F&M BANK CORP
Form 10-K
March 24, 2015

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, 2014
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 o No þ

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 o No þ

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 þ No o

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 þ No o

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. þ

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 o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting Company þ

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

The registrant’s Common Stock is traded Over-the-Counter under the symbol FMBM. The aggregate market value of the 2,949,938 shares of Common Stock of the registrant issued and outstanding held by non-affiliates on June 30, 2014 was approximately $52,213,903 based on the closing sales price of $17.70 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 20, 2015, there were 3,293,909 shares of the registrant's Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE:

Part III: Proxy Statement for the Annual Meeting of Shareholders to be held on May 9, 2015 (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 the 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 large portfolio of residential mortgages and a concentration in development lending. 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.FMBankVA.com, 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, 2014, the Bank had 156 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.

PART I, Continued

Item 1. Business, continued

Regulation and Supervision

General. The operations of F & M Bank Corp. and the Bank are subject to federal and state statutes, which apply to bank holding companies and state member banks of the Federal Reserve System. The stock of F & M Bank Corp. is registered pursuant to and subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (the “Exchange Act”). These include, but are not limited to, the filing of annual, quarterly and other current reports with the Securities and Exchange Commission (the “SEC”). As an Exchange Act reporting company, the Company is directly affected by the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), which is aimed at improving corporate governance and reporting procedures. The Company believes it is in compliance 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") 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 Board of Governors of the Federal Reserve System (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 limit activities of bank holding companies to managing or controlling banks or non-banking activities closely related to banking. 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 Federal Reserve Board 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. A bank also may not declare a dividend out of or in excess of its net undivided profits without regulatory approval. 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.

The Company also is subject to regulatory restrictions on dividends to its shareholders. Regulators have indicated that bank holding companies should generally pay dividends only if the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. Further, a bank holding company should inform and consult with the Federal Reserve Board prior to declaring a dividend that exceeds earnings for the period (e.g., quarter) for which the dividend is being paid or that could result in a material adverse change to the organization's capital structure.

PART I, Continued

Item 1. Business, continued

Regulation and Supervision, continued

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, 2014 were 16.09% and 17.35%, 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, 2014, was 12.88%, 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.

In 2013, the Federal Reserve, the FDIC and the OCC approved a new rule that will substantially amend the regulatory risk-based capital rules applicable to us. The final rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. The final rule includes new minimum risk-based capital and leverage ratios which was effective for us on January 1, 2015, and refines the definition of what constitutes "capital" for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 ("CET1") capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6%, which is increased from 4%; (iii) a total capital ratio of 8%, which is unchanged from the current rules; and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a "capital conservation buffer" of 2.5% above the new regulatory minimum capital ratios, and when fully effective in 2019, will result in the following minimum ratios: (a) a common equity Tier 1 capital ratio of 7.0%; (b) a Tier 1 to risk-based assets capital ratio of 8.5%; and (c) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such activities

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.

PART I, Continued

Item 1. Business, continued
Regulation and Supervision, continued

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.

Mortgage Lending. In 2013, the CFPB adopted a rule, effective in January 2014, to implement certain sections of the Dodd-Frank Act requiring creditors to make a reasonable, good faith determination of a consumer's ability to repay any closed-end consumer credit transaction secured by a 1-4 family dwelling. The rule also establishes certain protections from liability under this requirement to ensure a borrower's ability to repay for loans that meet the definition of "qualified mortgage." Loans that satisfy this "qualified mortgage" safe harbor will be presumed to have complied with the new ability-to-repay standard.

Forward-Looking Statements

Certain information contained in this report may include "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. These forward-looking statements are generally identified by phrases such as "we expect," "we believe" or words of similar import. Such forward-looking statements involve known and unknown risks including, but not limited to:

Changes in the quality or composition of our loan or investment portfolios, including adverse developments in borrower industries, declines in real estate values in our markets, or in the repayment ability of individual borrowers or issuers;

The strength of the economy in our target market area, as well as general economic, market, or business conditions;

An insufficient allowance for loan losses as a result of inaccurate assumptions;

Our ability to maintain our "well-capitalized" regulatory status;

Changes in the interest rates affecting our deposits and our loans;

Changes in our competitive position, competitive actions by other financial institutions and the competitive nature of the financial services industry and our ability to compete effectively against other financial institutions in our banking markets;

Our ability to manage growth;

Our potential growth, including our entrance or expansion into new markets, the opportunities that may be presented to and pursued by us and the need for sufficient capital to support that growth;

PART I, Continued

Item 1. Business, continued

Forward looking statements, continued

Our exposure to operational risk;
Our ability to raise capital as needed by our business;
Changes in laws, regulations and the policies of federal or state regulators and agencies; and
Other circumstances, many of which are beyond our control.

Although we believe that our expectations with respect to the forward-looking statements are based upon reliable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that our actual results, performance or achievements will not differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements.

Item 1A. Risk Factors

General economic conditions in our market area could adversely affect us.

We are affected by the general economic conditions in the local markets in which we operate. Since the recession began in 2008, our market has experienced a significant downturn in which we have seen falling home prices, rising foreclosures and an increased level of commercial and consumer delinquencies. Although economic conditions have improved, many businesses and individuals are still experiencing difficulty as a result of the recent economic downturn and protracted recovery. If economic conditions in our market do not improve, we could experience further adverse consequences, including a decline in demand for our products and services and an increase in problem assets, forecloses and loan losses. Future economic conditions in our market will depend on factors outside of our control such as political and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government, military and fiscal policies and inflation, any of which could negatively affect our performance and financial condition.

Our allowance for loan losses may prove to be insufficient to absorb losses in the loan portfolio.

Like all financial institutions, we maintain an allowance for loan losses to provide for loans that our borrowers may not repay in their entirety. We believe that we maintain an allowance for loan losses at a level adequate to absorb probable losses inherent in the loan portfolio. Through a periodic review and consideration of the loan portfolio, management determines the amount of the allowance for loan losses by considering general market conditions, credit quality of the loan portfolio, the collateral supporting the loans and performance of customers relative to their financial obligations with us. At December 31, 2014, our non-performing loans were $6.9 million, compared to $12.6 million at December 31, 2013. Our provision for loan losses was $2.3 million for the year ended December 31, 2014, and our loan loss allowance was $8.7 million, or 1.68% of total loans held for investment at December 31, 2014.

The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, which may be beyond our control, and these losses may exceed current estimates. Although we believe the allowance for loan losses is a reasonable estimate of known and inherent losses in the loan portfolio, it cannot fully predict such losses or that the loss allowance will be adequate in the future. While the risk of nonpayment is inherent in banking, we could experience greater nonpayment levels than we anticipate. In addition, we have loan participation arrangements with several other banks within the region and may not be able to exercise control of negotiations with borrowers in the event these loans do not perform. Additional problems with asset quality could cause our interest income and net interest margin to decrease and our provisions for loan losses to increase further, which could adversely affect our results of operations and financial condition.

Federal and state regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs, based on judgments different than those of management. Any increase in the amount of the provision or loans charged-off as required by these regulatory agencies could have a negative effect on our operating results.

PART I, Continued

Item 1A. Risk Factors, Continued

Our loan concentrations could, as a result of adverse market conditions, increase credit losses which could adversely impact earnings.

We offer a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity, consumer and other loans. Many of our loans are secured by real estate (both residential and commercial) in our market area, which could result in adverse consequences to us in the event of a prolonged economic downturn in our market. As of December 31, 2014, approximately 84% of our loans had real estate as a primary or secondary component of collateral. A further significant decline in real estate values in our market would mean that the collateral for many of our loans would provide less security. As a result, we would be more likely to suffer losses on defaulted loans because our ability to fully recover on defaulted loans by selling the real estate collateral would be diminished. In addition, our consumer loans (such as automobile loans) are collateralized, if at all, with assets that may not provide an adequate source of repayment of the loan due to depreciation, damage or loss.

In addition, we have a large portfolio of residential mortgages and a concentration in development lending, both of which could be adversely affected by a decline in the real estate markets. Construction and development lending entails significant additional risks, because these loans, which often involve larger loan balances concentrated with single borrowers or groups of related borrowers, are dependent on the successful completion of real estate projects. Loan funds for construction and development loans often are advanced upon the security of the land or home under construction, which value is estimated prior to the completion of construction. The deterioration of one or a few of these loans could cause a significant increase in the percentage of non-performing loans. An increase in non-performing loans could result in a loss of earnings from these loans, an increase in the provision for loan losses and an increase in charge-offs, all of which could have a material adverse effect on our financial condition.

Our small-to-medium sized business target market may have fewer financial resources to weather continued downturn in the economy.

We target our commercial development and marketing strategy primarily to serve the banking and financial services needs of small and medium sized businesses. These businesses generally have less capital or borrowing capacity than larger entities. If general economic conditions negatively impact this major economic sector in the markets in which we operate, our results of operations and financial condition may be adversely affected.

Our inability to maintain adequate sources of funding and liquidity may negatively impact our current financial condition or our ability to grow.

Our access to funding and liquidity sources in amounts adequate to finance our activities on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. In managing our balance sheet, a primary source of funding asset growth and liquidity historically has been deposits, including both local customer deposits and brokered deposits. If the level of deposits were to materially decrease, we would have to raise additional funds by increasing the interest that we pay on certificates of deposit or other depository accounts, seek other debt or equity financing, or draw upon our available lines of credit. Our access to these funding and liquidity sources could be detrimentally impacted by a number of factors, including operating losses, rising levels of non-performing assets, a decrease in the level of our business activity as a result of a downturn in the markets in which our loans or deposits are concentrated or regulatory restrictions. In addition, our ability to continue to attract deposits and other funding or liquidity sources is subject to variability based upon additional factors including volume and volatility in the securities markets and the relative interest rates that we are prepared to pay for these liabilities. We do not maintain significant additional sources of liquidity through potential sales in our investment portfolio or liquid assets at the holding company level. Our potential inability to maintain adequate sources of funding or liquidity may, among other things, inhibit our ability to fund asset growth or negatively impact our financial condition, including our ability to pay dividends or satisfy our obligations.

PART I, Continued

Item 1A. Risk Factors, Continued

If we do not maintain our capital requirements and our status as a “well-capitalized” bank, there could an adverse effect on our liquidity and our ability to fund our loan portfolio.

We are subject to regulatory capital adequacy guidelines. If we fail to meet the capital adequacy guidelines for a “well-capitalized” bank, it could increase the regulatory scrutiny for the Bank and the Company. In addition, if we failed to be “well capitalized” for regulatory capital purposes, we would not be able to renew or accept brokered deposits without prior regulatory approval and we would not be able to offer interest rates on our deposit accounts that are significantly higher than the average rates in our market area. As a result, it would be more difficult for us to attract new deposits as our existing brokered deposits mature and do not roll over and to retain or increase existing, non-brokered deposits. If we are prohibited from renewing or accepting brokered deposits and are unable to attract new deposits, our liquidity and our ability to fund our loan portfolio may be adversely affected. In addition, we would be required to pay higher insurance premiums to the FDIC, which would reduce our earnings.

