

F&M BANK CORP  
Form 10-K  
March 30, 2011

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549  
FORM 10-K  
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For fiscal year ended December 31, 2010  
Commission file number: 0-13273  
F & M BANK CORP.  
(Exact name of registrant as specified in its charter)**

**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**54-1280811**  
(I.R.S. Employer Identification No.)

**P. O. Box 1111, Timberville, Virginia 22853**  
(Address of principal executive offices) (Zip Code)  
**(540) 896-8941**

(Registrant's telephone number including area code)  
Securities registered pursuant to Section 12(b) of the Act: **None**  
Securities registered pursuant to Section 12(g) of the Act:  
**Common Stock \$5 Par value per share**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Sarbanes Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting  
Company

(Do not check if a smaller  
reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The registrant's Common Stock is traded Over-the-Counter under the symbol FMBM. The aggregate market value of the 2,061,156 shares of Common Stock of the registrant issued and outstanding held by non-affiliates on June 30,

2010 was approximately \$39,161,964 based on the closing sales price of \$19.00 per share on that date. For purposes of this calculation, the term "affiliate" refers to all directors and executive officers of the registrant. As of the close of business on March 1, 2011, there were 2,307,436 shares of the registrant's Common Stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE:**

Proxy Statement for the Annual Meeting of Shareholders to be held on May 14, 2011 (the "Proxy Statement").

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**PART I**

**Item 1. Business**

**General**

F & M Bank Corp. (the Company or we ), incorporated in Virginia in 1983, is a one-bank holding company pursuant to section 3(a)(1) of the Bank Holding Company Act of 1956, and owns 100% of the outstanding stock of its affiliate, Farmers & Merchants Bank (Bank). TEB Life Insurance Company (TEB) and Farmers & Merchants Financial Services, Inc. (FMFS) are wholly owned subsidiaries of Farmers & Merchants Bank. Farmers & Merchants Bank also holds a majority ownership in VBS Mortgage LLC, (VBS).

Farmers & Merchants Bank was chartered on April 15, 1908, as a state chartered bank under the laws of the Commonwealth of Virginia. TEB was incorporated on January 27, 1988, as a captive life insurance company under the laws of the State of Arizona. FMFS is a Virginia chartered corporation and was incorporated on February 25, 1993. VBS (formerly Valley Broker Services, Inc.) was incorporated on May 11, 1999. The Bank purchased a majority interest in VBS on November 3, 2008.

The Bank offers all services normally offered by a full-service commercial bank, including commercial and individual demand and time deposit accounts, repurchase agreements for commercial customers, commercial and individual loans, internet banking, drive-in banking services, ATMs at all branch locations and several off-site locations, as well as a courier service for its commercial banking customers. TEB was organized to re-insure credit life and accident and health insurance currently being sold by the Bank in connection with its lending activities. FMFS was organized to write title insurance but now provides brokerage and other financial services to customers of Farmers & Merchants Bank. VBS originates conventional and government sponsored mortgages through their offices in Harrisonburg and Woodstock.

The Bank makes various types of commercial and consumer loans and has a heavy concentration of residential and agricultural real estate loans. The local economy is relatively diverse with strong employment in the agricultural, manufacturing, service and governmental sectors.

The Company's and the Bank's principal executive office is at 205 South Main Street, Timberville, VA 22853, and its phone number is (540) 896-8941.

**Filings with the SEC**

The Company files annual, quarterly and other reports under the Securities Exchange Act of 1934 with the Securities and Exchange Commission ( SEC ). These reports are posted and are available at no cost on the Company's website, [www.farmersandmerchants.biz](http://www.farmersandmerchants.biz), as soon as reasonably practicable after the Company files such documents with the SEC. The Company's filings are also available through the SEC's website at [www.sec.gov](http://www.sec.gov).

**Employees**

On December 31, 2010, the Bank had 141 full-time and part-time employees; including executive officers, loan and other banking officers, branch personnel, operations personnel and other support personnel. None of the Company's employees is represented by a union or covered under a collective bargaining agreement. Management of the Company considers their employee relations to be excellent. No one employee devotes full-time services to F & M Bank Corp.

**Competition**

The Bank's offices face strong competition from numerous other financial institutions. These other institutions include large national and regional banks, other community banks, nationally chartered savings banks, credit unions, consumer finance companies, mortgage companies, loan production offices, mutual funds and life insurance companies. Competition for loans and deposits is affected by a variety of factors including interest rates, types of products offered, the number and location of branch offices, marketing strategies and the reputation of the Bank within the communities served.

**Table of Contents****Regulation and Supervision**

*General.* The operations of F & M Bank Corp. and the Bank are subject to federal and state statutes, which apply to state member banks of the Federal Reserve System. The stock of F & M Bank Corp. is subject to the registration requirements of the Securities Act of 1934. F & M Bank Corp. is subject to the periodic reporting requirements of the Securities Exchange Act of 1934. These include, but are not limited to, the filing of annual, quarterly and other current reports with the Securities and Exchange Commission. As an Exchange Act reporting company, the Corporation is directly affected by the Sarbanes-Oxley Act of 2002, which is aimed at improving corporate governance and reporting procedures. The Corporation is complying with SEC and other rules and regulations implemented pursuant to Sarbanes-Oxley and intends to comply with any applicable rules and regulations implemented in the future.

F & M Bank Corp., as a bank holding company, is subject to the provisions of the Bank Holding Company Act of 1956, as amended (the Act). It is registered as such and is supervised by the Federal Reserve Board. The Act requires F & M Bank Corp. to secure the prior approval of the Federal Reserve Board before F & M Bank Corp. acquires ownership or control of more than 5% of the voting shares or substantially all of the assets of any institution, including another bank.

As a bank holding company, F & M Bank Corp. is required to file with the Federal Reserve Board an annual report and such additional information as it may require pursuant to the Act. The Federal Reserve Board may also conduct examinations of F & M Bank Corp. and any or all of its subsidiaries. Under Section 106 of the 1970 Amendments to the Act and the regulations of the Federal Reserve Board, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with an extension of credit, provision of credit, sale or lease of property or furnishing of services.

Federal Reserve Board regulations permit bank holding companies to engage in non-banking activities closely related to banking or to managing or controlling banks. These activities include the making or servicing of loans, performing certain data processing services, and certain leasing and insurance agency activities. Since 1994, the Company has entered into agreements with the Virginia Community Development Corporation to purchase equity positions in several Low Income Housing Funds; these funds provide housing for low-income individuals throughout Virginia. Approval of the Federal Reserve Board is necessary to engage in any of the activities described above or to acquire interests engaging in these activities.

The Bank as a state member bank is supervised and regularly examined by the Virginia Bureau of Financial Institutions and the Federal Reserve Board. Such supervision and examination by the Virginia Bureau of Financial Institutions and the Federal Reserve Board is intended primarily for the protection of depositors and not the stockholders of F & M Bank Corp.

*Payment of Dividends.* The Company is a legal entity, separate and distinct from its subsidiaries. A significant portion of the revenues of the Company result from dividends paid to it by the Bank. There are various legal limitations applicable to the payment of dividends by the Bank to the Company. Under the current regulatory guidelines, prior approval from the Board of Governors of the Federal Reserve System is required if cash dividends declared in any given year exceed net income for that year, plus retained net profits of the two preceding years. The payment of dividends by the Bank or the Company may also be limited by other factors, such as requirements to maintain capital above regulatory guidelines.

Bank regulatory agencies have the authority to prohibit the Bank or the Company from engaging in an unsafe or unsound practice in conducting their businesses. The payment of dividends, depending on the financial condition of the Bank, or the Company, could be deemed to constitute such an unsafe or unsound practice. Based on the Bank's current financial condition, the Company does not expect that any of these laws will have any impact on its ability to obtain dividends from the Bank.

*Capital Requirements.* The Federal Reserve has issued risk-based and leverage capital guidelines applicable to United States banking organizations. In addition, regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels because of its financial condition or actual or anticipated growth. Under the risk-based capital requirements, the Company and Bank are required to maintain a minimum ratio of total capital to risk-weighted assets of at least 8%. At least half of the total capital is required to be Tier 1 capital, which consists principally of common and certain qualifying preferred stockholders' equity (including Trust Preferred

Securities), less certain intangibles and other adjustments. The remainder ( Tier 2 capital ) consists of a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments) and a limited amount of the general loan loss allowance. The Tier 1 and total capital to risk-weighted asset ratios of the Company as of December 31, 2010 were 9.77% and 13.51%, respectively, significantly above the minimum requirements.

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In addition, each of the federal regulatory agencies has established a minimum leverage capital ratio (Tier 1 capital to average adjusted assets) ( Tier 1 leverage ratio ). These guidelines provide for a minimum Tier 1 leverage ratio of 4% for banks and bank holding companies that meet certain specified criteria, including that they have the highest regulatory examination rating and are not contemplating significant growth or expansion. The Tier 1 leverage ratio of the Company as of December 31, 2010, was 7.37%, which is significantly above the minimum requirements. The guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

*The Gramm-Leach-Bliley Act.* Effective on March 11, 2001, the Gramm-Leach-Bliley Act (the GLB Act ) allows a bank holding company or other company to certify status as a financial holding company, which will allow such company to engage in activities that are financial in nature, that are incidental to such activities, or are complementary to such activities. The GLB Act enumerates certain activities that are deemed financial in nature, such as underwriting insurance or acting as an insurance principal, agent or broker; underwriting; dealing in or making markets in securities; and engaging in merchant banking under certain restrictions. It also authorizes the Federal Reserve to determine by regulation what other activities are financial in nature, or incidental or complementary thereto.

*USA Patriot Act of 2001.* In October, 2001, the USA Patriot Act of 2001 was enacted in response to the terrorist attacks in New York, Pennsylvania and Northern Virginia which occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcements and the intelligence communities abilities to work cohesively to combat terrorism on a variety of fronts. The continuing and potential impact of the Patriot Act and related regulations and policies on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws, and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

*Community Reinvestment Act.* The requirements of the Community Reinvestment Act are also applicable to the Bank. The act imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those institutions. A financial institution s efforts in meeting community needs currently are evaluated as part of the examination process pursuant to twelve assessment factors. These factors are also considered in evaluating mergers, acquisitions and applications to open a branch or facility.

**Forward-Looking Statements**

F & M Bank Corp. makes forward-looking statements in the Management s Discussion and Analysis of Financial Condition and Results of Operations and in other portions of this Annual Report on Form 10-K that are subject to risks and uncertainties. These forward-looking statements include: estimates of risks and of future costs and benefits; assessments of probable loan losses and statements of goals and expectations. These forward-looking statements are subject to significant uncertainties because they are based upon management s estimates and projections of future interest rates and other economic conditions; future laws and regulations; and a variety of other matters. As a result of these uncertainties, actual results may be materially different from the results indicated by these forward-looking statements. In addition, the Company s past results of operations do not necessarily indicate its future results.



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**Item 1A. Risk Factors**

**General economic conditions, either national or within the Company's local markets.**

The Company is affected by general economic conditions in the United States and the local markets within which it operates. An economic downturn within the Company's markets, or the nation as a whole; a significant decline in general economic conditions caused by inflation, recession, unemployment or other factors beyond the Company's control could negatively impact the growth rate of loans and deposits, the quality of the loan portfolio, loan and deposit pricing and other key factors of the Company's business. Such negative developments could adversely impact the Company's financial condition and performance.

**Changes in interest rates could affect the Company's income and cash flows.**

The direction and speed of interest rate changes affects our net interest margin and net interest income. Typically, in a period of declining interest rates our net interest income is negatively affected in the short term as our interest earning assets (primarily loans and investment securities) reprice more quickly than our interest bearing liabilities (deposits and borrowings).

We attempt to mitigate this risk by maintaining a neutral position regarding the volume of assets and liabilities that mature or reprice during any period; however, interest rate fluctuations, loan prepayments, loan production and deposit flows constantly change and influence the ability to maintain a neutral position. Generally speaking, the Company's earnings will be more sensitive to fluctuations in interest rates the greater the variance in volume of assets and liabilities that mature and reprice in any period. Accordingly, the Company may not be successful in maintaining a neutral position and, as a result, the Company's net interest margin may be impacted.

**The Company faces substantial competition that could adversely affect the Company's growth and/or operating results.**

The Company operates in a competitive market for financial services and faces intense competition from other financial institutions both in making loans and in attracting deposits. Many of these financial institutions have been in business for many years, are significantly larger, have established customer bases, and have greater financial resources and lending limits.

**There could be an adverse effect on the way in which we do business if we do not maintain our capital requirements and our status as a well-capitalized bank.**

The Bank is subject to regulatory capital adequacy guidelines. If the Bank fails to meet the capital adequacy guidelines for a well-capitalized bank, it could increase the regulatory scrutiny for the Bank and the Company; increase our FDIC insurance premiums, and could lead to a decline in the confidence that our customers have in us and a reduction in the demand for our products and services.

**The inability of the Company to successfully manage its growth or implement its growth strategy may adversely affect the result of operations and financial conditions.**

The Company may not be able to successfully implement its growth strategy if unable to identify attractive markets, locations or opportunities to expand in the future. The ability to manage growth successfully also depends on whether the Company can maintain capital levels adequate to support its growth, maintain cost controls, asset quality and successfully integrate any businesses acquired into the organization.

As the Company continues to implement its growth strategy by opening new branches it expects to incur increased personnel, occupancy and other operating expenses. The Company must absorb those higher expenses while it begins to generate new deposits, and there is a further time lag involved in redeploying new deposits into attractively priced loans and other higher yielding earning assets. Thus, the Company's plans to branch could depress earnings in the short run, even if it efficiently executes a branching strategy leading to long-term financial benefits.

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**The Company's exposure to operational risk may adversely affect the Company.**

Similar to other financial institutions, the Company is exposed to many types of operational risk, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer or telecommunications systems.

**The Company's concentration in loans secured by real estate may adversely impact earnings due to changes in the real estate markets.**

The Company offers a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity, consumer and other loans. Many of the Company's loans are secured by real estate (both residential and commercial) in the Company's market area. A major change in the real estate market, resulting in deterioration in the value of this collateral, or in the local or national economy, could adversely affect the customers ability to pay these loans, which in turn could impact the Company. Risk of loan defaults and foreclosures are unavoidable in the banking industry, and the Company tries to limit its exposure to this risk by monitoring extensions of credit carefully. The Company cannot fully eliminate credit risk, and as a result credit losses may occur in the future.

**Legislative or regulatory changes or actions, or significant litigation, could adversely impact the Company or the businesses in which the Company is engaged.**

The Company is subject to extensive state and federal regulation, supervision and legislation that govern almost all aspects of its operations. Laws and regulations may change from time to time and are primarily intended for the protection of consumers, depositors and the deposit insurance funds. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively impact the Company or its ability to increase the value of its business. Additionally, actions by regulatory agencies or significant litigation against the Company could cause it to devote significant time and resources to defending itself and may lead to penalties that materially affect the Company and its shareholders. Future changes in the laws or regulations or their interpretations or enforcement could be materially adverse to the Company and its shareholders.

**Changes in accounting standards could impact reported earnings.**

The accounting standard setters, including the FASB, SEC and other regulatory bodies, periodically change the financial accounting and reporting standards that govern the preparation of the Company's consolidated financial statements. These changes can be hard to predict and can materially impact how it records and reports its financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of prior period financial statements.

**Item 1B. Unresolved Staff Comments**

The Company does not have any unresolved staff comments to report for the year ended December 31, 2010.

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**Item 2. Description of Properties**

The locations of F & M Bank Corp., Inc. and its subsidiaries are shown below.

**Timberville Main Office**  
205 South Main Street  
Timberville, VA 22853

**Elkton Branch**  
127 West Rockingham Street  
Elkton, VA 22827

**Broadway Branch**  
126 Timberway  
Broadway, VA 22815

**Port Road Branch**  
1085 Port Republic Road  
Harrisonburg, VA 22801

**Bridgewater Branch**  
100 Plaza Drive  
Bridgewater, VA 22812

**Edinburg Branch**  
120 South Main Street  
Edinburg, VA 22824

**Woodstock Branch**  
161 South Main Street  
Woodstock, VA 22664

**Crossroads Branch**  
80 Cross Keys Road  
Harrisonburg, VA 22801

**Luray Branch**  
700 East Main Street  
Luray, VA 22835

With the exception of the Edinburg Branch, Port Road Branch and the Luray Branch, all facilities are owned by Farmers & Merchants Bank. ATMs are available at all locations.

Through an agreement with Nationwide Money ATM Services, the Bank also operates cash only ATMs at five Food Lion grocery stores, one in Mt. Jackson, VA and four in Harrisonburg, VA.

VBS offices are located at:

**Harrisonburg Office**  
2040 Deyerle Avenue  
Suite 107  
Harrisonburg, VA 22801

**Woodstock Office**  
161 South Main Street  
Woodstock, VA 22664

**Item 3. Legal Proceedings**

In the normal course of business, the Company may become involved in litigation arising from banking, financial, or other activities of the Company. Management after consultation with legal counsel, does not anticipate that the ultimate liability, if any, arising out of these matters will have a material effect on the Company's financial condition, operating results or liquidity.

**Item 4. Removed and Reserved**

**PART II**

**Item 5. Market for Registrant's Common Equity and Related Stockholder Matters**

**Stock Listing**

The Company's Common Stock trades under the symbol FMBM on the OTC Bulletin Board. The bid and asked price of the Company's stock is not published in any newspaper. Although several firms in both Harrisonburg and Richmond, Virginia occasionally take positions in the Company stock, they typically only match buyers and sellers.

**Table of Contents****Transfer Agent and Registrar**

Registrar &amp; Transfer Company

10 Commerce Drive

Cranford, NJ 07016

**Stock Performance**

The following graph compares the cumulative total return to the shareholders of the Company for the last five fiscal years with the total return of the Russell 2000 Index and the SNL Bank Index, as reported by SNL Financial, LC, assuming an investment of \$100 in the Company's common stock on December 31, 2006, and the reinvestment of dividends.

| <b>Index</b>   | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>2010</b> |
|----------------|-------------|-------------|-------------|-------------|-------------|-------------|
| F & M Corp     | 100.00      | 111.49      | 126.34      | 126.63      | 99.42       | 65.15       |
| Russell 2000   | 100.00      | 118.37      | 116.51      | 77.15       | 98.11       | 124.46      |
| SNL Bank Index | 100.00      | 116.98      | 90.90       | 51.87       | 51.33       | 57.52       |

**Recent Stock Prices and Dividends**

Dividends to shareholders totaled \$1,034,000 and \$1,743,000 in 2010 and 2009, respectively. Regular quarterly dividends have been declared for fifty six consecutive quarters. In the third quarter of 2009 dividends per share were reduced from \$.23 to \$.15 per quarter. This decrease was the result of reduced earnings and an effort to bring the dividend payout ratio within stated goals. The payment of dividends depends on the earnings of the Company and its subsidiaries, the financial condition of the Company and other factors including capital adequacy, regulatory requirements, general economic conditions and shareholder returns. The ratio of dividends per share to net income per share was 36.81% in 2010, compared to 89.18% in 2009.

**Table of Contents****Stock Repurchases**

As previously reported, on September 18, 2008, the Company's Board of Directors approved an increase in the number of shares of common stock that the Company can repurchase under the share repurchase program from 150,000 to 200,000 shares. Shares repurchased through the end of 2010 totaled 164,132 shares; of this amount, none were repurchased in 2010.

The number of common shareholders of record was approximately 1,759 as of March 1, 2011. This amount includes all shareholders, whether titled individually or held by a brokerage firm or custodian in street name.

**Quarterly Stock Information**

These quotes include the terms of trades transacted through a broker. The terms of exchanges occurring between individual parties may not be known to the Company.

| Quarter         | 2010              |       |   | 2009              |       |                              |
|-----------------|-------------------|-------|---|-------------------|-------|------------------------------|
|                 | Stock Price Range |       | Per Share Dividends Declared <sup>(1)</sup> | Stock Price Range |       | Per Share Dividends Declared |
|                 | Low               | High  |   | Low               | High  |                              |
| 1 <sup>st</sup> | 20.75             | 26.00 | \$ .15                                      | 20.00             | 30.75 | \$ .23                       |
| 2 <sup>nd</sup> | 18.05             | 22.00 | .15   | 22.00             | 28.15 | .23                          |
| 3 <sup>rd</sup> | 15.15             | 20.00 | .15   | 22.95             | 26.65 | .15                          |
| 4 <sup>th</sup> | 13.25             | 16.24 | .15   | 20.00             | 24.90 | .15                          |
| Total           |                   |       | \$ .60                                      |                   |       | \$ .76                       |

- (1) Beginning in the third quarter 2010, the dividend is now declared at the board meeting following quarter end. This is a result of a change in practice by our board of directors to declare dividends for a particular quarter following the completion of the quarter instead of prior to quarter end. The timing of actual dividend payments to shareholders remains unchanged.

**Table of Contents****Item 6. Selected Financial Data**  
**Five Year Summary of Selected Financial Data***(Dollars in thousands,  
except per share data)*

|  | 2010       | 2009       | 2008       | 2007       | 2006       |
|--|------------|------------|------------|------------|------------|
| <b>Income Statement Data:</b>                          |            |            |            |            |            |
| Interest and Dividend Income                           | \$ 27,870  | \$ 27,516  | \$ 25,544  | \$ 24,635  | \$ 22,526  |
| Interest Expense                                       | 9,005      | 10,182     | 10,498     | 11,043     | 9,091      |
| Net Interest Income                                    | 18,865     | 17,334     | 15,046     | 13,592     | 13,435     |
| Provision for Loan Losses                              | 4,300      | 4,210      | 815        | 270        | 240        |
| Net Interest Income after<br>Provision for Loan Losses | 14,565     | 13,124     | 14,231     | 13,322     | 13,195     |
| Noninterest Income                                     | 3,249      | 3,111      | 3,169      | 3,215      | 2,754      |
| Securities Gains (Losses)                              | 349        | (1,754)    | (1,680)    | 101        | 193        |
| Noninterest Expenses                                   | 12,741     | 12,188     | 11,097     | 10,532     | 9,688      |
| Income before Income Taxes                             | 5,422      | 2,293      | 4,623      | 6,106      | 6,454      |
| Income Tax Expense                                     | 1,681      | 339        | 1,419      | 1,653      | 1,925      |
| Net Income   | \$ 3,741   | \$ 1,954   | \$ 3,204   | \$ 4,453   | \$ 4,529   |
| <b>Per Share Data:</b>                                 |            |            |            |            |            |
| Net Income   | \$ 1.63    | \$ .85     | \$ 1.38    | \$ 1.89    | \$ 1.90    |
| Dividends Declared                                     | .60        | .76        | .90        | .86        | .82        |
| Book Value   | 18.31      | 16.99      | 15.64      | 16.71      | 16.05      |
| <b>Balance Sheet Data:</b>                             |            |            |            |            |            |
| Assets   | \$ 538,855 | \$ 539,223 | \$ 472,058 | \$ 386,727 | \$ 375,924 |
| Loans Held for Investment                              | 445,147    | 434,403    | 399,233    | 317,180    | 309,461    |
| Loans Held for Sale                                    | 23,764     | 31,168     | 3,780      |            |            |
| Securities   | 24,144     | 26,220     | 30,785     | 36,614     | 37,373     |
| Deposits   | 425,051    | 420,643    | 342,225    | 298,560    | 289,522    |
| Short-Term Debt  | 5,355      | 9,085      | 20,510     | 12,743     | 11,717     |
| Long-Term Debt   | 58,979     | 63,096     | 65,331     | 29,714     | 29,247     |
| Stockholders Equity                                    | 42,229     | 39,002     | 36,305     | 39,165     | 38,105     |
| Average Shares Outstanding                             | 2,299      | 2,292      | 2,319      | 2,360      | 2,386      |
| <b>Financial Ratios:</b>                               |            |            |            |            |            |
| Return on Average Assets <sup>1</sup>                  | .69%       | .38%       | .75%       | 1.17%      | 1.26%      |
| Return on Average Equity <sup>1</sup>                  | 9.22%      | 5.10%      | 8.50%      | 11.53%     | 12.13%     |
| Net Interest Margin                                    | 3.77%      | 3.70%      | 3.89%      | 3.94%      | 4.17%      |
| Efficiency Ratio <sup>2</sup>                          | 57.23%     | 57.74%     | 58.60%     | 60.31%     | 57.45%     |
| Dividend Payout Ratio                                  | 36.81%     | 89.18%     | 65.01%     | 45.60%     | 43.12%     |

**Capital and Credit Quality Ratios:**

|   |       |       |       |        |        |
|---|-------|-------|-------|--------|--------|
| Average Equity to Average Assets <sup>1</sup>     | 7.46% | 7.37% | 8.85% | 10.05% | 10.36% |
| Allowance for Loan Losses to Loans <sup>3</sup>   | 1.30% | .88%  | .55%  | .54%   | .58%   |
| Nonperforming Assets to Total Assets <sup>4</sup> | 3.06% | 1.42% | 1.01% | 1.11%  | .58%   |
| Net Charge-offs to Total Loans <sup>3</sup>       | .53%  | .59%  | .08%  | .11%   | .04%   |

<sup>1</sup> Ratios are primarily based on daily average balances.

