	35,454	52,409	87,863
Small Business Administration loan securities	222,119	307	1,625	1,932
Total temporarily impaired investment securities	<u>\$ 19,939,461</u>	<u>\$ 44,035</u>	<u>\$ 81,031</u>	<u>\$ 125,066</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 3 - Available-for-sale securities (continued)

December 31, 2018	Fair Value	Continuous Unrealized Losses Existing for:		Total Losses
		Less than 12 Months	More than 12 Months	
Available-for-sale securities:				
State and municipal securities	\$ 21,516,251	\$ 357,208	\$ 84,098	\$ 441,306
Residential mortgage-backed securities	16,767,519	86,217	381,080	467,297
Collateralized mortgage obligations	40,812,165	77,666	749,632	827,298
Small Business Administration loan securities	260,429	2,998	-	2,998
Total temporarily impaired investment securities	\$ 79,356,364	\$ 524,089	\$ 1,214,810	\$ 1,738,899

*State and municipal securities* - 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 mortgage-backed securities and collateralized mortgage obligations* - The Company's unrealized losses on residential 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. Our mortgage-related securities are backed by the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC"), which are Government Sponsored Entities ("GSE") or are collateralized by securities backed by these agencies. The Company intends 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. Because of the preceding factors the Company does not consider these investments other than temporarily impaired.

*Small Business Administration loan securities* - The Company's unrealized losses on small business administration loans 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.

At December 31, 2019 and 2018, securities with a carrying value of approximately \$55,908,435 and \$50,922,015, respectively, were pledged to the Commonwealth of Virginia to secure public deposits. In addition, at December 31, 2019 and 2018, securities with a carrying value of \$3,754,145 and \$13,431,015, respectively, were pledged to the FHLB to secure advances. Investment securities with carrying values of \$6,340,534 and \$5,874,785 were pledged to secure repurchase agreements at December 31, 2019 and 2018, respectively.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

At December 31, 2019, 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	\$ 976,574	\$ 985,000
Due from one to five years	3,083,851	3,151,911
Due from five to ten years	12,685,740	13,168,381
Due after ten years	125,234,631	127,994,338
Total debt securities	<u>\$ 141,980,796</u>	<u>\$ 145,299,630</u>

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

	2019	2018
State and municipal securities	\$ 296,468	\$ 154,773
Residential mortgage-backed securities	65,954	-
Total gross realized gains	<u>\$ 362,422</u>	<u>\$ 154,773</u>

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

	2019	2018
State and municipal securities	\$ 7,367	\$ -
Residential mortgage-backed securities	18,786	-
Total gross realized losses	<u>\$ 26,153</u>	<u>\$ -</u>

Proceeds from the sale of available-for-sale securities totaled \$21,598,655 and \$3,979,003 for the years ended December 31, 2019 and 2018, respectively.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### 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, 2019 and 2018, loans held for investment consisted of the following:

	2019	2018
Mortgage loans on real estate:		
Construction	\$ 41,154,005	\$ 37,308,602
Commercial Real Estate:		
Non-owner occupied	24,562,446	26,693,164
Owner occupied	59,310,900	63,422,601
Residential 1-4 family	34,757,775	39,010,134
Multifamily	4,435,830	5,333,956
Equity lines of credit	11,128,525	10,946,435
Total mortgage loans on real estate	<u>175,349,481</u>	<u>182,714,892</u>
Commercial and industrial	57,988,750	60,469,780
Agricultural	24,642,239	23,243,498
Individuals	8,563,898	8,951,568
Total loans	<u>266,544,368</u>	<u>275,379,738</u>
Less: Allowance for loan losses	(5,676,680)	(5,916,359)
Net deferred loan fees and costs	196,721	56,927
Loans, net	<u>\$ 261,064,409</u>	<u>\$ 269,520,306</u>

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

Construction/development lending totaled \$41.1 million and \$37.3 million at December 31, 2019 and 2018, 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 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 \$34.8 million and \$39.0 million at December 31, 2019 and 2018, respectively.

Commercial real estate loans totaled \$83.9 million and \$90.1 million at December 31, 2019 and 2018, 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, 2019 and 2018

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

Multifamily loans totaled \$4.4 million and \$5.3 million at December 31, 2019 and 2018, respectively. These loans are residential housing projects containing five or more rental units. Traditional multifamily projects charge market rents and are located in both city and suburban markets. Equity lines of credit are open-ended revolving lines of credit secured by the equity in a borrower's residence. Equity lines of credit totaled \$11.1 million and \$10.9 million at December 31, 2019 and 2018, respectively.

*Commercial and Industrial Loans* - At December 31, 2019 and 2018, the Bank's commercial loan portfolio totaled \$58.0 million and \$60.5 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 \$24.6 million and \$23.2 million at December 31, 2019 and 2018, 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 \$8.6 million and \$8.9 million at December 31, 2019 and 2018, respectively. Overdrafts totaling \$37 thousand and \$32 thousand at December 31, 2019 and 2018, respectively, were reclassified from deposits to loans and are also classified in loans to individuals. 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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

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.

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 high-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, 2019 and 2018

### 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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

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.

“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 Allowance 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, 2019 and 2018:

	Commercial Real Estate					Equity lines of credit
	Construction	Non-owner occupied	Owner occupied	Residential 1-4 Family	Multifamily	
	(in thousands)					
Prime	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Good	-	-	-	15	-	-
Acceptable 1	2,875	1,490	2,593	3,236	-	4,670
Acceptable 2	28,082	11,844	33,934	20,473	1,647	5,276
Weak Pass	9,526	11,228	21,482	9,518	2,789	799
Special Mention	305	-	119	290	-	25
Substandard	366	-	1,183	1,226	-	358
	<u>\$ 41,154</u>	<u>\$ 24,562</u>	<u>\$ 59,311</u>	<u>\$ 34,758</u>	<u>\$ 4,436</u>	<u>\$ 11,128</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

