

F&M BANK CORP  
Form 10-K  
March 20, 2007

**Table of Contents**

**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, 2006**  
**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 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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer  Accelerated filer  Non-accelerated filer

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 2,203,357 shares of Common Stock of the registrant issued and outstanding held by non-affiliates on June 30, 2006 was approximately \$61,693,996 based on the closing sales price of \$28.00 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, 2007, there were 2,369,333 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 12, 2007 (the "Proxy Statement").



## TABLE OF CONTENTS

		<u>Page</u>
<b><u>PART I</u></b>		
<u>Item 1</u>	<u>Business</u>	1
<u>Item 1A</u>	<u>Risk Factors</u>	4
<u>Item 1B</u>	<u>Unresolved Staff Comments</u>	6
<u>Item 2</u>	<u>Properties</u>	7
<u>Item 3</u>	<u>Legal Proceedings</u>	7
<u>Item 4</u>	<u>Submission of Matters to a Vote of Security Holders</u>	7
<b><u>PART II</u></b>		
<u>Item 5</u>	<u>Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	7
<u>Item 6</u>	<u>Selected Financial Data</u>	10
<u>Item 7</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	11
<u>Item 8</u>	<u>Financial Statements and Supplementary Information</u>	28
<u>Item 9</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	56
<u>Item 9A</u>	<u>Controls and Procedures</u>	56
<u>Item 9B</u>	<u>Other Information</u>	56
<b><u>PART III</u></b>		
<u>Item 10</u>	<u>Directors and Executive Officers of the Registrant</u>	57
<u>Item 11</u>	<u>Executive Compensation</u>	57
<u>Item 12</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	57
<u>Item 13</u>	<u>Certain Relationships and Related Transactions</u>	57
<u>Item 14</u>	<u>Principal Accounting Fees and Services</u>	57
<b><u>PART IV</u></b>		
<u>Item 15</u>	<u>Exhibits and Financial Statement Schedules</u>	57
	<u>EX-21</u>	
	<u>EX-31.1</u>	
	<u>EX-31.2</u>	
	<u>EX-32.1</u>	

---

**Table of Contents**

**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 two affiliates, Farmers & Merchants Bank (Bank) and TEB Life Insurance Company (TEB). Farmers & Merchants Financial Services, Inc. (FMFS) is a wholly owned subsidiary of Farmers & Merchants Bank.

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.

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, and drive-in banking services. 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.

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.

**Recent Developments**

During 2006, the Bank opened three new branch offices. The first office is a leased facility containing approximately 1312 square feet, located at 1085 Port Republic Road, Harrisonburg, Virginia. This is a full-service facility, staffed by six full-time equivalent employees. The facility has two drive-in teller lanes and a drive-up ATM. The facility opened on April 10, 2006. The second branch is located at 700 East Main Street, Luray, Virginia. This is also a leased facility containing approximately 1880 square feet. This is a full-service facility, staffed by five full-time equivalent employees. The facility has three drive-in lanes and a drive-up ATM and opened on July 5, 2006.

The third office is located at 80 Cross Keys Road, Harrisonburg, Virginia. This facility is owned by the Bank and contains approximately 6300 square feet. This is a full-service facility employing approximately thirteen full-time equivalent employees, including branch staff, business development officers, an investment officer and mortgage production staff. The facility has three drive-in teller lanes, and a drive-up ATM. The facility opened on August 28, 2006. Concurrently with the opening of this office we closed our branch office located at the Elkton Plaza Shopping Center, Elkton, Virginia and our mortgage origination/investment sales office located at 207 University Boulevard, Harrisonburg, Virginia. The employees at both of these locations were transferred to the new branch to form the core of the staffing for this new facility. At year end loans and deposits outstanding at these offices (excluding the loans and deposits of the two merged facilities) totaled \$10,283,000 and \$12,640,000, respectively.