We may be subject to more stringent capital requirements, which could adversely affect our results of operations and future growth.

In 2013, the Federal Reserve, the FDIC and the OCC approved a new rule that will substantially amend the regulatory risk-based capital rules applicable to us. The final rule implements the “Basel III” regulatory capital reforms and changes required by the Financial Reform Act. The final rule includes new minimum risk-based capital and leverage ratios which was effective for us on January 1, 2015, and refines the definition of what constitutes “capital” for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 (“CET1”) capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6%, which is increased from 4%; (iii) a total capital ratio of 8%, which is unchanged from the current rules; and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a “capital conservation buffer” of 2.5% above the new regulatory minimum capital ratios, and when fully effective in 2019, will result in the following minimum ratios: (a) a common equity Tier 1 capital ratio of 7.0%; (b) a Tier 1 to risk-based assets capital ratio of 8.5%; and (c) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such activities. In addition, the final rule provides for a number of new deductions from and adjustments to capital and prescribes a revised approach for risk weightings that could result in higher risk weights for a variety of asset categories.

The application of these more stringent capital requirements for us could, among other things, result in lower returns on equity, require the raising of additional capital, adversely affect our future growth opportunities, and result in regulatory actions such as a prohibition on the payment of dividends or on the repurchase shares if we were unable to comply with such requirements.

New regulations could adversely impact our earnings due to, among other things, increased compliance costs or costs due to noncompliance.

The Consumer Financial Protection Bureau has issued a rule, effective as of January 14, 2014, designed to clarify for lenders how they can avoid monetary damages under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower’s ability to repay a mortgage. Loans that satisfy this “qualified mortgage” safe-harbor will be presumed to have complied with the new ability-to-repay standard. Under the Consumer Financial Protection Bureau's rule, a "qualified mortgage" loan must not contain certain specified features, including but not limited to:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less "bona fide discount points" for prime loans);
- interest-only payments;
- negative-amortization; and
- terms longer than 30 years.

PART I, Continued

Item 1A. Risk Factors, Continued

Also, to qualify as a "qualified mortgage," a borrower's total monthly debt-to-income ratio may not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments. The Consumer Financial Protection Bureau's rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could adversely impact our growth or profitability.

Additionally, on December 10, 2013, five financial regulatory agencies, including our primary federal regulator, the Federal Reserve, adopted final rules implementing a provision of the Dodd-Frank Act, commonly referred to as the Volcker Rule. The Final Rules prohibit banking entities from, among other things, engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account; or owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to as "covered funds." On January 14, 2014, the five financial regulatory agencies, approved an adjustment to the final rule by allowing banks to keep certain collateralized debt obligations ("CDOs") acquired the bank before the Volcker Rule was finalized, if the CDO was established before May 2010 and is backed primarily by trust preferred securities issued by banks with less than $15 billion in assets established. The rules were effective April 1, 2014, but the conformance period has been extended from its statutory end date of July 21, 2014 until July 21, 2015. We are currently evaluating the Volcker Rule; if we are required to divest any securities in our portfolio as a result of the Volcker Rule, it could result in impairments that could adversely impact our financial condition and results of operations.

Difficult market conditions have adversely affected our industry.

Dramatic declines in the housing market, with falling home prices and increasing foreclosures, unemployment and under-employment, have negatively impacted the credit performance of real estate related loans and resulted in significant write-downs of asset values by financial institutions. These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting economic pressure on consumers and lack of confidence in the financial markets has adversely affected our business and results of operations. Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for credit losses. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial institutions industry.

Our future success is dependent on our ability to effectively compete in the face of substantial competition from other financial institutions in our primary markets.

We encounter significant competition for deposits, loans and other financial services from banks and other financial institutions, including savings and loan associations, savings banks, finance companies, and credit unions in our market area. A number of these banks and other financial institutions are significantly larger than us and have substantially greater access to capital and other resources, larger lending limits, more extensive branch systems, and may offer a wider array of banking services. To a limited extent, we compete with other providers of financial services, such as money market mutual funds, brokerage firms, consumer finance companies, insurance companies and governmental organizations any of which may offer more favorable financing rates and terms than us. Most of these non-bank competitors are not subject to the same extensive regulations that govern us. As a result, these non-bank competitors may have advantages in providing certain services. This competition may reduce or limit our margins and our market share and may adversely affect our results of operations and financial condition.

PART I, Continued

Item 1A. Risk Factors, Continued

Changes in market interest rates could affect our cash flows and our ability to successfully manage our interest rate risk.

Our profitability and financial condition depend to a great extent on our ability to manage the net interest margin, which is the difference between the interest income earned on loans and investments and the interest expense paid for deposits and borrowings. The amounts of interest income and interest expense are principally driven by two factors; the market levels of interest rates, and the volumes of earning assets or interest bearing liabilities. The management of the net interest margin is accomplished by our Asset Liability Management Committee. Short term interest rates are highly sensitive to factors beyond our control and are effectively set and managed by the Federal Reserve, while longer term rates are generally determined by the market based on investors' inflationary expectations. Thus, changes in monetary and or fiscal policy will affect both short term and long term interest rates which in turn will influence the origination of loans, the prepayment speed of loans, the purchase of investments, the generation of deposits and the rates received on loans and investment securities and paid on deposits or other sources of funding. The impact of these changes may be magnified if we do not effectively manage the relative sensitivity of our earning assets and interest bearing liabilities to changes in market interest rates. We generally attempt to maintain a neutral position in terms of the volume of earning assets and interest bearing liabilities that mature or can re-price within a one year period in order that we may maintain the maximum net interest margin; however, interest rate fluctuations, loan prepayments, loan production and deposit flows are constantly changing and greatly influence this ability to maintain a neutral position.

Generally, our earnings will be more sensitive to fluctuations in interest rates the greater the difference between the volume of earning assets and interest bearing liabilities that mature or are subject to re-pricing in any period. The extent and duration of this sensitivity will depend on the cumulative difference over time, the velocity and direction of interest rate changes, and whether we are more asset sensitive or liability sensitive. Additionally, the Asset Liability Management Committee may desire to move our position to more asset sensitive or more liability sensitive depending upon their expectation of the direction and velocity of future changes in interest rates in an effort to maximize the net interest margin. Should we not be successful in maintaining the desired position, or should interest rates not move as anticipated, our net interest margin may be negatively impacted.

Our inability to successfully manage growth or implement our growth strategy may adversely affect our results of operations and financial condition.

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

As we continue to implement our growth strategy, we may incur increased personnel, occupancy and other operating expenses. We must absorb those higher expenses while we begin 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, our plans to branch could depress earnings in the short run, even if we efficiently execute a branching strategy leading to long-term financial benefits.

Our exposure to operational risk may adversely affect us.

Similar to other financial institutions, we are 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.

PART I, Continued

Item 1A. Risk Factors, Continued

Our operations rely on certain external vendors.

We are reliant upon certain external vendors to provide products and services necessary to maintain our day-to-day operations. Accordingly, our operations are exposed to risk that these vendors will not perform in accordance with the contracted arrangements under service agreements. Although we maintain a system of comprehensive policies and a control framework designed to monitor vendor risks, the failure of an external vendor to perform in accordance with the contracted arrangements under service agreements could be disruptive to our operations, which could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

Our operations may be adversely affected by cyber security risks.

In the ordinary course of business, we collect and store sensitive data, including proprietary business information and personally identifiable information of its customers and employees in systems and on networks. The secure processing, maintenance and use of this information is critical to operations and our business strategy. We have invested in accepted technologies and review processes and practices that are designed to protect our networks, computers and data from damage or unauthorized access. Despite these security measures, our computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged or disclosed. A breach in security could result in legal claims, regulatory penalties, disruption in operations, and damage to our reputation, which could adversely affect our business.

Legislative or regulatory changes or actions, or significant litigation, could adversely impact us or the businesses in which we are engaged.

We are subject to extensive state and federal regulation, supervision and legislation that govern almost all aspects of our 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 us or our ability to increase the value of our business. Additionally, actions by regulatory agencies or significant litigation against us could cause us to devote significant time and resources to defending ourselves and may lead to penalties that materially affect us. Future changes in the laws or regulations or their interpretations or enforcement could be materially adverse us and our 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 our consolidated financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we 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, 2014.

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PART I, Continued

Item 2. Properties

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

Timberville Branch and Administrative Offices
205 South Main Street
Timberville, VA 22853

Broadway Branch
126 Timberway
Broadway, VA 22815

Bridgewater Branch
100 Plaza Drive
Bridgewater, VA 22812

Woodstock Branch
161 South Main Street
Woodstock, VA 22664

Luray Branch
700 East Main Street
Luray, VA 22835

Fishersville Loan Production Office
1842 Jefferson Hwy
Fishersville, VA 22939

Elkton Branch
127 West Rockingham Street
Elkton, VA 22827

Port Road Branch
1085 Port Republic Road
Harrisonburg, VA 22801

Edinburg Branch
120 South Main Street
Edinburg, VA 22824

Crossroads Branch
80 Cross Keys Road
Harrisonburg, VA 22801

Dealer Finance Division
4759 Spotswood Trail
Penn Laird, VA 22846

With the exception of the Edinburg Branch, Port Road Branch, Luray Branch, Dealer Finance Division and the Fishersville Loan Production Office the remaining facilities are owned by Farmers & Merchants Bank. ATMs are available at all branch 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. The Bank also has an agreement with Welch ATM to operate five cash only ATMs in Rite Aid Pharmacies in Augusta County, 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, Related Stockholder Matters and Issuer Purchases of Equity Securities

Stock Listing

The Company’s Common Stock trades under the symbol “FMBM” on the OTC QB Market. 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, 2009, and the reinvestment of dividends.

	Period Ending					
Index	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14
F & M Bank Corp.	100.00	65.53	64.26	74.50	94.04	102.84
Russell 2000	100.00	126.86	121.56	141.43	196.34	205.95
SNL Bank	100.00	112.05	86.78	117.11	160.79	179.74

PART II, Continued

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities, Continued

Recent Stock Prices and Dividends

Dividends to shareholders totaled $2,232,000 and $1,706,000 in 2014 and 2013, respectively. Regular quarterly dividends have been declared for sixty four 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 37.36% in 2014, compared to 36.17% in 2013.

Refer to Payment of Dividends in Item 1. Business, Regulation and Supervision section above for restrictions on dividends.

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 2014 totaled 164,132 shares; of this amount, none were repurchased in 2014.

The number of common shareholders of record was approximately 1,853 as of March 20, 2015. 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.