	Commerical and industrial	Agricultural	Individuals	Total
	(in thousands)			
Prime	\$ 301	\$ -	\$ 16	\$ 317
Good	-	-	-	15
Acceptable 1	6,161	1,732	207	22,962
Acceptable 2	30,533	11,718	523	144,030
Weak Pass	19,286	11,192	7,558	93,378
Special Mention	1,699	-	260	2,699
Substandard	9	-	-	3,143
	<u>\$ 57,989</u>	<u>\$ 24,642</u>	<u>\$ 8,564</u>	<u>\$ 266,544</u>

### Real Estate Credit Exposure as of December 31, 2018

	Commercial Real Estate					Equity lines of credit
	Construction	Non-owner occupied	Owner occupied	Residential 1-4 Family	Multifamily	
	(in thousands)					
Good	\$ -	\$ -	\$ -	\$ 15	\$ -	\$ -
Acceptable 1	2,448	1,832	3,263	5,126	-	4,534
Acceptable 2	26,393	11,136	34,402	20,766	1,931	5,415
Weak Pass	7,968	13,432	24,369	10,476	3,403	522
Special Mention	500	-	140	1,231	-	60
Substandard	-	293	1,249	1,396	-	415
	<u>\$ 37,309</u>	<u>\$ 26,693</u>	<u>\$ 63,423</u>	<u>\$ 39,010</u>	<u>\$ 5,334</u>	<u>\$ 10,946</u>

### Other Credit Exposures as of December 31, 2018

	Commerical and industrial	Agricultural	Individuals	Total
	(in thousands)			
Good	\$ -	\$ -	\$ -	\$ 15
Acceptable 1	7,929	1,962	186	27,280
Acceptable 2	35,930	12,835	1,055	149,863
Weak Pass	16,243	8,446	7,427	92,286
Special Mention	350	-	284	2,565
Substandard	18	-	-	3,371
	<u>\$ 60,470</u>	<u>\$ 23,243</u>	<u>\$ 8,952</u>	<u>\$ 275,380</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

*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, 2019 or 2018. Nonaccrual loans as of December 31, 2019 totaled \$753,205, or 0.28% of total loans, compared with \$699,604, or 0.25% of total loans, as of December 31, 2018. 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, 2019 and 2018 was 7 and 10, respectively.

For the years ended December 31, 2019 and 2018, the Bank recognized \$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 \$16,967 and \$38,829 for the years ended December 31, 2019 and 2018, respectively.

The following is a breakdown of nonaccrual loans as of December 31, 2019 and 2018:

	December 31,	
	2019	2018
Mortgage loans on real estate:		
Construction	\$ 366,239	\$ -
Commercial real estate:		
Non-owner occupied	-	151,523
Residential 1-4 family	209,716	327,853
Equity lines of credit	168,786	204,887
Commerical and industrial	8,465	15,341
Total	<u>\$ 753,206</u>	<u>\$ 699,604</u>

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, 2019 and 2018:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Greater Than	Total Past Due	Current	Total Loans
				90 Days Still Accruing			
(in thousands)							
<b>December 31, 2019</b>							
Mortgage loans on real estate:							
Construction	\$ -	\$ -	\$ 366	\$ -	\$ 366	\$ 40,788	\$ 41,154
Commercial real estate:							
Non-owner occupied	84	-	-	-	84	24,478	24,562
Owner occupied	-	-	-	-	-	59,311	59,311
Residential 1-4 family	10	94	113	-	217	34,541	34,758
Multifamily	53	-	-	-	53	4,383	4,436
Equity lines of credit	54	-	145	-	199	10,929	11,128
Commercial and industrial	-	-	-	-	-	57,989	57,989
Agricultural	-	-	-	-	-	24,642	24,642
Individuals	8	-	-	-	8	8,556	8,564
Total	<u>\$ 209</u>	<u>\$ 94</u>	<u>\$ 624</u>	<u>\$ -</u>	<u>\$ 927</u>	<u>\$ 265,617</u>	<u>\$ 266,544</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

	30-59 Days	60-89 Days	Greater Than	Greater Than	Total Past		
	Past Due	Past Due	90 Days	90 Days Still	Due	Current	Total Loans
<b>December 31, 2018</b>	(in thousands)						
Mortgage loans on real estate:							
Construction	\$ 248	\$ -	\$ -	\$ -	\$ 248	\$ 37,061	\$ 37,309
Commercial real estate:							
Non-owner occupied	-	-	70	-	70	26,623	26,693
Owner occupied	49	-	-	-	49	63,374	63,423
Residential 1-4 family	142	12	193	-	347	38,663	39,010
Multifamily	-	-	-	-	-	5,334	5,334
Equity lines of credit	-	-	-	-	-	10,946	10,946
Commercial and industrial	84	-	-	-	84	60,386	60,470
Agricultural	-	-	-	-	-	23,243	23,243
Individuals	-	-	-	-	-	8,952	8,952
<b>Total</b>	<b>\$ 523</b>	<b>\$ 12</b>	<b>\$ 263</b>	<b>\$ -</b>	<b>\$ 798</b>	<b>\$ 274,582</b>	<b>\$ 275,380</b>

*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, 2019 and 2018, the following table presents a breakdown of the types of concession made by loan class:

	Year ended December 31, 2019			Year ended December 31, 2018		
		Pre-Modification	Post-Modification		Pre-Modification	Post-Modification
	Number of loans	Outstanding Recorded Investment	Outstanding Recorded Investment	Number of loans	Outstanding Recorded Investment	Outstanding Recorded Investment
Extended payment terms						
Mortgage loans on real estate:						
Commercial real estate:						
Non-owner occupied	-	\$ -	\$ -	1	\$ 47,157	\$ 47,157
Residential 1-4 family	-	-	-	2	163,607	163,607
Equity lines of credit	1	165,245	165,245	3	373,039	373,039
<b>Total</b>	<b>1</b>	<b>\$ 165,245</b>	<b>\$ 165,245</b>	<b>6</b>	<b>\$ 583,803</b>	<b>\$ 583,803</b>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

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 2019 or 2018. Within the last 12 months, no loans that were restructured in 2019 or 2018, subsequently defaulted and were foreclosed upon. These modifications resulted in specific reserves in the Bank's allowance for loan losses of \$-0- and \$252 thousand as of December 31, 2019 and 2018, respectively.