<sup>2</sup> The Efficiency Ratio equals noninterest expenses divided by the sum of tax equivalent net interest income and noninterest income. Noninterest expenses exclude intangible asset amortization. Noninterest income excludes gains (losses) on securities transactions.

<sup>3</sup> Calculated based on Loans Held for Investment, excludes Loans Held for Sale.

<sup>4</sup> Calculated based on 90 day past due, non-accrual and restructured loans to Total Assets.

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**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion provides information about the major components of the results of operations and financial condition, liquidity and capital resources of F & M Bank Corp. and its subsidiaries. This discussion and analysis should be read in conjunction with the Consolidated Financial Statements and the Notes to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Information, of this Form 10-K.

**Lending Activities**

**Credit Policies**

The principal risk associated with each of the categories of loans in our portfolio is the creditworthiness of our borrowers. Within each category, such risk is increased or decreased, depending on prevailing economic conditions. In an effort to manage the risk, our loan policy gives loan amount approval limits to individual loan officers based on their position and level of experience and to our loan committees based on the size of the lending relationship. The risk associated with real estate and construction loans, commercial loans and consumer loans varies, based on market employment levels, consumer confidence, fluctuations in the value of real estate and other conditions that affect the ability of borrowers to repay indebtedness. The risk associated with real estate construction loans varies, based on the supply and demand for the type of real estate under construction.

We have written policies and procedures to help manage credit risk. We have a loan review policy that includes regular portfolio reviews to establish loss exposure and to ascertain compliance with our loan policy.

We use a management loan committee and a directors' loan committee to approve loans. The management loan committee is comprised of members of management, and the directors' loan committee is composed of any four directors, of which at least three are independent directors. Both committees approve new, renewed and or modified loans that exceed officer loan authorities. The directors' loan committee also reviews any changes to our lending policies, which are then approved by our board of directors.

**Construction and Development Lending**

We make construction loans, primarily residential, and land acquisition and development loans. The construction loans are secured by residential houses under construction and the underlying land for which the loan was obtained. The average life of a construction loan is approximately 12 months, and it is typically re-priced as the prime rate of interest changes. The majority of the interest rates charged on these loans floats with the market. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans often involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is attributable to the fact that loan funds are advanced upon the security of the land or home under construction, which value is estimated prior to the completion of construction. Thus, it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate the risks associated with construction lending, we generally limit loan amounts to 75% to 90% of appraised value, in addition to analyzing the creditworthiness of our borrowers. We also obtain a first lien on the property as security for our construction loans and typically require personal guarantees from the borrower's principal owners.

**Commercial Real Estate Lending**

Commercial real estate loans are secured by various types of commercial real estate in our market area, including multi-family residential buildings, commercial buildings and offices, shopping centers and churches. Commercial real estate lending entails significant additional risks, compared with residential mortgage lending. Commercial real estate loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Additionally, the payment experience on loans secured by income producing properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or in the economy in general. Our commercial real estate loan underwriting criteria require an examination of debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. We also evaluate the location of the security property and typically require personal guarantees or endorsements of the borrower's principal owners.



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**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Business Lending**

Business loans generally have a higher degree of risk than residential mortgage loans but have higher yields. To manage these risks, we generally obtain appropriate collateral and personal guarantees from the borrower's principal owners and monitor the financial condition of our business borrowers. Residential mortgage loans generally are made on the basis of the borrower's ability to make repayment from his employment and other income and are secured by real estate whose value tends to be readily ascertainable. In contrast, business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as real estate, accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for business loans may depreciate over time and generally cannot be appraised with as much precision as residential real estate.

**Consumer Lending**

We offer various consumer loans, including personal loans and lines of credit, automobile loans, deposit account loans, installment and demand loans, and home equity lines of credit and loans. Such loans are generally made to clients with whom we have a pre-existing relationship. We currently originate all of our consumer loans in our geographic market area.

The underwriting standards employed by us for consumer loans include a determination of the applicant's payment history on other debts and an assessment of their ability to meet existing obligations and payments on the proposed loan. The stability of the applicant's monthly income may be determined by verification of gross monthly income from primary employment and additionally from any verifiable secondary income. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes an analysis of the value of the security in relation to the proposed loan amount. For home equity lines of credit and loans, our primary consumer loan category, we require title insurance, hazard insurance and, if required, flood insurance.

**Portfolio Mortgage Lending**

The Bank makes residential mortgage loans for the purchase or refinance of existing loans with loan to value limits ranging between 80 and 90% depending on the age of the property, borrower's income and credit worthiness. Loans that are retained in our portfolio generally carry adjustable rates that can change every three to five years, based on amortization periods of twenty to thirty years. All fixed rate loans for longer terms, typically fifteen or thirty years, are originated by VBS Mortgage and are sold to investors in the secondary market.

**Critical Accounting Policies**

**General**

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial information contained within the statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. The Company's financial position and results of operations are affected by management's application of accounting policies, including estimates, assumptions and judgments made to arrive at the carrying value of assets and liabilities and amounts reported for revenues, expenses and related disclosures. Different assumptions in the application of these policies could result in material changes in the Company's consolidated financial position and/or results of operations.

In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of these transactions would be the same, the timing of events that would impact these transactions could change. Following is a summary of the Company's significant accounting policies that are highly dependent on estimates, assumptions and judgments.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Allowance for Loan Losses**

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) ASC 450 (formerly SFAS No. 5) "Contingencies", which requires that losses be accrued when they are probable of occurring and estimable and (ii) ASC 310 (formerly SFAS No. 114),

"Receivables", which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

The Company's allowance for loan losses is the accumulation of various components that are calculated based on independent methodologies. All components of the allowance represent an estimation performed pursuant to either ASC 450 or ASC 310. Management's estimate of each ASC 450 component is based on certain observable data that management believes are most reflective of the underlying credit losses being estimated. This evaluation includes credit quality trends; collateral values; loan volumes; geographic, borrower and industry concentrations; seasoning of the loan portfolio; the findings of internal credit quality assessments and results from external bank regulatory examinations. These factors, as well as historical losses and current economic and business conditions, are used in developing estimated loss factors used in the calculations.

Allowances for loans are determined by applying estimated loss factors to the portfolio based on management's evaluation and risk grading of the loan portfolio. Specific allowances are typically provided on all impaired loans in excess of a defined threshold that are classified in the Substandard or Doubtful risk grades. The specific reserves are determined on a loan-by-loan basis based on management's evaluation of the Company's exposure for each credit, given the current payment status of the loan and the value of any underlying collateral.

While management uses the best information available to establish the allowance for loan and lease losses, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the valuations or, if required by regulators, based upon information available to them at the time of their examinations. Such adjustments to original estimates, as necessary, are made in the period in which these factors and other relevant considerations indicate that loss levels may vary from previous estimates.

**Goodwill and Intangibles**

In June 2001, the Financial Accounting Standards Board issued ASC 805 (formerly SFAS No. 141), *Business Combinations* and ASC 350 (formerly SFAS No. 142), *Intangibles*. ASC 805 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Additionally, it further clarifies the criteria for the initial recognition and measurement of intangible assets separate from goodwill. ASC 350 was effective for fiscal years beginning after December 15, 2001 and prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. The provisions of ASC 350 discontinue the amortization of goodwill and intangible assets with indefinite lives. Instead, these assets are subject to an annual impairment review and more frequently if certain impairment indicators are in evidence. ASC 350 also requires that reporting units be identified for the purpose of assessing potential future impairments of goodwill.

The Company adopted ASC 350 on January 1, 2002. Goodwill totaled \$2,639,000 at January 1, 2002. As of December 31, 2008, the Company recognized \$30,000 in additional goodwill related to the purchase of 70% ownership in VBS Mortgage. The goodwill is not amortized but is tested for impairment at least annually. Based on this testing, there were no impairment charges for 2010 or 2009. Application of the non-amortization provisions of the Statement resulted in additional net income of \$120,000 for each of the years ended December 31, 2010, 2009 and 2008.

Core deposit intangibles are amortized on a straight-line basis over a ten year life. Core deposit intangible, net of amortization, amounted to \$46,000 and \$322,000 at December 31, 2010 and 2009, respectively. The Company adopted ASC 350 on January 1, 2002 and determined that the core deposit intangible will continue to be amortized over its estimated useful life.

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**Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Securities Impairment**

The Company follows the guidance in ASC 320-10 and SAB Topic 5M, *Other Than Temporary Impairment* in evaluating if these impairments are temporary or other than temporary in nature. This determination is made on an investment by investment basis and includes all available evidence at the time of the determination including the following:

- The length of time of impairment;
- The extent of the impairment relative to the cost of the investment;
- Recent volatility in the market value of the investment;
- The financial condition and near-term prospects of the issuer, including any specific events which may impair the earnings potential of the issuer; or
- The intent and ability of the Company to hold its investment for a period of time sufficient to allow for any anticipated recovery in market value.

The following description provides our revised policies/procedures for the evaluation for Other Than Temporary Impairment (OTTI) for the quarter ended September 30, 2009 and for subsequent periods:

We begin our evaluation using a default position that OTTI has occurred and then use all available evidence to determine whether prospects for the individual security are sufficient to support temporary impairment at the date of the SEC filing. This evaluation is conducted at each filing date.

For purposes of determining OTTI, the security value recovery period is projected for a maximum of a two year holding period. This is the maximum; a shorter period may be used when there are particular conditions related to the individual security which make recovery unlikely.

The primary focus in determining whether a security is OTTI, and projecting potential recovery, is the prospects for the individual security, rather than broad market indices. All available evidentiary material is considered, including the Company's public filings with the SEC, press releases, analyst reports, etc. Secondary consideration is given to historic returns, but only to the extent that this evidence is instructive in determining whether the individual security has shown a history of outperforming (or underperforming) the market (or industry) in prior economic cycles. This factor is only considered when the declines in value were not limited to the individual security, but were prevalent over the broader market. This measure is considered to aid in determining whether OTTI should be recognized earlier, rather than later (ie. a security which underperforms relative to the industry or market will result in early recognition of OTTI). In no event will OTTI recognition be delayed beyond the two year projection period.

OTTI may be recognized as early as quarter 1, regardless of holding period projections, when there are specific factors relative to the security which make recovery unlikely. These factors could include evidence contained in the aforementioned SEC filings, press releases, analyst reports, but may also be based on the severity of the impairment.

Situations where a security has declined in value more rapidly than the industry (or market), absent strong evidence supporting prospects for recover, will result in OTTI being recognized in quarter 1 or quarter 2 rather than continuing to evaluate the security over several quarters, based on holding period projections.

Declines determined to be other than temporary are charged to operations and included in the gain (loss) on security sales. Such charges were \$65,000 for 2010, \$1,751,000 for 2009 and \$1,759,000 for 2008.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued****Overview**

The Company's net income for 2010 totaled \$3,741,000 or \$1.63 per share, an increase of 91% over \$1,954,000 or \$.85 a share in 2009. Return on average equity increased in 2010 to 9.22% versus 5.10% in 2009, while the return on average assets increased from .38% to .69%. The Company's operating earnings, which are net earnings excluding gains (losses) on the sale of investments, non-recurring tax entries and other non-recurring income was \$3,539,000 in 2010 versus \$3,095,000 in 2009, an increase of 14.3%. Core profitability increased due to the growth in the net interest margin which was driven by growth in the loan portfolio.

See page 10 for a five-year summary of selected financial data.

**Changes in Net Income per Common Share**

|  | <b>2010<br/>to 2009</b> | <b>2009<br/>to 2008</b> |
|--|-------------------------|-------------------------|
| Prior Year Net Income Per Share                | \$ .85                  | \$ 1.38                 |
| Change from differences in:                    |                         |                         |
| Net interest income                            | .67                     | 1.07                    |
| Provision for credit losses                    | (.04)                   | (1.49)                  |
| Noninterest income, excluding securities gains | .06                     | (.01)                   |
| Securities gains                               | .91                     | (.05)                   |
| Noninterest expenses                           | (.24)                   | (.51)                   |
| Income taxes                                   | (.58)                   | .46                     |
| <br>Total Change                               | <br>.78                 | <br>(.53)               |
| <br>Net Income Per Share                       | <br>\$ 1.63             | <br>\$ .85              |

**Net Interest Income**

The largest source of operating revenue for the Company is net interest income, which is calculated as the difference between the interest earned on earning assets and the interest expense paid on interest bearing liabilities. The net interest margin is the net interest income expressed as a percentage of interest earning assets. Changes in the volume and mix of interest earning assets and interest bearing liabilities, along with their yields and rates, have a significant impact on the level of net interest income. Net interest income for 2010 was \$18,865,000 representing an increase of \$1,531,000 or 8.83% over the prior year. A 15.21% increase in 2009 versus 2008 resulted in total net interest income of \$17,334,000. In this discussion and in the tabular analysis of net interest income performance, entitled "Consolidated Average Balances, Yields and Rates," (found on page 16), the interest earned on tax exempt loans and investment securities has been adjusted to reflect the amount that would have been earned had these investments been subject to normal income taxation. This is referred to as tax equivalent net interest income.

Tax equivalent income on earning assets increased \$318,000, supported by the increase in loan income of \$675,000. Loans held for investment, expressed as a percentage of total earning assets, decreased slightly in 2010 to 87.92% as compared to 88.65% in 2009. During 2010, yields on earning assets decreased 29 basis points (BP), primarily due to a 20BP decrease in the yield on loans held for investment. This decrease is consistent with declining market rates resulting from Federal Reserve interest rate cuts and a slowing economy. The average cost of interest bearing liabilities decreased 42BP in 2010, following a decrease of 69BP in 2009. The decrease in average cost resulted from maturing liabilities repricing at lower rates following action by the Federal Reserve's Federal Open Market Committee (FOMC), which cut the Federal Funds rate on seven occasions in 2008. These rate cuts were in response to the aforementioned slowing in the national economy following the subprime mortgage crisis and resulting capital markets crisis. To date the economy has continued to struggle and the FOMC has conducted monetary policy designed to keep short-term rates at historically low levels.

The analysis on the next page reveals an increase in net interest margin to 3.77% in 2010 primarily due to changes in balance sheet leverage as the decline in yields on earning assets (29BP) is less than the decline in the cost of funds on interest bearing liabilities (42BP).

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued  
Consolidated Average Balances, Yields and Rates<sup>1</sup>**

|  | 2010       |          |       | 2009       |          |       | 2008       |          |       |
|--|------------|----------|-------|------------|----------|-------|------------|----------|-------|
|  | Balance    | Interest | Rate  | Balance    | Interest | Rate  | Balance    | Interest | Rate  |
| <b>ASSETS</b>                              |            |          |       |            |          |       |            |          |       |
| Loans <sup>2</sup>                         |            |          |       |            |          |       |            |          |       |
| Commercial                                 | \$ 180,292 | \$ 9,474 | 5.25% | \$ 172,883 | \$ 9,382 | 5.43% | \$ 128,815 | \$ 7,976 | 6.19% |
| Real estate                                | 236,318    | 14,502   | 6.14% | 217,677    | 13,473   | 6.19% | 195,743    | 13,061   | 6.67% |
| Installment                                | 26,831     | 2,086    | 7.77% | 28,945     | 2,663    | 9.20% | 31,239     | 2,735    | 8.76% |
| Loans held for investment <sup>4</sup>     |            |          |       |            |          |       |            |          |       |
|  | 443,441    | 26,062   | 5.88% | 419,505    | 25,518   | 6.08% | 355,797    | 23,772   | 6.68% |
| Loans held for sale                        | 32,503     | 1,300    | 4.00% | 29,619     | 1,169    | 3.95% | 5,816      | 238      | 4.09% |
| Investment securities <sup>3</sup>         |            |          |       |            |          |       |            |          |       |
| Fully taxable                              | 12,298     | 420      | 3.42% | 15,602     | 720      | 4.61% | 19,813     | 1,101    | 5.56% |
| Partially taxable                          | 3,722      | 189      | 5.08% | 3,542      | 267      | 7.54% | 6,583      | 509      | 7.73% |
| Tax exempt                                 |            |          |       | 38         | 3        | 7.89% | 169        | 8        | 4.73% |
| Total investment securities                | 16,020     | 609      | 3.80% | 19,182     | 990      | 5.16% | 26,565     | 1,618    | 6.09% |
| Interest bearing deposits in banks         |            |          |       |            |          |       |            |          |       |
|  | 2,997      | 26       | .87%  | 924        | 16       | 1.73% | 2,426      | 117      | 4.82% |
| Federal funds sold                         | 9,390      | 21       | .22%  | 3,964      | 7        | .18%  | 2,821      | 50       | 1.77% |
| Total Earning Assets                       | 504,351    | 28,018   | 5.56% | 473,194    | 27,700   | 5.85% | 393,425    | 25,795   | 6.56% |
| Allowance for loan losses                  |            |          |       |            |          |       |            |          |       |
|  | (4,990)    |          |       | (3,132)    |          |       | (1,946)    |          |       |
| Nonearning assets                          | 44,700     |          |       | 37,962     |          |       | 34,748     |          |       |
| Total Assets                               | \$ 544,061 |          |       | \$ 508,024 |          |       | \$ 426,227 |          |       |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b> |            |          |       |            |          |       |            |          |       |
| Deposits                                   |            |          |       |            |          |       |            |          |       |
| Demand interest bearing                    |            |          |       |            |          |       |            |          |       |
|  | \$ 110,814 | \$ 1,939 | 1.75% | \$ 78,556  | \$ 1,306 | 1.66% | \$ 58,682  | \$ 798   | 1.36% |
| Savings                                    | 35,666     | 191      | .54%  | 32,650     | 202      | .62%  | 30,073     | 293      | .97%  |
| Time deposits                              | 222,919    | 4,426    | 1.99% | 218,396    | 6,294    | 2.88% | 169,978    | 6,955    | 4.09% |

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|  |            |           |       |            |           |       |            |           |       |
|--|------------|-----------|-------|------------|-----------|-------|------------|-----------|-------|
| Total interest bearing deposits            | 369,399    | 6,556     | 1.77% | 329,602    | 7,802     | 2.37% | 258,733    | 8,046     | 3.11% |
| Short-term debt                            | 6,035      | 29        | .48%  | 14,700     | 78        | .53%  | 23,622     | 456       | 1.93% |
| Long-term debt                             | 63,565     | 2,421     | 3.81% | 67,320     | 2,302     | 3.42% | 50,135     | 1,996     | 3.98% |
| Total interest bearing liabilities         | 438,999    | 9,006     | 2.05% | 411,622    | 10,182    | 2.47% | 332,490    | 10,498    | 3.16% |
| Noninterest bearing deposits               | 56,328     |           |       | 51,124     |           |       | 49,557     |           |       |
| Other liabilities                          | 8,166      |           |       | 6,929      |           |       | 6,469      |           |       |
| Total liabilities                          | 503,493    |           |       | 469,675    |           |       | 388,516    |           |       |
| Stockholders equity                        | 40,568     |           |       | 38,349     |           |       | 37,711     |           |       |
| Total liabilities and stockholders equity  | \$ 544,061 |           |       | \$ 508,024 |           |       | \$ 426,227 |           |       |
| Net interest earnings                      |            | \$ 19,012 |       |            | \$ 17,518 |       |            | \$ 15,297 |       |
| Net yield on interest earning assets (NIM) |            |           | 3.77% |            |           | 3.70% |            |           | 3.89% |

<sup>1</sup> Income and yields are presented on a tax-equivalent basis using the applicable federal income tax rate.

<sup>2</sup> Interest income on loans includes loan fees.

<sup>3</sup> Average balance information is reflective of historical cost and has not been adjusted for changes in market value.

<sup>4</sup> Includes nonaccrual loans.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**

The following table illustrates the effect of changes in volumes and rates.

|                                       | 2010 Compared to 2009<br>Increase (Decrease) |            |                              | 2009 Compared to 2008<br>Increase (Decrease) |            |                              |
|---------------------------------------|--|------------|------------------------------|--|------------|------------------------------|
|                                       | Due to<br>Change<br>in<br>Average:<br>Volume | Rate       | Increase<br>or<br>(Decrease) | Due to<br>Change<br>in<br>Average:<br>Volume | Rate       | Increase<br>or<br>(Decrease) |
| <b>Interest income</b>                |  |            |                              |  |            |                              |
| Loans held for investment             | \$ 1,455                                     | \$ (911)   | \$ 544                       | \$ 4,256                                     | \$ (2,510) | \$ 1,746                     |
| Loans held for sale                   | 114  | 17         | 131                          | 974  | (43)       | 931                          |
| Investment securities                 |  |            |                              |  |            |                              |
| Taxable                               | (152)  | (148)      | (300)                        | (234)  | (147)      | (381)                        |
| Partially taxable                     | 14   | (92)       | (78)                         | (235)  | (7)        | (242)                        |
| Tax exempt                            | (3)  |            | (3)                          | (6)  | 1          | (5)                          |
| Interest bearing deposits in<br>banks | 36   | (26)       | 10                           | (72)   | (29)       | (101)                        |
| Federal funds sold                    | 10   | 4          | 14                           | 20   | (63)       | (43)                         |
| Total Interest Income                 | 1,474  | (1,156)    | 318                          | 4,703  | (2,798)    | 1,905                        |
| <b>Interest expense</b>               |  |            |                              |  |            |                              |
| Deposits                              |  |            |                              |  |            |                              |
| Demand                                | 535  | 98         | 633                          | 270  | 238        | 508                          |
| Savings                               | 19   | (30)       | (11)                         | 25   | (116)      | (91)                         |
| Time deposits                         | (3,348)                                      | 1,480      | (1,868)                      | 1,980  | (2,641)    | (661)                        |
| Short-term debt                       | (46)   | (3)        | (49)                         | (172)  | (206)      | (378)                        |
| Long-term debt                        | (128)  | 247        | 119                          | 684  | (378)      | 306                          |
| Total Interest Expense                | (2,968)                                      | 1,792      | (1,176)                      | 2,787  | (3,103)    | (316)                        |
| Net Interest Income                   | \$ 4,442                                     | \$ (2,948) | \$ 1,494                     | \$ 1,916                                     | \$ 305     | \$ 2,221                     |

**Note:** Volume changes have been determined by multiplying the prior years' average rate by the change in average balances outstanding. The rate change is the difference between the total change and the volume change.

**Interest Income**

Tax equivalent interest income increased \$318,000 or 1.15% in 2010, after increasing 7.39% or \$1,905,000 in 2009. Overall, the yield on earning assets decreased .29%, from 5.85% to 5.56%. Average loans outstanding grew during 2010, with average loans outstanding increasing \$23,936,000 to \$443,441,000. Real estate loans increased 8.56% and commercial loans increased 4.29%. Combined these categories accounted for the total increase in year ending loans. Lending conditions within the market were sluggish for the year as a result of the slow economy, approximately one half of the growth in the loan portfolio came from repurchasing loans that had previously been sold to other financial institutions. The remainder of the increase is attributed to the fact that many banks within the market appear to have pulled back on lending due to rising loan losses, exposure to subprime lending, or reduced capital positions.