	2014			2013		
	Stock Price Range		Per Share Dividends	Stock Price Range		Per Share Dividends
Quarter	Low	High	Declared	Low	High	Declared
1st	17.21	18.00	$ .17	15.00	17.73	$ .17
2nd	17.27	19.90	.17	17.00	18.25	.17
3rd	17.70	19.08	.17	16.98	18.15	.17
4th	17.83	19.73	.17	16.90	19.00	.17
Total			$ .68			$ .68

PART II, Continued

Item 6. Selected Financial Data

Five Year Summary of Selected Financial Data (Dollars in thousands, except per share data)	2014		2013		2012		2011		2010	
Income Statement Data:										
Interest and Dividend Income	$26,772		$25,966		$27,225		$27,680		$27,870	
Interest Expense	3,648		4,773		6,294		7,719		9,005	
Net Interest Income	23,124		21,193		20,931		19,961		18,865	
Provision for Loan Losses	2,250		3,775		4,200		4,000		4,300	
Net Interest Income after Provision for Loan Losses	20,874		17,418		16,731		15,961		14,565	
Noninterest Income	3,485		3,925		3,627		3,118		3,249	
Securities Gains (Losses)	-		-		-		1,024		349	
Noninterest Expenses	15,656		14,720		13,362		12,892		12,741	
Income before Income Taxes	8,703		6,623		6,996		7,211		5,422	
Income Tax Expense	2,901		1,907		2,095		2,523		1,681	
Net Income	$5,802		$4,716		$4,901		$4,688		$3,741	
Per Share Data:										
Net Income – basic	$1.82		$1.88		$1.96		$1.91		$1.63	
Net Income - diluted	$1.80		$-		$-		$-		$-	
Dividends Declared	.68		.68		.64		.60		.60	
Book Value	21.20		21.56		19.76		18.53		18.31	
Balance Sheet Data:										
Assets	$605,308		$552,788		$596,904		$566,734		$538,855	
Loans Held for Investment	518,202		478,453		465,819		451,570		445,147	
Loans Held for Sale	13,382		3,804		77,207		60,543		23,764	
Securities	22,305		38,486		18,807		22,108		24,144	
Deposits	491,505		464,149		453,796		435,947		425,051	
Short-Term Debt	14,358		3,423		34,597		18,539		5,355	
Long-Term Debt	9,875		21,691		47,905		57,298		58,979	
Stockholders' Equity	77,798		54,141		49,384		46,180		42,229	
Average Common Shares Outstanding – basic	3,119		2,504		2,496		2,450		2,299	
Average Common Shares Outstanding – diluted	3,230		-		-		-		-	
Financial Ratios:										
Return on Average Assets1	1.00	%	.82	%	.86	%	.84	%	.69	%
Return on Average Equity1	8.65	%	9.11	%	10.26	%	10.41	%	9.22	%
Net Interest Margin	4.30	%	4.02	%	3.95	%	3.87	%	3.77	%
Efficiency Ratio 2	58.51	%	58.15	%	54.03	%	55.43	%	57.23	%
Dividend Payout Ratio	37.36	%	36.17	%	32.65	%	31.41	%	36.81	%
Capital and Credit Quality Ratios:										
Average Equity to Average Assets1	11.59	%	9.00	%	8.35	%	8.14	%	7.46	%

Allowance for Loan Losses to Loans3	1.68	%	1.71	%	1.75	%	1.54	%	1.30	%
Nonperforming Loans to Total Assets4	1.15	%	2.28	%	2.24	%	2.61	%	2.94	%
Nonperforming Assets to Total Assets5	1.73	%	2.75	%	2.73	%	3.15	%	3.22	%
Net Charge-offs to Total Loans3	.33	%	.78	%	.64	%	.63	%	.53	%

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

PART II, Continued

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.

Capital Activities

The Company raised an additional $12 million in common equity in a private placement offering in March of 2014. In addition they raised $9.4 million in a new preferred stock offering in December 2014. Both amounts are net of fees related to the offering.

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 float 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.

PART II, Continued

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

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.

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.

Residential 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.

PART II, Continued

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

Loans Held for Sale

The Bank makes fixed rate mortgage loans with terms of typically fifteen or thirty years through its subsidiary VBS Mortgage. These loans are typically on the Bank's books for two to three weeks prior to being sold to investors in the secondary market. Similarly, the Bank also has a relationship with Gateway Savings Bank in Oakland, CA and NorthPointe Bank in Grand Rapids, MI where it purchases fixed rate loans for short periods of time pending those loans being sold to investors in the secondary market. These loans have an average life of ten days to two weeks, but occasionally remain on the Bank's books for up to 60 days. The Bank has maintained a relationship with Gateway Bank since 2003 and began its relationship with NorthPointe Bank in 2014. This relationship allows the Bank to achieve a higher rate of return than it would on other short term investment opportunities.

Dealer Finance Division

On September 25, 2012, the Bank began operations of a loan production office in Penn Laird, VA which specializes in providing automobile financing through a network of automobile dealers. The new Dealer Finance Division was staffed with three officers that have extensive experience in Dealer Finance. This office is serving the automobile finance needs for customers of dealers throughout the existing geographic footprint of the Bank. Approximately forty dealers have signed contracts to originate loans on behalf of the Bank.

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.

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.

PART II, Continued

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

Allowance for Loan Losses, continued

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 2014, 2013 or 2012. 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, 2014, 2013 and 2012.

Core deposit intangibles are amortized on a straight-line basis over a ten year life. 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.

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.

PART II, Continued

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

Overview

The Company's net income for 2014 totaled $5,802,000 or $1.82 per common share, an increase of 23.03% from $4,716,000 or $1.88 a share in 2013. Return on average equity decreased in 2014 to 8.65% versus 9.11% in 2013, while the return on average assets increased from .82% to 1.00%. The decrease in earnings per share and return on average equity resulted from the increase in shares outstanding following the issuance of additional common stock in March 2014.

See page 11 for a five-year summary of selected financial data.

Changes in Net Income per Common Share

	2014 to 2013	2013 to 2012
Prior Year Net Income Per Common Share	$1.88	$1.96
Change from differences in:		
Net interest income	.77	.10
Provision for credit losses	.61	.17
Noninterest income, excluding securities gains	(.18)	.12
Securities gains	-	-
Noninterest expenses	(.37)	(.54)
Income taxes	(.40)	.07
Effect of common stock raise	(.49)	-
Total Change	(.06)	(.08)
Net Income Per Common Share	$1.82	$1.88

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 2014 was $23,124,000 representing an increase of $1,931,000 or 9.11% over the prior year. A 1.25% increase in 2013 versus 2012 resulted in total net interest income of $21,193,000.

In this discussion and in the tabular analysis of net interest income performance, entitled "Consolidated Average Balances, Yields and Rates," (found on page 21), 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. For a reconciliation of tax equivalent net interest income to GAAP measures, see the table on page 23.

Tax equivalent income on earning assets increased $818,000. Loans held for investment, expressed as a percentage of total earning assets, increased in 2014 to 91.84% as compared to 89.17% in 2013. During 2014, yields on earning assets increased 5 basis points (BP), primarily due to a 47BP increase in the yield on installment loans. This increase is due to the growth in the Dealer Finance division, which is a higher yielding portfolio. The average cost of interest bearing liabilities decreased 24BP in 2014, following a decrease of 25BP in 2013. The decrease in average cost resulted from maturing liabilities repricing at lower rates. Following the recession of 2008/2009 the Federal Reserve's Federal Open Market Committee (FOMC) has continued its accommodative monetary policy.

The analysis on the next page reveals an increase in the net interest margin to 4.30% in 2014 primarily due to changes in balance sheet leverage as higher rate borrowings decreased, the increase in noninterest bearing deposit accounts and the growth in the Dealer Finance division produced higher yields.

PART II, Continued

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

Consolidated Average Balances, Yields and Rates1

	2014			2013			2012		
	Balance	Interest	Rate	Balance	Interest	Rate	Balance	Interest	Rate
ASSETS									
Loans2									
Commercial	$ 164,666	$ 7,810	4.74 %	$ 169,431	$ 7,896	4.66 %	$ 168,135	$ 8,204	4.88 %
Real estate	281,052	14,542	5.17 %	268,902	14,796	5.50 %	264,400	15,122	5.72 %
Installment	50,695	3,960	7.81 %	33,625	2,467	7.34 %	23,560	2,019	8.57 %
Loans held for investment4	496,413	26,312	5.30 %	471,958	25,159	5.33 %	456,095	25,345	5.56 %
Loans held for sale	9,072	312	3.44 %	21,298	648	3.04 %	50,814	1,736	3.42 %
Investment securities3									
Fully taxable	13,392	205	1.53 %	11,718	194	1.66 %	16,424	209	1.27 %
Partially taxable	116	-	.-	107	-	.-	108	1	.93 %
Tax exempt	-	-	-	-	-	-	-	-	-
Total investment securities	13,508	205	1.53 %	11,825	194	1.66 %	16,532	210	1.27 %
Interest bearing deposits in banks	896	-	-	1,084	4	.37 %	1,334	5	.37 %
Federal funds sold	20,602	44	.21 %	23,094	50	.22 %	11,463	25	.22 %
Total Earning Assets	540,491	26,873	4.97 %	529,259	26,055	4.92 %	536,238	27,321	5.09 %
Allowance for loan losses	(8,476)			(8,384)			(7,711)		
Nonearning assets	47,036			48,565			44,002		
Total Assets	$ 579,051			$ 569,440			$ 572,529		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Deposits									
Demand –interest bearing	$ 117,396	$ 664	.57 %	$ 120,482	$ 792	.66 %	$ 121,209	$ 1,195	.99 %
Savings	60,460	122	.20 %	52,714	119	.23 %	45,120	182	.40 %
Time deposits	195,933	1,704	.87 %	198,786	2,331	1.17 %	214,145	2,944	1.83 %
Total interest bearing deposits	373,789	2,490	.67 %	371,982	3,242	.87 %	380,474	4,321	1.14 %

Short-term debt	3,872	9	.23 %	6,171	24	.39 %	12,816	52	.41 %
Long-term debt	21,501	1,149	5.34 %	36,280	1,507	4.15 %	55,275	1,921	3.48 %
Total interest bearing liabilities	399,162	3,648	.91 %	414,433	4,773	1.15 %	448,565	6,294	1.40 %
Noninterest bearing deposits	107,647			90,170			75,983		
Other liabilities	5,134			13,074			199		
Total liabilities	511,943			517,677			524,747		
Stockholders' equity	67,108			51,763			47,782		
Total liabilities and stockholders' equity	$ 579,051			$ 569,440			$ 572,529		
		$ 17,508			$ 17,508			$ 17,508	
Net interest earnings		$ 23,225			$ 21,282			$ 21,027	
Net yield on interest earning assets (NIM)			4.30 %			4.02 %			3.92 %

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.

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PART II, Continued

Item 7. 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.

