

F&M BANK CORP
Form 10-K
March 22, 2012

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, 2011

Commission file number: 0-13273

F & M BANK CORP.

(Exact name of registrant as specified in its charter)

Virginia	54-1280811
(State or other jurisdiction of incorporation or organization)	(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

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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	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting Company	<input type="checkbox"/>

(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 2,225,428 shares of Common Stock of the registrant issued and outstanding held by non-affiliates on June 30, 2011 was approximately \$28,374,207 based on the closing sales price of \$12.75 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 16, 2012, there were 2,494,598 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, 2012 (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 and mobile 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 services, commercial and personal lines of insurance 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, 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, 2011, the Bank had 144 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 Company 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, pro- vision 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, 2011 were 10.52% and 14.09%, respectively, significantly above 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, 2011, was 8.03%, 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; 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.

Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act was signed into law on July 21, 2010. Its wide ranging provisions affect all federal financial regulatory agencies and nearly every aspect of the American financial services industry. Among the provisions of the Dodd-Frank Act that directly impact the Company is the creation of an independent Consumer Financial Protection Bureau (CFPB), which has the ability to write rules for consumer protections governing all financial institutions. All consumer protection responsibility formerly handled by other banking regulators is consolidated in the CFPB. It will also oversee the enforcement of all federal laws intended to ensure fair access to credit. For smaller financial institutions such as the Company and the Bank, the CFPB will coordinate its examination activities through their primary regulators.

The Dodd-Frank Act contains provisions designed to reform mortgage lending, which includes the requirement of additional disclosures for consumer mortgages. In addition, the Federal Reserve has issued new rules that have the effect of limiting the fees charged to merchants for debit card transactions. The result of these rules will be to limit the amount of interchange fee income available explicitly to larger banks and indirectly to us. The Dodd-Frank Act also contains provisions that affect corporate governance and executive compensation.

Although the Dodd-Frank Act provisions themselves are extensive, the ultimate impact on the Company of this massive legislation is unknown. The Act provides that several federal agencies, including the Federal Reserve and the Securities and Exchange Commission, shall issue regulations implementing major portions of the legislation, and this process is ongoing.

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.

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.

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, 2011.

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. MINE SAFETY DISCLOSURES

None.

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.

Transfer Agent and Registrar

Registrar & 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.

Index	2006	2007	2008	2009	2010	2011
F & M Corp	100.00	113.32	113.58	89.17	58.43	57.30
Russell 2000	100.00	98.43	65.18	82.89	105.14	100.75
SNL Bank Index	100.00	77.71	44.34	43.88	49.17	38.08

Recent Stock Prices and Dividends

Dividends to shareholders totaled \$1,466,000 and \$1,034,000 in 2011 and 2010, respectively. Regular quarterly dividends have been declared for sixty consecutive quarters. 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 31.41% in 2011, compared to 36.81% in 2010.

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 2011 totaled 164,132 shares; of this amount, none were repurchased in 2011.

The number of common shareholders of record was approximately 1,774 as of March 16, 2012. 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	2011		Per Share Dividends Declared(1)	2010		Per Share Dividends Declared
	Stock Price Range Low	High		Stock Price Range Low	High	
1st	13.00	15.50	\$.15	20.75	26.00	\$.15
2nd	12.20	13.99	.15	18.05	22.00	.15
3rd	11.75	15.00	.15	15.15	20.00	.15
4th	12.40	14.00	.15	13.25	16.24	.15
Total			\$.60			\$.60

(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.

ITEM 6. SELECTED FINANCIAL DATA

Five Year Summary of Selected Financial Data

(Dollars in thousands, except per share data)