Average total securities, yielding 3.80%, decreased \$3,162,000 during 2010. Proceeds from the sale and maturity of investment securities were used to fund (in part) the growth in the loan portfolio. Income on loans held for sale totaled \$1,300,000, as compared to the \$1,169,000 during 2009. This category is made up of loans originated by VBS Mortgage and loans that are purchased from a bank that has a large secondary market lending presence (Gateway Bank, California). This arrangement has been used for several years as a higher yielding alternative to federal funds sold. As market rates began to fall in the early part of 2009 the volume of mortgage loan refinancing increased for both VBS Mortgage and Gateway. This trend continued throughout 2010. These loans are short-term, residential real estate loans that have an average life of approximately two weeks. The Bank holds these loans during the period of time between loan closing and when the loan is paid off by the ultimate secondary market purchaser.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued****GAAP Financial Measurements:**

(dollars in thousands).

|   | 2010      | 2009      | 2008      |
|---|-----------|-----------|-----------|
| Interest Income - Loans   | \$ 27,256 | \$ 26,563 | \$ 23,877 |
| Interest Income - Securities and Other Interest-Earnings Assets | 615       | 953       | 1,667     |
| Interest Expense - Deposits                                     | 6,556     | 7,802     | 8,046     |
| Interest Expense - Other Borrowings                             | 2,450     | 2,380     | 2,452     |

|                                  |               |               |               |
|----------------------------------|---------------|---------------|---------------|
| <b>Total Net Interest Income</b> | <b>18,865</b> | <b>17,334</b> | <b>15,046</b> |
|----------------------------------|---------------|---------------|---------------|

**Non-GAAP Financial Measurements:**

|  |     |     |     |
|--|-----|-----|-----|
| Add: Tax Benefit on Tax-Exempt Interest Income - Loans   | 106 | 125 | 133 |
| Add: Tax Benefit on Tax-Exempt Interest Income - Securities and Other Interest-Earnings Assets | 41  | 36  | 118 |

|  |            |            |            |
|--|------------|------------|------------|
| <b>Total Tax Benefit on Tax-Exempt Interest Income</b> | <b>147</b> | <b>161</b> | <b>251</b> |
|--|------------|------------|------------|

|   |                  |                  |                  |
|---|------------------|------------------|------------------|
| <b>Tax-Equivalent Net Interest Income</b> | <b>\$ 19,012</b> | <b>\$ 17,495</b> | <b>\$ 15,297</b> |
|---|------------------|------------------|------------------|

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued****Interest Expense**

Interest expense decreased \$1,176,000 or 11.55% during 2010, which followed a 3.01% decrease or \$316,000 in 2009. The average cost of funds of 2.05% decreased .42% compared to 2009. Average interest bearing liabilities increased \$27,377,000 in 2010 following an increase of \$79,132,000 in 2009. The increase in interest bearing liabilities was primarily the result of an increase in interest bearing demand deposits and time deposits. Interest bearing demand deposits increased primarily due to the Platinum Rewards Checking product. This product pays an above market interest rate, but rewards the customer to adopt certain behaviors that either drive down operating expenses or drive up non-interest income for the Bank. Interest expense of demand deposits increased \$638,000 (48.7%), while the average balance in interest bearing demand deposits increased \$32.2 million in 2010.

Time deposits increased primarily due to the Bank's participation in the Certificate of Deposit Account Registry Service (CDARS), which through reciprocal agreements among banks allows customers to gain access to significantly higher levels of FDIC deposit insurance coverage. Due to declining rates, both locally and nationally, the expense associated with time deposits decreased \$1,868,000 (29.7%) in 2009, in spite of an increase in balances of \$4.5 million. Changes in the cost of funds attributable to rate and volume variances can be found in the table at the top of page 17.

**Noninterest Income**

Noninterest income continues to be an increasingly important factor in maintaining and growing profitability. Management is conscious of the need to constantly review fee income and develop additional sources of complementary revenue.

Exclusive of securities transactions, non-interest income increased 4.77% (\$152,000) in 2010 following a decrease of 1.83% in 2009. Service charges on deposit accounts decreased \$100,000, primarily due to a decrease in overdraft charges. All of the decrease occurred following the implementation of Reg. E which required customers to Opt-In to allowing debit card transactions to create account overdrafts. Other operating income increased \$174,000. This category includes a number of revenue items; however the largest category is debit card revenue. In 2010 debit card revenue totaled \$618,000 versus \$439,000 in 2009 an increase of \$178,000. The increase in revenue can be traced to higher levels of card usage resulting from the increase in the number of checking accounts, primarily the previously mentioned Platinum Rewards Checking product.

Securities transactions in 2010 resulted in net gains of \$349,000 after recognition of impairment write-downs totaling \$65,000 on several holdings within the equities portfolio. This followed a loss of \$1,754,000 in 2009. In 2009, the losses within the securities portfolio were not the result of securities actually sold, but due to the recognition of Other Than Temporary Impairment (OTTI) losses on securities that declined significantly in value. Typically securities are considered impaired when their value has been significantly below cost for over a year. Based on the losses already recognized in 2008, 2009 and 2010, there is reduced risk of additional significant OTTI in 2011.

**Noninterest Expense**

Noninterest expenses increased from \$12,188,000 in 2009 to \$12,741,000 in 2010, a 4.54% increase. Salary and benefits increased .19% to \$6,742,000 in 2010, following a 1.60% increase in 2009. The FDIC insurance assessment increased \$272,000 in 2010 to \$1,207,000. This increase was a result of increases in the standard assessment rates. Other operating expense increased \$281,000 in 2010, following a \$182,000 increase in 2009. Much of the increase was due to an increase in other loan expense and Bank franchise tax. The increase in other loan expense resulted when the bank forfeited an escrow deposit on a loan participation when it chose to not pursue the purchase of the controlling interest in the loan. Noninterest expenses continue to be substantially lower than peer group averages. Total noninterest expense as a percentage of average assets totaled 2.36%, 2.41%, and 2.60%, in 2010, 2009 and 2008, respectively. Peer group averages have ranged between 3.09% and 3.45% over the same time period.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Provision for Loan Losses**

Management evaluates the loan portfolio in light of national and local economic trends, changes in the nature and volume of the portfolio and industry standards. Specific factors considered by management in determining the adequacy of the level of the allowance for loan losses include internally generated loan review reports, past due reports and historical loan loss experience. This review also considers concentrations of loans in terms of geography, business type and level of risk. Management evaluates nonperforming loans relative to their collateral value and makes the appropriate adjustments to the allowance for loan losses when needed. Based on the factors outlined above, the current year provision for loan losses increased from \$4,210,000 in 2009 to \$4,300,000 in 2010. The increase in the provision for loan losses and the current levels of the allowance for loan losses reflect specific reserves related to nonperforming loans, changes in risk rating on loans, net charge-off activity, loan growth, delinquency trends and other credit risk factors that the Company considers in assessing the adequacy of the allowance for loan losses. Actual net loan charge-offs were \$2,350,000 in 2010 and \$2,563,000 in 2009. Loan losses as a percentage of average loans held for investment totaled .53% and .61% in 2010 and 2009, respectively. This loss rate is significantly better than peer group averages which were 1.09% in 2010 and 1.18% in 2009.

**Balance Sheet**

Total assets decreased .07% during the year to \$538,855,000, a decrease of \$368,000 from \$539,223,000 in 2009. Earning assets increased .61% or \$3,030,000 to \$503,531,000 at December 31, 2010. Virtually all of the increase in earning assets resulted from growth in the loan portfolio, loans held for investment increased \$10,744,000 and loans held for sale decreased \$7,404,000. Deposit growth for 2010 totaled \$4,408,000 or 1.05%, much of the growth resulted from the growth in interest bearing demand deposits. The Company continues to utilize its assets well with 93.44% of year-end assets consisting of earning assets.

**Investment Securities**

Average balances in investment securities decreased 16.48% in 2010 to \$16,020,000. Proceeds from the sale or maturity of investments were used in part to support loan growth and for debt repayment. At year end, 3.05% of earning assets of the Company were held as investment securities to provide security for public deposits and to secure repurchase agreements. Management strives to match the types and maturities of securities owned to balance projected liquidity needs, interest rate sensitivity and to maximize earnings through a portfolio bearing low credit risk. Portfolio yields averaged 3.80% for 2010, down from 5.16% in 2009. The decline can be attributed to maturing securities being reinvested at lower rates, due to market conditions.

The Company recognized gains totaling \$349,000 on its equities portfolio. This was net of \$65,000 in losses resulting from Other Than Temporary Impairment (OTTI) write-downs on several of its holdings. Management considers a number of factors in determining whether to recognize OTTI on any of its securities, including current market conditions, historical trends in individual securities, historical trends in the overall market and length of time that a security has been below cost. Additional information on the securities impairment write-downs can be found on page 14 under the caption Securities Impairment and page 19 under the caption Noninterest Income .

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Investment Securities, continued**

The composition of securities at December 31 was:

| <i>(Dollars in thousands)</i>                                    | 2010      | 2009      | 2008      |
|--|-----------|-----------|-----------|
| Available for Sale <sup>1</sup>                                  |           |           |           |
| U.S. Treasury, Agency and Government Sponsored Enterprises (GSE) | \$ 8,001  | \$ 6,012  | \$ 10,194 |
| Municipal  |           |           | 125       |
| Mortgage-backed <sup>2</sup>                                     | 3,931     | 6,170     | 8,574     |
| Corporate bonds  |           | 505       | 281       |
| Marketable equity securities                                     | 3,315     | 3,742     | 3,063     |
| Total  | 15,247    | 16,429    | 22,237    |
| Held to Maturity   |           |           |           |
| U.S. Treasury and Agency   | 109       | 110       | 110       |
| Total  | 109       | 110       | 110       |
| Other Equity Investments   | 8,789     | 9,681     | 8,439     |
| Total Securities   | \$ 24,145 | \$ 26,220 | \$ 30,786 |

<sup>1</sup> At estimated fair value. See Note 4 for amortized cost.<sup>2</sup> Issued by a U.S. Government Agency or secured by U.S. Government Agency collateral.

Maturities and weighted average yields of debt securities at December 31, 2010 are presented in the table below.

Amounts are shown by contractual maturity; expected maturities will differ as issuers may have the right to call or prepay obligations.

| <i>(Dollars in thousands)</i>             | Less than one |       | One to Five |       | Over Five |       | Total     | Yield |
|---|---------------|-------|-------------|-------|-----------|-------|-----------|-------|
|   | Amount        | Yield | Amount      | Yield | Amount    | Yield |           |       |
| <b>Debt Securities Available for Sale</b> |               |       |             |       |           |       |           |       |
| U.S. Treasury, Agency & GSE               | \$            |       | \$ 8,001    | 4.37% | \$        |       | \$ 8,001  | 4.37% |
| Municipal                                 |               |       |             |       |           |       |           |       |
| Mortgage-backed                           | 260           | 3.18% |             |       | 3,671     | 5.18% | 3,931     | 5.05% |
| Corporate bonds                           |               |       |             |       |           |       |           |       |
| Total                                     | \$ 260        | 3.18% | \$ 8,001    | 4.37% | \$ 3,671  | 5.18% | \$ 11,932 | 4.59% |
| <b>Debt Securities Held to Maturity</b>   |               |       |             |       |           |       |           |       |
|   | \$ 109        | 2.25% |             |       |           |       | \$ 109    | 2.25% |

U.S. Treasury &  
Agency

|       |        |       |        |       |
|-------|--------|-------|--------|-------|
| Total | \$ 109 | 2.25% | \$ 109 | 2.25% |
|-------|--------|-------|--------|-------|

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Analysis of Loan Portfolio**

The Company's portfolio of loans held for investment totaled \$445,147,000 at December 31, 2010 compared with \$434,403,000 at the beginning of the year. The Company's policy has been to make conservative loans that are held for future interest income. Collateral required by the Company is determined on an individual basis depending on the purpose of the loan and the financial condition of the borrower. Commercial loans, including agricultural and multi-family loans, increased 5.59% during 2010 to \$153,512,000. Real estate mortgages increased \$10,172,000 (5.62%). Growth has included a variety of loan and collateral types including residential real estate and real estate development. Construction loans decreased \$6,983,000 or 8.09%. The decline in construction loans resulted from the slower economy which reduced construction within the Bank's primary market area and efforts by management to reduce its concentration levels in construction lending. The Bank also has loan participation arrangements with several other banks within the region to aid in diversification of the loan portfolio geographically, by collateral type and by borrower.

Consumer installment loans decreased \$206,000. This category includes personal loans, auto loans and other loans to individuals. This category continues to suffer from strong competition by other providers of automobile financing. Credit card balances increased \$415,000 to \$2,771,000 but are a minor component of the loan portfolio. The following table presents the changes in the loan portfolio over the previous five years.

| <i>(Dollars in thousands)</i> | <b>December 31</b> |                   |                   |                   |                   |
|-------------------------------|--------------------|-------------------|-------------------|-------------------|-------------------|
|                               | <b>2010</b>        | <b>2009</b>       | <b>2008</b>       | <b>2007</b>       | <b>2006</b>       |
| Real estate mortgage          | \$ 190,162         | \$ 180,990        | \$ 161,224        | \$ 141,836        | \$ 137,595        |
| Real estate construction      | 79,337             | 86,320            | 71,259            | 51,301            | 46,669            |
| Consumer installment          | 19,043             | 19,247            | 22,792            | 18,772            | 15,990            |
| Commercial                    | 121,490            | 115,638           | 115,297           | 86,048            | 89,347            |
| Agricultural                  | 19,761             | 19,355            | 18,711            | 15,701            | 14,587            |
| Multi-family residential      | 12,259             | 10,391            | 7,898             | 1,412             | 3,462             |
| Credit cards                  | 2,771              | 2,356             | 1,940             | 1,800             | 1,709             |
| Other                         | 324                | 106               | 112               | 310               | 102               |
| <b>Total Loans</b>            | <b>\$ 445,147</b>  | <b>\$ 434,403</b> | <b>\$ 399,233</b> | <b>\$ 317,180</b> | <b>\$ 309,461</b> |

The following table shows the Company's loan maturity and interest rate sensitivity as of December 31, 2010:

| <i>(Dollars in thousands)</i>           | <b>Less Than</b>  | <b>1-5</b>       | <b>Over</b>       | <b>Total</b>      |
|---|-------------------|------------------|-------------------|-------------------|
|   | <b>1 Year</b>     | <b>Years</b>     | <b>5 Years</b>    |                   |
| Commercial and agricultural loans       | \$ 55,057         | \$ 33,404        | \$ 52,790         | \$ 141,251        |
| Multi-family residential                | 7,383             | 2,233            | 2,643             | 12,259            |
| Real Estate mortgage                    | 56,264            | 56,216           | 77,682            | 190,162           |
| Real Estate construction                | 75,047            | 1,632            | 2,658             | 79,337            |
| Consumer installment/other              | 14,390            | 4,961            | 2,787             | 22,138            |
| <b>Total</b>                            | <b>\$ 208,141</b> | <b>\$ 98,446</b> | <b>\$ 138,560</b> | <b>\$ 445,147</b> |
| Loans with predetermined rates          | 19,481            | 9,611            | 34,699            | 63,791            |
| Loans with variable or adjustable rates | 188,660           | 88,835           | 103,861           | 381,356           |
| <b>Total</b>                            | <b>\$ 208,141</b> | <b>\$ 98,446</b> | <b>\$ 138,560</b> | <b>\$ 445,147</b> |





**Table of Contents**

**Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Analysis of Loan Portfolio, continued**

Residential real estate loans are generally made for a period not to exceed 25 years and are secured by a first deed of trust which normally does not exceed 90% of the appraised value. If the loan to value ratio exceeds 90%, the Company requires additional collateral, guarantees or mortgage insurance. On approximately 96% of the real estate loans, interest is adjustable after each three or five year period. Fixed rate loans are generally made for a fifteen-year or a twenty-year period with an interest rate adjustment after ten years.

Since 1992, fixed rate real estate loans have been funded with fixed rate borrowings from the Federal Home Loan Bank, which allows the Company to control its interest rate risk. In addition, the Company makes home equity loans secured by second deeds of trust with total indebtedness not to exceed 90% of the appraised value. Home equity loans are made for three, five or ten year periods at a fixed rate or as a revolving line of credit.

Construction loans may be made to individuals, who have arranged with a contractor for the construction of a residence, or to contractors that are involved in building pre-sold, spec-homes or subdivisions. The majority of commercial loans are made to small retail, manufacturing and service businesses. Consumer loans are made for a variety of reasons; however, approximately 22% of the loans are secured by automobiles and trucks.

The Company's market area has a stable economy which tends to be less cyclical than the national economy. Major industries in the market area include agricultural production and processing, higher education, retail sales, services and light manufacturing. The agricultural production and processing industry is a major contributor to the local economy and its performance and growth tend to be cyclical in nature, however, this cyclical nature is offset by other stable industries in the trade area. In addition to direct agricultural loans, a large percentage of residential real estate loans and consumer installment loans are made to borrowers whose income is derived from the agricultural sector of the economy. A large percentage of the agricultural loans are made to poultry growers.

Prior to the recent recession, real estate values in the Company's market area for commercial, agricultural and residential property increased, on the average, between 5% and 8% annually depending on the location and type of property, however due to the slowing economy and declining real estate sales it is estimated that values actually have declined during 2009 and 2010. Depending on a number of factors, including property type, location and price point, the decline in value ranges from relatively modest, perhaps 10%, to more severe, up to 30%. Approximately 89% of the Company's loans are secured by real estate; however, policies relating to appraisals and loan to value ratios are adequate to control the related risk. Unemployment rates in the Company's market area continue to be below both the national and state averages.

The Bank has identified loan concentrations of greater than 25% of capital in the following categories, multi-family properties and construction/development. While the Bank has not developed a formal policy limiting the concentration level to any particular loan type or industry segment, it has established target limits on both a nominal and percentage of capital basis. Concentrations are monitored and reported to the board of directors quarterly. Concentration levels have been used by management to determine how aggressively they may price or pursue new loan requests. At December 31, 2010, there are no industry categories of loans that exceed 10% of total loans.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Nonaccrual and Past Due Loans**

Nonperforming loans include nonaccrual loans, loans 90 days or more past due and restructured loans. Nonaccrual loans are loans on which interest accruals have been suspended or discontinued permanently. Restructured loans are loans which have had the original interest rate or repayment terms changed due to financial hardship. Nonperforming loans totaled \$16,486,000 at December 31, 2010 compared to \$7,653,000 at December 31, 2009. Approximately 90% of these past due loans are secured by real estate. Although management expects that there will be some loan losses, the bank is generally well secured and continues to actively work with its customers to effect payment. As of December 31, 2010, the Company holds \$1,513,000 of real estate which was acquired through foreclosure. Although problem loans have increased approximately \$8.2 million since December 31, 2009, most of the increase is limited to two large commercial relationships totaling approximately \$6.7 million. One of these relationships is anticipated to be fully current by the end of March 2011. The other may be brought current by the borrower bringing another partner into the business. However at this point, that situation is questionable and we have begun the foreclosure process. No loss is anticipated on either of these relationships due an evaluation of the values of the properties that we hold as collateral.

The following is a summary of information pertaining to risk elements and impaired loans:

|  | <b>December<br/>31,<br/>2010</b> | <b>September<br/>30,<br/>2010</b> | <b>June<br/>30,<br/>2010</b> | <b>March<br/>31,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|--|----------------------------------|-----------------------------------|------------------------------|-------------------------------|----------------------------------|
| Nonaccrual Loans:  |                                  |                                   |                              |                               |                                  |
| Real Estate  | \$ 5,189                         | \$ 4,456                          | \$ 3,676                     | \$ 4,814                      | \$ 2,995                         |
| Commercial   | 1,656                            | 2,490                             | 1,394                        | 951                           | 261                              |
| Home Equity  | 715                              | 983                               | 356                          | 381                           | 250                              |
| Other  | 30                               | 71                                | 124                          | 151                           |                                  |
| Loans past due 90 days or more:                                  |                                  |                                   |                              |                               |                                  |
| Real Estate  | 3,021                            | 1,112                             | 1,146                        | 1,010                         | 3,475                            |
| Commercial   | 4,581                            | 146                               | 663                          | 1,474                         | 57                               |
| Home Equity  | 588                              | 162                               | 504                          | 111                           | 375                              |
| Other  | 54                               | 75                                | 69                           | 84                            | 240                              |
| Restructured loans:  |                                  |                                   |                              |                               |                                  |
| Real Estate  | 267                              | 267                               |                              |                               |                                  |
| Commercial   | 385                              | 385                               |                              |                               |                                  |
| Total Nonperforming loans  | \$ 16,486                        | \$ 10,147                         | \$ 7,932                     | \$ 8,976                      | \$ 7,653                         |
| Nonperforming loans as a percentage of loans held for investment |                                  |                                   |                              |                               |                                  |
|  | 3.70%                            | 2.27%                             | 1.78%                        | 2.04%                         | 1.76%                            |
| Net Charge Offs to Total Loans                                   | .53%                             | .39%                              | .17%                         | .05%                          | .59%                             |
| Allowance for loan and lease losses to nonperforming loans       | 36.54%                           | 54.77%                            | 61.65%                       | 50.25%                        | 50.12%                           |

**Potential Problem Loans**

Loans classified for regulatory purposes as loss, doubtful, substandard, or special mention do not represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity or capital resources. Nor do they represent material credits about which management is aware of any information which causes it to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms. As of December 31, 2010, management is not aware of any potential problem loans which are not already classified for regulatory purposes or on the watch list as part of the Bank's internal grading system.

**Table of Contents**

**Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Loan Losses and the Allowance for Loan Losses**

In evaluating the portfolio, loans are segregated into loans with identified potential losses, and pools of loans by type (commercial, residential, consumer, credit cards). Loans with identified potential losses include examiner and bank classified loans. Classified relationships in excess of \$200,000 are reviewed individually for impairment under ASC 310. A variety of factors are taken into account when reviewing these credits, including borrower cash flow, payment history, fair value of collateral, company management, industry and economic factors. Loan relationships that are determined to have no impairment are placed back into the appropriate loan pool and reviewed under ASC 450.

Loan pools are further segmented into watch list, past due over 90 days and all other. Watch list loans include loans that are 60 days past due and may include restructured loans, borrowers that are highly leveraged, loans that have been upgraded from classified or loans that contain policy exceptions (term, collateral coverage, etc.). Loss estimates on these loans reflect the increased risk associated with these assets due to any of the above factors. The past due pools contain loans that are currently 90 days or more past due. Loss rates assigned to these past due loans reflect the fact that these loans bear a significant risk of charge-off. Loss rates vary by loan type to reflect the likelihood that collateral values will offset a portion of the anticipated losses.

The remainder of the portfolio falls into pools by type of homogenous loans that do not exhibit any of the above described weaknesses. Loss rates are assigned based on historical rates over the prior two year period. All potential losses are evaluated within a range of low to high. An allowance for environmental factors (such as trends in past due/impaired loans, volume and terms of loans, changes in lending policies/procedures, experience of lending staff/management, local/national economic trends and credit concentrations) has been established to reflect other unidentified losses within the portfolio. The environment factor allowance mitigates the increased risk of loss associated with fluctuations in past due trends, changes in the local and national economies, and other unusual events. The Board approves the loan loss provision for each quarter based on this evaluation. An effort is made to keep the actual allowance at or above the midpoint of the range established by the evaluation process.

The allowance for loan losses of \$5,786,000 at December 31, 2010 is equal to 1.30% of total loans held for investment. This compares to an allowance of \$3,836,000 (.88%) at December 31, 2009 and .55% at December 31, 2008. Management and the Board of Directors have made a concentrated effort at increasing the allowance during the recent recession to reflect the increased risks within the portfolio. While the overall level of the allowance remains below peer group averages, management feels the current reserve level is appropriate. Management has reached this conclusion based on historical losses, delinquency rates, collateral values of delinquent loans and a thorough review of the loan portfolio.