	2014 Compared to 2013 Increase (Decrease)			2013 Compared to 2012 Increase (Decrease)		
	Due to Change in Average: Volume	Rate	Increase Or (Decrease)	Due to Change in Average: Volume	Rate	Increase or (Decrease)
Interest income						
Loans held for investment	$1,303	$(150)	$1,153	$882	$(1,068)	$(186)
Loans held for sale	(372)	36	(336)	(1,009)	(79)	(1,088)
Investment securities						
Taxable	28	(17)	11	(60)	45	(15)
Partially taxable	-	-	-	-	(1)	(1)
Tax exempt	-	-	-	-	-	-
Interest bearing deposits in banks	(1)	(3)	(4)	(1)	-	(1)
Federal funds sold	(5)	(1)	(6)	25	-	25
Total Interest Income	953	(135)	818	(163)	(1,103)	(1,266)
Interest expense						
Deposits						
Demand	(20)	(108)	(128)	(7)	(396)	(403)
Savings	18	(15)	3	30	(93)	(63)
Time deposits	(33)	(594)	(627)	(281)	(332)	(613)
Short-term debt	(9)	(6)	(15)	(27)	(1)	(28)
Long-term debt	(613)	255	(358)	(661)	247	(414)
Total Interest Expense	(657)	(468)	(1,125)	(946)	(575)	(1,521)
Net Interest Income	$1 ,610	$333	$1,943	$783	$(528)	$255

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

Interest Income

Tax equivalent interest income increased $818,000 or 3.14% in 2014, after decreasing 4.63% or $1,266,000 in 2013. Overall, the yield on earning assets increased .05%, from 4.92% to 4.97%. Average loans held for investment grew during 2014, with average loans outstanding increasing $24,455,000 to $496,413,000. Real estate loans increased 4.52%, commercial loans decreased 2.81% and consumer loans increased 50.77%. The increase in consumer loans is result of the growth in our Dealer Finance division which opened at the end of 2012. As you can see, the increase in tax equivalent interest income is due to the growth in the Dealer Finance division, which is a higher yielding portfolio.

PART II, Continued

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

The following table provides detail on the components of tax equivalent net interest income:

GAAP Financial Measurements:			
(Dollars in thousands).	2014	2013	2012
Interest Income – Loans	$26,522	$25,718	$26,984
Interest Income - Securities and Other Interest-Earnings Assets	249	248	240
Interest Expense – Deposits	2,490	3,242	4,321
Interest Expense - Other Borrowings	1,158	1,531	1,973
Total Net Interest Income	23,123	21,193	20,930
Non-GAAP Financial Measurements:			
Add: Tax Benefit on Tax-Exempt Interest Income – Loans	102	89	97
Add: Tax Benefit on Tax-Exempt Interest Income - Securities and Other Interest-Earnings Assets	-	-	-
Total Tax Benefit on Tax-Exempt Interest Income	102	89	97
Tax-Equivalent Net Interest Income	$23,225	$21,282	$21,027

Interest Expense

Interest expense decreased $1,125,000 or 23.57% during 2014, which followed a 24.17% decrease or $1,521,000 in 2013. The average cost of funds of .91% decreased .24% compared to 2013. Average interest bearing liabilities decreased $15,271,000 in 2014 following decrease of $34,132,000 in 2013. The decrease in interest bearing liabilities was the result of a decrease in short and long term debt and migration from interest bearing deposits to noninterest bearing accounts. Long term debt decreased with the subordinated debt redemption and/or conversion to Preferred Stock. Due to declining rates and the migration into noninterest bearing accounts the expense associated with time deposits decreased $627,000 (26.90%) in 2014. Changes in the cost of funds attributable to rate and volume variances can be found in the table at the top of page 22.

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.

Non-interest income decreased 12.45% ($502,000) in 2014 following an increase of 6.87% in 2013. The majority of the decrease is from decreased income from our mortgage and investment subsidiaries ($233,000). Other areas of decrease were service charges on deposit accounts ($84,000) and bank owned life insurance ($42,000).

There were no security transactions in 2014, 2013 or 2012 which resulted in a gain or loss.

PART II, Continued

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

Noninterest Expense

Noninterest expenses increased from $14,720,000 in 2013 to $15,656,000 in 2014, a 6.36% increase. Salary and benefits increased 1.60% to $8,810,000 in 2014, following an 11.22% increase in 2013. This increase was the result of normal salary increases and increasing benefit costs (primarily health insurance). This year the pension expense declined which resulted in a smaller increase than 2013. Other real estate owned expenses increased $192,000 or 8.96% due to costs associated with maintaining the properties and losses from sales or write-downs of property. Other operating expenses increased $562,000 in 2014, following a $523,000 increase in 2013. Increases were in advertising ($38,000), data processing expense ($200,000), and supplies and stationary ($92,000). Noninterest expenses continue to be substantially lower than peer group averages. Total noninterest expense as a percentage of average assets totaled 2.61%, 2.58%, and 2.33%, in 2014, 2013 and 2012, respectively. Peer group averages (as reported in the most recent Uniform Bank Performance Report) have ranged between 2.89%, 2.93% and 2.93% over the same time period.

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 $3,775,000 in 2013 to $2,250,000 in 2014. The decrease 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 $1,709,000 in 2014 and $3,745,000 in 2013. Loan losses as a percentage of average loans held for investment totaled .33% and .78% in 2014 and 2013, respectively. As stated in the most recently available Bank Holding Company Performance Report (BHCPR), peer group loss averages were .18% in 2014 and .32% in 2013.

Balance Sheet

Total assets increased 9.50% during the year to $605,308,000, an increase of $52,520,000 from $552,788,000 in 2013. Average earning assets increased 2.12% or $11,232,000 to $540,491,000 at December 31, 2014. The increase in earning assets is due largely to the growth in the Dealer Finance division in installment loans. Average interest bearing deposits increased $1,807,000 for 2014 or .49%, with all the growth resulting from an increase in the savings category. The Company continues to utilize its assets well with 90.00% of average assets consisting of earning assets.

Investment Securities

Average balances in investment securities increased 14.23% in 2014 to $13,508,000. At year end, 2.50% 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 1.53% for 2014, down from 1.66% in 2013.

There were no security gains or losses and no Other Than Temporary Impairment (OTTI) write-downs in 2014, 2013 or 2012. Additional information on the securities impairment write-downs can be found on page 19 under the caption "Securities Impairment".

PART II, Continued

Item 7. 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)	2014	2013	2012
Available for Sale[1]			
U.S. Treasury, Agency and Government Sponsored Enterprises (GSE)	$12,058	$29,065	$7,031
Mortgage-backed[2]	1,022	1,201	1,647
Marketable equity securities	135	-	-
Total	13,215	30,266	8,678
Held to Maturity			
U.S. Treasury and Agency	125	106	107
Total	125	106	107
Other Equity Investments	8,965	8,114	10,022
Total Securities	$22,305	$38,486	$18,807

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, 2014 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.

	Less Than one Year		One to Five Years		Five to Ten Years		Over Ten Years			
(Dollars in thousands)	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Total	Yield
Debt Securities Available for Sale										
U.S. Treasury, Agency & GSE	$ 2,000	.05 %	$ 10,058	.94 %	$ -		$ -		$ 12,058	.79 %
Mortgage-backed							1,022	2.29 %	1,022	2.29 %
Marketable equities	-		-		-		135		135	
Total	$ 2,000	.05 %	$ 10,058	.94 %	$ -		$ 1,157	2.29 %	$ 13,215	.90 %
Debt Securities Held to Maturity										

U.S. Treasury & Agency	$	125	.38	%		$	125	.38	%
Total	$	125	.38	%		$	125	.38	%

PART II, Continued

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

Analysis of Loan Portfolio

The Company's market area has a relatively 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 Company's portfolio of loans held for investment totaled $518,202,000 at December 31, 2014 compared with $478,453,000 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 6.62% during 2014 to $174,748,000. Real estate mortgages increased $11,194,000 (5.26%). Growth has included a variety of loan and collateral types including owner occupied residential real estate and residential rental properties.

Construction loans decreased $1,332,000 or 1.94%. The decline in construction loans resulted from the slower economy which reduced construction within the Bank's primary market area. 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 increased $18,972,000 or 61.91%. This category includes personal loans, auto loans and other loans to individuals. This category began increasing during the fourth quarter of 2012 due to the opening of the Dealer Finance Division in Penn Laird, Virginia; at year end this Division had a loan portfolio of $40,634,000. Credit card balances increased $25,000 to $2,705,000 but are a minor component of the loan portfolio. The following table presents the changes in the loan portfolio over the previous five years.

	December 31				
(Dollars in thousands)	2014	2013	2012	2011	2010
Real estate – mortgage	$223,824	$212,630	$204,812	$193,280	$190,162
Real estate – construction	67,180	68,512	71,251	72,224	79,337
Consumer installment	49,615	30,643	15,753	13,015	19,043
Commercial	147,599	135,835	147,089	141,014	121,490
Agricultural	15,374	16,265	14,099	15,985	19,761
Multi-family residential	11,775	11,797	9,357	13,157	12,259
Credit cards	2,705	2,680	2,788	2,812	2,771
Other	130	91	670	83	324
Total Loans	$518,202	$478,453	$465,819	$451,570	$445,147

The following table shows the Company's loan maturity and interest rate sensitivity as of December 31, 2014:

(Dollars in thousands)	Less Than 1 Year	1-5 Years	Over 5 Years	Total
Commercial and agricultural loans	$53,878	$104,035	$5,060	$162,973
Multi-family residential	2,296	8,838	641	11,775

Real Estate – mortgage	90,887	132,689	248	223,824
Real Estate – construction	56,789	9,941	450	67,180
Consumer – installment/other	7,314	45,092	44	52,450
Total	$211,164	$300,595	$6,443	$518,202
Loans with predetermined rates	$21,555	$64,465	$3,764	$89,784
Loans with variable or adjustable rates	189,609	236,130	2,679	428,418
Total	$211,164	$300,595	$6,443	$518,202

PART II, Continued

Item 7. 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 94% of the real estate loans, interest is adjustable after each one, three or five year period. The remainder of the portfolio is comprised of fixed rate loans that 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 81% of the loans are secured by automobiles and trucks.

Prior to the 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 peaked in 2007 or 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%. Values appear to have bottomed out in 2011, with modest increases in both 2013 and 2014. Approximately 84% 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, 2014, there are no industry categories of loans that exceed 10% of total loans.

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. The Company would have earned approximately $361,000 in additional interest income had the loans on nonaccrual status been current and performing. Nonperforming loans totaled $6,975,000 at December 31, 2014 compared to $12,582,000 at December 31, 2013. At December 31, 2014 $1,000 of loans (credit cards) 90 days or more past due were not on nonaccrual status. Approximately 97% of these nonperforming loans are secured by real estate. Although management expects that there may be additional loan losses, the bank is generally well secured and continues to actively work with its customers to effect payment. As of December 31, 2014, the Company holds $3,507,000 of real estate which was acquired through foreclosure, of which $475,000 was under contract pending sale in the first quarter of 2015.