There was one TDR that was on non-accrual status and had an unpaid principal balance of \$146,952 as of December 31, 2019. There were two TDRs that were on non-accrual status and had an unpaid principal balance of \$249,685 as of December 31, 2018. Eight TDRs with a current principal balance of \$1,000,082 and nine TDRs with current principal balance of \$1,443,281 were considered performing loans and are accruing interest based on their sustained payment performance as of December 31, 2019 and 2018, 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.

*Other real estate owned* - At December 31, 2019 and 2018 the Company held \$-0- and \$-0-, respectively of foreclosed residential real estate. The recorded investment in one-to-four family residential loans secured by residential real estate properties where formal foreclosure procedures were in process as of December 31, 2019 and 2018 was \$-0-. The remaining balance of other real estate owned consists of commercial real estate properties.

*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 problem loans considered impaired based on other underlying factors. Potential problem loans totaled \$3,285,534 and \$3,799,751 as of December 31, 2019 and 2018, 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, 2019 and 2018

### 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, 2019 and 2018:

	Recorded Investment	Unpaid Principal Balance	Related Allowance (in thousands)	Year to Date	
				Average Recorded Investment	Interest Income Recognized
<b>December 31, 2019</b>					
<b>Impaired loans without a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Construction	\$ 366	\$ 366	\$ -	\$ 366	\$ -
Commercial real estate:					
Non-owner occupied	132	132	-	132	8
Owner occupied	1,137	1,137	-	1,143	55
Residential 1-4 family	247	247	-	226	10
Equity lines of credit	190	190	-	190	10
<b>Impaired loans with a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Residential 1-4 family	1,037	1,037	155	1,048	55
Equity lines of credit	169	169	169	170	-
Commercial and industrial	8	8	8	83	-
<b>Total impaired loans</b>					
Mortgage loans on real estate:					
Construction	\$ 366	\$ 366	\$ -	\$ 366	\$ -
Commercial real estate:					
Non-owner occupied	132	132	-	132	8
Owner occupied	1,137	1,137	-	1,143	55
Residential 1-4 family	1,284	1,284	155	1,274	65
Equity lines of credit	359	359	169	360	10
Commercial and industrial	8	8	8	83	-
<b>Total impaired loans</b>	<b>\$ 3,286</b>	<b>\$ 3,286</b>	<b>\$ 332</b>	<b>\$ 3,358</b>	<b>\$ 138</b>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### 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
<b>December 31, 2018</b>					
<b>Impaired loans without a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Construction	\$ 263	\$ 263	\$ -	\$ 313	\$ 13
Commercial real estate:					
Non-owner occupied	212	212	-	225	6
Owner occupied	1,196	1,196	-	1,197	46
Residential 1-4 family	615	658	-	751	26
Equity lines of credit	63	63	-	63	3
Commercial and industrial	2	2	-	2	-
<b>Impaired loans with a related allowance for loan losses</b>					
Mortgage loans on real estate:					
Commercial real estate:					
Non-owner occupied	81	81	7	83	-
Residential 1-4 family	1,000	1,000	172	1,001	43
Equity lines of credit	352	352	252	359	7
Commercial and industrial	15	15	15	15	-
<b>Total impaired loans</b>					
Mortgage loans on real estate:					
Construction	\$ 263	\$ 263	\$ -	\$ 313	\$ 13
Commercial real estate:					
Non-owner occupied	293	293	7	308	6
Owner occupied	1,196	1,196	-	1,197	46
Residential 1-4 family	1,615	1,658	172	1,752	69
Equity lines of credit	415	415	252	422	10
Commercial and industrial	17	17	15	17	-
<b>Total impaired loans</b>	<b>\$ 3,799</b>	<b>\$ 3,842</b>	<b>\$ 446</b>	<b>\$ 4,009</b>	<b>\$ 144</b>

*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.



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

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 no provisions for the years ended December 31, 2019 and 2018, respectively. 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 regulatory 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 some uncertainty from the general economy and a slow real estate market. Other factors impacting the allowance at December 31, 2019 were watch list trends, unemployment rate trends, government spending expectations and underwriting and servicing assessments.

The following table's present changes in the allowance for loan losses for the years ended December 31, 2019 and 2018:

	December 31, 2018	Charge-offs	Recoveries	Provision	December 31, 2019
	(in thousands)				
Mortgage loans on real estate:					
Construction	\$ 612	\$ -	\$ -	\$ 81	\$ 693
Commercial real estate:					
Non-owner occupied	494	-	-	46	540
Owner occupied	1,372	-	-	(240)	1,132
Residential 1-4 family	881	15	37	(143)	760
Multifamily	52	-	20	(21)	51
Equity lines of credit	431	-	12	(103)	340
Commercial and industrial	1,248	8	6	(27)	1,219
Agricultural	392	-	-	21	413
Individuals	434	313	22	386	529
	<u>\$ 5,916</u>	<u>\$ 336</u>	<u>\$ 97</u>	<u>\$ -</u>	<u>\$ 5,677</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

	December 31, 2017	Charge-offs	Recoveries	Provision	December 31, 2018
			(in thousands)		
Mortgage loans on real estate:					
Construction	\$ 643	\$ -	\$ -	\$ (31)	\$ 612
Commercial real estate:					
Non-owner occupied	601	-	-	(107)	494
Owner occupied	1,630	-	1	(259)	1,372
Residential 1-4 family	1,123	8	53	(287)	881
Multifamily	101	-	20	(69)	52
Equity lines of credit	262	48	2	215	431
Commercial and industrial	1,150	-	6	92	1,248
Agricultural	385	-	-	7	392
Individuals	27	33	1	439	434
	<u>\$ 5,922</u>	<u>\$ 89</u>	<u>\$ 83</u>	<u>\$ -</u>	<u>\$ 5,916</u>

The activity in the allowance for loan loss for 2019 and 2018 are summarized by loan class as follows:

	Reserves for loans individually evaluated for impairment	Loans individually evaluated for impairment	Reserves for loans collectively evaluated for impairment	Loans collectively evaluated for impairment
		(in thousands)		
<b>As of December 31, 2019</b>				
Mortgage loans on real estate:				
Construction	\$ -	\$ 366	\$ 693	\$ 40,788
Commercial real estate:				
Non owner occupied	-	132	540	24,430
Owner occupied	-	1,137	1,132	58,174
Residential 1-4 family	155	1,284	605	33,474
Multifamily	-	-	51	4,436
Equity lines of credit	169	359	171	10,769
Commercial and industrial	8	8	1,211	57,981
Agricultural	-	-	413	24,642
Individuals	-	-	529	8,564
	<u>\$ 332</u>	<u>\$ 3,286</u>	<u>\$ 5,345</u>	<u>\$ 263,258</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

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

As of December 31, 2018	Reserves for loans individually evaluated for impairment	Loans individually evaluated for impairment	Reserves for loans collectively evaluated for impairment	Loans collectively evaluated for impairment
	(in thousands)			
Mortgage loans on real estate:				
Construction	\$ -	\$ 263	\$ 612	\$ 37,046
Commercial real estate:				
Non owner occupied	7	293	487	26,400
Owner occupied	-	1,196	1,372	62,227
Residential 1-4 family	172	1,615	709	37,395
Multifamily	-	-	52	5,334
Equity lines of credit	252	415	179	10,531
Commercial and industrial	15	17	1,233	60,453
Agricultural	-	-	392	23,243
Individuals	-	-	434	8,952
	<u>\$ 446</u>	<u>\$ 3,799</u>	<u>\$ 5,470</u>	<u>\$ 271,581</u>

### Note 5 - Premises and equipment

At December 31, 2019 and 2018, premises and equipment consist of the following:

	2019	2018
Land	\$ 1,433,786	\$ 456,450
Buildings	8,038,388	6,151,012
Equipment, furniture and fixtures	3,147,967	3,075,892
Computer equipment	1,360,096	892,140
	<u>13,980,237</u>	<u>10,575,494</u>
Less accumulated depreciation	(8,184,337)	(7,640,745)
Total premises and equipment, net	<u>\$ 5,795,900</u>	<u>\$ 2,934,749</u>

For 2019 and 2018, depreciation charged to operating expense was \$560,701 and \$511,307, respectively.

### Note 6 - Leases

The Company's long-term lease agreements are classified as operating leases. Certain of these leases offer the option to extend the lease term and the Company has included such extensions in its calculation of the lease liabilities to the extent the options are reasonably assured of being exercised. The lease agreements do not provide for residual value guarantees and have no restrictions or covenants that would impact dividends or require incurring additional financial obligations.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 6 – Leases (concluded)

The following tables present information about the Company's leases:

	2019
Lease liabilities	\$ 618,887
Right-of-use assets	657,157
Weighted average remaining lease term (in years)	3.36
Weighted average discount rate	5.50%

Lease Cost	2019
Operating lease cost (1) included in occupancy and equipment expense	\$ 463,767
Total lease cost	\$ 463,767

(1) Includes short-term leases, which are immaterial.

A maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total of operating lease liabilities as follow:

2020	\$ 271,415
2021	153,070
2022	90,192
2023	82,278
After 2023	86,520
Total lease payments	\$ 683,475
Less interest	(64,588)
Present value of lease liabilities	\$ 618,887

### Note 7 – Goodwill and intangible assets

The gross carrying amount and accumulated amortization for the Company's intangible assets as of December 31,

	2019		2018	
	Gross Carrying	Accumulated Amortization	Gross Carrying	Accumulated Amortization
<b>Intangible assets subject to amortization</b>				
Customer lists	\$ 5,392,879	\$ 810,695	\$ 4,261,879	\$ 450,693
Total intangible assets subject to amortization	5,392,879	810,695	4,261,879	450,693
Goodwill	6,027,286	-	4,807,857	-
<b>Total intangible assets</b>	\$ 11,420,165	\$ 810,695	\$ 9,069,736	\$ 450,693

Aggregate amortization expense for intangible assets with finite lives for the year ended December 31, 2019 was \$360,002, compared to \$271,804 for 2018. The estimated aggregate annual amortization expense for each of the five years subsequent to December 31, 2019, is \$359,525.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 7 – Goodwill and intangible assets (concluded)

Manry Rawls recorded \$1,219,429 in increases to goodwill and \$1,131,000 in intangible assets with the the acquisition of Carolina East Insurance Agency, which occurred on January 1, 2019. During 2018, Manry Rawls recorded \$296,111 in increases to goodwill and \$236,879 in intangible assets from the acquisition of The Lankford Agency. The intangible assets acquired are finite-lived, consisting primarily of book-of-business purchases. No impairment charges were recorded in any year reported. Impairment testing indicated that goodwill was not impaired in 2019 or 2018.

Balance, December 31, 2018	<u>\$ 4,807,857</u>
Additions to goodwill	1,219,429
Other adjustments	-
<b>Balance, December 31, 2019</b>	<u><u>\$ 6,027,286</u></u>

### Note 8 - Non-marketable equity securities

Non-marketable equity securities consist of the following at December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
FHLB stock	\$ 1,068,100	\$ 1,473,600
FRB stock	403,550	401,800
Community Bankers' Bank stock	61,300	61,300
Plexus Captial, LLC	1,880,856	961,007
Tidewater Home Funding, LLC	828,611	732,992
Senior Housing Crime Prevention Foundation stock	500,000	500,000
Community Capital Funds	522,572	-
Total non-marketable equity securities	<u><u>\$ 5,264,989</u></u>	<u><u>\$ 4,130,699</u></u>

### Note 9 - Interest-bearing deposits

Interest-bearing deposits consist of the following:

	<u>2019</u>	<u>2018</u>
NOW accounts	\$ 23,331,690	\$ 20,391,339
Money market accounts	90,327,858	95,240,589
Personal relationship checking	1,456,698	993,604.00
Business interest checking	23,017,893	24,977,600
Savings accounts	29,205,822	27,397,406
Certificates of deposits and IRAs \$250,000 and over	47,881,312	42,113,656
Certificates of deposit and IRAs under \$250,000	54,060,882	59,697,152
Total interest-bearing deposits	<u><u>\$ 269,282,155</u></u>	<u><u>\$ 270,811,346</u></u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 9 - Interest-bearing deposits (concluded)

At December 31, 2019, the scheduled maturities of time deposits are as follows:

2020	\$ 59,850,159
2021	9,406,709
2022	13,604,638
2023	13,387,683
2024	5,693,005
Thereafter	-
Total time deposits	<u>\$ 101,942,194</u>

### Note 10 - Capital notes

During the second quarter of 2017, the Company closed the private placement of unregistered debt securities (the “2017 Offering”) pursuant to which the Company issued \$6.0 million in principal of notes (the “2017 Notes”). The 2017 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 2017 Notes bear interest at the rate of 3.25% per year with interest payable quarterly in arrears. The 2017 Notes mature on March 31, 2022, but are subject to prepayment in whole or in part on or after March 31, 2018 at the Company’s sole discretion on 30 days written notice to the holders. There are no assets pledged as collateral for the 2017 Notes. Of these capital notes, \$0- is due to executive officers and board members of the Company as of December 31, 2019 and 2018, respectively.

There was no interest expense paid to these related parties on the capital notes for the years ended December 31, 2019 and 2018, respectively.

### Note 11 - Securities sold under agreements to repurchase and other borrowings

The Bank utilizes securities sold under agreement to repurchase to facilitate the needs of customers. Securities sold under agreements to repurchase, 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. The average interest rate was 0.63% and 0.58% during the years ended December 31, 2019 and 2018, respectively.

The Bank monitors collateral levels on a continuous basis and maintains records of each transaction specifically describing the applicable security and the customer’s fractional interest in that security, and the Bank segregates the security from its general assets in accordance with regulations governing custodial holding of securities. The primary risk with the Bank’s repurchase agreements is market risk associated with the investments securing the transactions, as the Bank may be required to provide additional collateral based on air value changes of the underlying investments. Securities pledged as collateral under repurchase agreements are maintained with the Bank’s safekeeping agent. The carrying value of available for sale investment securities pledged as collateral under repurchase agreement was \$6,340,534 and \$5,874,785 at December 31, 2019 and 2018, respectively.

The remaining contractual maturity of the securities sold under agreements to repurchase by class of collateral pledged included in short-term borrowings in the Consolidated Balance Sheets as of December 31, 2019 and December 31, 2018 is presented in the following tables.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 11 - Securities sold under agreements to repurchase and other borrowings (continued)

December 31, 2019	Overnight and continuous	Up to 30 Days	30-90 Days (in thousands)	Greater than 90	Total
Repurchase agreements:					
Small Business Administration Pools	\$ 5,142	\$ -	\$ -	\$ -	\$ 5,142
Total borrowings	<u>\$ 5,142</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,142</u>
Gross amount of recognized liabilities for repurchase agreements					<u>\$ 5,142</u>
December 31, 2018	Overnight and continuous	Up to 30 Days	30-90 Days (in thousands)	Greater than 90	Total
Repurchase agreements:					
Small Business Administration Pools	\$ 3,849	\$ -	\$ -	\$ -	\$ 3,849
Total borrowings	<u>\$ 3,849</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,849</u>
Gross amount of recognized liabilities for repurchase agreements					<u>\$ 3,849</u>

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, 2019 and 2018, the Bank had no outstanding federal funds purchased.

The Bank also has arrangements with the FHLB which enables the Bank to borrow up to 25% of total assets.

At December 31, 2019 and 2018, FHLB advances were as follows:

#### December 31, 2019

Maturity date	Call Feature	Amount	Rate
April 15, 2020	-	\$ 2,500,000	2.040%
July 29, 2020	-	5,000,000	1.944%
October 13, 2020	-	2,500,000	2.176%
May 17, 2021	-	<u>5,000,000</u>	1.953%
Total FHLB borrowings/weighted average rate		<u>\$ 15,000,000</u>	2.000%

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 11 - Securities sold under agreements to repurchase and other borrowings (concluded)

December 31, 2018

Maturity date	Call Feature	Amount	Rate
January 8, 2019	-	\$ 5,000,000	1.977%
September 3, 2019	-	5,000,000	1.999%
April 15, 2020	-	2,500,000	2.040%
July 29, 2020	-	5,000,000	1.944%
October 13, 2020	-	2,500,000	2.176%
May 17, 2021	-	5,000,000	1.953%
Total FHLB borrowings/weighted average rate		<u>\$ 25,000,000</u>	2.000%

The carrying value of loans pledged as collateral to the FHLB were \$24.6 million and \$20.8 million at December 31, 2019 and 2018, respectively.

During 2019 and 2018, \$10.0 million and \$0- of FHLB advances were repaid.

### Note 12 - 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 Company. Employee benefits expense included \$534,705 and \$454,996 for the plan for 2019 and 2018, 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. In 2016, the Company amended one of these plans and froze the other plan while creating a new plan for this executive, such that upon the executives' retirement, the Company will provide for a monthly retirement payment for their lifetime. The agreements provide that a retirement benefit is payable upon a defined normal retirement age while in service to the Company and a lesser benefit is payable upon early retirement. Other benefits are payable upon disability, death or change in control.

The agreements are unfunded arrangements maintained primarily to provide supplemental retirement benefits and comply with Section 409A of the Internal Revenue Code.

However, the Company has elected to finance the retirement benefits by purchasing annuities that have been designed to provide a future source of funds for the lifetime retirement benefits of the agreements. The primary impetus for utilizing these annuities is a substantial savings in compensation expense for the Company as opposed to a typically designed supplemental retirement plan.