Loan losses, net of recoveries, totaled \$2,350,000 in 2010 which is equivalent to .53% of total loans outstanding. Over the preceding three years, the Company has had an average loss rate of .40%, compared to a 1.05% loss rate for its peer group.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Loan Losses and the Allowance for Loan Losses, continued**

A summary of the activity in the allowance for loan losses follows:

| <i>(Dollars in thousands)</i>                      | <b>2010</b> | <b>2009</b> | <b>2008</b> | <b>2007</b> | <b>2006</b> |
|--|-------------|-------------|-------------|-------------|-------------|
| Balance at beginning of period                     | \$ 3,836    | \$ 2,189    | \$ 1,703    | \$ 1,791    | \$ 1,673    |
| Provision charged to expenses                      | 4,300       | 4,210       | 815         | 270         | 240         |
| Loan losses:                                       |             |             |             |             |             |
| Commercial   | 1,541       | 1,110       | 294         | 331         | 19          |
| Installment  | 211         | 193         | 106         | 119         | 143         |
| Real estate  | 731         | 1,336       |             |             |             |
| Total loan losses                                  | 2,483       | 2,639       | 400         | 450         | 162         |
| Recoveries:  |             |             |             |             |             |
| Commercial   | 54          | 10          | 7           | 9           | 4           |
| Installment  | 77          | 63          | 63          | 83          | 36          |
| Real estate  | 2           | 3           | 1           |             |             |
| Total recoveries                                   | 133         | 76          | 71          | 92          | 40          |
| Net loan losses                                    | (2,350)     | (2,563)     | (329)       | (358)       | (122)       |
| Balance at end of period                           | \$ 5,786    | \$ 3,836    | \$ 2,189    | \$ 1,703    | \$ 1,791    |
| Allowance for loan losses as a percentage of loans | 1.30%       | .88%        | .55%        | .54%        | .58%        |
| Net loan losses to loans outstanding               | .53%        | .59%        | .08%        | .11%        | .04%        |

Refer to Note 6 for the allocation of the allowance for loan losses.

**Deposits and Borrowings**

The Bank recognized an increase in year-end deposits in 2010 of 1.05%. The average deposit balances and average rates paid for 2010, 2009 and 2008 were as follows:

## Average Deposits and Rates Paid

(dollars in thousands)

|                     | 2010       |       | December 31,<br>2009 |       | 2008      |       |
|---------------------|------------|-------|----------------------|-------|-----------|-------|
|                     | Amount     | Rate  | Amount               | Rate  | Amount    | Rate  |
| Noninterest-bearing | \$ 56,328  |       | \$ 51,124            |       | \$ 49,557 |       |
| Interest-bearing:   |            |       |                      |       |           |       |
| Interest Checking   | \$ 110,814 | 1.75% | \$ 78,556            | 1.66% | \$ 58,682 | 1.36% |
| Savings Accounts    | 35,666     | .54%  | 32,650               | .62%  | 30,073    | .97%  |
| Time Deposits:      |            |       |                      |       |           |       |
| CDARS               | 37,102     | 1.08% | 28,667               | 1.55% | 877       | 3.08% |
| \$100,000 or more   | 83,669     | 1.34% | 92,414               | 1.99% | 59,949    | 3.18% |
| Less than \$100,000 | 102,147    | 2.84% | 97,315               | 4.12% | 109,152   | 4.60% |

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|                        |            |       |            |       |            |       |
|------------------------|------------|-------|------------|-------|------------|-------|
| Total Interest-bearing | 369,398    | 1.77% | 329,602    | 2.37% | 258,733    | 3.11% |
| Total deposits         | \$ 425,726 | 1.54% | \$ 380,726 | 2.05% | \$ 308,290 | 2.61% |

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Deposits and Borrowings, continued**

This Discussion relates to table of Average balances on the previous page. Noninterest-bearing demand deposits, which are comprised of checking accounts, increased \$5,204,000 or 10.2% from \$51,124,000 at December 31, 2009 to \$56,328,000 at December 31, 2010. Interest-bearing deposits, which include interest checking accounts, money market accounts, regular savings accounts and time deposits, increased \$39,796,000 or 12.07% from \$329,602,000 at December 31, 2009 to \$369,398,000 at December 31, 2010. Total interest checking (including money market) account balances increased \$32,258,000 or 41.06% from \$78,556,000 at December 31, 2009 to \$110,814,000 at December 31, 2010. Total savings account balances increased \$3,016,000 or 9.24% from \$32,650,000 at December 31, 2009 to \$35,666,000 at December 31, 2010.

CDARS deposits increased \$8,435,000 or 29.4% from \$28,667,000 at December 31, 2009 to \$37,102,000 at December 31, 2010. Time deposits increased \$4,523,000 or 2.01% from \$218,396,000 at December 31, 2009 to \$222,919,000 at December 31, 2010. This is comprised of a decrease in certificates of deposit of \$100,000 and more of \$8,745,000 or 9.5% from \$92,414,000 at December 31, 2009 to \$83,669,000 at December 31, 2010, an increase in certificates of deposit of less than \$100,000 of \$4,832,000 or 5.0% from \$97,315,000 at December 31, 2009 to \$102,147,000 at December 31, 2010 and an increase in CDARS deposits of \$8,435,000 or 29.42% from \$28,667,000 at December 31, 2009 to \$37,102,000 at December 31, 2010. The Bank joined the CDARS network in 2008, which allows it to offer over \$50 million in FDIC insurance on a certificate of deposit.

The maturity distribution of certificates of deposit of \$100,000 or more is as follows:

| <i>(Actual Dollars in thousands)</i> | <b>2010</b>      | <b>2009</b>      |
|--------------------------------------|------------------|------------------|
| Less than 3 months                   | \$ 6,426         | \$ 31,381        |
| 3 to 12 months                       | 41,712           | 36,631           |
| 1 year to 5 years                    | 31,922           | 31,318           |
| <b>Total</b>                         | <b>\$ 80,060</b> | <b>\$ 99,330</b> |

Non-deposit borrowings include repurchase agreements, federal funds purchased, Federal Home Loan Bank (FHLB) borrowings and the issue of Subordinated Debt. Repurchase agreements continue to be an important source of funding and provide commercial customers the opportunity to earn market rates of interest on funds that are secured by specific securities owned by the Bank. See Note 10 Short Term Debt for short term borrowing disclosures. Borrowings from the Federal Home Loan Bank are used to support the Bank's lending program and allow the Bank to manage interest rate risk by laddering maturities and matching funding terms to the terms of various loan types in the loan portfolio. The Bank borrowed \$11,250,000 in 2010 and \$22,250,000 in 2009 in long term loans. Repayment of amortizing and fixed maturity loans through FHLB totaled \$21,596,000 for the year. These loans carry an average rate of 3.12% at December 31, 2010.

Contractual Obligations and Scheduled Payments (dollars in thousands)

|            | December 31, 2010  |                              |                                |                      | Total     |
|------------|--------------------|------------------------------|--------------------------------|----------------------|-----------|
|            | Less than One Year | One Year Through Three Years | Three Years Through Five Years | More than Five Years |           |
| FHLB Notes | \$ 4,773           | \$ 2,155                     | \$ 33,107                      | \$ 5,000             | \$ 45,035 |
| PVB Note   | 1,000              | 2,000                        | 1,000                          |                      | 4,000     |
|            | 5,355              |                              |                                |                      | 5,355     |

Securities sold under agreements to  
repurchase

|                   |  |  |  |       |       |
|-------------------|--|--|--|-------|-------|
| Subordinated Debt |  |  |  | 9,944 | 9,944 |
|-------------------|--|--|--|-------|-------|

|       |           |          |           |           |           |
|-------|-----------|----------|-----------|-----------|-----------|
| Total | \$ 11,128 | \$ 4,155 | \$ 34,107 | \$ 14,944 | \$ 64,334 |
|-------|-----------|----------|-----------|-----------|-----------|

The \$45,035,000 in outstanding FHLB advances is comprised of thirteen advances. Note 11 to the Consolidated Financial Statements discusses the rates, terms, and conversion features on these advances



**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Stockholder's Equity**

Total stockholders' equity increased \$3,227,000 or 8.27% in 2010. While net income totaled \$3,741,000, noncontrolling interest net income totaled \$63,000, sales of common stock totaled \$196,000 and changes in other comprehensive income increased \$260,000, capital was reduced by dividends (\$1.033 million). As of December 31, 2010, book value per share was \$18.31 compared to \$16.99 as of December 31, 2009. Dividends are paid to stockholders on a quarterly basis in uniform amounts unless unexpected fluctuations in net income indicate a change to this policy is needed.

Banking regulators have established a uniform system to address the adequacy of capital for financial institutions. The rules require minimum capital levels based on risk-adjusted assets. Simply stated, the riskier an entity's investments, the more capital it is required to maintain. The Bank, as well as the Company, is required to maintain these minimum capital levels. The two types of capital guidelines are Tier I capital (referred to as core capital) and Tier II capital (referred to as supplementary capital). At December 31, 2010, the Company had Tier I capital of 9.77% of risk weighted assets and combined Tier I and II capital of 13.51% of risk weighted assets. Regulatory minimums at this date were 4% and 8%, respectively. The Bank has maintained capital levels far above the minimum requirements throughout the year. In the unlikely event that such capital levels are not met, regulatory agencies are empowered to require the Company to raise additional capital and/or reallocate present capital.

In addition, the regulatory agencies have issued guidelines requiring the maintenance of a capital leverage ratio. The leverage ratio is computed by dividing Tier I capital by average total assets. The regulators have established a minimum of 3% for this ratio, but can increase the minimum requirement based upon an institution's overall financial condition. At December 31, 2010, the Company reported a leverage ratio of 7.37%. The Bank's leverage ratio was also substantially above the minimum.

**Market Risk Management**

Most of the Company's net income is dependent on the Bank's net interest income. Rapid changes in short-term interest rates may lead to volatility in net interest income resulting in additional interest rate risk to the extent that imbalances exist between the maturities or repricing of interest bearing liabilities and interest earning assets. The net interest margin increased .07% in 2010 following a decrease of .19% in 2009. Due to a slowing of the national economy and market turbulence related to the sub-prime mortgage lending crisis, the Federal Reserve began cutting short term interest rates in September 2007. The Federal Reserve has cut short term rates a total of 5.00% to a target of 0 to .25%. Net interest income is also affected by changes in the mix of funding that supports earning assets. For example, higher levels of non-interest bearing demand deposits and leveraging earning assets by funding with stockholder's equity would result in greater levels of net interest income than if most of the earning assets were funded with higher cost interest-bearing liabilities, such as certificates of deposit.

Liquidity as of December 31, 2010 is acceptable; the Bank historically has had a stable core deposit base and, therefore, does not have to rely on volatile funding sources. Because of the stable core deposit base, changes in interest rates should not have a significant effect on liquidity. The Bank's membership in the Federal Home Loan Bank has historically provided liquidity as the Bank borrows money that is repaid over a five to ten year period and uses the money to make fixed rate loans. The matching of the long-term receivables and liabilities helps the Bank reduce its sensitivity to interest rate changes. The Company reviews its interest rate gap periodically and makes adjustments as needed. There are no off balance sheet items that will impair future liquidity.

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**Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Market Risk Management, continued**

The following table depicts the Company's interest rate sensitivity, as measured by the repricing of its interest sensitive assets and liabilities as of December 31, 2010. As the notes to the table indicate, the data was based in part on assumptions as to when certain assets or liabilities would mature or reprice. The analysis indicates an asset sensitive one-year cumulative GAP position of 17.87% of total earning assets, compared to 6.86% in 2009. Approximately 51.08% of rate sensitive assets and 38.80% of rate sensitive liabilities are subject to repricing within one year. Short term assets (less than one year) increased \$5,639,000 during the year, while total earning assets increased \$3,030,000. Growth in the loan portfolio was concentrated in real estate secured loans, including both amortizing residential and commercial loans which typically have an initial rate adjustment period of three to five years and construction loans which typically have a term of one year and a rate that floats with the prime rate. Short term liabilities decreased \$50,050,000, while total interest bearing liabilities decreased \$8,460,000. Due to the relatively flat yield curve, management has aggressively cut deposit rates and has lengthened the term on some of its fixed rate borrowings with the FHLB. These actions and the increase in interest bearing deposits (which are allocated based on FDICIA 305) have resulted in the increase in the positive GAP position in the one year time period.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Market Risk Management, continued**

The following GAP analysis shows the time frames as of December 31, 2010, in which the Company's assets and liabilities are subject to repricing:

| <i>(Dollars in thousands)</i>    | <b>1-90<br/>Days</b> | <b>91-365<br/>Days</b> | <b>1-5<br/>Years</b> | <b>Over 5<br/>Years</b> | <b>Not<br/>Classified</b> | <b>Total</b>   |
|----------------------------------|----------------------|------------------------|----------------------|-------------------------|---------------------------|----------------|
| Rate Sensitive Assets:           |                      |                        |                      |                         |                           |                |
| Loans held for investment        | \$ 161,566           | \$ 43,804              | \$ 213,484           | \$ 23,522               | \$                        | \$ 442,376     |
| Loans held for sale              | 23,764               |                        |                      |                         |                           | 23,764         |
| Federal Funds Sold               | 16,338               |                        |                      |                         |                           | 16,338         |
| Investments securities           | 55                   | 6,202                  | 2,112                | 3,671                   | 3,315                     | 15,355         |
| Credit Cards                     | 2,771                |                        |                      |                         |                           | 2,771          |
| Interest bearing bank deposits   | 936                  | 1,743                  | 248                  |                         |                           | 2,927          |
| <b>Total</b>                     | <b>205,430</b>       | <b>51,749</b>          | <b>215,844</b>       | <b>27,193</b>           | <b>3,315</b>              | <b>503,531</b> |
| Rate Sensitive Liabilities:      |                      |                        |                      |                         |                           |                |
| Interest bearing demand deposits |                      |                        |                      |                         |                           |                |
| Savings                          |                      | 30,217                 | 67,855               | 18,818                  |                           | 116,890        |
| Certificates of deposit          |                      |                        |                      |                         |                           |                |
| \$100,000 and over               | 6,426                | 41,712                 | 31,922               |                         |                           | 80,060         |
| Other certificates of deposit    | 17,356               | 51,027                 | 65,462               |                         |                           | 133,845        |
| <b>Total Deposits</b>            | <b>23,782</b>        | <b>130,108</b>         | <b>186,695</b>       | <b>25,970</b>           |                           | <b>366,555</b> |
| Short-term debt                  | 5,355                |                        |                      |                         |                           | 5,355          |
| Long-term debt                   | 5,023                | 2,905                  | 36,107               | 14,944                  |                           | 58,979         |
| <b>Total</b>                     | <b>34,160</b>        | <b>133,013</b>         | <b>222,802</b>       | <b>40,914</b>           |                           | <b>430,889</b> |
| Discrete Gap                     | 171,270              | (81,264)               | (6,958)              | (13,721)                | 3,315                     | 72,642         |
| Cumulative Gap                   | 171,270              | 90,006                 | 83,048               | 69,327                  | 72,642                    |                |
| As a % of Earning Assets         | 34.01%               | 17.87%                 | 16.49%               | 13.77%                  | 14.43%                    |                |

In preparing the above table, no assumptions are made with respect to loan prepayments or deposit run off. Loan principal payments are included in the earliest period in which the loan matures or can be repriced. Principal payments on installment loans scheduled prior to maturity are included in the period of maturity or repricing. Proceeds from the redemption of investments and deposits are included in the period of maturity. Estimated maturities on deposits which have no stated maturity dates were derived from guidance contained in FDICIA 305.

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**Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**

**Recent Accounting Pronouncements**

In July 2010, the Receivables topic of the ASC was amended to require expanded disclosures related to a company's allowance for credit losses and the credit quality of its financing receivables. The amendments will require the allowance disclosures to be provided on a disaggregated basis. The Company is required to begin to comply with the disclosures in its financial statements for the year ended December 31, 2010. Disclosures about Troubled Debt Restructurings (TDRs) required by the Update have been deferred by FASB in an update issued in early 2011. The TDR disclosures are anticipated to be effective for periods ending after June 15, 2011.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes several provisions that will affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolish the Office of Thrift Supervision and transfer its functions to the other federal banking agencies, relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage, and impose new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also establishes the Bureau of Consumer Financial Protection as an independent entity within the Federal Reserve, which will be given the authority to promulgate consumer protection regulations applicable to all entities offering consumer financial services or products, including banks. Additionally, the Dodd-Frank Act includes a series of provisions covering mortgage loan origination standards affecting originator compensation, minimum repayment standards, and pre-payments. Management is actively reviewing the provisions of the Dodd-Frank Act and assessing its probable impact on our business, financial condition, and results of operations.

In August 2010, two updates were issued to amend various SEC rules and schedules pursuant to Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules and Codification of Financial Reporting Policies and based on the issuance of SEC Staff Accounting Bulletin 112. The amendments related primarily to business combinations and removed references to minority interest and added references to controlling and noncontrolling interests(s). The updates were effective upon issuance but had no impact on the Company's financial statements.

In December 2010, the Intangibles topic of the ASC was amended to modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. Any resulting goodwill impairment should be recorded as a cumulative-effect adjustment to beginning retained earnings upon adoption. Impairments occurring subsequent to adoption should be included in earnings. The amendment is effective for the Company beginning January 1, 2011. Early adoption is not permitted.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations, continued**  
**Quarterly Results (unaudited)**

The table below lists the Company's quarterly performance for the years ended December 31, 2010 and 2009:

| <i>(Dollars in thousands)</i>                        | <b>2010</b>   |              |               |              |              |
|--|---------------|--------------|---------------|--------------|--------------|
|  | <b>Fourth</b> | <b>Third</b> | <b>Second</b> | <b>First</b> | <b>Total</b> |
| Interest and Dividend Income                         | \$ 7,086      | \$ 7,075     | \$ 6,902      | \$ 6,807     | \$ 27,870    |
| Interest Expense                                     | 2,136         | 2,213        | 2,252         | 2,404        | 9,005        |
| Net Interest Income                                  | 4,950         | 4,862        | 4,650         | 4,403        | 18,865       |
| Provision for Loan Losses                            | 1,200         | 1,300        | 900           | 900          | 4,300        |
| Net Interest Income after Provision, For Loan Losses | 3,750         | 3,562        | 3,750         | 3,503        | 14,565       |
| Non-Interest Income                                  | 853           | 1,094        | 895           | 756          | 3,598        |
| Non-Interest Expense                                 | 3,095         | 3,257        | 3,243         | 3,146        | 12,741       |
| Income before taxes                                  | 1,508         | 1,399        | 1,402         | 1,113        | 5,422        |
| Income Tax Expense                                   | 394           | 508          | 422           | 357          | 1,681        |
| Net Income   | \$ 1,114      | \$ 891       | \$ 980        | \$ 756       | \$ 3,741     |
| Net Income Per Share                                 | \$ .48        | \$ .39       | \$ .43        | \$ .33       | \$ 1.63      |
|  |               |              | <b>2009</b>   |              |              |
| <i>(Dollars in thousands)</i>                        | <b>Fourth</b> | <b>Third</b> | <b>Second</b> | <b>First</b> | <b>Total</b> |
| Interest and Dividend Income                         | \$ 7,035      | \$ 6,761     | \$ 7,019      | \$ 6,701     | \$ 27,516    |
| Interest Expense                                     | 2,458         | 2,475        | 2,548         | 2,701        | 10,182       |
| Net Interest Income                                  | 4,577         | 4,286        | 4,471         | 4,000        | 17,334       |
| Provision for Loan Losses                            | 900           | 2,790        | 310           | 210          | 4,210        |
| Net Interest Income after Provision For Loan Losses  | 3,677         | 1,496        | 4,161         | 3,790        | 13,124       |
| Non-Interest Income                                  | 718           | (101)        | 420           | 320          | 1,357        |
| Non-Interest Expense                                 | 3,057         | 3,249        | 3,088         | 2,794        | 12,188       |
| Income before taxes                                  | 1,338         | (1,854)      | 1,493         | 1,316        | 2,293        |
| Income Tax Expense                                   | 483           | (978)        | 402           | 432          | 339          |

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|                      |        |          |          |        |          |
|----------------------|--------|----------|----------|--------|----------|
| Net Income           | \$ 855 | \$ (876) | \$ 1,091 | \$ 884 | \$ 1,954 |
| Net Income Per Share | \$ .36 | \$ (.38) | \$ .48   | \$ .39 | \$ .85   |

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**Table of Contents****Item 8. Financial Statements and Supplementary Information****F & M Bank Corp. and Subsidiaries***Consolidated Balance Sheets**December 31, 2010 and 2009*

|  | <b>2010</b>    | <b>2009</b>    |
|--|----------------|----------------|
| <b>Assets</b>  |                |                |
| Cash and due from banks (notes 3 and 14)   | \$ 4,585,693   | \$ 5,314,285   |
| Federal funds sold   | 16,338,229     | 18,326,000     |
| Cash and cash equivalents  | 20,923,922     | 23,640,285     |
| Interest bearing deposits (note 14)  | 2,926,978      | 64,971         |
| Securities:  |                |                |
| Held to maturity fair value of \$108,974 and \$109,813 in 2010 and 2009, respectively (note 4) | 108,974        | 109,813        |
| Available for sale (note 4)  | 15,246,524     | 16,429,533     |
| Other investments (note 4)   | 8,788,997      | 9,680,733      |
| Loans held for sale  | 23,764,237     | 31,167,763     |
| Loans held for investment (notes 5 and 14)   | 445,147,227    | 434,402,916    |
| Less allowance for loan losses (note 6)  | (5,785,633)    | (3,835,698)    |
| Net Loans Held for Investment  | 439,361,594    | 430,567,218    |
| Other real estate owned (note 8)   | 1,513,199      | 525,897        |
| Bank premises and equipment, net (note 7)  | 6,792,494      | 7,079,504      |
| Interest receivable  | 2,001,226      | 2,037,612      |
| Core deposit intangible (note 22)  | 45,771         | 321,932        |
| Goodwill (note 22)   | 2,669,517      | 2,669,517      |
| Bank owned life insurance (note 23)  | 6,883,248      | 6,593,081      |
| Other assets   | 7,827,883      | 8,334,778      |
| Total Assets   | \$ 538,854,564 | \$ 539,222,637 |
| <b>Liabilities</b>   |                |                |
| Deposits: (note 9)   |                |                |
| Noninterest bearing  | \$ 58,497,146  | \$ 53,475,063  |
| Interest bearing:  |                |                |
| Demand   | 94,090,825     | 77,483,164     |
| Money market accounts  | 22,798,543     | 23,230,861     |
| Savings  | 35,759,634     | 34,228,965     |
| Time deposits over \$100,000   | 80,060,033     | 99,329,716     |
| All other time deposits  | 133,844,576    | 132,895,542    |
| Total Deposits   | 425,050,757    | 420,643,311    |
| Short-term debt (note 10)  | 5,354,992      | 9,084,909      |

|                          |             |             |
|--------------------------|-------------|-------------|
| Accrued liabilities      | 7,240,003   | 7,396,233   |
| Subordinated debt        | 9,944,000   | 2,715,000   |
| Long-term debt (note 11) | 49,035,464  | 60,380,702  |
| Total Liabilities        | 496,625,216 | 500,220,155 |

## Commitments and Contingencies (note 15)

**Stockholders Equity (Note 21)**

|  |                |                |
|--|----------------|----------------|
| Common stock \$5 par value, 6,000,000 shares authorized, 2,306,086 and 2,295,053 shares issued and outstanding for 2010 and 2009, respectively | 11,530,430     | 11,475,265     |
| Capital surplus  |                |                |
| Retained earnings (note 18)  | 30,837,090     | 27,989,144     |
| Noncontrolling interest  | 186,133        | 122,709        |
| Accumulated other comprehensive income (loss)  | (324,305)      | (584,636)      |
| Total Stockholders Equity  | 42,229,348     | 39,002,482     |
| Total Liabilities and Stockholders Equity  | \$ 538,854,564 | \$ 539,222,637 |