Nonperforming loans have decreased approximately $5,607,000 since December 31, 2013.

PART II, Continued

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

Nonaccrual and Past Due Loans, continued

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

(Dollars in thousands)	2014		2013		2012		2011		2010	
Nonaccrual Loans:										
Real Estate - 2011 includes $1,040 of restructured loans	$5,481		$9,963		$9,611		$7,671		$5,189	
Commercial - 2011 includes $309 of restructured loans	1,179		1,890		2,914		5,888		1,656	
Home Equity	153		402		740		266		715	
Other	161		-		121		39		30	
Loans past due 90 days or more:										
Real Estate	0		246		-		646		3021	
Commercial	0		4		-		-		4581	
Home Equity	0		61		-		260		588	
Other	1		16		-		6		54	
Total Nonperforming loans	$6,975		$12,582		$13,386		$14,776		$15,834	
Restructured Loans:										
Real Estate	179		50		147		4,786		267	
Commercial	22		1,450		4,628		1,292		385	
Nonperforming loans as a percentage of loans held for investment	1.35	%	2.63	%	2.87	%	3.27	%	3.56	%
Net Charge Offs to Total Loans Held for Investment(1)	0.33	%	0.78	%	0.64	%	0.63	%	0.53	%
Allowance for loan and lease losses to nonperforming loans	125.09	%	65.04	%	60.91	%	46.95	%	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, 2014, 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.

PART II, Continued

Item 7. 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, pools of loans by type and a general allowance based on a variety of criteria. Loans with identified potential losses include examiner and bank classified loans. Classified relationships in excess of $500,000 and loans identified as Troubled Debt Restructuring 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.

Loans that are not impaired are categorized by call report code and an estimate is calculated based on actual loss experience over the last two years. Dealer finance loans utilize a five year loss history. The Company will monitor the net losses for this division and adjust based on how the portfolio performs since the department was established in 2012. A general allowance for inherent losses has been established to reflect other unidentified losses within the portfolio. The general allowance is calculated using eight environmental factors (loan growth, unemployment, past due/criticized loans, interest rates, changes in underwriting practices, local real estate industry conditions, and experience of lending staff) with a range for worst and best case. The general allowance assists in managing recent changes in portfolio risk that may not be captured in individually impaired loans or in the homogeneous pools based on two year loss histories. 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 $8,725,000 at December 31, 2014 is equal to 1.68% of total loans held for investment. This compares to an allowance of $8,184,000 (1.71%) at December 31, 2013 and 1.75% at December 31, 2012. 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. The overall level of the allowance is comparable with peer group averages and 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 $1,709,000 in 2014 which is equivalent to .33% of total loans outstanding. Over the preceding three years, the Company has had an average loss rate of .58%, compared to a .33% loss rate for its peer group.

PART II, Continued

Item 7. 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)	2014		2013		2012		2011		2010	
Balance at beginning of period	$8,184		$8,154		$6,937		$5,786		$3,836	
Provision charged to expenses	2,250		3,775		4,200		4,000		4,300	
Loan losses:										
Construction/land development	1,611		2,127		1,480		1,263		249	
Farmland	-		-		-		-		3	
Real Estate	208		173		482		474		181	
Multi-family	-		-		-		-		958	
Commercial Real Estate	-		201		424		381		346	
Home Equity – closed end	-		159		69		222		200	
Home Equity – open end	80		68		-		83		-	
Commercial & Industrial – Non Real Estate	385		986		776		423		332	
Consumer	33		173		45		90		117	
Dealer Finance	107		17		-		-		-	
Credit Cards	46		121		71		106		97	
Total loan losses	2,470		4,025		3,347		3,042		2,483	
Recoveries:										
Construction/land development	223		40		192		-		-	
Farmland	-		-		3		-		-	
Real Estate	-		-		-		8		2	
Multi-family	-		-		-		48		52	
Commercial Real Estate	108		42		48		16		2	
Home Equity – closed end	-		-		-		3		-	
Home Equity – open end	-		29		-		27		-	
Commercial & Industrial – Non Real Estate	356		127		62		24		-	
Consumer	33		14		27		42		56	
Dealer Finance	6		-		-		-		-	
Credit Cards	35		28		32		25		21	
Total recoveries	761		280		364		193		133	
Net loan losses	(1,709	)	(3,745	)	(2,983	)	(2,849	)	(2,350	)
Balance at end of period	$8,725		$8,184		$8,154		$6,937		$5,786	
Allowance for loan losses as a percentage of loans	1.68	%	1.71	%	1.75	%	1.54	%	1.30	%
Net loan losses to loans outstanding	.33	%	.78	%	.64	%	.63	%	.53	%

PART II, Continued

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

Loan Losses and the Allowance for Loan Losses, continued

ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES

	2014		2013		2012		2011*		2010*	
Allowance for loan losses: (in thousands)	Balance	Percentage of Loans in Each Category	Balance	Percentage of Loans in Each Category	Balance	Percentage of Loans in Each Category	Balance	Percentage of Loans in Each Category	Balance	Percentage of Loans in Each Category
Construction/Land Development	$4,738	54.30 %	$4,007	45.93 %	$2,771	33.86 %	$-	-	$-	-
Real Estate	623	7.14 %	400	4.58 %	924	11.29 %	-	-	-	-
Commercial, Financial and Agricultural	1,337	15.33 %	2,239	25.66 %	3,187	38.94 %	2,984	36.60 %	2,653	38.24 %
Consumer	1,685	19.31 %	905	10.37 %	253	3.09 %	298	3.65 %	270	3.89 %
Home Equity	342	3.92 %	633	7.26 %	1,019	12.45 %	920	11.28 %	578	8.33 %
Total	$8,725	100.00 %	$8,184	93.80 %	$8,154	99.63 %	$6,937	85.07 %	$5,785	83.39 %

* Allocation detail for Construction/Land Development verses Real Estate is not easily available.

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PART II, Continued

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

Deposits and Borrowings

The average deposit balances and average rates paid for 2014, 2013 and 2012 were as follows:

Average Deposits and Rates Paid (Dollars in thousands)

	December 31,								
	2014			2013			2012		
	Amount	Rate		Amount	Rate		Amount	Rate	
Noninterest-bearing	$ 119,203			$ 90,170			$ 75,983		
Interest-bearing:									
Interest Checking	$ 117,396	.57	%	$ 120,482	.66	%	$ 121,209	.99	%
Savings Accounts	60,460	.20	%	52,714	.23	%	45,120	.40	%
Time Deposits:									
CDARS	19,771	.21	%	8,581	.53	%	10,339	.69	%
$100,000 or more	74,743	.61	%	69,130	.87	%	67,562	1.01	%
Less than $100,000	101,419	1.19	%	121,075	1.39	%	136,244	1.61	%
Total Interest-bearing	373,789	.67	%	371,982	.87	%	380,474	1.14	%
Total deposits	$ 492,992	.51	%	$ 462,152	.70	%	$ 456,457	.95	%

Noninterest-bearing demand deposits, which are comprised of checking accounts, increased $29,033,000 or 32.20% from $90,170,000 at December 31, 2013 to $119,203,000 at December 31, 2014. Interest-bearing deposits, which include interest checking accounts, money market accounts, regular savings accounts and time deposits, increased $1,807,000 or .49% from $371,982,000 at December 31, 2013 to $373,789,000 at December 31, 2014. Total interest checking (including money market) account balances decreased $3,086,000 or 2.56% from $120,482,000 at December 31, 2013 to $117,396,000 at December 31, 2014. Total savings account balances increased $7,746,000 or 14.69% from $52,714,000 at December 31, 2013 to $60,460,000 at December 31, 2014.

Time deposits decreased $2,853,000 or 1.44% from $198,786,000 at December 31, 2013 to $195,933,000 at December 31, 2014. This is comprised of an increase in certificates of deposit of $100,000 and more of $5,613,000 or 8.12% from $69,130,000 at December 31, 2013 to $74,743,000 at December 31, 2014, a decrease in certificates of deposit of less than $100,000 of $19,656,000 or 16.23% from $121,075,000 at December 31, 2013 to $101,419,000 at December 31, 2014 and an increase in CDARs deposits of $11,190,000 or 130.40% from $8,581,000 at December 31, 2013 to $19,771,000 at December 31, 2014. 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)	2014	2013
Less than 3 months	$32,378	$14,360
3 to 6 months	6,915	5,485
6 to 12 months	7,439	15,219
1 year to 5 years	33,080	34,610
Total	$79,812	$69,674

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PART II, Continued

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

Deposits and Borrowings, continued

Non-deposit borrowings include repurchase agreements, federal funds purchased, Federal Home Loan Bank (FHLB) borrowings, (both short term and long term) and subordinated debt. Non-deposit borrowings are an important source of funding for the Bank. These sources assist in managing short and long term funding needs, often at rates that are more favorable than raising additional funds within the deposit portfolio.

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 Company borrowed $10,000,000 during 2014, with maturities ranging from 5 to 10 years, to replace maturities and lock in lower rates. There were no new long term borrowings in 2013 or 2012. Repayment of amortizing and fixed maturity loans through FHLB totaled $11,625,000 for the year. These loans carry an average rate of 2.33% at December 31, 2014. The subordinated debt was all redeemed and/or converted to Preferred stock by December 31. 2014.

Contractual Obligations and Scheduled Payments (dollars in thousands)

	December 31, 2014				
	Less than One Year	One Year Through Three Years	Three Years Through Five Years	More than Five Years	Total
Securities sold under agreements to repurchase	$4,358	-	-	-	$4,358
FHLB Short term advances	10,000	-	-	-	10,000
Federal Funds Purchased	-	-	-	-	-
FHLB long term advances	500	1,500	3,500	4,375	9,875
Subordinated Debt	-	-	-	-	-
Total	$14,858	$1,500	$3,500	$4,375	$24,233

See Note 11 (Short Term Debt) and Note 12 (Long Term Debt) to the Consolidated Financial Statements for a discussion of the rates, terms, and conversion features on these advances.

Stockholders' Equity

Total stockholders' equity increased $23,657,000 or 43.70% in 2014. This increase includes a common stock raise of $12,000,000 and a new issuance of preferred stock which totaled $9,425,123. In addition, net income totaled $5,801,609, noncontrolling interest net income totaled $45,653, other sales of common stock totaled $55,709, changes in other comprehensive income decreased $1,401,498, and capital was reduced by dividends ($2.232 million) and minority interest distributions of $37,516. As of December 31, 2014, book value per common share was $21.20 compared to $21.56 as of December 31, 2013. 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, 2014, the Company had Tier I capital of 16.09% of risk weighted assets and combined Tier I and II capital of 17.35% of risk weighted assets. Regulatory minimums at this date were 6% 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 4% for this ratio, but can increase the minimum requirement based upon an institution's overall financial condition. At December 31, 2014, the Company reported a leverage ratio of 12.88%. The Bank's leverage ratio was also substantially above the minimum.