	2011	2010	2009	2008	2007	
Income Statement Data:						
Interest and Dividend Income	\$27,680	\$27,870	\$27,516	\$25,544	\$24,635	
Interest Expense	7,719	9,005	10,182	10,498	11,043	
Net Interest Income	19,961	18,865	17,334	15,046	13,592	
Provision for Loan Losses	4,000	4,300	4,210	815	270	
Net Interest Income after Provision for Loan Losses						
Noninterest Income	3,118	3,249	3,111	3,169	3,215	
Securities Gains (Losses)	1,024	349	(1,754)	(1,680)	101	
Noninterest Expenses	12,892	12,741	12,188	11,097	10,532	
Income before Income Taxes	7,211	5,422	2,293	4,623	6,106	
Income Tax Expense	2,523	1,681	339	1,419	1,653	
Net Income	\$4,688	\$3,741	\$1,954	\$3,204	\$4,453	
Per Share Data:						
Net Income	\$1.91	\$1.63	\$.85	\$1.38	\$1.89	
Dividends Declared	.60	.60	.76	.90	.86	
Book Value	18.53	18.31	16.99	15.64	16.71	
Balance Sheet Data:						
Assets	\$566,734	\$538,855	\$539,223	\$472,058	\$386,727	
Loans Held for Investment	451,570	445,147	434,403	399,233	317,180	
Loans Held for Sale	60,543	23,764	31,168	3,780	-	
Securities	22,108	24,144	26,220	30,785	36,614	
Deposits	435,947	425,051	420,643	342,225	298,560	
Short-Term Debt	18,539	5,355	9,085	20,510	12,743	
Long-Term Debt	57,298	58,979	63,096	65,331	29,714	
Stockholders' Equity	46,180	42,229	39,002	36,305	39,165	
Average Shares Outstanding	2,450	2,299	2,292	2,319	2,360	
Financial Ratios:						
Return on Average Assets ¹	.84	% .69	% .38	% .75	% 1.17	%
Return on Average Equity ¹	10.41	% 9.22	% 5.10	% 8.50	% 11.53	%
Net Interest Margin	3.87	% 3.77	% 3.70	% 3.89	% 3.94	%
Efficiency Ratio ²	55.57	% 57.23	% 57.74	% 58.60	% 60.31	%
Dividend Payout Ratio	31.41	% 36.81	% 89.18	% 65.01	% 45.60	%
Capital and Credit Quality Ratios:						
Average Equity to Average Assets ¹	8.14	% 7.46	% 7.37	% 8.85	% 10.05	%

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Allowance for Loan Losses to Loans ³	1.54	%	1.30	%	.88	%	.55	%	.54	%
Nonperforming Loans to Total Assets ⁴	2.61	%	2.94	%	1.42	%	1.01	%	1.11	%
Nonperforming Assets to Total Assets ⁵	3.15	%	3.22	%	1.52	%	1.01	%	1.11	%
Net Charge-offs to Total Loans ³	.63	%	.53	%	.59	%	.08	%	.11	%

¹ Ratios are primarily based on daily average balances.

² 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.

³ Calculated based on Loans Held for Investment, excludes Loans Held for Sale.

⁴ Calculated based on 90 day past due and non-accrual to Total Assets.

⁵ Calculated based on 90 day past due, non-accrual and OREO to Total Assets

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 senior 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.

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.

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 loan size 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 2011 or 2010. 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, 2011, 2010 and 2009.

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 \$276,000 at December 31, 2011 and 2010, 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. The core deposit intangible was fully amortized during 2011.

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 security 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) beginning with 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 was 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 other than temporary impairment losses. There were no such charges for 2011; however there were \$65,000 for 2010 and \$1,751,000 for 2009.

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

Overview

The Company's net income for 2011 totaled \$4,688,000 or \$1.91 per share, an increase of 25% over \$3,741,000 or \$1.63 a share in 2010. Return on average equity increased in 2011 to 10.41% versus 9.22% in 2010, while the return on average assets increased from .69% to .84%. 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 \$4,373,000 in 2011 versus \$3,539,000 in 2010, an increase of 23.6%. Core profitability increased due to the growth in the net interest margin which was driven by reduced interest expense.

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

Changes in Net Income per Common Share

	2011 to 2010	2010 to 2009
Prior Year Net Income Per Share	\$1.63	\$.85
Change from differences in:		
Net interest income	.45	.67
Provision for credit losses	.12	(.04)
Noninterest income, excluding securities gains	(.05)	.06
Securities gains	.28	.91
Noninterest expenses	(.06)	(.24)
Income taxes	(.34)	(.58)
Effect of rights offering	(.12)	-
Total Change	.28	.78
Net Income Per Share	\$1.91	\$1.63

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 2011 was \$19,921,000 representing an increase of \$1,096,000 or 5.81% over the prior year. An 8.83% increase in 2010 versus 2009 resulted in total net interest income of \$18,865,000. 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 decreased \$219,000. Loans held for investment, expressed as a percentage of total earning assets, decreased slightly in 2011 to 87.35% as compared to 87.92% in 2010. During 2011, yields on earning assets decreased 20 basis points (BP), primarily due to a 13BP 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 29BP in 2011, following a decrease of 42BP in 2010. 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. Recently the FOMC announced its intention to keep short term interest rates at these historically low levels until 2014.