*The accompanying notes are an integral part of this statement.*



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**F & M Bank Corp. and Subsidiaries**  
**Consolidated Statements of Income**  
**For the years ended 2010, 2009 and 2008**

|  | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|--|-------------------|-------------------|-------------------|
| <b><i>Interest and Dividend Income</i></b>                 |                   |                   |                   |
| Interest and fees on loans held for investment             | \$ 25,955,716     | \$ 25,393,347     | \$ 23,638,923     |
| Interest on loans held for sale                            | 1,300,373         | 1,169,228         | 238,249           |
| Interest on deposits and federal funds sold                | 46,715            | 23,533            | 167,441           |
| Interest on debt securities                                | 369,932           | 697,982           | 970,523           |
| Dividends on equity securities                             | 197,737           | 231,838           | 529,268           |
| <b>Total Interest and Dividend Income</b>                  | <b>27,870,473</b> | <b>27,515,928</b> | <b>25,544,404</b> |
| <b><i>Interest Expense</i></b>                             |                   |                   |                   |
| Interest on demand deposits                                | 1,939,352         | 1,306,439         | 798,137           |
| Interest on savings deposits                               | 190,838           | 202,027           | 293,461           |
| Interest on time deposits over \$100,000                   | 1,120,415         | 1,551,360         | 1,906,538         |
| Interest on all other time deposits                        | 3,305,294         | 4,742,443         | 5,047,994         |
| <b>Total interest on deposits</b>                          | <b>6,555,899</b>  | <b>7,802,269</b>  | <b>8,046,130</b>  |
| Interest on short-term debt                                | 28,485            | 77,818            | 456,398           |
| Interest on long-term debt                                 | 2,421,159         | 2,302,246         | 1,995,514         |
| <b>Total Interest Expense</b>                              | <b>9,005,543</b>  | <b>10,182,333</b> | <b>10,498,042</b> |
| <b><i>Net Interest Income</i></b>                          | <b>18,864,930</b> | <b>17,333,595</b> | <b>15,046,362</b> |
| <b><i>Provision for Loan losses</i></b> (note 6)           | <b>4,300,000</b>  | <b>4,210,000</b>  | <b>815,000</b>    |
| <b>Net Interest Income After Provision for Loan Losses</b> | <b>14,564,930</b> | <b>13,123,595</b> | <b>14,231,362</b> |
| <b><i>Noninterest Income (Expenses)</i></b>                |                   |                   |                   |
| Service charges on deposit accounts                        | 1,193,081         | 1,292,965         | 1,356,494         |
| Insurance and other commissions                            | 548,828           | 476,734           | 271,078           |
| Other operating income                                     | 1,260,900         | 1,086,890         | 1,193,991         |
| Income on bank owned life insurance                        | 336,727           | 330,756           | 336,459           |
| Other than temporary impairment losses                     | (65,158)          | (1,751,169)       | (1,758,730)       |
| Gain (loss) on the sale of securities (note 4)             | 413,970           | (2,424)           | 78,173            |
| <b>Total Noninterest Income</b>                            | <b>3,688,348</b>  | <b>1,433,752</b>  | <b>1,477,465</b>  |

***Noninterest Expenses***

|  |                     |                     |                     |
|--|---------------------|---------------------|---------------------|
| Salaries   | 5,126,414           | 5,037,699           | 5,131,045           |
| Employee benefits (note 13)                      | 1,615,222           | 1,690,834           | 1,491,847           |
| Occupancy expense                                | 551,334             | 563,923             | 578,735             |
| Equipment expense                                | 590,822             | 592,075             | 564,410             |
| Amortization of intangibles (notes 2 and 22)     | 275,942             | 275,942             | 275,942             |
| FDIC insurance assessment                        | 1,207,333           | 934,864             | 144,308             |
| Other operating expenses                         | 3,374,177           | 3,092,799           | 2,911,190           |
| <b>Total Noninterest Expenses</b>                | <b>12,741,244</b>   | <b>12,188,136</b>   | <b>11,097,477</b>   |
| <br>   |                     |                     |                     |
| Income before Income Taxes                       | 5,512,034           | 2,369,211           | 4,611,350           |
| <b><i>Income Tax Expense</i></b> (note 12)       | <b>1,681,392</b>    | <b>339,309</b>      | <b>1,418,628</b>    |
| <br>   |                     |                     |                     |
| Consolidated Net Income                          | 3,830,642           | 2,029,902           | 3,192,722           |
| <b><i>Net Income Noncontrolling interest</i></b> | <b>(89,982)</b>     | <b>(75,880)</b>     | <b>11,294</b>       |
| <br>   |                     |                     |                     |
| <b>Net Income-F &amp; M Bank Corp.</b>           | <b>\$ 3,740,660</b> | <b>\$ 1,954,022</b> | <b>\$ 3,204,016</b> |
| <br>   |                     |                     |                     |
| <b><i>Per Share Data</i></b>                     |                     |                     |                     |
| <b>Net Income</b>                                | <b>1.63</b>         | <b>.85</b>          | <b>1.38</b>         |
| <br>   |                     |                     |                     |
| <b>Cash Dividends</b>                            | <b>.60</b>          | <b>.84</b>          | <b>.90</b>          |
| <br>   |                     |                     |                     |
| <b><i>Average Common Shares Outstanding</i></b>  | <b>2,299,294</b>    | <b>2,291,845</b>    | <b>2,318,998</b>    |

*The accompanying notes are an integral part of this statement.*

**Table of Contents****F & M Bank Corp. and Subsidiaries****Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income  
For the years ended December 31, 2010, 2009 and 2008**

|   | Common<br>Stock | Capital<br>Surplus | Retained<br>Earnings | Noncontrolling<br>Interest | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total         |
|---|-----------------|--------------------|----------------------|----------------------------|---|---------------|
| <b>Balance</b>  |                 |                    |                      |                            |   |               |
| <b>December 31, 2007</b>                                    | \$ 11,719,450   |                    | \$ 28,409,273        |                            | \$ (964,042)  | \$ 39,164,681 |
| Cumulative effect of<br>initial adoption of<br>EITF 06-4    |                 |                    | (428,112)            |                            |   | (428,112)     |
| Comprehensive<br>Income:                                    |                 |                    |                      |                            |   |               |
| Net income  |                 |                    | 3,204,016            | (11,294)                   |   | 3,192,722     |
| Minority Interest<br>Contributed Capital<br>(Distributions) |                 |                    |                      | 58,123                     |   | 58,123        |
| Net change in other<br>comprehensive<br>income (note 2)     |                 |                    |                      |                            | (1,912,214)   | (1,912,214)   |
| Total Comprehensive<br>Income                               |                 |                    |                      |                            |   | 1,338,631     |
| Dividends on<br>common stock                                |                 |                    | (2,083,015)          |                            |   | (2,083,015)   |
| Stock issued (3,951<br>shares)                              | 19,755          | 98,380             |                      |                            |   | 118,135       |
| Stock repurchased<br>(58,344 shares)                        | (291,720)       | (98,380)           | (1,415,417)          |                            |   | (1,805,517)   |
| <b>Balance</b>  |                 |                    |                      |                            |   |               |
| <b>December 31, 2008</b>                                    | 11,447,485      |                    | 27,686,745           | 46,829                     | (2,876,256)   | 36,304,803    |
| Comprehensive<br>Income:                                    |                 |                    |                      |                            |   |               |
| Net income  |                 |                    | 1,954,022            | 75,880                     |   | 2,029,902     |
| Minority Interest<br>Contributed Capital<br>(Distributions) |                 |                    |                      |                            |   |               |
| Net change in other<br>comprehensive<br>income (note 2)     |                 |                    |                      |                            | 2,291,620   | 2,291,620     |
| Total Comprehensive<br>Income                               |                 |                    |                      |                            |   | 4,321,522     |

|   |               |               |            |              |               |
|---|---------------|---------------|------------|--------------|---------------|
| Dividends on common stock                         |               | (1,742,637)   |            |              | (1,742,637)   |
| Stock issued (8,478 shares)                       | 38,390        | 134,680       |            |              | 173,070       |
| Stock repurchased (2,122 shares)                  | (10,610)      | (43,666)      |            |              | (54,276)      |
| <b>Balance</b>                                    |               |               |            |              |               |
| <b>December 31, 2009</b>                          | 11,475,265    | 27,989,144    | 122,709    | (584,636)    | 39,002,482    |
| Comprehensive Income:                             |               |               |            |              |               |
| Net income  |               | 3,740,660     | 89,982     |              | 3,830,642     |
| Minority Interest                                 |               |               |            |              |               |
| Contributed Capital (Distributions)               |               |               | (26,558)   |              | (26,558)      |
| Net change in other comprehensive income (note 2) |               |               |            | 260,331      | 260,331       |
| Total Comprehensive Income                        |               |               |            |              | 4,064,415     |
| Dividends on common stock                         |               | (1,033,632)   |            |              | (1,033,632)   |
| Stock issued (11,033 shares)                      | 55,165        | 140,918       |            |              | 196,083       |
| <b>Balance</b>                                    |               |               |            |              |               |
| <b>December 31, 2010</b>                          | \$ 11,530,430 | \$ 30,837,090 | \$ 186,133 | \$ (324,305) | \$ 42,229,348 |

*The accompanying notes are an integral part of this statement.*

**Table of Contents**

**F & M Bank Corp. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**For the years ended December 31, 2010, 2009 and 2008**

|   | <b>2010</b>  | <b>2009</b>  | <b>2008</b>  |
|---|--------------|--------------|--------------|
| <b><i>Cash Flows from Operating Activities</i></b>  |              |              |              |
| Net income  | \$ 3,740,660 | \$ 1,954,022 | \$ 3,204,016 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |              |              |              |
| (Gain) loss on the sale of securities   | (413,970)    | 2,424        | (78,173)     |
| Other than temporary impairment losses  | 65,158       | 1,751,169    | 1,758,730    |
| Depreciation  | 635,706      | 654,401      | 630,314      |
| Amortization (Accretion) of securities  | 50,031       | 27,383       | (29,717)     |
| Net decrease (increase) in loans held for sale  | 7,403,526    | (27,387,476) | (3,780,287)  |
| Provision for loan losses   | 4,300,000    | 4,210,000    | 815,000      |
| Benefit for deferred taxes  | (350,392)    | (694,041)    | (159,824)    |
| (Increase) decrease in interest receivable  | 36,386       | 18,550       | (124,187)    |
| (Increase) decrease in other assets   | 710,961      | (3,187,314)  | (69,785)     |
| Increase (decrease) in accrued expenses   | 233,194      | (15,740)     | 538,980      |
| Change in pension liability   | 38,002       | 852,683      | (1,835,082)  |
| Amortization of limited partnership investments   | 407,537      | 370,808      | 431,584      |
| Gain on sale of other real estate owned   | (49,828)     |              |              |
| Amortization of intangibles   | 275,942      | 275,942      | 275,942      |
| Gain on sale of property and equipment  |              |              | (1,902)      |
| Income from life insurance investment   | (290,167)    | (288,818)    | (298,952)    |
| Net Cash Provided by (Used in) Operating Activities   | 16,792,746   | (21,456,007) | 1,276,657    |
| <b><i>Cash Flows from Investing Activities</i></b>  |              |              |              |
| (Increase) decrease in interest bearing bank deposits                                       | (2,862,007)  | 1,097,294    | 1,969,600    |
| Purchase of securities held to maturity   | (110,000)    |              |              |
| Proceeds from maturities of securities held to maturity                                     | 110,062      |              |              |
| Proceeds from maturities of securities available for sale                                   | 1,859,712    | 17,618,208   | 23,843,841   |
| Proceeds from sales of securities available for sale  | 23,630,342   | 32,228       | 1,511,286    |
| Purchases of securities available for sale  | (23,149,597) | (12,724,664) | (22,654,078) |
| Net increase in loans held for investment   | (15,912,135) | (38,259,840) | (82,381,163) |
| Purchase of property and equipment  | (348,696)    | (276,777)    | (864,047)    |
| Proceeds from sale of other real estate owned   | 1,880,285    |              |              |
| Net Cash Used in Investing Activities   | (14,902,034) | (32,513,551) | (78,574,561) |
| <b><i>Cash Flows from Financing Activities</i></b>  |              |              |              |
| Net change in federal funds purchased   |              |              | (2,932,000)  |
| Net change in demand and savings deposits   | 22,728,095   | 46,713,540   | 8,147,063    |
| Net change in time deposits   | (18,320,649) | 31,704,568   | 35,518,478   |
| Net change in short-term debt   | (3,729,917)  | (11,425,378) | 10,699,236   |
| Dividends paid in cash  | (1,364,449)  | (1,932,332)  | (2,103,775)  |

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|  |               |               |               |
|--|---------------|---------------|---------------|
| Proceeds from long-term debt                         | 11,250,000    | 27,400,000    | 39,747,500    |
| Proceeds for issuance of subordinated debt           | 7,229,000     | 2,715,000     |               |
| Payments to repurchase common stock                  |               | (54,276)      | (1,805,517)   |
| Proceeds from issuance of common stock               | 196,083       | 173,071       | 118,135       |
| Repayments of long-term debt                         | (22,595,238)  | (32,350,131)  | (4,130,953)   |
| Net Cash Provided by (Used in) Financing Activities  | (4,607,075)   | 62,944,062    | 83,258,167    |
| Net Increase (Decrease) in Cash and Cash Equivalents | (2,716,363)   | 8,974,504     | 5,960,263     |
| Cash and Cash Equivalents, Beginning of Year         | 23,640,285    | 14,665,781    | 8,705,518     |
| Cash and Cash Equivalents, End of Year               | \$ 20,923,922 | \$ 23,640,285 | \$ 14,665,781 |

Supplemental Disclosure:

Cash paid for:

|  |               |               |               |
|--|---------------|---------------|---------------|
| Interest expense                                       | \$ 10,394,986 | \$ 10,419,858 | \$ 10,646,216 |
| Income taxes   | 720,000       | 720,000       | 950,000       |
| Transfers from loans to other real estate owned        | 2,944,033     | 525,897       |               |
| Transfers from other real estate owned to fixed assets | 126,294       |               |               |

**The accompanying notes are an integral part of this statement.**

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 1 NATURE OF OPERATIONS:**

F & M Bank Corp. (the Company), through its subsidiary Farmers & Merchants Bank (the Bank), operates under a charter issued by the Commonwealth of Virginia and provides commercial banking services. As a state chartered bank, the Bank is subject to regulation by the Virginia Bureau of Financial Institutions and the Federal Reserve Bank. The Bank provides services to customers located mainly in Rockingham, Shenandoah and Page Counties in Virginia, and the adjacent counties of Augusta, Virginia and Hardy, West Virginia. Services are provided at nine branch offices. The Company offers insurance, mortgage lending and financial services through its subsidiaries, TEB Life Insurance, Inc. and Farmers & Merchants Financial Services, Inc. and VBS Mortgage, LLC.

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

The accounting and reporting policies of the Company and its subsidiaries conform to generally accepted accounting principles and to accepted practice within the banking industry.

The following is a summary of the more significant policies:

**Principles of Consolidation**

The consolidated financial statements include the accounts of Farmers and Merchants Bank, TEB Life Insurance Company, Farmers & Merchants Financial Services, Inc. and VBS Mortgage, LLC, (net of minority interest). Significant inter-company accounts and transactions have been eliminated.

**Use of Estimates in the Preparation of Financial Statements**

In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts in those statements; actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant changes in the near term are the determination of the allowance for loan losses, which is sensitive to changes in local and national economic conditions, and the other than temporary impairment of investments in the investment portfolio.

**Cash and Cash Equivalents**

Cash and cash equivalents include cash on hand, deposits at other financial institutions whose initial maturity is ninety days or less and Federal funds sold.

**Investment Securities**

Management reviews the securities portfolio and classifies all securities as either held to maturity or available for sale at the date of acquisition. Securities that the Company has both the positive intent and ability to hold to maturity (at time of purchase) are classified as held to maturity securities. All other securities are classified as available for sale. Securities held to maturity are carried at historical cost and adjusted for amortization of premiums and accretion of discounts, using the effective interest method. Securities available for sale are carried at fair value with any valuation adjustments reported, net of deferred taxes, as a part of other accumulated comprehensive income. Also included in securities available for sale are marketable equity securities.

Interest, amortization of premiums and accretion of discounts on securities are reported as interest income using the effective interest method. Gains (losses) realized on sales and calls of securities are determined on the specific identification method.

**Accounting for Historic Rehabilitation and Low Income Housing Partnerships**

The Company periodically invests in low income housing partnerships whose primary benefit is the distribution of federal income tax credits to partners. The Company recognizes these benefits and the cost of the investments over the life of the partnership (usually 15 years). In addition, state and federal historic rehabilitation credits are generated from some of the partnerships. Amortization of these investments are prorated based on the amount of benefits received in each year to the total estimated benefits over the life of the projects. All benefits have been shown as investment income since income tax benefits are the only anticipated benefits of ownership.

**Table of Contents****F & M Bank Corp. and Subsidiaries*****Notes to the Consolidated Financial Statements******December 31, 2010 and 2009*****NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):****Loans**

Loans are carried on the balance sheet net of any unearned interest and the allowance for loan losses. Interest income on loans is determined using the effective interest method on the daily amount of principal outstanding except where serious doubt exists as to collectibility of the loan, in which case the accrual of income is discontinued.

**Allowance for Loan Losses**

The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance that management considers adequate to absorb potential losses in the portfolio. Loans are charged against the allowance when management believes the collectibility of the principal is unlikely. Recoveries of amounts previously charged-off are credited to the allowance. Management's determination of the adequacy of the allowance is based on an evaluation of the composition of the loan portfolio, the value and adequacy of collateral, current economic conditions, historical loan loss experience, and other risk factors. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions, particularly those affecting real estate values. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

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

**Other Real Estate Owned (OREO)**

As of December 31, 2010, we had \$1.5 million classified as OREO on the balance sheet, compared to \$.5 million as of December 31, 2009. The table in Note 7 reflects the OREO activity in 2010.

**Nonaccrual Loans**

Commercial loans are placed on nonaccrual status when they become ninety days or more past due, unless there is an expectation that the loan will either be brought current or paid in full in a reasonable period of time. Interest accruals are continued on past due, secured residential real estate loans and consumer purpose loans until the principal and accrued interest equal the value of the collateral and on unsecured loans until the financial condition of the borrower deteriorates to the point that any further accrued interest would be determined to be uncollectible.



**Table of Contents****F & M Bank Corp. and Subsidiaries*****Notes to the Consolidated Financial Statements******December 31, 2010 and 2009*****NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):****Bank Premises and Equipment**

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is charged to income over the estimated useful lives of the assets on a combination of the straight-line and accelerated methods. The ranges of the useful lives of the premises and equipment are as follows:

|                            |             |
|----------------------------|-------------|
| Buildings and Improvements | 10-40 years |
| Furniture and Fixtures     | 5-20 years  |

Maintenance, repairs, and minor improvements are charged to operations as incurred. Gains and losses on dispositions are reflected in other income or expense.

**Intangible Assets**

Core deposit intangibles are amortized on a straight-line basis over ten years. Core deposit intangibles, net of amortization totaled \$45,771 and \$321,932 at December 31, 2010 and 2009, respectively. The Company adopted ASC 350 on January 1, 2002 and determined that the core deposit intangible will continue to be amortized over the estimated useful life.

**Goodwill**

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard ASC 805, Business Combinations and ASC 350, Intangibles. ASC 805 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Additionally, it further clarifies the criteria for the initial recognition and measurement of intangible assets separate from goodwill. ASC 350 became effective for fiscal years beginning after December 15, 2001 and prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. The provisions of ASC 350 discontinue the amortization of goodwill and intangible assets with indefinite lives. Instead, these assets are subject to an impairment review on an annual basis and more frequently if certain impairment indicators are in evidence. ASC 350 also requires that reporting units be identified for the purpose of assessing potential future impairments of goodwill.

Goodwill totaled \$2,669,517 at December 31, 2010 and 2009. The goodwill is no longer amortized, but instead tested for impairment at least annually. Based on the testing, there were no impairment charges for 2010, 2009 or 2008.

**Pension Plans**

The Bank has a qualified noncontributory defined benefit pension plan which covers substantially all of its employees. The benefits are primarily based on years of service and earnings. On December 31, 2006 the Company adopted ASC 325-960 Defined Benefit Pension Plans (formerly SFAS No. 158), which was issued in September of 2006 and amends SFAS 87 and SFAS 106 to require recognition of the over-funded or under-funded status of pension and other postretirement benefit plans on the balance sheet. Under ASC 325-960, gains and losses, prior service costs and credits, and any remaining transition amounts under SFAS 87 and SFAS 106 that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects, until they are amortized as a component of net periodic cost.

**Advertising Costs**

The Company follows the policy of charging the cost of advertising to expense as incurred. Total advertising costs included in other operating expenses for 2010, 2009, and 2008 were \$191,449, \$223,762, and \$295,214, respectively.

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):****Income Taxes**

Amounts provided for income tax expense are based on income reported for financial statement purposes rather than amounts currently payable under income tax laws. Deferred taxes, which arise principally from temporary differences between the period in which certain income and expenses are recognized for financial accounting purposes and the period in which they affect taxable income, are included in the amounts provided for income taxes.

In 2006, the FASB issued ASC 740 (formerly Interpretation No. 48), Income Taxes. ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109,

Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement of a tax position taken or expected to be taken in an enterprise's tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, the Company adopted FIN 48 effective January 1, 2007. The adoption of FIN 48 did not have any impact on the Company's consolidated financial position.

**Comprehensive Income**

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities and changes in pension plan funding status, such as unrealized gains and losses on available-for-sale securities and gains or losses on certain derivative contracts, are reported as a separate component of the equity section of the balance sheet. Such items, along with operating net income, are components of comprehensive income.

The components of other comprehensive income and related tax effects are as follows:

|   | <b>Years Ended December 31,</b> |              |              |
|---|---------------------------------|--------------|--------------|
|   | <b>2010</b>                     | <b>2009</b>  | <b>2008</b>  |
| Changes in:   |                                 |              |              |
| Net income  | \$ 3,830,642                    | \$ 2,029,902 | \$ 3,192,722 |
| Minority Interest Contributed Capital (Distributions)                   | (26,558)                        |              | 58,123       |
| Adjustment for initial adoption of ASC 325-960 funded status adjustment | (38,002)                        | 852,683      | (1,835,082)  |
| Tax effect  | 12,921                          | (289,912)    | 623,928      |
| Pension plan adjustment, net of tax                                     | (25,081)                        | 562,771      | (1,211,154)  |
| Unrealized holding gains (losses) on available-for-sale securities      | 781,254                         | 865,875      | (2,742,769)  |
| Other than temporary impairment losses                                  | 65,158                          | 1,751,169    | 1,758,730    |
| Reclassification adjustment for (gains) losses realized in income       | (413,970)                       | 2,424        | (78,173)     |
| Net unrealized gains (losses)   | 432,442                         | 2,619,468    | (1,062,212)  |
| Tax effect  | 147,030                         | 890,619      | (361,152)    |
| Unrealized holding gain (losses), net of tax                            | 285,412                         | 1,728,849    | (701,060)    |
| Total other comprehensive income  | \$ 4,064,415                    | \$ 4,321,522 | \$ 1,338,631 |

**Earnings Per Share**

Earnings per share are based on the weighted average number of shares outstanding. The Company had no potentially dilutive instruments during the three-year period ended December 31, 2010.

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):****Derivative Financial Instruments and Change in Accounting Principle**

On January 1, 2001, the Company adopted ASC 815 Derivative and Hedging Investments (formerly SFAS No. 133). This statement requires that all derivatives be recognized as assets or liabilities in the balance sheet and measured at fair value.

Under ASC 815, the gain or loss on a derivative designated and qualifying as a fair value hedging instrument, as well as the offsetting gain or loss on the hedging item attributable to the risk being hedged, is recognized currently in earnings in the same accounting period. The effective portion of the gain or loss on a derivative designated and qualifying as a cash flow hedging instrument is initially reported as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument, if any, is recognized currently in earnings.