The liabilities associated with these deferred compensation arrangements were \$1,623,228 and \$1,520,980 as of December 31, 2019 and 2018, respectively. The annuity had a balance of \$2,913,142 and \$2,961,521 as of December 31, 2019 and 2018, respectively, and is recorded at amortized cost. Salaries and employee benefits expense included \$127,248 and \$115,956 of expense related to these arrangements for 2019 and 2018, respectively.



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 13 - Income taxes

The principal components of the income tax expense as of December 31, 2019 and 2018 are as follows:

	2019	2018
Federal - current tax expense	\$ 793,787	\$ 566,495
Federal - deferred tax expense (benefit)	(55,428)	52,637
	<u>\$ 738,359</u>	<u>\$ 619,132</u>

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

	2019	2018
Income tax expense computed at federal statutory rate (21%)	\$ 1,280,291	\$ 1,200,129
Tax effects of:		
Tax-exempt interest	(448,840)	(475,598)
Non-taxable bank owned life insurance	(59,184)	(59,523)
Non-deductible expenses	19,808	21,112
Minority investment interest	(55,053)	(46,309)
Other	1,337	(20,679)
	<u>\$ 738,359</u>	<u>\$ 619,132</u>

The Company's deferred tax assets and liabilities and their components are included on the Consolidated Balance Sheets. The components of these deferred tax assets and liabilities are as follows:

	2019	2018
Deferred tax assets:		
Available-for-sale investment securities	\$ -	\$ 101,999
Allowance for loan losses	663,634	663,634
Deferred compensation	340,878	319,406
Interest on non-performing loans	14,138	20,762
Other real estate owned	2,599	2,599
Other	68,827	24,442
Total deferred tax asset	<u>1,090,076</u>	<u>1,132,842</u>
Deferred tax liabilities:		
Available-for-sale investment securities	(696,955)	-
Accumulated depreciation	(159,624)	(226,649)
Accumulated accretion	(75,719)	(80,065)
Net unamortized deferred fees and expenses	(141,318)	(66,141)
Total deferred tax liability	<u>(1,073,616)</u>	<u>(372,855)</u>
Net deferred tax asset	<u>\$ 16,460</u>	<u>\$ 759,987</u>

The Company measures deferred tax assets and liabilities using enacted tax rates that will apply in the years in which the temporary differences are expected to be recovered or paid.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 13 - Income taxes (concluded)

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax asset will not be realized. Management considers recoverable taxes paid in prior years, projected future taxable income, and tax planning strategies in making this assessment. It is management's belief that the realization of the net deferred tax assets is more likely than not.

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions.

The Company and its subsidiaries file income tax returns with the federal government. With few exceptions, the Company is no longer subject to federal income tax examinations by tax authorities for years before 2016.

### Note 14 - Related party transactions

In the ordinary course of business, the Company 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 2019 and 2018 is as follows:

	2019	2018
Beginning balance, January 1	\$ 5,424,545	\$ 6,096,986
Originations	2,930,229	-
Repayments	(1,189,445)	(672,441)
Ending balance, December 31	<u>\$ 7,165,329</u>	<u>\$ 5,424,545</u>

Commitments to extend credit to related parties amounted to \$4,159,585 and \$5,109,850 at December 31, 2019 and 2018, respectively.

Deposits from related parties held by the Bank amounted to \$11,372,117 and \$12,068,589 at December 31, 2019 and 2018, respectively.

The Bank currently has loans outstanding to Manry Rawls, LLC with a current principal balance of \$845,567 and \$1,568,824 as of December 31, 2019 and 2018, respectively. These loans are eliminated in consolidation. These loans are at substantially the same terms as similarly situated customers.

### Note 15 - 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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 15 - Credit commitments and concentrations of credit risk (concluded)

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 Bank also has commitments, as detailed below, to invest in a private investment fund that focuses on investments and partnerships with middle market businesses that need capital for growth.

The amounts of loan commitments, guarantees and standby letters of credit are set out in the following table as of December 31, 2019 and 2018. 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, as well as capital commitments to investment funds in which the Company invests are as follows:

	<u>2019</u>	<u>2018</u>
Loan commitments	\$ 75,870,889	\$ 76,245,388
Standby letters of credit and guarantees written	6,802,069	519,958
Capital commitment to private investment funds	4,100,000	540,000

Standby letters of credit outstanding at December 31, 2019 expire between 2020 and 2023.

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, 2019 and 2018

### Note 16 - 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.

In July 2013, the FDIC and other federal banking agencies approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III).

On January 1, 2015, the Bank became subject to the Basel III Capital Rules which revises definitions of regulatory capital, the new minimum regulatory capital ratios, and various regulatory capital adjustments and deductions according to transition provision and timelines. The revised rules now require the Bank to maintain (i) a minimum ratio of Common Tier 1 capital to risk-weighted assets of at least 4.5%, plus 2.5% "capital conservation buffer" (conservation buffer will be phased in), (ii) minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, (iii) a minimum ratio of total capital to risk-weighted assets of at 8.0%, and (iv) a minimum leverage ratio of 4.0%. A transition period for the capital conservation buffer under Basel III for all banking organizations began on January 1, 2016 and ended on January 1, 2019. The conservation buffer began at the 0.625% level and is phased in over a four-year period (increasing on each subsequent January 1, reaching 2.5% on January 1, 2019).

Management believes, as of December 31, 2019 and 2018, the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2019, 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, Common Equity 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
As of December 31, 2019:			<i>(Dollars in thousands)</i>			
Total Capital						
(to Risk-Weighted Assets)	\$ 51,441	15.1%	\$ 27,265	8.0%	\$ 34,082	10.0%
Tier I Risk-Based Capital						
(to Risk-Weighted Assets)	47,164	13.8%	20,449	6.0%	27,265	8.0%
Common Equity Risk-Based Capital						
(to Risk-Weighted Assets)	47,164	13.8%	15,337	4.5%	22,153	6.5%
Tier I Leverage Ratio						
(to Average Assets)	47,164	10.3%	18,232	4.0%	22,790	5.0%

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 16 - Regulatory matters (concluded)

	Actual		Adequacy Purposes		Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2018:			<i>(Dollars in thousands)</i>			
Total Capital						
(to Risk-Weighted Assets)	\$ 48,267	13.8%	\$ 27,923	8.0%	\$ 34,904	10.0%
Tier I Risk-Based Capital						
(to Risk-Weighted Assets)	43,904	12.6%	20,943	6.0%	27,923	8.0%
Common Equity Risk-Based Capital						
(to Risk-Weighted Assets)	43,904	12.6%	15,707	4.5%	22,688	6.5%
Tier I Leverage Ratio						
(to Average Assets)	43,904	9.7%	18,146	4.0%	22,682	5.0%

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.