The analysis on the next page reveals an increase in net interest margin to 3.87% in 2011 primarily due to changes in balance sheet leverage as the decline in yields on earning assets (20BP) is less than the decline in the cost of funds on interest bearing liabilities (29BP).

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

Consolidated Average Balances, Yields and Rates¹

	2011			2010			2009		
	Balance	Interest	Rate	Balance	Interest	Rate	Balance	Interest	Rate
ASSETS									
Loans²									
Commercial	\$ 174,748	\$ 8,992	5.15 %	\$ 180,292	\$ 9,474	5.25 %	\$ 172,883	\$ 9,382	5.43 %
Real estate	254,641	15,198	5.97 %	236,318	14,502	6.14 %	217,677	13,473	6.19 %
Installment	24,022	1,872	7.79 %	26,831	2,086	7.77 %	28,945	2,663	9.20 %
Loans held for investment ⁴	453,411	26,062	5.75 %	443,441	26,062	5.88 %	419,505	25,518	6.08 %
Loans held for sale	36,277	1,331	3.67 %	32,503	1,300	4.00 %	29,619	1,169	3.95 %
Investment securities³									
Fully taxable	12,246	259	2.11 %	12,298	420	3.42 %	15,602	720	4.61 %
Partially taxable	1,321	89	6.74 %	3,722	189	5.08 %	3,542	267	7.54 %
Tax exempt	-	-	-	-	-	-	38	3	7.89 %
Total investment securities	13,567	348	2.57 %	16,020	609	3.80 %	19,182	990	5.16 %
Interest bearing deposits in banks									
Federal funds sold	2,773	29	1.05 %	2,997	26	.87 %	924	16	1.73 %
Total Earning Assets	13,050	29	.22 %	9,390	21	.22 %	3,964	7	.18 %
Allowance for loan losses	(6,558)			(4,990)			(3,132)		
Nonearning assets	40,929			44,700			37,962		
Total Assets	\$ 553,449			\$ 544,061			\$ 508,024		

LIABILITIES AND STOCKHOLDERS' EQUITY

Deposits

Demand –interest bearing									
Savings	\$ 119,453	\$ 1,599	1.34 %	\$ 110,814	\$ 1,939	1.75 %	\$ 78,556	\$ 1,306	1.66 %
Time deposits	38,248	191	.50 %	35,666	191	.54 %	32,650	202	.62 %
Total interest bearing deposits	215,164	3,606	1.68 %	222,919	4,426	1.99 %	218,396	6,294	2.88 %
Total interest bearing deposits	372,865	5,396	1.45 %	369,399	6,556	1.77 %	329,602	7,802	2.37 %

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Short-term debt	8,845	40	.45 %	6,035	29	.48 %	14,700	78	.53 %
Long-term debt	56,258	2,282	4.06 %	63,565	2,421	3.81 %	67,320	2,302	3.42 %
Total interest bearing liabilities									
	437,968	7,718	1.76 %	438,999	9,006	2.05 %	411,622	10,182	2.47 %
Noninterest bearing deposits									
	68,141			56,328			51,124		
Other liabilities									
	2,272			8,166			6,929		
Total liabilities									
	508,381			503,493			469,675		
Stockholders' equity									
	45,068			40,568			38,349		
Total liabilities and stockholders' equity									
	\$ 553,449			\$ 544,061			\$ 508,024		
Net interest earnings									
		\$ 20,081			\$ 19,012			\$ 17,518	
Net yield on interest earning assets (NIM)									
			3.87 %			3.77 %			3.70 %

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

2 Interest income on loans includes loan fees.

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

4 Includes nonaccrual loans.

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.