Interest rate derivative financial instruments receive hedge accounting treatment only if they are designated as a hedge and are expected to be, and are, effective in substantially reducing interest rate risk arising from the assets and liabilities identified as exposing the Company to risk. Those derivative financial instruments that do not meet the hedging criteria discussed below would be classified as trading activities and would be recorded at fair value with changes in fair value recorded in income. Derivative hedge contracts must meet specific effectiveness tests (i.e., over time the change in their fair values due to the designated hedge risk must be within 80 to 125 percent of the opposite change in the fair value of the hedged assets or liabilities). Changes in fair value of the derivative financial instruments must be effective at offsetting changes in the fair value of the hedging items due to the designated hedge risk during the term of the hedge. Further, if the underlying financial instrument differs from the hedged asset or liability, there must be a clear economic relationship between the prices of the two financial instruments. If periodic assessment indicates derivatives no longer provide an effective hedge, the derivatives contracts would be closed out and settled or classified as a trading activity.

**Recent Accounting Pronouncements**

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.

**Subsequent Events**

In preparing these financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through the date the financial statements were issued.

**NOTE 3 CASH AND DUE FROM BANKS:**

The Bank is required to maintain average reserve balances based on a percentage of deposits. The average balance of cash, which the Federal Reserve Bank requires to be on reserve, was \$25,000 for the years ended December 31, 2010 and 2009.

**NOTE 4 INVESTMENT SECURITIES:**

The amortized cost and fair value of securities held to maturity are as follows:

|                          | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <b>December 31, 2010</b> |                   |                              |                               |               |
| U. S. Treasuries         | \$ 108,974        | \$                           | \$                            | \$ 108,974    |
| <b>December 31, 2009</b> |                   |                              |                               |               |
| U. S. Treasuries         | \$ 109,813        | \$                           | \$                            | \$ 109,813    |



**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 4 INVESTMENT SECURITIES (CONTINUED):**

The amortized cost and fair value of securities available for sale are as follows:

|   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-----------------------|
| <b>December 31, 2010</b>                        |                           |                                       |  |                       |
| Government sponsored enterprises                | \$ 7,997,077              | \$ 7,020                              | \$ 3,415                               | \$ 8,000,682          |
| Mortgage-backed obligations of federal agencies | 3,723,928                 | 209,386                               | 2,353                                  | 3,930,961             |
| Marketable equities                             | 2,642,833                 | 710,857                               | 38,809                                 | 3,314,881             |
| Corporate bonds                                 |                           |                                       |  |                       |
| Total Securities Available for Sale             | \$ 14,363,838             | \$ 927,263                            | \$ 44,577                              | \$ 15,246,524         |
| <b>December 31, 2009</b>                        |                           |                                       |  |                       |
| Government sponsored enterprises                | \$ 5,975,816              | \$ 35,878                             | \$                                     | \$ 6,011,694          |
| Mortgage-backed obligations of federal agencies | 5,895,747                 | 277,032                               | 2,439                                  | 6,170,340             |
| Marketable equities                             | 3,768,175                 | 263,700                               | 288,906                                | 3,742,969             |
| Corporate bonds                                 | 280,800                   | 223,730                               |  | 504,530               |
| Total Securities Available for Sale             | \$ 15,920,538             | \$ 800,340                            | \$ 291,345                             | \$ 16,429,533         |

The amortized cost and fair value of securities at December 31, 2010, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                       | <b>Securities Held to<br/>Maturity</b> |                       | <b>Securities Available for Sale</b> |                       |
|---------------------------------------|--|-----------------------|--------------------------------------|-----------------------|
|                                       | <b>Amortized<br/>Cost</b>              | <b>Fair<br/>Value</b> | <b>Amortized<br/>Cost</b>            | <b>Fair<br/>Value</b> |
| Due in one year or less               | \$ 108,974                             | \$ 108,974            | \$                                   | \$                    |
| Due after one year through five years |  |                       | 7,997,077                            | 8,000,682             |
| Due after five years                  |  |                       | 3,723,928                            | 3,930,961             |
| Marketable equities                   | 108,974                                | 108,974               | 11,721,005                           | 11,931,643            |
|                                       |  |                       | 2,642,833                            | 3,314,881             |
| Total                                 | \$ 108,974                             | \$ 108,974            | \$ 14,363,838                        | \$ 15,246,524         |

There were no sales of debt securities during 2010, 2009, or 2008. Following is a table reflecting gains and losses on equity securities:

| 2010 | 2009 | 2008 |
|------|------|------|
|------|------|------|

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|           |            |            |            |
|-----------|------------|------------|------------|
| Gains     | \$ 506,379 | \$ 2,475   | \$ 244,181 |
| Losses    | (92,409)   | (4,899)    | (166,008)  |
| Net Gains | \$ 413,970 | \$ (2,424) | \$ 78,173  |

The carrying value (which approximates fair value) of securities pledged by the Bank to secure deposits and for other purposes amounted to \$8,019,000 at December 31, 2010 and \$15,229,000 at December 31, 2009.

**Table of Contents****F & M Bank Corp. and Subsidiaries****Notes to the Consolidated Financial Statements****December 31, 2010 and 2009****NOTE 4 INVESTMENT SECURITIES (CONTINUED):**

Other investments consist of investments in fourteen low-income housing and historic equity partnerships (carrying basis of \$3,797,000), stock in the Federal Home Loan Bank (carrying basis of \$4,059,000), and various other investments (carrying basis of \$933,000). The interests in the low-income housing and historic equity partnerships have limited transferability and the interests in the other stocks are restricted as to sales. The market values of these securities are estimated to approximate their carrying value as of December 31, 2010. At December 31, 2010, the Company was committed to invest an additional \$2,043,299 in five low-income housing limited partnerships. These funds will be paid as requested by the general partner to complete the projects. This additional investment has been reflected in the above carrying basis and in accrued liabilities on the balance sheet.

The primary purpose of the investment portfolio is to generate income and meet liquidity needs of the Company through readily saleable financial instruments. The portfolio includes fixed rate bonds, whose prices move inversely with rates, variable rate bonds and equity securities. At the end of any accounting period, the investment portfolio has unrealized gains and losses. The Company monitors the portfolio, which is subject to liquidity needs, market rate changes and credit risk changes, to see if adjustments are needed. The primary concern in a loss situation is the credit quality of the business behind the instrument. Bonds deteriorate in value due to credit quality of the individual issuer and changes in market conditions. These losses relate to market conditions and the timing of purchases.

A summary of these losses (in thousands) is as follows:

|                                  | <b>Less than 12 Months</b> |                          | <b>More than 12 Months</b> |                          | <b>Total</b>      |                          |
|----------------------------------|----------------------------|--------------------------|----------------------------|--------------------------|-------------------|--------------------------|
|                                  | <b>Fair Value</b>          | <b>Unrealized Losses</b> | <b>Fair Value</b>          | <b>Unrealized Losses</b> | <b>Fair Value</b> | <b>Unrealized Losses</b> |
| <b>2010</b>                      |                            |                          |                            |                          |                   |                          |
| Government sponsored enterprises | \$ 2,004                   | \$ (4)                   | \$                         | \$                       | \$ 2,004          | \$ (4)                   |
| Mortgage backed obligations      |                            |                          | 260                        | (2)                      | 260               | (2)                      |
| Marketable equities              |                            |                          | 575                        | (39)                     | 575               | (39)                     |
| <b>Total</b>                     | <b>\$ 2,004</b>            | <b>\$ (4)</b>            | <b>\$ 835</b>              | <b>\$ (41)</b>           | <b>\$ 2,839</b>   | <b>\$ (45)</b>           |
| <b>2009</b>                      |                            |                          |                            |                          |                   |                          |
| Government sponsored enterprises | \$                         | \$                       | \$                         | \$                       | \$                | \$                       |
| Mortgage backed obligations      |                            |                          | 300                        | (2)                      | 300               | (2)                      |
| Marketable equities              |                            |                          | 1,891                      | (289)                    | 1,891             | (289)                    |
| <b>Total</b>                     | <b>\$</b>                  | <b>\$</b>                | <b>\$ 2,191</b>            | <b>\$ (291)</b>          | <b>\$ 2,191</b>   | <b>\$ (291)</b>          |

Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than the cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery of fair value. The Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell these securities before recovery



of their amortized cost.

The Company recognized other-than-temporary impairment losses of \$65,000, \$1,751,000, and \$1,759,000 in the carrying basis of its equity holdings in 2010, 2009, and 2008, respectively. These write downs were a result of management's evaluation and determination that these assets met the definition of other than temporary impairment under ASC 320-10.

**Table of Contents****F & M Bank Corp. and Subsidiaries****Notes to the Consolidated Financial Statements****December 31, 2010 and 2009****NOTE 5 LOANS:**Loans held for investment as of December 31:

|                             | <b>2010</b>           | <b>2009</b>           |
|-----------------------------|-----------------------|-----------------------|
| Real Estate                 |                       |                       |
| Construction                | \$ 79,336,716         | \$ 86,319,632         |
| Mortgage                    | 202,420,540           | 191,381,547           |
| Commercial and agricultural | 141,252,566           | 134,992,512           |
| Installment                 | 19,042,600            | 19,247,550            |
| Credit cards                | 2,770,826             | 2,355,510             |
| Other                       | 323,979               | 106,165               |
| <b>Total</b>                | <b>\$ 445,147,227</b> | <b>\$ 434,402,916</b> |

The Company has pledged loans as collateral for borrowings with the Federal Home Loan Bank of Atlanta totaling \$150,813,000 and \$155,632,000 as of December 31, 2010 and 2009, respectively. During 2005, the Company switched to a blanket lien on its entire residential real estate portfolio and also began pledging commercial and home equity loans.

The following is a summary of information pertaining to impaired loans (in thousands):

| December 31, 2010                             | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|---|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| Impaired loans without a valuation allowance: |                        |                                |                      |                                   |                                  |
| Real Estate                                   | \$ 5,680               | \$ 5,680                       |                      | \$ 2,015                          | \$ 84                            |
| Commerical                                    | 888                    | 888                            |                      | 606                               | 19                               |
| Home Equity                                   | 673                    | 673                            |                      | 260                               | 5                                |
| Other   | 247                    | 247                            |                      | 292                               |                                  |
| Impaired loans with a valuation allowance     |                        |                                |                      |                                   |                                  |
| Real Estate                                   | 6,942                  | 6,942                          | 1,003                | 2,881                             | 211                              |
| Commerical                                    | 1,149                  | 1,149                          | 161                  | 5,013                             | 17                               |
| Home Equity                                   | 439                    | 439                            | 118                  | 333                               | 11                               |
| Other   | 7                      | 7                              | 1                    | 5                                 | 12                               |
| <b>Total impaired loans</b>                   | <b>\$ 16,025</b>       | <b>\$ 16,025</b>               | <b>\$ 1,283</b>      | <b>\$ 11,405</b>                  | <b>\$ 359</b>                    |

The Recorded Investment is defined as the principal balance, net of deferred fees, less principal payments and charge-offs.

As of December 31, 2009 there were \$8,935,000 in impaired loans, of which \$1,241,000 were impaired without a valuation allowance and \$7,694,000 were impaired with a valuation allowance. The related allowance for impaired loans for 2009 was \$986,000.



**Table of Contents****F & M Bank Corp. and Subsidiaries****Notes to the Consolidated Financial Statements****December 31, 2010 and 2009****NOTE 5 LOANS (CONTINUED):**

Loans held for sale consists of loans originated by VBS Mortgage and the Bank's commitment to purchase up to \$35,000,000 in residential mortgage loan participations from Gateway Bank. The loans purchased from Gateway are originated by a network of mortgage loan originators throughout the United States. A take out commitment is in place at the time the loans are purchased. The Bank receives certain loan documents daily for review, makes its purchase decision and wires funds to Gateway Bank. Typically loans for both VBS Mortgage and Gateway Bank are held on our books for approximately two weeks until purchased by the ultimate holder in the secondary market.

The volume of loans purchased fluctuates due to a number of factors including changes in secondary market rates, which affects demand for mortgage loans; the number of participating banks involved in the program; the number of mortgage loan originators selling loans to the lead bank and the funding capabilities of the lead bank.

Loans held for sale as of December 31:

|             |               |               |
|-------------|---------------|---------------|
|             | <b>2010</b>   | <b>2009</b>   |
| Real Estate | \$ 23,764,237 | \$ 31,167,763 |

**NOTE 6 ALLOWANCE FOR LOAN LOSSES:**

A summary of changes in the allowance for loan losses is shown in the following schedule:

|   | <b>2010</b>  | <b>2009</b>  | <b>2008</b>  |
|---|--------------|--------------|--------------|
| Balance, beginning of year              | \$ 3,835,698 | \$ 2,189,261 | \$ 1,702,501 |
| Provision charged to operating expenses | 4,300,000    | 4,210,000    | 815,000      |
| Loan recoveries                         | 133,206      | 75,997       | 71,751       |
| Loans charged off                       | (2,483,271)  | (2,639,560)  | (399,991)    |
| Balance, end of year                    | \$ 5,785,633 | \$ 3,835,698 | \$ 2,189,261 |
| Percentage of loans held for investment | 1.30%        | .88%         | .55%         |

**Table of Contents****F & M Bank Corp. and Subsidiaries****Notes to the Consolidated Financial Statements****December 31, 2010 and 2009****NOTE 6 ALLOWANCE FOR LOAN LOSSES (CONTINUED):**

Allowance for Loan Losses and Recorded Investment in Loan Receivables (in thousands)

| December 31, 2010  | Commercial | Real Estate | Home Equity | Credit Cards | Consumer  | Unallocated | Total      |
|--|------------|-------------|-------------|--------------|-----------|-------------|------------|
| Allowance for loan losses:   |            |             |             |              |           |             |            |
| Ending Balance   | \$ 1,724   | \$ 1,814    | \$ 407      | \$ 59        | \$ 111    | \$ 1,671    | \$ 5,786   |
| Ending Balance: Individually evaluated for impairment (specific reserve) | 161        | 1,003       | 118         |              | 1         |             | 1,283      |
| Ending Balance: Collectively evaluated for impairment                    | 1,563      | 811         | 289         | 59           | 110       | 1,671       | 4,503      |
| Loans Receivable:  |            |             |             |              |           |             |            |
| Ending balance   | \$ 153,511 | \$ 214,906  | \$ 54,593   | \$ 2,771     | \$ 19,366 |             | \$ 445,147 |
| Ending balance: Individually evaluated for impairment                    | \$ 12,406  | \$ 16,806   | \$ 1,538    |              | \$ 1,099  |             | \$ 31,849  |
| Ending Balance: Collectively evaluated for impairment                    | \$ 141,105 | \$ 198,100  | \$ 53,055   | \$ 2,771     | \$ 18,267 |             | \$ 413,298 |

## Aging of Past Due Loans Receivable (in thousands)

|              | 30-59 Days Past due | 60-89 Days Past Due | Greater than 90 Days (excluding non-accrual) | Total Past Due | Non-Accrual Loans | Current    | Total Loan Receivable | Recorded Investment > 90 Days & Accruing |
|--------------|---------------------|---------------------|--|----------------|-------------------|------------|-----------------------|--|
| Commercial   | \$ 756              | \$ 382              | \$ 4,581                                     | \$ 5,719       | \$ 1,656          | \$ 146,137 | \$ 153,512            | \$ 4,581                                 |
| Real Estate  | 6,303               | 1,395               | 3,021  | 10,719         | 5,189             | 198,998    | 214,906               | 3,021                                    |
| Home Equity  | 1,302               | 595                 | 588  | 2,485          | 715               | 51,392     | 54,592                | 588                                      |
| Credit Cards | 19                  | 6                   |  | 25             |                   | 2,746      | 2,771                 |  |
| Consumer     | 1,240               | 67                  | 54   | 1,361          | 30                | 17,975     | 19,366                | 54                                       |
| Total        | \$ 9,620            | \$ 2,445            | \$ 8,244                                     | \$ 20,309      | \$ 7,590          | \$ 417,248 | \$ 445,147            | \$ 8,244                                 |



**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 6 ALLOWANCE FOR LOAN LOSSES (CONTINUED)****CREDIT QUALITY INDICATORS**

AS OF DECEMBER 31, 2010

## Corporate Credit Exposure

## Credit Risk Profile by Creditworthiness Category

|                               | Real Estate    | Commercial     | Home Equity   |
|-------------------------------|----------------|----------------|---------------|
| Grade 1 Minimal Risk          | \$ 69,231      | \$ 174,582     |               |
| Grade 2 Modest Risk           | 817,827        | 1,678,841      | 574,374       |
| Grade 3 Average Risk          | 30,041,586     | 16,254,057     | 7,942,935     |
| Grade 4 Acceptable Risk       | 107,027,580    | 77,472,242     | 37,848,295    |
| Grade 5 Marginally Acceptable | 40,163,358     | 40,908,350     | 5,473,349     |
| Grade 6 Watch                 | 16,785,371     | 7,781,021      | 904,542       |
| Grade 7 Substandard           | 19,718,886     | 8,639,726      | 1,849,301     |
| Grade 8 Doubtful              | 281,678        | 602,691        |               |
| Total                         | \$ 214,905,517 | \$ 153,511,510 | \$ 54,592,796 |

## Consumer Credit Exposure

## Credit Risk Profile Based on Payment Activity

|                | Credit Cards | Consumer      |
|----------------|--------------|---------------|
| Performing     | \$ 2,770,826 | \$ 19,311,799 |
| Non performing |              | 54,779        |
| Total          | \$ 2,770,826 | \$ 19,366,578 |

**NOTE 7 BANK PREMISES AND EQUIPMENT**

Bank premises and equipment as of December 31 are summarized as follows:

|                               | 2010         | 2009         |
|-------------------------------|--------------|--------------|
| Land                          | \$ 1,488,270 | \$ 1,145,204 |
| Buildings and improvements    | 6,696,666    | 6,883,232    |
| Furniture and equipment       | 5,064,375    | 4,964,684    |
|                               | 13,249,311   | 12,993,120   |
| Less accumulated depreciation | (6,456,817)  | (5,913,616)  |
| Net                           | \$ 6,792,494 | \$ 7,079,504 |

Provisions for depreciation of \$635,706 in 2010, \$654,401 in 2009, and \$630,314 in 2008 were charged to operations.

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 8 OTHER REAL ESTATE OWNED**

The table below reflects OREO activity for 2010:

Other Real Estate Owned  
(dollars in thousands)

|   |              |
|---|--------------|
| Balance as of January 1, 2010               | \$ 525,897   |
| Property acquired at foreclosure            | 2,961,064    |
| Capital improvements on foreclosed property | 32,817       |
| Transfers to fixed assets                   | (126,294)    |
| Sales of foreclosed properties              | (1,880,285)  |
| Valuation adjustments                       |              |
| Balance as of December 31, 2010             | \$ 1,513,199 |

**NOTE 9 DEPOSITS:**

The composition of deposits at December 31, 2010 and 2009 was as follows:

|   | December 31,   |                |
|---|----------------|----------------|
|   | 2010           | 2009           |
|   | (in thousands) |                |
| Noninterest bearing demand deposits           | \$ 58,497,146  | \$ 53,475,063  |
| Savings and interest bearing demand deposits: |                |                |
| Interest checking accounts                    | 116,889,368    | 100,714,025    |
| Savings accounts                              | 35,759,634     | 34,228,965     |
| Time Deposits:                                |                |                |
| Balances of less than \$100,000               | 133,844,576    | 132,895,542    |
| Balances of \$100,000 and more                | 80,060,033     | 99,329,716     |
| Total Deposits                                | \$ 425,050,757 | \$ 420,643,311 |

At December 31, 2010, the scheduled maturities of time deposits are as follows:

|       |                |
|-------|----------------|
| 2011  | \$ 115,660,783 |
| 2012  | 55,966,363     |
| 2013  | 14,233,557     |
| 2014  | 14,636,158     |
| 2015  | 13,407,748     |
| Total | \$ 213,904,609 |



**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 10 SHORT-TERM DEBT:**

Short-term debt information is summarized as follows:

|  | <b>Maximum</b>     |                    |                    | <b>Weighted</b> |                 |
|--|--------------------|--------------------|--------------------|-----------------|-----------------|
|  | <b>Outstanding</b> | <b>Outstanding</b> | <b>Average</b>     | <b>Average</b>  | <b>Year</b>     |
|  | <b>at any</b>      | <b>at</b>          | <b>Balance</b>     | <b>Interest</b> | <b>End</b>      |
|  | <b>Month</b>       | <b>Year</b>        | <b>Outstanding</b> | <b>Rate</b>     | <b>Interest</b> |
|  | <b>End</b>         | <b>End</b>         |                    |                 | <b>Rate</b>     |
| <b>2010</b>                                    |                    |                    |                    |                 |                 |
| Short term note                                |                    |                    |                    |                 |                 |
| Federal funds purchased                        | 4,095,000          |                    | 470,493            | .55%            |                 |
| FHLB daily rate credit                         |                    |                    |                    |                 |                 |
| Securities sold under agreements to repurchase | 7,094,873          | 5,354,992          | 5,501,560          | .48%            | .48%            |
| Totals   |                    | \$ 5,354,992       | \$ 5,972,053       | .52%            | .48%            |
| <b>2009</b>                                    |                    |                    |                    |                 |                 |
| Short term note                                | 750,000            |                    | \$ 400,000         | 5.00%           |                 |
| Federal funds purchased                        | 14,924,000         |                    | 1,369,148          | .80%            |                 |
| FHLB daily rate credit                         | 21,002,500         | 2,800,000          | 6,890,041          | .49%            | .36%            |
| Securities sold under agreements to repurchase | 9,895,231          | 6,284,909          | 6,090,608          | .43%            | .47%            |
| Totals   |                    | \$ 9,084,909       | \$ 14,749,797      | .62%            | .44%            |
| <b>2008</b>                                    |                    |                    |                    |                 |                 |
| Short term note                                | 1,000,000          | 750,000            | 437,500            | 5.00%           | 5.00%           |
| Federal funds purchased                        | 10,684,000         |                    | 1,993,844          | 2.18%           |                 |
| FHLB daily rate credit                         | 35,000,000         | 12,252,500         | 12,366,810         | 2.15%           | .70%            |
| Securities sold under agreements to repurchase | 10,005,446         | 7,507,787          | 8,886,829          | 1.61%           | .59%            |
| Totals   |                    | \$ 20,510,287      | \$ 23,684,983      | 2.00%           | .75%            |

Repurchase agreements are secured transactions with customers and generally mature the day following the date sold. Federal funds purchased are unsecured overnight borrowings from other financial institutions. FHLB daily rate credit, which is secured by the loan portfolio, is a variable rate loan that acts as a line of credit to meet financing needs. As of December 31, 2010, the Company had lines of credit with correspondent banks totaling \$15,000,000, which may be used in the management of short-term liquidity.

**Table of Contents****F & M Bank Corp. and Subsidiaries*****Notes to the Consolidated Financial Statements******December 31, 2010 and 2009*****NOTE 11 LONG-TERM DEBT:**

New borrowings from the Federal Home Loan Bank of Atlanta (FHLB) were \$11,250,000 in 2010, \$22,250,000 in 2009, and \$34,747,000 in 2008. The interest rates on the notes payable are fixed at the time of the advance and range from 2.07% to 4.82%; the weighted average interest rate was 3.12% and 3.23% at December 31, 2010 and 2009, respectively. The balance of these obligations at December 31, 2010 was \$45,035,000. The long-term debt is secured by qualifying mortgage loans owned by the Company.

In November 2009, the Company entered into an agreement with Page Valley Bank (and several sub-participants) to refinance the Silverton Bank line of credit which was used for general corporate purposes, as a five year, fixed rate, amortizing loan at 6%. The repayment terms include quarterly payments of \$250,000 plus interest beginning in February 2010. The balance of this line of credit at December 31, 2010 was \$4,000,000.

In August 2009, the Company began to issue Subordinated debt agreements with local investors bearing terms of 7 to 10 years. Interest rates are fixed on the notes for the full term but vary by maturity. Rates range from 7.0% on the 7 year note to 8.05% on the ten year note. As of December 31, 2010 the balance outstanding was \$9,944,000. Due to their terms (greater than five years) and priority (subordinate to deposits and other borrowings) this debt is counted with capital for purposes of calculating the Total Risk Based Capital Ratio.