The Bank also operates a courier service which was started to pick up commercial deposits on a daily basis in the Harrisonburg area. In September the Bank received regulatory approval to expand its courier service into Page and Shenandoah Counties. The Bank has since added a second courier vehicle to accommodate the additional customer deposit pick ups.

**Table of Contents**

**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*, 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*.

**Employees**

On December 31, 2005, F & M Bank Corp., the Bank, TEB and FMFS had 133 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.

**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 new 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.

**Table of Contents**

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 the Housing Equity Fund of Virginia II, III, IV, V, VII, VIII, IX, X, Historic Equity Fund I and Local & Historic Fund II. 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 for 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, as well as the payment of dividends by the Company to its respective shareholders.

The Bank is subject to various statutory restrictions on its ability to pay dividends 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 shareholders' 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, 2006 were 12.76% and 13.42%, respectively, exceeding the minimum requirements.

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, 2006, was 9.48%, which is 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.

**Table of Contents**

*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 is 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* 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.

**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.

**Table of Contents**

**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 effects 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.

**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.

**Table of Contents**

**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, 2006.

**Table of Contents**

**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, with the exception of Edinburg.

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, four in Harrisonburg, VA, and one ATM at a convenience store in Edinburg, VA.

**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. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of security holders of the Company during the fourth quarter of the period covered by this report.

**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**

Farmers & Merchants Bank  
 205 South Main Street  
 P.O. Box 1111  
 Timberville, VA 22853

**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, 2001, and the reinvestment of dividends.

**Total Return Performance**

<i>Index</i>	<i>Period Ending</i>					
	<b>12/31/01</b>	<b>12/31/02</b>	<b>12/31/03</b>	<b>12/31/04</b>	<b>12/31/05</b>	<b>12/31/06</b>
F & M Bank Corp.	100.00	107.58	132.83	159.85	164.41	183.30
Russell 2000	100.00	79.52	117.09	138.55	144.86	171.47
SNL Bank Index	100.00	91.69	123.69	138.61	140.50	164.35

**Recent Stock Prices and Dividends**

Dividends to shareholders totaled \$1,953,000 and \$1,878,100 in 2006 and 2005, respectively. Regular quarterly dividends have been declared for forty-eight consecutive quarters. Dividends per share increased 5.13% in 2006. The ratio of dividends per share to net income per share was 43.16% in 2006, compared to 38.70% in 2005. The decision as to timing, amount and payment of dividends is at the discretion of the Company's Board of Directors. 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.

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

On June 12, 2003, the Board authorized the repurchase of 50,000 shares of the Company's outstanding common stock. Management has been authorized to repurchase shares from time to time in the open market or through privately negotiated transactions when market conditions warrant. The repurchased shares are accounted for as retired stock. On July 26, 2006, the Board of Directors approved an amendment to the share repurchase program. The amendment increases the number of shares of common stock that the Registrant can repurchase under the program from 50,000 to 100,000 shares. As of September 30, 2006, the Company had repurchased 69,862 shares of its common stock under the program. Shares repurchased through the end of 2006 total 72,969; of this amount, 37,844 shares were repurchased in 2006.

The number of common shareholders of record was approximately 1,675 as of March 1, 2007. This amount includes all shareholders, whether titled individually or held by a brokerage firm or custodian in street name.

**Quarterly Stock Information**

These quotes were obtained from Davenport & Company and 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	2006		Per Share Dividend	2005		Per Share Dividend
	Per Share Range			Stock Price Range		
	Low	High		Low	High	
1 <sup>st</sup>	25.75	28.60	.20	26.00	26.50	.19
2 <sup>nd</sup>	27.10	30.00	.20	24.15	26.20	.19
3 <sup>rd</sup>	27.50	30.00	.21	24.60	25.25	.20
4 <sup>th</sup>	27.00	30.00	.21	24.75	26.00	.20
Total			.82			.78

**Table of Contents****Item 6****Five Year Summary of Selected Financial Data**

(Dollars in thousands, except per share data)