PART II, Continued

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

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. Fortunately the Company's net interest margin increased .28% in 2014 following an increase of .10% in 2013. This increase can be attributed to the growth in the Dealer finance division and continued reduction in cost of funds, in addition to the matching of maturities of interest bearing liabilities to interest earning assets. 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.

Liquid assets, which include cash and cash equivalents, federal funds sold, interest bearing deposits and short term investments averaged $27,510,000 for 2014. 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.

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, 2014. 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 13.98% of total earning assets, compared to 15.35% in 2013. Approximately 43.36% of rate sensitive assets and 40.91% of rate sensitive liabilities are subject to repricing within one year. Short term assets (less than one year) increased $6,904,000 during the year, while total earning assets increased $48,547,000. The increase is attributed to growth in Loans Held for Investment of $39,749,000 as well as Loans Held for Sale of $9,578,000. Growth in the loan held for investment portfolio was concentrated in real estate secured loans, commercial and the Dealer Finance division. Short term liabilities increased $7,103,000, while total interest bearing liabilities increased $6,597,000. The increase in short term liabilities is due to an increase in short term debt of $10,000,000 to fund Loans Held for Sale. Due to the relatively flat yield curve, management has kept deposit rates low. These actions and the increase in total earning assets have resulted in a slightly lower one year cumulative gap than prior year.

PART II, Continued

Item 7. 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, 2014, 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	$ 110,491	$ 97,968	$ 300,595	$ 6,443	$ -	$ 515,497
Loans held for sale	13,382	-	-	-	-	13,382
Federal funds sold	16,051	-	-	-	-	16,051
Investment securities	2,000	125	10,058	1,022	135	13,340
Credit Cards	2,705	-	-	-	-	2,705
Interest bearing bank deposits	911	-	-	-	-	911
Total	145,540	98,093	310,653	7,465	135	561,886
Rate Sensitive Liabilities:						
Interest bearing demand deposits	-	31,689	69,166	18,739	-	119,594
Savings deposits	-	12,850	38,549	12,850	-	64,249
Certificates of deposit $100,000 and over	32,378	14,354	33,080	-	-	79,812
Other certificates of deposit	20,460	38,482	56,709	-	-	115,651
Total Deposits	52,838	97,375	197,504	31,589	-	379,306
Short-term debt	14,358	-	-	-	-	14,358
Long-term debt	125	375	5,000	4,375	-	9,875
Total	67,321	97,750	202,504	35,964	-	403,539
Discrete Gap	78,219	343	108,149	(28,499)	135	158,347
Cumulative Gap	78,219	78,562	186,711	158,212	158,347	
As a % of Earning Assets	13.92 %	13.98 %	33.22 %	28.16 %	28.18 %	

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.

PART II, Continued

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, Continued

Recent Accounting Pronouncements

In January 2014, the FASB amended the Equity Method and Joint Ventures topic of the Accounting Standards Codification. The amendments provide criteria that must be met in order to apply a proportional amortization method to Low-Income Housing Tax Credit investments and provide guidance on the method used to amortize the investment, the impairment approach, and the eligibility criteria for entities that have other arrangements (e.g., loans) with the limited liability entity. The amendments will be effective for the Company for new investments in qualified affordable housing projects for interim and annual periods beginning after December 15, 2014. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2014, the FASB amended Receivables topic of the Accounting Standards Codification. The amendments are intended to resolve diversity in practice with respect to when a creditor should reclassify a collateralized consumer mortgage loan to other real estate owned (OREO). In addition, the amendments require a creditor reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The amendments will be effective for the Company for annual periods, and interim periods within those annual period beginning after December 15, 2014 with early implementation of the guidance permitted. In implementing this guidance, assets that are reclassified from real estate to loans are measured at the carrying value of the real estate at the date of adoption. Assets reclassified from loans to real estate are measured at the lower of the net amount of the loan receivable or the fair value of the real estate less costs to sell at the date of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2014, the FASB issued guidance that is intended to define management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern and to provide related footnote disclosures. In connection with preparing financial statements, management will need to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the organization’s ability to continue as a going concern within one year after the date that the financial statements are issued. The amendments will be effective for the Company for annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2015, the FASB issued guidance that eliminated the concept of extraordinary items from U.S. GAAP. Existing U.S. GAAP required that an entity separately classify, present, and disclose extraordinary events and transactions. The amendments will eliminate the requirements for reporting entities to consider whether an underlying event or transaction is extraordinary, however, the presentation and disclosure guidance for items that are unusual in nature or occur infrequently will be retained and will be expanded to include items that are both unusual in nature and infrequently occurring. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The amendments may be applied either prospectively or retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

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.

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PART II, Continued

Item 7. 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, 2014 and 2013:

	2014				
(Dollars in thousands)	Fourth	Third	Second	First	Total
Interest and Dividend Income	$ 6,934	$ 6,873	$ 6,674	$ 6,291	$ 26,772
Interest Expense	871	908	919	950	3,648
Net Interest Income	6,063	5,965	5,755	5,341	23,124
Provision for Loan Losses	-	750	750	750	2,250
Net Interest Income after Provision,					
For Loan Losses	6,063	5,215	5,005	4,591	20,874
Non-Interest Income	780	995	934	776	3,485
Non-Interest Expense	4,194	3,923	3,801	3,738	15,656
Income before taxes	2,649	2,287	2,138	1,629	8,703
Income Tax Expense	1,057	726	642	476	2,901
Net Income	$ 1,592	$ 1,561	$ 1,496	$ 1,153	$ 5,802
Net Income Per Average					
Common Share	$ .43	$ .48	$ .45	$ .46	$ 1.82

	2013				
(Dollars in thousands)	Fourth	Third	Second	First	Total
Interest and Dividend Income	$ 6,400	$ 6,458	$ 6,509	$ 6,599	$ 25,966
Interest Expense	1,073	1,194	1,228	1,278	4,773
Net Interest Income	5,327	5,264	5,281	5,321	21,193
Provision for Loan Losses	750	1,000	1,125	900	3,775
Net Interest Income after Provision,					
For Loan Losses	4,577	4,264	4,156	4,421	17,418
Non-Interest Income	939	1,026	1,094	866	3,925
Non-Interest Expense	3,890	3,662	3,565	3,603	14,720
Income before taxes	1,626	1,628	1,685	1,684	6,623
Income Tax Expense	442	445	552	468	1,907

Net Income	$ 1,184	$ 1,183	$ 1,133	$ 1,216	$ 4,716
Net Income Per Average Common Share	$ .47	$ .47	$ .45	$ .49	$ 1.88

Item 8. Financial Statements and Supplementary Data

F & M Bank Corp. and Subsidiaries
Consolidated Balance Sheets
December 31, 2014 and 2013

	2014	2013
Assets		
Cash and due from banks (notes 3 and 15)	$ 6,241,016	$ 5,834,596
Money market funds	910,527	708,049
Federal funds sold	16,051,000	2,000
Cash and cash equivalents	23,202,543	6,544,645
Securities:		
Held to maturity - fair value of $125,150 and $106,387 in 2014 and 2013, respectively (note 4)	125,150	106,387
Available for sale (note 4)	13,215,112	30,265,781
Other investments (note 4)	8,964,640	8,113,600
Loans held for sale	13,381,941	3,804,425
Loans held for investment (notes 5)	518,201,574	478,453,008
Less allowance for loan losses (note 6)	(8,724,731)	(8,184,376)
Net Loans Held for Investment	509,476,843	470,268,632
Other real estate owned (note 9)	3,507,153	2,628,418
Bank premises and equipment, net (note 8)	6,458,254	6,525,057
Interest receivable	1,674,846	1,498,112
Goodwill (note 23)	2,669,517	2,669,517
Bank owned life insurance (note 24)	12,581,210	12,121,772
Other assets	10,050,893	8,241,821
Total Assets	$ 605,308,102	$ 552,788,167
Liabilities		
Deposits: (note 10)		
Noninterest bearing	$ 112,197,722	$ 92,396,921
Interest bearing:		
Demand	93,693,468	92,562,273
Money market accounts	25,900,061	24,894,002
Savings	64,249,199	58,292,273
Time deposits over $100,000	79,812,757	69,673,722
All other time deposits	115,651,329	126,330,053
Total Deposits	491,504,536	464,149,244
Short-term debt (note 11)	14,358,492	3,423,078
Accrued liabilities	11,771,671	9,383,610
Subordinated debt (note 12)	-	10,191,000
Long-term debt (note 12)	9,875,000	11,500,000
Total Liabilities	527,509,699	498,646,932
Commitments and Contingencies (notes 4 and 16)		

Stockholders’ Equity (Note 22)				
Preferred Stock $5 par value, 400,000 shares authorized, issued and outstanding for 2014				
and none in 2013		9,425,123		-
Common stock $5 par value, 6,000,000 shares authorized, 3,291,766 and				
2,511,735 shares issued and outstanding for 2014 and 2013, respectively		16,458,830		12,558,675
Additional paid in capital – common stock		11,259,995		3,104,441
Retained earnings (note 19)		42,554,421		38,984,724
Noncontrolling interest		426,365		418,228
Accumulated other comprehensive income (loss)		(2,326,331)		(924,833)
Total Stockholders' Equity		77,798,403		54,141,235
Total Liabilities and Stockholders' Equity	$	605,308,102	$	552,788,167

F & M Bank Corp. and Subsidiaries
Consolidated Statements of Income
For the years ended 2014, 2013 and 2012

	2014	2013	2012
Interest and Dividend Income			
Interest and fees on loans held for investment	$ 26,210,609	$ 25,070,039	$ 25,247,444
Interest on loans held for sale	312,364	647,622	1,736,361
Interest on deposits and federal funds sold	44,435	54,679	30,363
Interest on debt securities	204,649	193,244	210,371
Total Interest and Dividend Income	26,772,057	25,965,584	27,224,539
Interest Expense			
Interest on demand deposits	663,618	791,245	1,194,567
Interest on savings deposits	121,808	119,020	182,479
Interest on time deposits over $100,000	589,673	781,950	908,389
Interest on all other time deposits	1,114,470	1,549,273	2,035,900
Total interest on deposits	2,489,569	3,241,488	4,321,335
Interest on short-term debt	9,437	23,956	51,380
Interest on long-term debt	1,148,716	1,507,299	1,921,356
Total Interest Expense	3,647,722	4,772,743	6,294,071
Net Interest Income	23,124,335	21,192,841	20,930,468
Provision for Loan losses (note 6)	2,250,000	3,775,000	4,200,000
Net Interest Income After Provision for Loan Losses	20,874,335	17,417,841	16,730,468
Noninterest Income			
Service charges on deposit accounts	1,033,959	1,117,910	1,168,221
Insurance and other commissions	635,543	868,464	868,965
Other operating income	1,393,897	1,537,397	1,254,490
Income on bank owned life insurance	466,936	508,658	481,681
Total Noninterest Income	3,530,335	4,032,429	3,773,357
Noninterest Expenses			
Salaries	6,898,400	6,524,515	5,823,204
Employee benefits (note 14)	1,911,250	2,146,871	1,972,835
Occupancy expense	621,855	606,935	553,655
Equipment expense	589,919	547,948	549,564
FDIC insurance assessment	690,000	704,103	706,673
Other real estate owned expenses	407,219	214,832	303,802
Other operating expenses	4,537,269	3,974,791	3,451,645
Total Noninterest Expenses	15,655,912	14,719,995	13,361,378
Income before Income Taxes	8,748,758	6,730,275	7,142,447
Income Tax Expense (note 13)	2,901,496	1,907,297	2,095,397