	2011 Compared to 2010			2010 Compared to 2009		
	Increase (Decrease)			Increase (Decrease)		
	Due to		Increase or (Decrease)	Due to		Increase or (Decrease)
	Change in Average: Volume	Rate		Change in Average: Volume	Rate	
Interest income						
Loans held for investment	\$586	\$(586)	\$-	\$1,455	\$(911)	\$544
Loans held for sale	151	(120)	31	114	17	131
Investment securities						
Taxable	(2)	(159)	(161)	(152)	(148)	(300)
Partially taxable	(122)	22	(100)	14	(92)	(78)
Tax exempt	-	-	-	(3)	-	(3)
Interest bearing deposits in						
banks	(2)	5	3	36	(26)	10
Federal funds sold	8	-	8	10	4	14
Total Interest Income	619	(838)	(219)	1,474	(1,156)	318
Interest expense						
Deposits						
Demand	151	(491)	(340)	535	98	633
Savings	14	(14)	-	19	(30)	(11)
Time deposits	(154)	(666)	(820)	(3,348)	1,480	(1,868)
Short-term debt						
Long-term debt	13	(2)	11	(46)	(3)	(49)
Total Interest Expense	(254)	(1,034)	(1,288)	(2,968)	1,792	(1,176)
Net Interest Income	\$873	\$196	\$1,069	\$4,442	\$(2,948)	\$1,494

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 decreased \$219,000 or .78% in 2011, after increasing 1.15% or \$318,000 in 2010. Overall, the yield on earning assets decreased .20%, from 5.56% to 5.36%. Average loans outstanding grew during 2011, with average loans outstanding increasing \$9,970,000 to \$453,411,000. Real estate loans increased 7.75%, commercial loans decreased 3.08%. Lending conditions within the market were sluggish for the year as a result of the slow economy; virtually all 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 2.57%, decreased \$2,453,000 during 2011. 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 \$1,331,000, as compared to the \$1,300,000 during 2010. 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). The Gateway 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 and 2011. These loans are short-term, residential real estate loans that have an average life in our portfolio 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.

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

GAAP Financial Measurements:

(Dollars in thousands).	2011	2010	2009
Interest Income – Loans	\$27,295	\$27,256	\$26,563
Interest Income - Securities and Other Interest-Earnings Assets	384	615	976
Interest Expense – Deposits	5,396	6,556	7,802
Interest Expense - Other Borrowings	2,322	2,450	2,380
Total Net Interest Income	19,961	18,865	17,357

Non-GAAP Financial Measurements:

Add: Tax Benefit on Tax-Exempt Interest Income – Loans	98	106	125
Add: Tax Benefit on Tax-Exempt Interest Income - Securities and Other Interest-Earnings Assets	22	41	36
Total Tax Benefit on Tax-Exempt Interest Income	120	147	161
Tax-Equivalent Net Interest Income	\$20,081	\$19,012	\$17,518

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

Interest Expense

Interest expense decreased \$1,287,000 or 14.29% during 2011, which followed an 11.55% decrease or \$1,176,000 in 2010. The average cost of funds of 1.76% decreased .29% compared to 2010. Average interest bearing liabilities decreased \$1,031,000 in 2011 following an increase of \$27,377,000 in 2010. The decrease in interest bearing liabilities was primarily the result of a decrease in time deposits and long term debt. Time deposits decreased primarily due to a decrease in CDARS, 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. Long term debt decreased through normal debt repayment and decreased reliance on debt to fund loan originations due to increasing core deposits. Due to declining rates, both locally and nationally, the expense associated with time deposits decreased \$820,000 (18.5%) in 2011. 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 decreased 4.03% (161,000) in 2011 following an increase of 4.44% in 2010. Service charges on deposit accounts decreased \$90,000, 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 decreased \$88,000. This category includes a number of revenue items; however the largest category is debit card revenue. In 2011 debit card revenue totaled \$667,000 versus \$618,000 in 2010 an increase of \$49,000 which was offset by a \$149,000 decrease related to Low Income Housing project.

Securities transactions in 2011 resulted in net gains of \$1,025,000, which was primarily a result of the sale of the equities portfolio. This followed a gain of \$349,000 in 2010, including \$65,000 in write downs due to Other Than Temporary Impairment (OTTI) losses. Typically securities are considered impaired when their value has been significantly below cost for over a year.

Noninterest Expense

Noninterest expenses increased from \$12,741,000 in 2010 to \$12,892,000 in 2011, a 1.19% increase. Salary and benefits increased 8.70% to \$7,328,000 in 2011, following a .21% increase in 2010. The FDIC insurance assessment decreased \$436,000 in 2011 to \$772,000. This decrease was a result of the change in the assessment calculation. Other operating expenses increased \$235,000 in 2011, following a \$281,000 increase in 2010. Noninterest expenses continue to be substantially lower than peer group averages. Total noninterest expense as a percentage of average assets totaled 2.33%, 2.36%, and 2.41%, in 2011, 2010 and 2009, respectively. Peer group averages have ranged between 3.09% and 3.17% over the same time period.