	2006	2005	2004	2003	2002
<b>Income Statement Data:</b>					
Interest and Dividend Income	\$ 22,526	\$ 19,878	\$ 16,804	\$ 16,683	\$ 17,846
Interest Expense	9,091	6,998	5,396	6,010	7,390
Net Interest Income	13,435	12,880	11,408	10,673	10,456
Provision for Loan Losses	240	360	240	226	387
Net Interest Income after Provision for Loan Losses	13,195	12,520	11,168	10,447	10,069
Noninterest Income	2,754	2,643	2,254	2,308	1,380
Securities Gains (Losses)	193	71	532	179	(182)
Noninterest Expenses	9,688	8,608	7,741	7,256	6,448
Income before Income Taxes	6,454	6,626	6,213	5,678	4,819
Income Tax Expense	1,925	1,846	1,863	1,666	1,315
Net Income	\$ 4,529	\$ 4,780	\$ 4,350	\$ 4,012	\$ 3,504
<b>Per Share Data:</b>					
Net Income	\$ 1.90	\$ 1.99	\$ 1.80	\$ 1.66	\$ 1.44
Dividends Declared	.82	.78	.74	.70	.66
Book Value	16.05	15.22	14.21	13.35	12.19
<b>Balance Sheet Data:</b>					
Assets	\$ 375,924	\$ 346,328	\$ 369,957	\$ 309,126	\$ 303,149
Loans Held for Investment	309,461	277,398	248,972	211,231	201,980
Loans Held for Sale		3,528	47,150		
Securities	37,373	34,921	38,800	61,230	69,602
Deposits	289,522	267,310	246,505	240,715	228,284
Short-Term Debt	11,717	14,345	57,362	6,389	8,308
Long-Term Debt	29,247	22,808	26,462	24,784	32,312
Shareholders Equity	38,105	36,567	34,260	32,319	29,541
Average Shares Outstanding	2,386	2,404	2,414	2,418	2,429
<b>Financial Ratios:</b>					
Return on Average Assets <sup>1</sup>	1.26%	1.34%	1.31%	1.29%	1.21%
Return on Average Equity <sup>1</sup>	12.13%	13.56%	13.11%	13.13%	12.12%
Net Interest Margin	4.17%	4.01%	3.82%	3.82%	4.03%
Efficiency Ratio <sup>2</sup>	57.45%	53.07%	54.02%	53.96%	51.28%

Dividend Payout Ratio	43.12%	38.70%	41.06%	42.17%	45.72%
<b>Capital and Credit Quality Ratios:</b>					
Average Equity to Average Assets <sup>1</sup>	10.36%	9.86%	10.00%	9.86%	9.98%
Allowance for Loan Losses to Loans <sup>3</sup>	.58%	.60%	.61%	.70%	.73%
Nonperforming Assets to Total Assets	.58%	.20%	.63%	.52%	.86%
Net Charge-offs to Total Loans <sup>3</sup>	.04%	.07%	.09%	.10%	.10%

<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.

**Table of Contents**

**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.

**Critical Accounting Policies**

**General**

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States ( 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.

**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) Statement of Financial Accounting Standard ( SFAS ) No. 5, "Accounting for Contingencies", which requires that losses be accrued when they are probable of occurring and estimable and (ii) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan", 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 SFAS No. 5 or SFAS No. 114. Management's estimate of each SFAS No. 5 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 commercial loans are determined by applying estimated loss factors to the portfolio based on management's evaluation and risk grading of the commercial loan portfolio. Allowances are provided for noncommercial loan categories using estimated loss factors applied to the total outstanding loan balance of each loan category. Specific allowances are typically provided on all impaired commercial loans in excess of a defined threshold that are classified in the Special Mention, Substandard or Doubtful risk grades. The specific reserves are determined on a loan-by-loan basis based on management's evaluation the Company's exposure for each credit, given the current payment status of the loan and the value of any underlying collateral.