Consolidated Net Income – F & M Bank Corp.		5,847,262		4,822,978		5,047,050
Net Income - Noncontrolling interest		(45,653)		(107,185)		(145,966)
Net Income-F & M Bank Corp.	$	5,801,609	$	4,715,793	$	4,901,084
Dividends paid/accumulated on preferred stock		127,500		-		-
Net Income available to common stockholders	$	5,674,109	$	4,715,793	$	4,901,084
Per Share Data						
Net Income - basic		1.82		1.88		1.96
Net Income - diluted		1.80		1.88		1.96
Cash Dividends		.68		.68		.64
Average Common Shares Outstanding – basic		3,119,333		2,504,015		2,496,300
Average Common Shares Outstanding – diluted		3,229,942		2,504,015		2,496,300

F & M BANK CORP.
Consolidated Statements of Comprehensive Income
For the years ended 2014, 2013 and 2012

	Years Ended December 31,		
	2014	2013	2012
Net Income:			
Net income – F & M Bank Corp	$5,801,609	$4,715,793	$4,901,084
Net income attributable to noncontrolling interest	45,653	107,185	145,966
Total net income	5,847,262	4,822,978	5,047,050
Other comprehensive income (loss):			
Pension plan adjustment	(2,145,868)	2,314,274	(557,609)
Tax effect	729,595	(786,853)	189,587
Pension plan adjustment, net of tax	(1,416,273)	1,527,421	(368,022)
Unrealized holding gains (losses)			
on available-for-sale securities	22,386	(75,127)	26,470
Tax effect	(7,611)	25,543	(9,000)
Unrealized holding gain (losses), net of tax	14,775	(49,584)	17,470
Total comprehensive income	$4,445,764	$6,300,815	$4,696,498

F & M Bank Corp. and Subsidiaries
Consolidated Statements of Changes in Stockholders' Equity
For the years ended December 31, 2014, 2013 and 2012

	Preferred Stock	Common Stock	Additional Paid in Capital	Retained Earnings	Noncontrolling Interest	Accumulated Other Comprehensive Income (Loss)	Total
Balance December 31, 2011	$ -	$ 12,463,580	$ 2,080,691	$ 32,671,401	$ 216,165	$ (2,052,118)	$ 46,179,719
Net income				4,901,084	145,966		5,047,050
Other comprehensive income (loss)						(350,552)	(350,552)
Dividends on common stock				(1,597,673)			(1,597,673)
Stock issued (6,828 shares)	-	34,140	71,276	-	-	-	105,416
Balance December 31, 2012	$ -	$ 12,497,720	$ 2,951,967	$ 35,974,812	$ 362,131	$ (2,402,670)	$ 49,383,960
Net income				4,715,793	107,185		4,822,978
Other comprehensive income (loss)						1,477,837	1,477,837
Minority Interest Contributed Capital (Distributions)					(51,088)		(51,088)
Dividends on common stock				(1,705,881)			(1,705,881)
Stock issued (12,141 shares)		60,955	152,474	-	-	-	213,429
Balance December 31, 2013	$ -	$ 12,558,675	$ 3,104,441	$ 38,984,724	$ 418,228	$ (924,833)	$ 54,141,235
Net income				5,801,609	45,653		5,847,262

Other comprehensive income (loss)						(1,401,498)	(1,401,498)
Minority Interest Contributed Capital (Distributions)					(37,516)		(37,516)
Dividends on preferred stock				(127,500)			(127,500)
Dividends on common stock				(2,104,412)			(2,104,412)
Preferred stock issued (400,000 shares)	9,425,123						9,425,123
Common Stock issued (780,031 shares)	-	3,900,155	8,155,554	-	-	-	12,055,709
Balance December 31, 2014	$ 9,425,123	$ 16,458,830	$ 11,259,995	$ 42,554,421	$ 426,365	$ (2,326,331)	$ 77,798,403

F & M Bank Corp. and Subsidiaries
Consolidated Statements of Cash Flows
For the years ended December 31, 2014, 2013 and 2012

	2014	2013	2012
Cash Flows from Operating Activities			
Net income	$5,801,609	$4,715,793	$4,901,084
Adjustments to reconcile net income to net cash			
provided by (used in) operating activities:			
Depreciation	612,116	581,625	597,920
Amortization (Accretion) of securities	76,057	45,416	74,190
Sale of loans held for sale originated	56,210,640	79,778,381	76,622,865
Loans held for sale originated	(56,044,669	(71,169,362)	(81,529,577)
Provision for loan losses	2,250,000	3,775,000	4,200,000
Benefit (expense) for deferred taxes	(515,538	(568,858)	494,733
(Increase) decrease in interest receivable	(176,734	204,735	113,014
(Increase) decrease in other assets	(1,473,634	(967,516)	1,729,648
Increase (decrease) in accrued expenses	1,159,913	1,731,973	528,576
Amortization of limited partnership investments	608,360	581,737	550,989
Loss on sale and valuation adjustments of other real estate owned	318,714	97,155	200,865
Income from life insurance investment	(466,936	(508,658)	(481,681)
Net Cash Provided by Operating Activities	8,359,898	18,297,421	8,002,626
Cash Flows from Investing Activities			
(Increase) decrease in interest bearing bank deposits	-	248,000	(95,585)
Purchase of bank owned life insurance	-	-	(4,063,687)
Proceeds from maturities of securities available for sale	27,495,319	10,712,508	20,647,760
Proceeds from maturities of securities held to maturity	106,000		
Purchases of securities available for sale	(11,957,235	(31,093,384)	(17,946,019)
Purchases of securities held to maturity	(125,250		
Net increase in loans held for investment	(43,642,033	(17,149,156)	(18,806,297)
Net (increase) decrease in loans held for sale participations	(9,743,487	64,793,073	(11,756,993)
Net purchase of property and equipment	(545,313	(661,621)	(565,898)
Proceeds from sale of other real estate owned	986,373	928,897	1,564,272
Net Cash Provided by (Used in) Investing Activities	(37,425,626	27,778,317	(31,022,447)
Cash Flows from Financing Activities			
Net change in demand and savings deposits	27,894,981	15,867,944	19,689,196
Net change in time deposits	(539,689	(5,514,239)	(1,840,280)
Net change in short-term debt	10,935,414	(31,174,274)	16,058,389
Dividends paid in cash	(2,231,912	(1,705,881)	(1,597,673)
Proceeds from long-term debt	10,000,000	-	-
Proceeds from issuance of preferred stock	6,831,123	-	-
Proceeds from issuance of common stock	12,055,709	213,429	105,416
Repayments of long-term debt	(19,222,000	(26,214,286)	(9,392,857)
Net Cash Provided by (Used in) Financing Activities	45,723,626	(48,527,307)	23,022,191
Net Increase (Decrease) in Cash and Cash Equivalents	16,657,898	(2,451,569)	2,370

Cash and Cash Equivalents, Beginning of Year	6,544,645	8,996,214	8,993,844
Cash and Cash Equivalents, End of Year	$23,202,543	$6,544,645	$8,996,214
Supplemental Disclosure:			
Cash paid for:			
Interest expense	$3,703,190	$6,500,592	$6,245,244
Income taxes	1,607,000	800,000	1,700,000
Transfers from loans to other real estate owned	2,914,958	1,337,890	1,972,032
Noncash exchange of other real estate owned	(780,097	(569,245)	(567,171)
Conversion of subordinated debt to preferred stock	2,594,000	-	-

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 1 NATURE OF OPERATIONS:

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

The Company raised an additional $12 million (net of fees) in common stock in a private placement offering in March of 2014. They also issued $9.4 million (net of fees) in a new offering of preferred stock during December 2014. This additional capital will be used to fund loan growth as well as support new branches in an adjoining county.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

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

The following is a summary of the more significant policies:

Principles of Consolidation

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

Use of Estimates in the Preparation of Financial Statements

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

Cash and Cash Equivalents

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

Investment Securities

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

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

Accounting for Historic Rehabilitation and Low Income Housing Partnerships

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

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Loans Held for Investment

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

Loans Held for Sale

These loans consists of fixed rate loans made through its subsidiary, VBS Mortgage and loans purchased from Gateway Savings Bank, Oakland, CA and NorthPointe Bank, Grand Rapids, MI.

VBS Mortgage originates conforming mortgage loans for sale in the secondary market. The bank (VBS) gives the customer a rate commitment at the time the rate is locked. The bank then immediately gets a rate lock-in from the investor that will be buying the loan upon closing. Both the rate lock and the purchase commitments (which is a blanket agreement) are best effort agreements, subject to final approval and underwriting. Because either party can walk away from these agreements prior to closing, neither the rate lock commitment nor the purchase commitment is considered a derivative contract. The bank provides a warehouse line for the Mortgage subsidiary after closing, until the loan is purchased by the investor. The average time on the line is two or three weeks. Although VBS does have a line, loans are actually assigned to the bank at closing and then reassigned prior to purchase from investor. There were $2.6 million of these mortgage loans held for resale at the end of the year. All of these loans are under contract to deliver to an investor as a specified price. Because of this and the short holding period, these loans are carried at par and a gain is recorded at transfer to the investor. The effect of not marking these loans to market is not material to the current year financial statements.

Gateway Savings Bank ("Gateway") loans are originated by a network of mortgage loan originators throughout the United States. A take out commitment is in place at the time the loans are purchased. The Gateway arrangement has been used since 2003 as a higher yielding alternative to federal funds sold or investment securities. 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. Gateway Savings Bank discontinued the loan participation program in December of 2014 and the Company became a participant with NorthPointe Bank which obtained the Gateway Savings Bank program and incorporated it into their existing program. The NorthPointe Bank program and procedures are the same as described above for Gateway.