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 decreased from \$4,300,000 in 2010 to \$4,000,000 in 2011. 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 \$2,849,000 in 2011 and \$2,350,000 in 2010. Loan losses as a percentage of average loans held for investment totaled .63% and .53% in 2011 and 2010, respectively. As stated in the most recently available Bank Holding Company Performance Report (BHCPR), this loss rate is significantly better than peer group averages which were .79% in 2011 and 1.01% in 2010.

Balance Sheet

Total assets increased 5.17% during the year to \$566,734,000, an increase of \$27,879,000 from \$538,855,000 in 2010. Earning assets increased 2.92% or \$14,727,000 to \$519,078,000 at December 31, 2011. Virtually all of the increase in average earning assets resulted from growth in the loan portfolio, average loans held for investment increased \$9,970,000 and average loans held for sale increased \$3,774,000. Average deposits grew \$15,279,000 for 2011 or 3.59%, much of the growth resulted from the growth in noninterest bearing demand deposits. The Company continues to utilize its assets well with 93.79% of average assets consisting of earning assets.

Investment Securities

Average balances in investment securities decreased 15.31% in 2011 to \$13,567,000. Proceeds from the sale or maturity of investments were used in part to support loan growth and for debt repayment. At year end, 2.61% of average 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 2.57% for 2011, down from 3.80% in 2010. The decline can be attributed to maturing securities being reinvested at lower rates, due to market conditions.

The Company recognized gains totaling \$813,000 on its equities portfolio which was liquidated in 2011. Gains on sales from the subsidiary Bank's bond portfolio totaled \$211,000 in 2011. There were no Other Than Temporary Impairment (OTTI) write-downs in 2011. 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".

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

Investment Securities, continued

The composition of securities at December 31 was:

(Dollars in thousands)	2011	2010	2009
Available for Sale¹			
U.S. Treasury, Agency and Government Sponsored Enterprises (GSE)	\$ 11,064	\$ 8,001	\$ 6,012
Municipal			
Mortgage-backed ²	2,063	3,931	6,170
Corporate bonds	-	-	505
Marketable equity securities	-	3,315	3,742
Total	13,127	15,247	16,429
Held to Maturity			
U.S. Treasury and Agency	108	109	110
Total	108	109	110
Other Equity Investments	8,872	8,789	9,681
Total Securities	\$ 22,107	\$ 24,145	\$ 26,220

1 At estimated fair value. See Note 4 to the Consolidated Financial Statements for amortized cost.

2 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, 2011 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. Maturities of Other Investments are not readily determinable due to the nature of the investment, see Note 4 to the Consolidated Financial Statements for a description of these investments.

(Dollars in thousands)	Less Than one Year		One to Five Years		Over Five Years		Total	Yield
	Amount	Yield	Amount	Yield	Amount	Yield		
Debt Securities Available for Sale								
U.S. Treasury, Agency & GSE	\$ -		\$ 11,064	.81 %	\$ -		\$ 11,064	.81 %
Municipal								
Mortgage-backed					2,063	1.99 %	2,063	1.99 %
Corporate bonds								
Total	\$ -		\$ 11,064	.81 %	\$ 2,063	1.99 %	\$ 13,127	1.00 %

Debt Securities Held to Maturity

U.S. Treasury & Agency	\$ 108	1.37%	\$ 108	1.37 %
Total	\$ 108	1.37%	\$ 108	1.37 %

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 \$451,570,000 at December 31, 2011 compared with \$445,147,000 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 multifamily loans, increased 10.84% during 2011 to \$170,156,000. Real estate mortgages increased \$3,118,000 (1.64%). Growth has included a variety of loan and collateral types including residential real estate and real estate development.

Construction loans decreased \$7,113,000 or 8.97%. 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 \$6,028,000. 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 \$41,000 to \$2,812,000 but are a minor component of the loan portfolio. The following table presents the changes in the loan portfolio over the previous five years.