**Table of Contents****Management's Discussion and Analysis of Financial Condition and Results of Operations  
Allowance for Loan Losses (Continued)**

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 Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 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. SFAS No. 142 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 SFAS No. 142 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. SFAS No. 142 also requires that reporting units be identified for the purpose of assessing potential future impairments of goodwill. The Company adopted SFAS No. 142 on January 1, 2002. Goodwill totaled \$2,639,000 at January 1, 2002. The goodwill is not amortized but is tested for impairment at least annually. Based on this testing, there were no impairment charges for 2006 or 2005. Application of the non-amortization provisions of the Statement resulted in additional net income of \$120,000 for 2006 and \$181,000 for the years ended December 31, 2005 and 2004. Core deposit intangibles are amortized on a straight-line basis over a ten year life. Core deposit intangible, net of amortization, amounted to \$1,150,000 and \$1,426,000 at December 31, 2006 and 2005, respectively. The Company adopted SFAS 147 on January 1, 2002 and determined that the core deposit intangible will continue to be amortized over its estimated useful life.

**Securities Impairment**

The Company evaluates each of its investments in securities, debt and equity, under guidelines contained in SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. These guidelines require the Company to determine whether a decline in value below original cost is other than temporary. In making its determination, management considers current market conditions, historical trends in the individual securities, and historical trends in the overall markets. Expectations are developed regarding potential returns from dividend reinvestment and price appreciation over a reasonable holding period (five years) and current carrying values are compared to these expected values. Declines determined to be other than temporary are charged to operations and included in the gain (loss) on security sales. Such charges were \$40,000 for 2006, \$119,000 for 2005 and \$162,000 for 2004.

**Overview**

The Company's net income for 2006 totaled \$4,529,000 or \$1.90 per share, down 5.25% from \$4,780,000 or \$1.99 a share in 2005. Return on average equity decreased in 2006 to 12.13% versus 13.56% in 2005, while the return on average assets decreased from 1.34% to 1.26%. The Company's operating earnings, which are net earnings excluding gains (losses) on the sale of investments, non-recurring tax entries and non-cash amortization of acquisition intangibles were \$4,632,000 in 2006 versus \$4,765,000 in 2005, a decrease of 2.79%. Core profitability decreased as a result of costs associated with opening three new branches and as a result of the decline in income on a mortgage loan participation program.

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

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

**Changes in Net Income per Common Share**

	<b>2006 to 2005</b>	<b>2005 to 2004</b>
Prior Year Net Income Per Share	\$ 1.99	\$ 1.80
Change from differences in:		
Net interest income	.28	.64
Provision for credit losses	.05	(.05)
Noninterest income, excluding securities gains	.05	.17
Securities gains	.05	(.19)
Noninterest expenses	(.48)	(.38)
Income taxes	(.04)	
 Total Change	 (.09)	 .19
 Net Income Per Share	 \$ 1.90	 \$ 1.99

**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 2006 was \$13,435,000 representing an increase of \$555,000 or 4.31%. A 12.90% increase in 2005 versus 2004 resulted in total net interest income of \$12,880,000. In this discussion and in the tabular analysis of net interest income performance, entitled Consolidated Average Balances, Yields and Rates, (found on page 14), 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.

The analysis on the next page reveals an increase in net interest margin to 4.17% in 2006 primarily due to the increase in loan volume and the Federal Reserve's measured increase in rates during the year. During 2005 the net interest margin increased .19% resulting from the Federal Reserve's accommodative monetary stance.

Loans held for investment increased in 2006 to 90.40% of total earning assets as compared to 83.05% in 2005. This increase in loan volume and the overall increase in rates generated interest income that more than offset the decline in volume in other asset categories. Tax equivalent income on earning assets increased \$2,665,000, supported by the increase in loan income of \$2,442,000. Increased yields in most asset categories resulted in overall increase in the yield on earning assets of .80%.

Interest bearing liabilities experienced increased costs during 2006, with the cost of funds rising .79% compared to an increase of .46% in 2005.

**Table of Contents**

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