The maturities of long-term debt, including Federal Home Loan Bank of Atlanta borrowings, the Page Valley Bank Loan and Subordinated debt agreements, as of December 31, 2010 are as follows:

|            |               |
|------------|---------------|
| 2011       | \$ 3,928,571  |
| 2012       | 17,892,857    |
| 2013       | 17,214,286    |
| 2014       | 9,999,750     |
| Thereafter | 9,944,000     |
| Total      | \$ 58,979,464 |

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 12 INCOME TAX EXPENSE:**

The components of the income tax expense are as follows:

|  | <b>2010</b>  | <b>2009</b>  | <b>2008</b>  |
|--|--------------|--------------|--------------|
| Current expense  |              |              |              |
| Federal  | \$ 2,031,784 | \$ 1,033,350 | \$ 1,578,452 |
| Deferred benefit   |              |              |              |
| Federal  | (415,964)    | (678,041)    | (140,074)    |
| State  | 65,572       | (16,000)     | (19,750)     |
| Total Income Tax Expense   | \$ 1,681,392 | \$ 339,309   | \$ 1,418,628 |
| Amounts in above arising from gains<br>(losses) on security transactions | \$ 56,094    | \$ (550,660) | \$ (402,807) |

The deferred tax effects of temporary differences are as follows:

|   | <b>2010</b>  | <b>2009</b>  | <b>2008</b>  |
|---|--------------|--------------|--------------|
| LIH Partnership Losses                    | (15,658)     | (21,505)     | (32,850)     |
| Securities impairment                     | 50,239       | (549,836)    | (378,759)    |
| Local & Historic State Credits Recognized | 65,572       | (16,000)     | (19,750)     |
| Provision for loan losses                 | (529,905)    | (404,016)    | (165,498)    |
| Non-qualified deferred compensation       | (32,669)     | 30,072       | (4,460)      |
| Depreciation                              | (53,330)     | 48,163       | 143,858      |
| Core deposit intangible amortization      | (33,113)     | (33,113)     | (33,113)     |
| Pension expense                           | 243,639      | 190,722      | 269,154      |
| Goodwill tax amortization                 | 61,424       | 61,424       | 61,424       |
| Secondary accrual on nonaccrual loans     | (106,695)    |              |              |
| Other                                     | 104          | 48           | 170          |
| Deferred Income Tax Expense (Benefit)     | \$ (350,392) | \$ (694,041) | \$ (159,824) |

The components of the deferred taxes as of December 31 are as follows:

**Deferred Tax Assets:**

|                                       | <b>2010</b>  | <b>2009</b> |
|---------------------------------------|--------------|-------------|
| Allowance for loan losses             | \$ 1,524,022 | \$ 994,117  |
| Split Dollar Life Insurance           | 4,892        | 4,892       |
| Nonqualified deferred compensation    | 378,152      | 345,483     |
| Secondary accrual on nonaccrual loans | 106,693      |             |
| Securities impairment                 | 1,118,078    | 1,179,426   |
| Core deposit amortization             | 298,019      | 264,906     |
| State historic tax credits            | 116,332      | 292,184     |
| Securities available for sale         | (129,337)    | (34,260)    |
| Bank owned life insurance             | 497,012      | 484,091     |

|   |              |              |
|---|--------------|--------------|
| Other                                   | 906          | 977          |
| Total Assets                            | \$ 3,914,769 | \$ 3,531,816 |
| <b><i>Deferred Tax Liabilities:</i></b> | <b>2010</b>  | <b>2009</b>  |
| Unearned low income housing credits     | \$ 723,315   | \$ 762,373   |
| Depreciation                            | 268,780      | 322,110      |
| Pension                                 | 1,010,413    | 766,774      |
| Goodwill tax amortization               | 604,003      | 542,578      |
| Securities available for sale           | 71,617       | 105,560      |
| Other                                   | 52,002       | 51,628       |
| Total Liabilities                       | 2,730,130    | 2,551,023    |
| Deferred Tax Asset (Liability)          | \$ 1,184,639 | \$ 980,793   |

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 12 INCOME TAX EXPENSE (CONTINUED):**

The following table summarizes the differences between the actual income tax expense and the amounts computed using the federal statutory tax rates:

|  | <b>2010</b>         | <b>2009</b>       | <b>2008</b>         |
|--|---------------------|-------------------|---------------------|
| Tax expense at federal statutory rates         | \$ 1,843,498        | \$ 779,734        | \$ 1,571,699        |
| Increases (decreases) in taxes resulting from: |                     |                   |                     |
| State income taxes, net                        | 3,372               | 3,514             | 4,497               |
| Partially exempt income                        | (74,495)            | (64,592)          | (19,524)            |
| Tax-exempt income                              | (154,571)           | (157,454)         | (170,210)           |
| Prior year LIH credits                         | 121,569             | (27,521)          | (27,356)            |
| Other  | (57,981)            | (194,372)         | 59,522              |
| <b>Total Income Tax Expense</b>                | <b>\$ 1,681,392</b> | <b>\$ 339,309</b> | <b>\$ 1,418,628</b> |

**NOTE 13 EMPLOYEE BENEFITS:**

The Bank has a qualified noncontributory defined benefit pension plan which covers substantially all of its employees. The benefits are primarily based on years of service and earnings. On December 31, 2006 the Company adopted ASC 325-960 Defined Benefit Pension Plans (formerly SFAS 158), which was issued in September of 2006 and amends SFAS 87 and SFAS 106 to require recognition of the over-funded or under-funded status of pension and other postretirement benefit plans on the balance sheet. Under ASC 325-960, gains and losses, prior service costs and credits, and any remaining transition amounts under SFAS 87 and SFAS 106 that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects, until they are amortized as a component of net periodic cost.

The following table provides a reconciliation of the changes in the benefit obligations and fair value of plan assets for 2010, 2009 and 2008:

|  | <b>2010</b>         | <b>2009</b>         | <b>2008</b>         |
|--|---------------------|---------------------|---------------------|
| <b><i>Change in Benefit Obligation</i></b> |                     |                     |                     |
| Benefit obligation, beginning              | \$ 5,311,851        | \$ 4,582,997        | \$ 4,111,188        |
| Service cost                               | 387,915             | 358,799             | 402,976             |
| Interest cost                              | 317,001             | 273,333             | 320,270             |
| Actuarial gain (loss)                      | 326,634             | 110,390             | 46,725              |
| Benefits paid                              | (485,118)           | (13,668)            | (298,162)           |
| <b>Benefit obligation, ending</b>          | <b>\$ 5,858,283</b> | <b>\$ 5,311,851</b> | <b>\$ 4,582,997</b> |
| <b><i>Change in Plan Assets</i></b>        |                     |                     |                     |
| Fair value of plan assets, beginning       | \$ 5,092,910        | \$ 3,948,698        | \$ 4,072,435        |
| Actual return on plan assets               | 710,128             | 1,157,880           | (1,325,575)         |
| Employer contribution                      | 1,000,000           |                     | 1,500,000           |
| Benefits paid                              | (485,118)           | (13,668)            | (298,162)           |
| <b>Fair value of plan assets, ending</b>   | <b>6,317,920</b>    | <b>5,092,910</b>    | <b>3,948,698</b>    |

|                                      |            |              |              |
|--------------------------------------|------------|--------------|--------------|
| Funded status at the end of the year | \$ 459,637 | \$ (218,941) | \$ (634,299) |
|--------------------------------------|------------|--------------|--------------|

The fair value of plan assets is measured based on the fair value hierarchy as discussed in Note 20, Fair Value Measurements to the Consolidated Financial Statements. The valuations are based on third party data received as of the balance sheet date. All plan assets are considered Level 1 assets, as quoted prices exist in active markets for identical assets.

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 13 EMPLOYEE BENEFITS (CONTINUED):**

|   | <b>2010</b>    | <b>2009</b>    | <b>2008</b>    |
|---|----------------|----------------|----------------|
| <b><i>Amount recognized in the Balance Sheet</i></b>                      |                |                |                |
| Accrued prepaid benefit cost  | \$ 1,921,434   | \$ 1,204,854   | \$ 1,642,179   |
| Unfunded pension benefit obligation under ASC 325-960                     | (1,461,797)    | (1,423,795)    | (2,276,478)    |
| <b><i>Amount recognized in accumulated other comprehensive income</i></b> |                |                |                |
| Net Gain/(Loss)   | \$ (1,602,882) | \$ (1,570,180) | \$ (2,428,163) |
| Prior service cost  | 141,085        | 146,385        | 151,685        |
| Net obligation at transition  |                |                |                |
| Amount recognized   | (1,461,797)    | (1,423,795)    | (2,276,478)    |
| Deferred Taxes  | 497,012        | 484,091        | 774,003        |
| Amount recognized in accumulated comprehensive income                     | \$ (964,785)   | \$ (939,704)   | \$ (1,502,475) |
| <b><i>(Accrued) Prepaid benefit detail</i></b>                            |                |                |                |
| Benefit obligation  | \$ (5,858,283) | \$ (5,311,851) | \$ (4,582,997) |
| Fair value of assets  | 6,317,920      | 5,092,910      | 3,948,698      |
| Unrecognized net actuarial loss   | 1,602,882      | 1,570,180      | 2,428,163      |
| Unrecognized transition obligation  |                |                |                |
| Unrecognized prior service cost   | (141,085)      | (146,385)      | (151,685)      |
| Prepaid (accrued) benefits  | \$ 1,921,434   | \$ 1,204,854   | \$ 1,642,179   |
| <b><i>Components of net periodic benefit cost</i></b>                     |                |                |                |
| Service cost  | \$ 387,915     | \$ 358,799     | \$ 322,381     |
| Interest cost   | 317,001        | 273,333        | 256,216        |
| Expected return on plan assets  | (481,706)      | (313,710)      | (376,713)      |
| Amortization of prior service cost  | (5,300)        | (5,300)        | (5,300)        |
| Amortization of transition obligation                                     |                |                |                |
| Recognized net actuarial (gain) loss                                      | 65,510         | 124,203        | 11,787         |
| Net periodic benefit cost   | \$ 283,420     | \$ 437,325     | \$ 208,371     |
| <b><i>Additional disclosure information</i></b>                           |                |                |                |
| Accumulated benefit obligation  | \$ 4,025,608   | \$ 3,538,352   | \$ 2,977,671   |
| Vested benefit obligation   | \$ 3,809,484   | \$ 3,398,034   | \$ 2,871,201   |
| Discount rate used for net pension cost                                   | 5.50%          | 6.00%          | 6.25%          |
| Discount rate used for disclosure   | 5.50%          | 6.00%          | 6.00%          |
| Expected return on plan assets  | 8.00%          | 8.00%          | 8.50%          |

|                                   |       |       |       |
|-----------------------------------|-------|-------|-------|
| Rate of compensation increase     | 4.00% | 4.00% | 4.00% |
| Average remaining service (years) | 15    | 16    | 16    |

***Funding Policy***

It is the Bank's policy to normally contribute the maximum tax-deductible amount each year as determined by the plan administrator. Based on current information, the 2011 contribution will be \$1,000,000 and pension cost for 2011 will be approximately \$319,000.



**Table of Contents****F & M Bank Corp. and Subsidiaries*****Notes to the Consolidated Financial Statements******December 31, 2010 and 2009*****NOTE 13 EMPLOYEE BENEFITS (CONTINUED):*****Long-Term Rate of Return***

The plan sponsor selects the expected long-term rate of return on assets assumption in consultation with their advisors and the plan actuary, and with concurrence from their auditor. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation) for the major asset classes held or anticipated to be held by the trust. Undue weight is not given to recent experience, which may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions. Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further solely for this purpose the plan is assumed to continue in force and not terminate during the period during which the assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

***Asset Allocation***

The following table provides the pension plan's asset allocation as of December 31:

|                             | <b>2010</b> | <b>2009</b> |
|-----------------------------|-------------|-------------|
| Mutual funds - equity       | 62%         | 61%         |
| Mutual funds - fixed income | 38%         | 38%         |
| Cash and equivalents        | 0%          | 1%          |

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 40% fixed income and 60% equity. The Investment Manager selects investment fund managers with demonstrated experience and expertise, and funds with demonstrated historical performance, for the implementation of the Plan's investment strategy. The Investment Manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

***Estimated Future Benefit Payments***

|           |                     |
|-----------|---------------------|
| 2011      | \$ 25,441           |
| 2012      | 49,177              |
| 2013      | 75,158              |
| 2014      | 153,724             |
| 2015      | 175,299             |
| 2016-2020 | 1,332,976           |
|           | <b>\$ 1,811,775</b> |

***Employee Stock Ownership Plan (ESOP)***

The Company sponsors an ESOP which provides stock ownership to substantially all employees of the Bank. The Plan provides total vesting upon the attainment of five years of service. Contributions to the plan are made at the discretion of the Board of Directors and are allocated based on the compensation of each employee relative to total compensation paid by the Bank. All shares issued and held by the Plan are considered outstanding in the computation of earnings per share. Dividends on Company stock are allocated and paid to participants at least annually. Shares of Company stock, when distributed, have restrictions on transferability. The Company contributed \$270,000 in 2010, \$180,000 in 2009, and \$275,000 in 2008 to the Plan and charged this expense to operations. The shares held by the ESOP totaled 132,845 and 123,908 at December 31, 2010 and 2009, respectively.



**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 13 EMPLOYEE BENEFITS (CONTINUED):****401K Plan**

The Company sponsors a 401(k) savings plan under which eligible employees may choose to save up to 20 percent of their salary on a pretax basis, subject to certain IRS limits. Under the Safe Harbor rules employees are automatically enrolled at 3% (in the third year this increases by 1% per year up to 6%) of their salary unless elected otherwise. The Company matches a hundred percent of the first 1% contributed by the employee and fifty percent from 2% to 6% of employee contributions. Vesting in the contributions made by the bank is 100% after two years of service. Contributions under the plan amounted to \$145,882, \$142,853 and \$116,422 in 2010, 2009 and 2008, respectively.

**Deferred Compensation Plan**

The Company has a nonqualified deferred compensation plan for several of its key employees and directors. The Company may make annual contributions to the plan, and the employee or director has the option to defer a portion of their salary or bonus based on qualifying annual elections. Contributions to the plan totaled \$60,000 in 2010 and 2008. Due to the level of earnings, the Company did not contribute to the plan in 2009.

**NOTE 14 CONCENTRATIONS OF CREDIT:**

The Company had cash deposits in other commercial banks totaling \$2,374,947 and \$3,062,630 at December 31, 2010 and 2009, respectively.

The Company grants commercial, residential real estate and consumer loans to customers located primarily in the northwestern portion of the State of Virginia. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent upon the agribusiness economic sector, specifically the poultry industry for which loans outstanding total \$15,190,000. Other identified loan concentration areas greater than 25% of capital include multi-family and construction/development. Collateral required by the Company is determined on an individual basis depending on the purpose of the loan and the financial condition of the borrower. Approximately 89% of the loan portfolio is secured by real estate.

**NOTE 15 COMMITMENTS:**

The Company makes commitments to extend credit in the normal course of business and issues standby letters of credit to meet the financing needs of its customers. The amount of the commitments represents the Company's exposure to credit loss that is not included in the balance sheet. As of the balance sheet dates, the Company had the following commitments outstanding:

|                           | <b>2010</b>   | <b>2009</b>   |
|---------------------------|---------------|---------------|
| Commitments to loan money | \$ 91,198,417 | \$ 83,081,156 |
| Standby letters of credit | 1,650,272     | 1,108,419     |

The Company uses the same credit policies in making commitments to lend money and issue standby letters of credit as it does for the loans reflected in the balance sheet.

Commitments to extend credit are agreements to lend 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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. Collateral required, if any, upon extension of credit is based on management's credit evaluation of the borrower's ability to pay. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment.

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 15 COMMITMENTS (CONTINUED):**

The Bank leases three of its branch offices on long term lease arrangements of either five or ten years. Lease expense for 2010, 2009 and 2008 were \$71,760, respectively. As of December 31, 2010, the required lease payments for the next five years are as follows:

|      |           |
|------|-----------|
| 2011 | \$ 77,760 |
| 2012 | 77,760    |
| 2013 | 77,760    |
| 2014 | 62,640    |
| 2015 | 48,600    |

**NOTE 16 ON BALANCE SHEET DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES:***Derivative Financial Instruments*

The Company has stand alone derivative financial instruments in the form of forward option contracts. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instruments, is reflected on the Company's balance sheet as derivative assets and derivative liabilities.

The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations. The Company deals only with primary dealers.

Derivative instruments are generally either negotiated OTC contracts or standardized contracts executed on a recognized exchange. Negotiated OTC derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

The Company issues to customers certificates of deposit with an interest rate that is derived from the rate of return on the stock of the companies that comprise The Dow Jones Industrial Average. In order to manage the interest rate risk associated with this deposit product, the Company has purchased a series of forward option contracts. These contracts provide the Company with a rate of return commensurate with the return of The Dow Jones Industrial Average from the time of the contract until maturity of the related certificate of deposit. These contracts are accounted for as fair value hedges. Because the certificates of deposit can be redeemed by the customer at anytime and this related forward options contracts cannot be cancelled by the Company, the hedge is not considered effective.

At December 31, the information pertaining to the forward option contracts, included in other assets and other liabilities on the balance sheet, is as follows:

|                                | <b>2010</b> | <b>2009</b> |
|--------------------------------|-------------|-------------|
| Notional amount                | \$ 125,787  | \$ 497,691  |
| Fair market value of contracts | 10,831      | 13,295      |

**Table of Contents****F & M Bank Corp. and Subsidiaries*****Notes to the Consolidated Financial Statements******December 31, 2010 and 2009*****NOTE 17 TRANSACTIONS WITH RELATED PARTIES:**

During the year, officers and directors (and companies controlled by them) were customers of and had transactions with the Company in the normal course of business. These transactions were made on substantially the same terms as those prevailing for other customers and did not involve any abnormal risk.

Loan transactions with related parties are shown in the following schedule:

|                                | <b>2010</b>  | <b>2009</b>  |
|--------------------------------|--------------|--------------|
| Total loans, beginning of year | \$ 6,724,423 | \$ 7,246,384 |
| New loans                      | 2,606,355    | 1,271,666    |
| Relationship Change            | 1,548,727    |              |
| Repayments                     | (3,283,636)  | (1,793,627)  |
| Total loans, end of year       | \$ 7,595,869 | \$ 6,724,423 |

**NOTE 18 DIVIDEND LIMITATIONS ON SUBSIDIARY BANK:**

The principal source of funds of F & M Bank Corp. is dividends paid by the Farmers and Merchants Bank. The Federal Reserve Act restricts the amount of dividends the Bank may pay. Approval by the Board of Governors of the Federal Reserve System is required if the dividends declared by a state member bank, in any year, exceed the sum of (1) net income of the current year and (2) income net of dividends for the preceding two years. As of January 1, 2011, approximately \$3,422,000 was available for dividend distribution without permission of the Board of Governors. Dividends paid by the Bank to the Company totaled \$920,000 in 2010, \$2,428,000 in 2009 and \$2,559,000 in 2008.

**Table of Contents****F & M Bank Corp. and Subsidiaries****Notes to the Consolidated Financial Statements****December 31, 2010 and 2009****NOTE 19 DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS:**

ASC 825 Financial Instruments (formerly SFAS 107) defines the fair value of a financial instrument as the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced liquidation or sale. As the majority of the Bank's financial instruments lack an available trading market, significant estimates, assumptions and present value calculations are required to determine estimated fair value.

Estimated fair value and the carrying value of financial instruments at December 31, 2010 and 2009 are as follows (in thousands):

|                               | 2010                       |                   | 2009                       |                   |
|-------------------------------|----------------------------|-------------------|----------------------------|-------------------|
|                               | Estimated<br>Fair<br>Value | Carrying<br>Value | Estimated<br>Fair<br>Value | Carrying<br>Value |
| <b>Financial Assets</b>       |                            |                   |                            |                   |
| Cash                          | \$ 4,586                   | \$ 4,586          | \$ 5,314                   | \$ 5,314          |
| Interest bearing deposits     | 2,927                      | 2,927             | 65                         | 65                |
| Federal funds sold            | 16,338                     | 16,338            | 18,326                     | 18,326            |
| Securities available for sale | 15,247                     | 15,247            | 16,430                     | 16,430            |
| Securities held to maturity   | 109                        | 109               | 110                        | 110               |
| Other investments             | 8,789                      | 8,789             | 9,681                      | 9,681             |
| Loans                         | 475,166                    | 445,147           | 481,967                    | 434,403           |
| Loan held for sale            | 23,764                     | 23,764            | 31,168                     | 31,168            |
| Bank owned life insurance     | 6,883                      | 6,883             | 6,593                      | 6,593             |
| Accrued interest receivable   | 2,001                      | 2,001             | 2,038                      | 2,038             |
| <b>Financial Liabilities</b>  |                            |                   |                            |                   |
| Demand Deposits:              |                            |                   |                            |                   |
| Non-interest bearing          | 58,497                     | 58,497            | 53,475                     | 53,475            |
| Interest bearing              | 116,889                    | 116,889           | 100,714                    | 100,714           |
| Savings deposits              | 35,760                     | 35,760            | 34,229                     | 34,229            |
| Time deposits                 | 216,199                    | 213,905           | 234,032                    | 232,225           |
| Short-term debt               | 5,355                      | 5,355             | 9,085                      | 9,085             |
| Subordinated debt             | 9,944                      | 9,944             | 2,715                      | 2,715             |
| Long-term debt                | 51,566                     | 49,035            | 61,216                     | 60,381            |

The carrying value of cash and cash equivalents, other investments, deposits with no stated maturities, short-term borrowings, and accrued interest approximate fair value. The fair value of securities was calculated using the most recent transaction price or a pricing model, which takes into consideration maturity, yields and quality. The remaining financial instruments were valued based on the present value of estimated future cash flows, discounted at various rates in effect for similar instruments entered into during the month of December of each year.

**Table of Contents****F & M Bank Corp. and Subsidiaries****Notes to the Consolidated Financial Statements****December 31, 2010 and 2009****NOTE 20 FAIR VALUE MEASUREMENTS**

Accounting Standards Codification (ASC 820), Fair Value Measurement Disclosures (formerly FAS No. 157), defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

**Level 1** Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

**Level 2** Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

**Level 3** Inputs to the valuation methodology are unobservable and significant to the fair value measurement. The following sections provide a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

**Securities:** Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

**Loans Held for Sale:** Loans held for sale are short-term loans purchased at par for resale to investors at the par value of the loan. These loans are generally repurchased within 15 days. Because of the short-term nature and fixed repurchased price, the book value of these loans approximates fair value.