(Dollars in thousands)	December 31				
	2011	2010	2009	2008	2007
Real estate – mortgage	\$193,280	\$190,162	\$180,990	\$161,224	\$141,836
Real estate – construction	72,224	79,337	86,320	71,259	51,301
Consumer installment	13,015	19,043	19,247	22,792	18,772
Commercial	141,014	121,490	115,638	115,297	86,048
Agricultural	15,985	19,761	19,355	18,711	15,701
Multi-family residential	13,157	12,259	10,391	7,898	1,412
Credit cards	2,812	2,771	2,356	1,940	1,800
Other	83	324	106	112	310
Total Loans	\$451,570	\$445,147	\$434,403	\$399,233	\$317,180

The following table shows the Company's loan maturity and interest rate sensitivity as of December 31, 2011:

(Dollars in thousands)	Less Than	1-5	Over	Total
	1 Year	Years	5 Years	
Commercial and agricultural loans	\$51,731	\$100,472	\$4,796	\$156,999
Multi-family residential	6,234	6,923	-	13,157
Real Estate – mortgage	68,510	108,520	16,250	193,280
Real Estate – construction	66,561	5,599	64	72,224
Consumer – installment/other	9,049	6,803	58	15,910
Total	\$202,085	\$228,317	\$21,168	\$451,570

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Loans with predetermined rates	19,737	26,800	20,494	67,031
Loans with variable or adjustable rates	182,348	201,517	674	384,539
Total	\$202,085	\$228,317	\$21,168	\$451,570

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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 89% of the real estate loans, interest is adjustable after each one, 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 have been declining since 2008. 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 real estate development category. 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, 2011, there are no industry categories of loans that exceed 10% of total loans.

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

Nonaccrual and Past Due Loans

Nonperforming loans include nonaccrual loans and loans 90 days or more past due. Nonaccrual loans are loans on which interest accruals have been suspended or discontinued permanently. Nonperforming loans totaled \$14,776,000 at December 31, 2011 compared to \$15,834,000 at December 31, 2010. 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, 2011, the Company holds \$3,074,000 of real estate which was acquired through foreclosure, of which approximately \$1 million is under contract for sale during the first quarter of 2012.

Problem loans have decreased approximately \$1.05 million since December 31, 2010.

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

(Dollars in thousands)	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011	December 31, 2010
Nonaccrual Loans:					
Real Estate	\$ 7,671	\$ 3,892	\$ 2,896	\$ 5,628	\$ 5,189
Commercial	5,888	6,264	4,729	5,454	1,656
Home Equity	266	-	366	675	715
Other	39	24	1,769	1,107	30
Loans past due 90 days or more:					
Real Estate	646	1,715	1,781	1,466	3,021
Commercial	-	86	315	255	4,581
Home Equity	260	328	468	411	588
Other	6	21	76	21	54
Total Nonperforming loans	\$ 14,776	\$ 12,330	\$ 12,400	\$ 15,017	\$ 15,834
Nonperforming loans as a percentage of loans held for investment	3.27	% 2.73	% 2.70	% 3.32	% 3.56
Net Charge Offs to Total Loans Held for Investment	.63	% .45	% .32	% .17	% .53
Allowance for loan and lease losses to nonperforming loans	46.95	% 55.51	% 52.48	% 40.59	% 36.54

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, 2011, 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.

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 \$6,937,000 at December 31, 2011 is equal to 1.54% of total loans held for investment. This compares to an allowance of \$5,786,000 (1.30%) at December 31, 2010 and .88% at December 31, 2009. 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 \$2,849,000 in 2011 which is equivalent to .63% of total loans outstanding. Over the preceding three years, the Company has had an average loss rate of .56%, compared to a 1.06% loss rate for its peer group.

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:

(Dollars in thousands)	2011	2010	2009	2008	2007
Balance at beginning of period	\$5,786	\$3,836	\$2,189	\$1,703	\$1,791
Provision charged to expenses	4,000	4,300	4,210	815	270
Loan losses:					
Commercial	804	1,541	1,110	294	331
Installment	196	211	193	106	119
Real estate	2,043	731	1,336	-	-
Total loan losses	3,043	2,483	2,639	400	450
Recoveries:					
Commercial	88	54	10	7	9
Installment	68	77	63	63	83
Real estate	38	2	3	1	-
Total recoveries	194	133	76	71	92
Net loan losses	(2,849)	(2,350)	(2,563)	(329)	(358)
Balance at end of period	\$6,937	\$5,786	\$3,836	\$2,189	\$1,703
Allowance for loan losses as a percentage of loans	1.54 %	1.30 %	.88 %	.55 %	.54 %
Net loan losses to loans outstanding	.63 %	.53 %	.59 %	.08 %	.11 %