### Note 17 - 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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 17 - Fair value measurements (continued)

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, 2019 and 2018:

Description	Balance as of			
	December 31, 2019	Level 1	Level 2	Level 3
State and municipal	\$ 54,136,880	\$ -	\$ 51,650,647	\$ -
Residential mortgage-backed securities	38,758,106	-	38,469,234	-
Collateralized mortgage obligations	41,200,854	-	41,039,760	-
Small Business Administration loan securities	11,203,790	-	10,821,155	-
	<u>\$ 145,299,630</u>	<u>\$ -</u>	<u>\$ 145,299,630</u>	<u>\$ -</u>

Description	Balance as of			
	December 31, 2018	Level 1	Level 2	Level 3
State and municipal	\$ 66,164,107	\$ -	\$ 66,164,107	\$ -
Residential mortgage-backed securities	24,359,423	-	24,359,423	-
Collateralized mortgage obligations	52,220,150	-	52,220,150	-
Small Business Administration loan securities	14,271,828	-	14,271,828	-
	<u>\$ 157,015,508</u>	<u>\$ -</u>	<u>\$ 157,015,508</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.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 17 - Fair value measurements (continued)

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, 2019	Level 1	Level 2	Level 3
Assets				
Other real estate owned	\$ 672,404	\$ -	\$ -	\$ 672,404
Impaired loans	2,953,660	-	-	2,953,660
Total assets	<u>\$ 3,626,064</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,626,064</u>

Description	Balance as of			
	December 31, 2018	Level 1	Level 2	Level 3
Assets				
Other real estate owned	\$ 672,404	\$ -	\$ -	\$ 672,404
Impaired loans	3,353,434	-	-	3,353,434
Total assets	<u>\$ 4,025,838</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,025,838</u>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 17 - Fair value measurements (concluded)

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

Description	Fair Value at December 31, 2019	Valuation Technique	Unobservable Input	Range (Weighted Average)
Assets				
Other real estate owned	\$ 672,404	Discounted appraisals	Collateral discounts	10-20%
Impaired loans	2,953,660	Discounted appraisals	Collateral discounts	10-30%
		Discounted cash flows	Discount rate	6%
Total assets	<u>\$ 3,626,064</u>			

Description	Fair Value at December 31, 2018	Valuation Technique	Unobservable Input	Range (Weighted Average)
Assets				
Other real estate owned	\$ 672,404	Discounted appraisals	Collateral discounts	10-20%
Impaired loans	3,353,434	Discounted appraisals	Collateral discounts	10-30%
		Discounted cash flows	Discount rate	6%
Total Assets	<u>\$ 4,025,838</u>			

The following table presents the carrying amounts and fair value of the Company's financial instruments as of December 31, 2019 and 2018. 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. The capital notes are valued at amortized cost based on the lack of marketability due to transfer restrictions.

	2019		2018	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
(Dollars in thousands)				
Financial assets:				
Cash and cash equivalents	\$ 31,120	\$ 31,120	\$ 16,490	\$ 16,490
Investment securities, available-for-sale	145,300	145,300	157,016	157,016
Loans held for investment, net	261,064	267,523	269,520	273,701
Accrued interest receivable	1,807	1,807	1,978	1,978
Bank-owned annuity contract	2,913	2,913	2,961	2,961
Financial liabilities:				
Demand deposits, NOW, savings and money market accounts	284,685	283,263	284,872	283,762
Time deposits	101,942	102,132	101,810	100,239
Accrued interest payable	299	299	337	337
FHLB Advances	15,000	14,977	25,000	24,723
Capital notes	6,000	5,809	6,000	5,636
Securities sold under agreement to repurchase	5,142	5,142	3,849	3,849



# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 18 - Stock incentive plan

The Company's shareholders approved stock incentive plans effective January 1, 2018 and previously January 1, 2007. The plans authorize the grant of awards for a period of ten years, which expires on December 31, 2028 and previously December 31, 2017. The number of shares authorized for issuance under both of the plans is limited to 2.25% of the total authorized and unissued shares of common stock. Three types of awards may be granted under the plans: Incentive Stock Options, Nonqualified Stock Options and Restricted Stock. The Company granted restricted stock awards during 2019 and 2018. The Company 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 vesting requirements range from three to four years. The compensation expense recognized for the years ended December 31, 2019 and 2018 was \$220,155 and \$167,284, respectively. Members of the Board of Directors of the Company 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, 2019 and 2018, the expense related to these issuances was \$82,525 and \$57,975, respectively.

A summary of the status of the non-vested shares in relation to our restricted stock awards as of December 31, 2019 and 2018, and changes during the years ended December 31, 2019 and 2018, is presented below; the weighted average price is the weighted average fair value at the date of grant:

Restricted Share Awards	2019		2018	
	Shares	Weighted Average Price	Shares	Weighted Average Price
Nonvested - Beginning of the year	17,806	\$ 15.54	13,011	\$ 13.43
Granted	12,316	17.32	9,020	20.50
Vested	2,072	17.09	2,864	11.91
Forfeited	197	17.30	1,361	10.54
Nonvested - End of year	27,853	\$ 16.33	17,806	\$ 15.54

### Note 19 - 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.

	2019	2018
<b>Basic</b>		
Net income attributable to common shareholders	\$ 5,096,105	\$ 4,875,251
Average common shares outstanding	3,087,868	3,071,643
Basic earnings per share amount	\$ 1.65	\$ 1.59
<b>Diluted</b>		
Net income attributable to common shareholders	\$ 5,096,105	\$ 4,875,251
Average common shares outstanding	3,087,868	3,071,643
Effect of dilutive unvested restricted stock awards	2,741	2,784
Average diluted shares outstanding	3,090,609	3,074,427
Diluted earnings per share	\$ 1.65	\$ 1.59

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 20 – 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 ended December 31, 2019 and 2018 are presented for the Company as a consolidated entity.