**Impaired Loans:** SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

**Other Real Estate Owned:** Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

**Assets and Liabilities Recorded at Fair Value on a Recurring Basis (in thousands)**

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis.

| <b>December 31, 2010</b>                        | <b>Total</b>     | <b>Level 1</b>  | <b>Level 2</b>   | <b>Level 3</b> |
|---|------------------|-----------------|------------------|----------------|
| Government sponsored enterprises                | \$ 8,001         |                 | \$ 8,001         |                |
| Mortgage-backed obligations of federal agencies | 3,931            |                 | 3,931            |                |
| Marketable Equities                             | 3,315            | 3,315           |                  |                |
| Investment securities available for sale        | 15,247           | 3,315           | 11,932           |                |
| <b>Total assets at fair value</b>               | <b>\$ 15,247</b> | <b>\$ 3,315</b> | <b>\$ 11,932</b> |                |

Total liabilities at fair value

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**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 20 FAIR VALUE MEASUREMENTS, CONTINUED**

| <b>December 31, 2009</b>                        | <b>Total</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> |
|---|--------------|----------------|----------------|----------------|
| Government sponsored enterprises                | \$ 6,012     |                | \$ 6,012       |                |
| Mortgage-backed obligations of federal agencies | 6,170        |                | 6,170          |                |
| Marketable Equities                             | 3,743        | 3,743          |                |                |
| Corporate Bonds                                 | 505          | 505            |                |                |
| Investment securities available for sale        | 16,430       | 4,248          | 12,182         |                |
| Total assets at fair value                      | \$ 16,430    | 4,248          | \$ 12,182      |                |

Total liabilities at fair value

**Assets and Liabilities Recorded at Fair Value on a Non-Recurring Basis (in thousands)**

The table below presents the recorded amount of assets and liabilities measured at fair value on a non-recurring basis.

| <b>December 31, 2010</b>   | <b>Total</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> |
|----------------------------|--------------|----------------|----------------|----------------|
| Loans Held for Sale        | \$ 23,764    |                | \$ 23,764      |                |
| Other Real Estate Owned    | 1,513        |                | 1,513          |                |
| Real Estate                | 5,938        |                | 5,938          |                |
| Commercial                 | 988          |                | 988            |                |
| Consumer                   | 7            |                | 7              |                |
| Home Equity                | 321          |                | 321            |                |
| Impaired loans             | 7,254        |                | 7,254          |                |
| Total assets at fair value | \$ 32,531    |                | \$ 32,531      |                |

Total liabilities at fair value

| <b>December 31, 2009</b>   | <b>Total</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> |
|----------------------------|--------------|----------------|----------------|----------------|
| Loans Held for Sale        | \$ 31,168    |                | \$ 31,168      |                |
| Other Real Estate Owned    | 526          |                | 526            |                |
| Real Estate                | 1,123        |                | 1,123          |                |
| Commercial                 | 5,585        |                | 5,585          |                |
| Consumer                   |              |                |                |                |
| Impaired loans             | 6,708        |                | 6,708          |                |
| Total assets at fair value | \$ 38,402    |                | \$ 38,402      |                |

Total liabilities at fair value

There were no significant transfers between levels 1 and 2.

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**Table of Contents****F & M Bank Corp. and Subsidiaries****Notes to the Consolidated Financial Statements****December 31, 2010 and 2009****NOTE 21 REGULATORY MATTERS:**

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

Quantitative measures established by regulation, to ensure capital adequacy, require the Company to maintain minimum amounts and ratios. These ratios are defined in the regulations and the amounts are set forth in the table below. Management believes, as of December 31, 2010, that the Company and its subsidiary bank meet all capital adequacy requirements to which they are subject.

As of the most recent notification from the Federal Reserve Bank Report of Examination (which was as of January 12, 2009), the subsidiary bank was categorized as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company must maintain minimum total risk based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Company's actual consolidated capital ratios are presented in the following table (dollars in thousands):

|  | 2010       | Analysis of Capital<br>At December 31, |            | Regulatory<br>Requirements |                     |
|--|------------|--|------------|----------------------------|---------------------|
|  |            | 2009                                   | 2008       | Adequately<br>Capitalized  | Well<br>Capitalized |
| Tier1 capital:                               |            |  |            |                            |                     |
| Common stock                                 | \$ 11,530  | \$ 11,476                              | \$ 11,447  |                            |                     |
| Capital surplus                              |            |  |            |                            |                     |
| Retained earnings                            | 30,837     | 27,989                                 | 27,687     |                            |                     |
| Intangible assets                            | (2,716)    | (2,992)                                | (3,268)    |                            |                     |
| Accumulated other comprehensive<br>income    | 502        | 150                                    | (1,614)    |                            |                     |
| Total Tier 1 Capital                         | \$ 40,153  | \$ 36,623                              | \$ 34,252  |                            |                     |
| Tier 2 capital:                              |            |  |            |                            |                     |
| Qualifying subordinated debt                 | \$ 9,944   | \$ 2,715                               |            |                            |                     |
| Allowance for loan losses                    | 5,146      | 3,836                                  | 2,189      |                            |                     |
| Unrealized gains on AFS equity<br>securities | 302        | 150                                    |            |                            |                     |
| Total risk based capital                     | \$ 55,545  | \$ 43,324                              | \$ 36,441  |                            |                     |
| Risk-weighted assets                         | \$ 411,065 | \$ 420,379                             | \$ 362,851 |                            |                     |
| Capital ratios:                              |            |  |            |                            |                     |
| Total risk-based ratio                       | 13.51%     | 10.65%                                 | 10.00%     | 8.00%                      | 10.00%              |
| Tier 1 risk-based ratio                      | 9.77%      | 9.01%                                  | 9.44%      | 4.00%                      | 6.00%               |
| Total assets leverage ratio                  | 7.37%      | 7.08%                                  | 7.64%      | 3.00%                      | 5.00%               |



**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 21 REGULATORY MATTERS CONTINUED:**

The actual capital ratios for the subsidiary bank are presented in the following table (dollars in thousands):

|   | Analysis of Capital<br>At December 31, |                  |                  | Regulatory<br>Requirements |                     |
|---|--|------------------|------------------|----------------------------|---------------------|
|   | 2010                                   | 2009             | 2008             | Adequately<br>Capitalized  | Well<br>Capitalized |
| Tier1 capital:                            |  |                  |                  |                            |                     |
| Common stock                              | \$ 500                                 | \$ 500           | \$ 500           |                            |                     |
| Capital surplus                           | 18,971                                 | 18,971           | 15,550           |                            |                     |
| Retained earnings                         | 24,336                                 | 21,290           | 20,915           |                            |                     |
| Intangible assets                         | (2,716)                                | (2,992)          | (3,237)          |                            |                     |
| Accumulated other comprehensive<br>income | 251                                    | 84               | (1)              |                            |                     |
| <b>Total Tier 1 Capital</b>               | <b>\$ 41,342</b>                       | <b>\$ 37,853</b> | <b>\$ 33,727</b> |                            |                     |
| Tier 2 capital:                           |  |                  |                  |                            |                     |
| Qualifying subordinated debt              | \$ 9,944                               | \$ 2,715         |                  |                            |                     |
| Allowance for loan losses                 | 5,107                                  | 3,836            | 2,168            |                            |                     |
| Unrealized gains on AFS securities        | 131                                    | 84               |                  |                            |                     |
| <b>Total risked based capital</b>         | <b>\$ 56,524</b>                       | <b>\$ 44,488</b> | <b>\$ 35,895</b> |                            |                     |
| Risk-weighted assets                      | \$ 407,902                             | \$ 415,802       | \$ 356,375       |                            |                     |
| Capital ratios:                           |  |                  |                  |                            |                     |
| Total risk-based ratio                    | 13.86%                                 | 10.70%           | 10.07%           | 8.00%                      | 10.00%              |
| Tier 1 risk-based ratio                   | 10.14%                                 | 9.10%            | 9.46%            | 4.00%                      | 6.00%               |
| Total assets leverage ratio               | 7.64%                                  | 7.32%            | 7.53%            | 3.00%                      | 5.00%               |

**NOTE 22 INTANGIBLES:**

Core deposit intangible costs recognized from the acquisition of the Woodstock and Edinburg branches are being amortized using the straight-line method over a ten-year period. The core deposit intangibles and goodwill totaled \$2,833,476 and \$2,638,677, respectively at the acquisition date. Amortization expense for the years ending December 31, 2010, 2009 and 2008 was \$276,000 in each year.

**NOTE 23 INVESTMENT IN LIFE INSURANCE CONTRACTS**

The Bank currently offers a variety of benefit plans to all full time employees. While the costs of these plans are generally tax deductible to the Bank, the cost has been escalating greatly in recent years. To help offset escalating benefit costs and to attract and retain qualified employees, the Bank purchased Bank Owned Life Insurance (BOLI) contracts that will provide benefits to employees during their lifetime. Dividends received on these policies are tax-deferred and the death benefits under the policies are tax exempt. Rates of return on a tax-equivalent basis are very favorable when compared to other long-term investments which the Bank might make.

**Table of Contents****F & M Bank Corp. and Subsidiaries*****Notes to the Consolidated Financial Statements******December 31, 2010 and 2009*****NOTE 24 PARENT CORPORATION ONLY FINANCIAL STATEMENTS:*****Balance Sheets******December 31, 2010 and 2009***

|  | <b>2010</b>          | <b>2009</b>          |
|--|----------------------|----------------------|
| <b><i>Assets</i></b>   |                      |                      |
| Cash and cash equivalents  | \$ 279,671           | \$ 174,950           |
| Investment in subsidiaries   | 43,231,596           | 40,109,958           |
| Securities available for sale  | 2,340,897            | 3,347,452            |
| Limited partnership investments  | 228,826              | 1,814,800            |
| Deferred income taxes  | 326,527              | 592,604              |
| Other assets   | 211,442              | 61,839               |
| <b>Total Assets</b>  | <b>\$ 46,618,959</b> | <b>\$ 46,101,603</b> |
| <b><i>Liabilities</i></b>  |                      |                      |
| Long term debt   | \$ 3,999,750         | \$ 6,389,650         |
| Accrued interest payable   | 19,808               | 57,129               |
| Other liabilities  | 264,748              | 44,882               |
| Dividends payable  |                      | 345,731              |
| Due to subsidiaries  | 18,000               | 18,000               |
| Demand obligations for low income housing investment   | 273,438              | 366,438              |
| <b>Total Liabilities</b>   | <b>4,575,744</b>     | <b>7,221,830</b>     |
| <b><i>Stockholders Equity</i></b>  |                      |                      |
| Common stock par value \$5 per share, 6,000,000 shares authorized, 2,306,086 and 2,295,053 shares issued and outstanding for 2010 and 2009, respectively | \$ 11,530,430        | \$ 11,475,265        |
| Capital surplus  |                      |                      |
| Retained earnings  | 30,837,090           | 27,989,144           |
| Accumulated other comprehensive income (loss)  | (324,305)            | (584,636)            |
| <b>Total Stockholders Equity</b>   | <b>42,043,215</b>    | <b>38,879,773</b>    |
| <b>Total Liabilities and Stockholders Equity</b>   | <b>\$ 46,618,959</b> | <b>\$ 46,101,603</b> |

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 24 PARENT CORPORATION ONLY FINANCIAL STATEMENTS (CONTINUED):***Statements of Net Income and Retained Earnings**For the years ended December 31, 2010, 2009 and 2008*

|  | <b>2010</b>          | <b>2009</b>          | <b>2008</b>          |
|--|----------------------|----------------------|----------------------|
| <b><i>Income</i></b>   |                      |                      |                      |
| Dividends from affiliate   | \$ 920,000           | \$ 2,428,000         | \$ 2,809,000         |
| Investment income  |                      | 101                  | 465                  |
| Dividend income  | 126,838              | 169,966              | 324,219              |
| Interest Income  |                      |                      | 64,777               |
| Other than temporary impairment losses   | (65,158)             | (1,617,165)          | (1,206,581)          |
| Security gains (losses)  | 230,140              | (2,424)              | 21,855               |
| Net limited partnership income   | 11,941               | 192,597              | 101,518              |
| <b>Total Income</b>  | <b>1,223,761</b>     | <b>1,171,075</b>     | <b>2,115,253</b>     |
| <b><i>Expenses</i></b>   |                      |                      |                      |
| Interest expense   | 265,581              | 233,627              | 219,492              |
| Administrative expenses  | 216,854              | 211,294              | 182,285              |
| <b>Total Expenses</b>  | <b>482,435</b>       | <b>444,921</b>       | <b>401,777</b>       |
| Net income before income tax expense (benefit) and undistributed subsidiary net income | 741,326              | 726,154              | 1,713,476            |
| Income Tax Expense (Benefit)   | 46,532               | (824,542)            | (430,706)            |
| Income before undistributed subsidiary net income                                      | 694,794              | 1,550,696            | 2,144,182            |
| Undistributed subsidiary net income  | 3,045,866            | 403,326              | 1,059,834            |
| <b>Net Income</b>  | <b>\$ 3,740,660</b>  | <b>\$ 1,954,022</b>  | <b>\$ 3,204,016</b>  |
| <b><i>Retained earnings, beginning of year</i></b>                                     |                      |                      |                      |
| Adoption of FAS 106  |                      |                      | (428,112)            |
| Stock issuance   | 140,918              | 134,680              |                      |
| Stock repurchase   |                      | (43,666)             | (1,415,417)          |
| Dividends on common stock  | (1,033,632)          | (1,742,637)          | (2,083,015)          |
| <b>Retained Earnings, End of Year</b>  | <b>\$ 30,837,090</b> | <b>\$ 27,989,144</b> | <b>\$ 27,686,745</b> |





**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 24 PARENT CORPORATION ONLY FINANCIAL STATEMENTS (CONTINUED):***Statements of Cash Flows**For the years ended December 31, 2010, 2009 and 2008*

|   | <b>2010</b>         | <b>2009</b>           | <b>2008</b>           |
|---|---------------------|-----------------------|-----------------------|
| <b><i>Cash Flows from Operating Activities</i></b>                                |                     |                       |                       |
| Net income  | \$ 3,740,660        | \$ 1,954,022          | \$ 3,204,016          |
| Adjustments to reconcile net income to net cash provided by operating activities: |                     |                       |                       |
| Undistributed subsidiary income   | (3,045,866)         | (403,326)             | (1,059,834)           |
| Gain (Loss) on sale of securities   | (230,140)           | 2,424                 | (21,855)              |
| Other than temporary impairment losses  | 65,158              | 1,617,165             | 1,206,581             |
| Deferred tax (benefit) expense  | (106,056)           | (276,118)             | (1,269)               |
| Increase (decrease) in other assets   | 155,532             | (510,937)             | 144,130               |
| Increase (decrease) in other liabilities  | 74,631              | 261,568               | 97,407                |
| Net change in deferred tax credits  | (28,080)            | (20,235)              | 15,931                |
| Amortization of limited partnership investments                                   | 98,497              | 354,108               | 431,584               |
| <b>Net Cash Provided by Operating Activities</b>                                  | <b>\$ 724,336</b>   | <b>\$ 2,978,671</b>   | <b>\$ 4,016,691</b>   |
| <b><i>Cash Flows from Investing Activities</i></b>                                |                     |                       |                       |
| Proceeds from sales of securities available for sale                              | \$ 1,543,261        | \$ 32,228             | \$ 1,511,286          |
| Proceeds from maturities of securities available for sale                         | 1,487,477           | 656,250               |                       |
| Change in loans receivable  |                     |                       | 1,089,167             |
| Purchase of securities available for sale   | (92,087)            | (253,222)             | (962,408)             |
| Capital contributed to subsidiary   |                     |                       | (5,500,000)           |
| <b>Net Cash Provided by (Used in) Investing Activities</b>                        | <b>\$ 2,938,651</b> | <b>\$ 435,256</b>     | <b>\$ (3,861,955)</b> |
| <b><i>Cash Flows from Financing Activities</i></b>                                |                     |                       |                       |
| Proceeds of long-term debt  | \$ 7,229,000        | \$ 5,150,000          | \$ 5,650,000          |
| Payments on long-term debt  | (9,618,900)         | (6,019,706)           | (2,626,540)           |
| Change in short term debt   |                     | (750,000)             | 750,000               |
| Payments to repurchase common stock   |                     | (54,276)              | (1,805,517)           |
| Proceeds from issuance of common stock  | 196,083             | 173,071               | 118,135               |
| Dividends paid in cash  | (1,364,449)         | (1,932,332)           | (2,103,775)           |
| <b>Net Cash Used in Financing Activities</b>                                      | <b>(3,558,266)</b>  | <b>\$ (3,433,243)</b> | <b>\$ (17,697)</b>    |
| <b>Net Increase (decreases) in Cash and Cash Equivalents</b>                      | <b>104,721</b>      | <b>(19,316)</b>       | <b>137,039</b>        |
| <b><i>Cash and Cash Equivalents, Beginning of Year</i></b>                        | <b>\$ 174,950</b>   | <b>\$ 194,266</b>     | <b>\$ 57,227</b>      |

|   |            |            |            |
|---|------------|------------|------------|
| <i>Cash and Cash Equivalents, End of Year</i> | \$ 279,671 | \$ 174,950 | \$ 194,266 |
|---|------------|------------|------------|

**Table of Contents****F & M Bank Corp. and Subsidiaries***Notes to the Consolidated Financial Statements**December 31, 2010 and 2009***NOTE 25 INVESTMENT IN VBS MORTGAGE, LLC**

On November 3, 2008, the Bank acquired a 70% ownership interest in VBS Mortgage, LLC (formerly Valley Broker Services, DBA VBS Mortgage). VBS originates both conventional and government sponsored mortgages for sale in the secondary market. As of December 31, 2010 and 2009, VBS summarized balance sheet and income statement were as follows:

***Balance Sheets***  
***December 31, 2010 and 2009***

|                                      | <b>2010</b>    | <b>2009</b>    |
|--------------------------------------|----------------|----------------|
| <i>Assets</i>                        |                |                |
| Cash and cash equivalents            | \$ 392,707     | \$ 382,601     |
| Interest bearing deposits with banks | 150,549        |                |
| Property and equipment, net          | 41,867         | 36,688         |
| Other Assets                         | 222,330        | 127,448        |
| <br>Total Assets                     | <br>\$ 807,453 | <br>\$ 546,737 |
| <br><i>Liabilities</i>               |                |                |
| Other liabilities                    | 187,008        | 137,707        |
| <br>Total Liabilities                | <br>187,008    | <br>137,707    |
| <br><i>Equity</i>                    |                |                |
| Capital                              | 131,108        | 219,634        |
| Retained earnings                    | 489,337        | 189,396        |
| <br>Total Equity                     | <br>620,445    | <br>409,030    |
| <br>Total Liabilities and Equity     | <br>\$ 807,453 | <br>\$ 546,737 |

***Statements of Income***  
***For the years ended December 31, 2010 and 2009***

|                                | <b>2010</b>   | <b>2009</b>   |
|--------------------------------|---------------|---------------|
| <i>Income</i>                  |               |               |
| Mortgage origination income    | \$ 1,839,289  | \$ 1,740,801  |
| Other income                   | 147           | 5,933         |
| <br>Total Income               | <br>1,839,436 | <br>1,746,734 |
| <br><i>Expenses</i>            |               |               |
| Interest expense               |               | 6             |
| Salaries and employee benefits | 937,007       | 775,521       |

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|                                  |            |            |
|----------------------------------|------------|------------|
| Occupancy and equipment expense  | 120,503    | 111,583    |
| Management and professional fees | 330,224    | 382,076    |
| Other                            | 151,761    | 224,615    |
| Total Expenses                   | 1,539,495  | 1,493,801  |
| Net income (loss)                | \$ 299,941 | \$ 252,933 |

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors  
F & M Bank Corp. and Subsidiaries  
Timberville, Virginia

We have audited the accompanying consolidated balance sheets of F & M Bank Corp. and Subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, changes in stockholders' equity and comprehensive income and cash flows each of the three years in the period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of F & M Bank Corp. and Subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the three years in the period ended December 31, 2010 in conformity with U.S. generally accepted accounting principles.

Galax, Virginia  
March 24, 2011

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**Table of Contents****Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

*Disclosure Controls and Procedures.* The Company, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of December 31, 2010 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Management's Report on Internal Control over Financial Reporting.* Management is responsible for establishing and maintaining adequate internal control over financial reporting (as such term is defined in Rule 13a-15(f) and Rule 15d-15(f) under the Exchange Act). Our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Because of the inherent limitations in any internal control, no matter how well designed, misstatements may occur and not be prevented or detected. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, the evaluation of the effectiveness of internal control over financial reporting was made as of a specific date, and continued effectiveness in future periods is subject to the risks that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies and procedures may decline.

Management conducted an evaluation of the effectiveness of our system of internal control over financial reporting as of December 31, 2010 based on the framework set forth in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its evaluation, management concluded that, as of December 31, 2010, F&M's internal control over financial reporting was effective.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

*Changes in Internal Control over Financial Reporting.* There were no changes in the Company's internal control over financial reporting during the Company's quarter ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Item 9B. Other Information**

None.

**Table of Contents****PART III****Item 10. Directors and Executive Officers of the Registrant**

Information regarding directors, executive officers and the audit committee financial expert is incorporated by reference from the Company's definitive proxy statement for the Company's 2011 Annual Meeting of Shareholders to be held May 14, 2011 ( Proxy Statement ), under the captions Election of Directors, Board of Directors and Committees, and Executive Officers.

Information on Section 16(a) beneficial ownership reporting compliance for the directors and executive officers of the Company is incorporated by reference from the Proxy Statement under the caption Section 16(a) Beneficial Ownership Reporting Compliance.

The Company has adopted a broad based code of ethics for all employees and directors. The Company has also adopted a code of ethics tailored to senior officers who have financial responsibilities. A copy of the codes may be obtained without charge by request from the corporate secretary.

**Item 11. Executive Compensation**

This information is incorporated by reference from the Proxy Statement under the caption Executive Compensation.

**Item 12. Security Ownership of Certain Beneficial Owners and Management**

This information is incorporated by reference from the Proxy Statement under the caption Ownership of Company Common Stock and Executive Compensation and from Item 5 of this 10-K.

**Item 13. Certain Relationships and Related Transactions**

This information is incorporated by reference from the Proxy Statement under the caption Interest of Directors and Officers in Certain Transactions.

**Item 14. Principal Accounting Fees and Services**

This information is incorporated by reference from the Proxy Statement under the caption Principal Accounting Fees.

**PART IV****Item 15. Exhibits and Financial Statement Schedules**

The following financial statements are filed as a part of this report:

**(a)(1) Financial Statements**

The following consolidated financial statements and reports of independent auditors of the Company are in Part II, Item 8 on pages 33 thru 67:

|   |    |
|---|----|
| <u>Consolidated Balance Sheets</u> December 31, 2010 and 2009                                       | 33 |
| <u>Consolidated Statements of Income</u> Years ended December 31, 2010, 2009 and 2008               | 34 |
| <u>Consolidated Statements of Stockholders' Equity</u> Years ended December 31, 2010, 2009 and 2008 | 35 |
| <u>Consolidated Statements of Cash Flows</u> Years ended December 31, 2010, 2009 and 2008           | 36 |
| <u>Notes to the Consolidated Financial Statements</u>   | 37 |
| <u>Report of the Independent Registered Public Accounting Firm</u>                                  | 67 |

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**(a)(2) Financial Statement Schedules**

All schedules are omitted since they are not required, are not applicable, or the required information is shown in the consolidated financial statements or notes thereto.

**(a)(3) Exhibits**

The following exhibits are filed as a part of this form 10-K and this list includes the Exhibit index:

Exhibit No.

- 3.1 Restated Articles of Incorporation of F & M Bank Corp. as incorporated by reference to F & M Bank Corp. s 10-Q filed August 13, 2007.
- 3.2 Amended and Restated Bylaws of F & M Bank Corp. as incorporated by reference to F & M Bank Corp. s 10-K filed March 8, 2002.

21.0 Subsidiaries of the Registrant

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Shareholders may obtain, free of charge, a copy of the exhibits to this Report on Form 10-K by writing Larry A. Caplinger, Corporate Secretary, at F & M Bank Corp., P.O. Box 1111, Timberville, VA 22853 or our website at [www.farmersandmerchants.biz](http://www.farmersandmerchants.biz).**



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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

F & M Bank Corp.  
(Registrant)

By: /s/ Dean W. Withers March 24, 2011

Dean W. Withers Date  
Director, President and Chief Executive  
Officer

By: /s/ Neil W. Hayslett March 24, 2011

Neil W. Hayslett Date  
Executive Vice President and Chief Financial  
Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and as of the date indicated.

| <b>Signature</b>          | <b>Title</b>       | <b>Date</b>    |
|---------------------------|--------------------|----------------|
| /s/ Thomas L. Cline       | Director, Chairman | March 24, 2011 |
| Thomas L. Cline           |                    |                |
|                           | Director           | March 24, 2011 |
| John N. Crist             |                    |                |
| /s/ Ellen R. Fitzwater    | Director           | March 24, 2011 |
| Ellen R. Fitzwater        |                    |                |
| /s/ Daniel J. Harshman    | Director           | March 24, 2011 |
| Daniel J. Harshman        |                    |                |
|                           | Director           | March 25, 2011 |
| Richard S. Myers          |                    |                |
|                           | Director           | March 24, 2011 |
| Michael W. Pugh           |                    |                |
| /s/ Christopher S. Runion | Director           | March 24, 2011 |
| Christopher S. Runion     |                    |                |

Director

March 24, 2011

Ronald E. Wampler

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