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

Deposits and Borrowings

The Bank recognized an increase in year-end deposits in 2011 of 2.56%. The average deposit balances and average rates paid for 2011, 2010 and 2009 were as follows:

Average Deposits and Rates Paid

(Dollars in thousands)

	2011		December 31, 2010		2009	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing	\$68,141		\$56,328		\$51,124	
Interest-bearing:						
Interest Checking	\$119,453	1.34 %	\$110,814	1.75 %	\$78,556	1.66 %
Savings Accounts	38,248	.50 %	35,666	.54 %	32,650	.62 %
Time Deposits:						
CDARS	22,775	1.04 %	37,102	1.08 %	28,667	1.55 %

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\$100,000 or more	73,299	1.59	%	83,669	1.34	%	92,414	1.99	%
Less than \$100,000	119,090	1.85	%	102,147	2.84	%	97,315	4.12	%
Total Interest-bearing	372,865	1.45	%	369,398	1.77	%	329,602	2.37	%
Total deposits	\$441,006	1.22	%	\$425,726	1.54	%	\$380,726	2.05	%

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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 \$11,813,000 or 20.97% from \$56,328,000 at December 31, 2010 to \$68,141,000 at December 31, 2011. Interest-bearing deposits, which include interest checking accounts, money market accounts, regular savings accounts and time deposits, increased \$3,467,000 or .94% from \$369,398,000 at December 31, 2010 to \$372,865,000 at December 31, 2011. Total interest checking (including money market) account balances increased \$8,639,000 or 7.80% from \$110,814,000 at December 31, 2010 to \$119,453,000 at December 31, 2011. Total savings account balances increased \$2,582,000 or 7.24% from \$35,666,000 at December 31, 2010 to \$38,248,000 at December 31, 2011.

Time deposits increased \$6,573,000 or 3.54% from \$185,816,000 at December 31, 2010 to \$192,389,000 at December 31, 2011. This is comprised of a decrease in certificates of deposit of \$100,000 and more of \$10,370,000 or 12.39% from \$83,669,000 at December 31, 2010 to \$73,299,000 at December 31, 2011, an increase in certificates of deposit of less than \$100,000 of \$16,943,000 or 16.59% from \$102,147,000 at December 31, 2010 to \$119,090,000 at December 31, 2011 and a decrease in CDARS deposits of \$14,327,000 or 38.62% from \$37,102,000 at December 31, 2010 to \$22,775,000 at December 31, 2011. 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:

(Actual Dollars in thousands)	2011	2010
Less than 3 months	\$9,643	\$6,426
3 to 12 months	21,601	41,712
1 year to 5 years	35,294	31,922
Total	\$66,538	\$80,060

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 11 (Short Term Debt) to the Consolidated Financial Statements 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 \$5,000,000 in 2011 and \$11,250,000 in 2010 in long term loans. Repayment of amortizing and fixed maturity loans through FHLB totaled \$2,928,000 for the year. These loans carry an average rate of 2.78% at December 31, 2011.

Contractual Obligations and Scheduled Payments (dollars in thousands)

December 31, 2011	
One Year	Three Years

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	Less than One Year	Through Three Years	Through Five Years	More than Five Years	Total
Securities sold under agreements to repurchase	3,539	-	-	-	3,539
Subordinated Debt	-	-	956	9,235	10,191
Total	\$3,539	\$-	\$956	\$9,235	\$13,730

The \$62,107,000 in outstanding FHLB advances is comprised of twelve advances. Note 12 to the Consolidated Financial Statements discusses the rates, terms, and conversion features on these advances

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

Stockholder's Equity

Total stockholders' equity increased \$3,950,000 or 9.35% in 2011. While net income totaled \$4,688,191, noncontrolling interest net income totaled \$61,525, sales of common stock totaled \$2,478,000 (including \$2,381,000 from a rights offering) and changes in other comprehensive income decreased \$1,780,000, and capital was reduced by dividends (\$1.466 million). As of December 31, 2011, book value per share was \$18.53 compared to \$18.31 as of December 31, 2010. 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, 2011, the Company had Tier I capital of 10.52% of risk weighted assets and combined Tier I and II capital of 14.09% 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, 2011, the Company reported a leverage ratio of 8.03%. 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 .10% in 2011 following an increase of .07% in 2010. 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, 2011 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.