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

#### Balance Sheets

	December 31,	
	2019	2018
<b>Assets</b>		
Cash	\$ 1,066,093	\$ 1,066,093
Taxes receivable	723,316	682,365
Investment in Farmers Bank	60,394,602	52,139,723
Other assets	367,394	336,386
<b>Total assets</b>	<b>\$ 62,551,405</b>	<b>\$ 54,224,567</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Capital notes	\$ 6,000,000	\$ 6,000,000
Other liabilities	367,394	336,386
<b>Total liabilities</b>	<b>6,367,394</b>	<b>6,336,386</b>
<b>Stockholders' equity</b>		
Common stock, \$0.125 par value	386,518	384,484
Capital surplus	3,000,031	2,895,515
Retained earnings	50,175,584	44,991,893
Accumulated other comprehensive income (loss)	2,621,878	(383,711)
<b>Total stockholders' equity</b>	<b>56,184,011</b>	<b>47,888,181</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 62,551,405</b>	<b>\$ 54,224,567</b>

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 20 – Condensed financial statements of parent company (concluded)

#### Statements of Operations

	December 31,	
	2019	2018
<b>Assets</b>		
<b>Income</b>	\$ 1,603,174	\$ 1,478,200
<b>Operating expenses</b>		
Interest expense	195,000	195,000
<b>Total expenses</b>	195,000	195,000
<b>Allocated income tax benefits</b>	(40,951)	(40,950)
<b>Income before equity in undistributed income of subsidiary</b>	1,449,125	1,324,150
<b>Equity in undistributed income - Farmers Bank</b>	3,646,980	3,551,101
<b>Net income</b>	\$ 5,096,105	\$ 4,875,251

#### Statements of Cash Flows

	Years Ended December 31,	
	2019	2018
<b>Cash flows from operating activities</b>		
Net income	\$ 5,096,105	\$ 4,875,251
Adjustments to reconcile net income to net cash provided by operating activities		
Taxes receivable	(40,952)	(40,950)
Other assets	(31,007)	66,484
Other liabilities	-	31,016
Equity in undistributed net income of Farmers Bank	(3,646,980)	(3,551,101)
<b>Net cash provided by operating activities</b>	1,377,166	1,380,700
<b>Cash flows from financing activities</b>		
Cash dividends paid on common shares	(1,377,166)	(1,283,200)
<b>Net cash used in financing activities</b>	(1,377,166)	(1,283,200)
<b>Increase (decrease) in cash and cash equivalents</b>	-	97,500
<b>Cash and cash equivalents</b>		
Beginning of the year	1,066,093	968,593
<b>End of year</b>	\$ 1,066,093	\$ 1,066,093

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 21 – Revenue from Contracts with Customers

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within Non-Interest Income. A description of the Company's revenue streams accounted for under ASC 606 is as follows:

*Service Charges on Deposit Accounts* - Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, and other deposit account related fees. The Company's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

*Other Service Charges, Commissions and Fees* - Other service charges, commissions and fees are primarily comprised of debit card income, ATM fees, merchant services income, and other service charges. Debit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, safe deposit box rentals, cashier's checks, and other services. The Company's performance obligation for other service charges, commission and fees are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month.

*Insurance Commissions* - Insurance income primarily consists of commissions received on insurance product sales. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the insurance policy. Shortly after the insurance policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue.

*Gain on Sales of OREO* - The Company records a gain or loss from the sale of other real estate owned when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of other real estate owned to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the other real estate owned asset is derecognized and the gain on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain on the sale, the Company adjusts the transaction price and related gain on sale if a significant financing component is present.

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements For Years Ended December 31, 2019 and 2018

### Note 21 – Revenue from Contracts with Customers (concluded)

The following table presents the Company's sources of Non-Interest Income for the twelve months ended December 31, 2019. Items outside the scope of ASC 606 are noted as such.

	<u>2019</u>	<u>2018</u>
<b>Non-interest income</b>		
Service charges on deposits		
Overdraft fees	\$ 367,172	\$ 375,771
Other	210,684	222,609
Income from automated teller machines and bank card interchange	576,109	560,452
Insurance commissions	5,554,730	4,452,749
Net gain on disposition of securities (outside of scope)	336,269	154,773
Income on bank owned life insurance (outside of scope)	305,307	306,814
Other income (outside of scope)	363,080	190,168
Total non-interest income	<u>\$ 7,713,351</u>	<u>\$ 6,263,336</u>

On January 1, 2019, the Company recorded a net increase to beginning retained earnings of \$1,456,160 due to the cumulative impact of adopting the standard. The adoption did not have a significant impact on the Company's Consolidated Financial Statements for the year ended December 31, 2019 and, as a result, comparisons of revenues and operating profit performance between periods are not materially affected by the adoption of this ASU.

### Note 22 – Subsequent events

The Company has evaluated subsequent events through March 9, 2020, in connection with the preparation of these financial statements which is the date the financial statements were available to be issued.

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## BRANCH LOCATIONS

### **Chesapeake**

821 North Battlefield Boulevard,

### **Courtland**

28319 Southampton Parkway, Suite D

### **Smithfield**

1119 South Church Street, PO Box 888

### **Suffolk – Harbour View**

6255 College Drive, Suite L

### **Suffolk – Hillpoint**

3100 Godwin Boulevard

### **Suffolk – Lakeside**

1008 West Washington Street

### **Windsor**

50 East Windsor Boulevard, PO Box 285

### *Opening Soon*

### **Virginia Beach – Pungo**

1776 Princess Anne Road, Unit S

[www.farmersbankva.com](http://www.farmersbankva.com)

757-242-6111



# FARMERS BANK

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