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, 2011. 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 17.06% of total earning assets, compared to 17.87% in 2010. Approximately 50.28% of rate sensitive assets and 39.84% of rate sensitive liabilities are subject to repricing within one year. Short term assets (less than one year) increased \$8,678,000 during the year, while total earning assets increased \$25,186,000. 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 increased \$23,649,000, while total interest bearing liabilities increased \$8,509,000. The increase in short term liabilities is primarily due to increased FHLB Daily Rate Credit borrowing used to fund increases in Loans Held for Sale. 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.

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, 2011, in which the Company's assets and liabilities are subject to repricing:

(Dollars in thousands)	1-90 Days	91-365 Days	1-5 Years	Over 5 Years	Not Classified	Total
Rate Sensitive Assets:						
Loans held for investment	\$143,077	\$56,195	\$228,317	\$21,168	\$-	\$448,757
Loans held for sale	60,543	-	-	-	-	60,543
Federal Funds Sold	2,181	-	-	-	-	2,181
Investments securities	-	108	11,064	2,063	-	13,235
Credit Cards	2,813	-	-	-	-	2,813
Interest bearing bank deposits	940	-	248	-	-	1,188
Total	209,554	56,303	239,629	23,231	-	528,717
Rate Sensitive Liabilities:						
Interest bearing demand						
deposits	-	31,924	70,599	19,337	-	121,860
Savings	-	7,988	23,964	7,988	-	39,940
Certificates of deposit						
\$100,000 and over	9,643	21,601	35,294	-	-	66,538
Other certificates of deposit	24,353	43,241	69,226	-	-	136,820
Total Deposits	33,996	104,754	199,083	27,325	-	365,158
Short-term debt	18,539	-	-	-	-	18,539
Long-term debt	9,607	8,786	29,670	9,235	-	57,298
Total	62,142	113,540	228,753	36,560	-	440,995
Discrete Gap	147,412	(57,237)	10,876	(13,329)	-	87,722
Cumulative Gap	147,412	90,175	101,051	87,722	-	426,360
As a % of Earning Assets	27.88 %	17.06 %	19.11 %	16.59 %	-	42.64 %

- 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.

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

Recent Accounting Pronouncements

In July 2010, the Receivables topic of the Accounting Standards Codification ("ASC") was amended by Accounting Standards Update ("ASU") 2010-20 to require expanded disclosures related to a company's allowance for credit losses and the credit quality of its financing receivables. The amendments require the allowance disclosures to be provided on a disaggregated basis. The Company is required to include these disclosures in its interim and annual financial statements. See Note 6 to the Consolidated Financial Statements.

Disclosures about Troubled Debt Restructurings ("TDRs") required by ASU 2010-20 were deferred by the Financial Accounting Standards Board ("FASB") in ASU 2011-01 issued in January 2011. In April 2011 the FASB issued ASU 2011-02 to assist creditors with their determination of when a restructuring is a TDR. The determination is based on whether the restructuring constitutes a concession and whether the debtor is experiencing financial difficulties as both events must be present. Disclosures related to TDRs under ASU 2010-20 have been presented in Note 7 to the Consolidated Financial Statements.

In September 2011, the Intangibles topic was amended to permit an entity to consider qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. These amendments will be effective for the Company on January 1, 2012.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments will be applicable to the Company on January 1, 2012 and will be applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while FASB redeliberates future requirements.

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

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, 2011 and 2010:

(Dollars in thousands)	2011				
	Fourth	Third	Second	First	Total
Interest and Dividend Income	\$ 7,067	\$ 7,026	\$ 6,994	\$ 6,593	\$ 27,680
Interest Expense	1,800	1,901	1,986	2,032	7,719
Net Interest Income	5,267	5,125	5,008	4,561	19,961
Provision for Loan Losses	900	900	1,100	1,100	4,000
Net Interest Income after Provision, For Loan Losses	4,367	4,225	3,908	3,461	15,961
Non-Interest Income	755	1,527	1,068	792	4,142
Non-Interest Expense	3,197	3,084	3,339	3,272	12,892
Income before taxes	1,925	2,668	1,637	981	7,211
Income Tax Expense	492	1,330	406	295	2,523
Net Income	\$ 1,433	\$ 1,338	\$ 1,231	\$ 686	\$ 4,688
Net Income Per Share	\$.59	\$.54	\$.49	\$.29	\$ 1.91
	2010				
(Dollars in thousands)	Fourth	Third	Second	First	Total
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	