Allowance for Loan Losses

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

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Allowance for Loan Losses continued

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

Other Real Estate Owned (OREO)

As of December 31, 2014, the Bank had $3.5 million classified as OREO on the balance sheet, compared to $2.63 million as of December 31, 2013. The table in Note 9 reflects the OREO activity in 2014. The Company's policy is to carry OREO on its balance sheet at the lower of cost or market. Values are reviewed periodically and additional losses are recognized if warranted based on market conditions.

Nonaccrual Loans

Loans are placed on nonaccrual status when they become ninety days or more past due, unless there is an expectation that the loan will either be brought current or paid in full in a reasonable period of time.

Bank Premises and Equipment

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

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

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

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Goodwill

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

Goodwill totaled $2,669,517 at December 31, 2014 and 2013. The goodwill is no longer amortized, but instead tested for impairment at least annually. Based on the testing, there were no impairment charges for 2014, 2013 or 2012.

Pension Plans

The Bank has a qualified noncontributory defined benefit pension plan which covers all full time employees hired prior to April 1, 2012. The benefits are primarily based on years of service and earnings. On December 31, 2006 the Company adopted ASC 325-960 “Defined Benefit Pension Plans” (formerly SFAS No. 158), which was issued in September of 2006 to require recognition of the over-funded or under-funded status of pension and other postretirement benefit plans on the balance sheet. Under ASC 325-960, gains and losses, prior service costs and credits, and any remaining transition amounts that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects, until they are amortized as a component of net periodic cost.

Advertising Costs

The Company follows the policy of charging the cost of advertising to expense as incurred. Total advertising costs included in other operating expenses for 2014, 2013, and 2012 were $317,780, $278,555, and $251,258, respectively.

Income Taxes

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

Comprehensive Income

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

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Earnings per Share

Accounting guidance specifies the computation, presentation and disclosure requirements for earnings per share ("EPS") for entities with publicly held common stock or potential common stock such as options, warrants, convertible securities or contingent stock agreements if those securities trade in a public market. Basic EPS is computed by dividing net income by the weighted average number of common shares outstanding. Diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive common shares had been issued. The dilutive effect of conversion of preferred stock is reflected in the diluted earnings per share calculation.

Net income available to common stockholders represents consolidated net income adjusted for preferred dividends declared.

The following table provides a reconciliation of net income to net income available to common stockholders for the periods presented:

		For the year ended December 31, 2014
Earnings Available to Common Stockholders:		
Net Income	$	5,801,609
Preferred Stock Dividends		127,500
Net Income Available to Common Stockolders	$	5,674,109

The following table shows the effect of dilutive preferred stock conversion on the Company's earnings per share for the periods indicated:

	Year ending December 31, 2014				
		Income	Shares		Per Share Amounts
Basic EPS	$	5,674,109	3,119,333	$	1.82
Effect of Dilutive Securities:					
Convertible Preferred Stock		127,500	110,609		(0.02)
Diluted EPS	$	5,801,609	3,229,942	$	1.80

There were no dilutive securities for the years ended December 31, 2013 and 2012.

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F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Derivative Financial Instruments and Change in Accounting Principle

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

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

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

Recent Accounting Pronouncements

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

Subsequent Events

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

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 3 CASH AND DUE FROM BANKS:

The Bank is required to maintain average reserve balances based on a percentage of deposits. The average balance of cash, which the Federal Reserve Bank requires to be on reserve, was $25,000 for the years ended December 31, 2014 and 2013.

NOTE 4 INVESTMENT SECURITIES:

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2014				
U. S. Treasuries	$ 125,150	$ -	$ -	$ 125,150
December 31, 2013				
U. S. Treasuries	$ 106,387	$ -	$ -	$ 106,387

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2014				
U. S. Treasuries	$ 4,025,740	$ -	$ 6,100	$ 4,019,640
Government sponsored enterprises	8,039,540	8,940	9,880	8,038,600
Mortgage-backed obligations of federal agencies	1,011,092	10,780	-	1,021,872
Marketable equities	135,000	-	-	135,000
Total Securities Available for Sale	$ 13,211,372	$ 19,720	$ 15,980	$ 13,215,112
December 31, 2013				
U. S. Treasuries	$ -	$ -	$ -	$ -
Government sponsored enterprises	29,075,893	11,460	22,253	29,065,100
Mortgage-backed obligations of federal agencies	1,208,533	-	7,852	1,200,681
Marketable equities	-	-	-	-
Total Securities Available for Sale	$ 30,284,426	$ 11,460	$ 30,105	$ 30,265,781

The amortized cost and fair value of securities at December 31, 2014, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Held to Maturity		Securities Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value

Due in one year or less	$125,150	$ 125,150	$2,000,000	$ 1,999,980
Due after one year through five years	-	-	10,065,280	10,058,260
Due after five years	-	-	1,146,092	1,156,872
Total	125,150	125,150	13,211,372	13,215,112

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 4 INVESTMENT SECURITIES (CONTINUED):

There were no sales of debt or equity securities during 2014, 2013 or 2012

The carrying value (which approximates fair value) of securities pledged by the Bank to secure deposits and for other purposes amounted to $13,080,000 at December 31, 2014 and $10,255,000 at December 31, 2013.

Other investments consist of investments in eighteen low-income housing and historic equity partnerships (carrying basis of $6,340,000), stock in the Federal Home Loan Bank (carrying basis of $1,392,000), and various other investments (carrying basis of $1,233,000). The interests in the low-income housing and historic equity partnerships have limited transferability and the interests in the other stocks are restricted as to sales. The market values of these securities are estimated to approximate their carrying value as of December 31, 2014. At December 31, 2014, the Company was committed to invest an additional $3,679,541 in seven low-income housing limited partnerships. These funds will be paid as requested by the general partner to complete the projects. This additional investment has been reflected in the above carrying basis and in accrued liabilities on the balance sheet.

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

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

	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2014						
U. S. Treasuries	$ 4,020	$ (6)	$ -	$ -	$ 4,020	$ (6)
Government sponsored enterprises	2,004	(2)	1,991	(8)	3,995	(10)
Mortgage-backed obligations	-	-	-	-	-	-
Total	$ 6,024	$ (8)	$ 1,991	$ (8)	$ 8,015	$ (16)
2013						
U. S. Treasuries	$ -	$ -	$ -	$ -	$ -	$ -
Government sponsored enterprises	4,984	(22)	-	-	4,984	(22)
Mortgage-backed obligations	1,191	(8)	-	-	1,191	(8)
Total	$ 6,175	$ (30)	$ -	$ -	$ 6,175	$ (30)

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 4 INVESTMENT SECURITIES (CONTINUED):

Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than the cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery of fair value. The Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell these securities before recovery of their amortized cost. The Company did not recognize any other-than-temporary impairment losses in 2014, 2013 or 2012.

NOTE 5 LOANS:

Loans held for investment as of December 31:

	2014	2013
Construction/Land Development	$ 67,180,467	$ 68,512,341
Farmland	12,507,446	13,197,398
Real Estate	162,248,606	154,628,068
Multi-Family	11,775,205	11,797,010
Commercial Real Estate	122,305,417	113,415,234
Home Equity – closed end	9,393,805	10,228,264
Home Equity – open end	52,181,679	47,357,787
Commercial & Industrial – Non-Real Estate	28,160,584	25,903,011
Consumer	9,109,994	10,162,457
Credit cards	2,705,285	2,679,718
Dealer Finance	40,633,086	20,571,720
Total	$ 518,201,574	$ 478,453,008

The Company has pledged loans as collateral for borrowings with the Federal Home Loan Bank of Atlanta totaling $183,483,000 and $164,605,000 as of December 31, 2014 and 2013, respectively. The Company maintains a blanket lien on its entire residential real estate portfolio and also began pledges commercial and home equity loans.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 5 LOANS (CONTINUED):

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

December 31, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Construction/Land Development	$ 4,982	$ 5,402	$ -	$ 5,412	$ 251
Farmland	-	-	-	1,163	-
Real Estate	141	141	-	85	5
Multi-Family	-	-	-	-	-
Commercial Real Estate	1,159	1,459	-	1,450	66
Home Equity – closed end	-	-	-	123	-
Home Equity – open end	1,649	1,649	-	330	57
Commercial & Industrial – Non-Real Estate	191	191	-	237	11
Consumer	-	-	-	-	-
Credit cards	-	-	-	-	-
Dealer Finance	-	-	-	-	-
	8,122	8,842	-	8,800	390
Impaired loans with a valuation allowance					
Construction/Land Development	12,976	14,749	1,469	12,056	326
Farmland	-	-	-	-	-
Real Estate	926	926	101	988	105
Multi-Family	-	-	-	-	-
Commercial Real Estate	938	938	47	1,030	4
Home Equity – closed end	-	-	-	72	-
Home Equity – open end	-	-	-	40	-
Commercial & Industrial – Non-Real Estate	-	-	-	-	-
Consumer	-	-	-	-	-
Credit cards	-	-	-	-	-
Dealer Finance	-	-	-	-	-
	14,840	16,613	1,617	14,186	435
Total impaired loans	$ 22,962	$ 25,455	$ 1,617	$ 22,986	$ 825

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 5 LOANS (CONTINUED):

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

The Recorded Investment is defined as the principal balance less principal payments and charge-offs.

December 31, 2013	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Construction/Land Development	$ 3,960	$ 4,543	$ -	$ 5,750	$ 153
Farmland	1,459	1,459	-	1,475	67
Real Estate	49	49	-	529	3
Multi-Family	-	-	-	-	-
Commercial Real Estate	851	851	-	616	56
Home Equity – closed end	308	308	-	284	25
Home Equity – open end	-	-	-	20	-
Commercial & Industrial – Non-Real Estate	242	242	-	64	12
Consumer	-	-	-	-	-
Credit cards	-	-	-	-	-
Dealer Finance	-	-	-	-	-
	6,869	7,452	-	8,738	316
Impaired loans with a valuation allowance					
Construction/Land Development	8,291	9,716	1,560	10,855	175
Farmland	-	-	-	-	-
Real Estate	1,145	1,145	154	966	48
Multi-Family	-	-	-	-	-
Commercial Real Estate	818	1,118	282	1,171	4
Home Equity – closed end	180	180	17	409	3
Home Equity – open end	100	100	9	93	5
Commercial & Industrial – Non-Real Estate	-	-	-	141	-
Consumer	2	2	-	1	1
Credit cards	-	-	-	-	-
Dealer Finance	-	-	-	-	-
	10,536	12,261	2,022	13,636	236
Total impaired loans	$ 17,405	$ 19,713	$ 2,022	$ 22,374	$ 552

Loans held for sale consists of loans originated by VBS Mortgage and the Bank's commitment to purchase residential mortgage loan participations from Gateway Bank and NorthPointe Bank. The volume of loans purchased fluctuates due to a number of factors including changes in secondary market rates, which affects demand for mortgage loans; the number of participating banks involved in the program; the number of mortgage loan originators selling loans to the lead bank and the funding capabilities of the lead bank. Loans held for sale as of December 31, 2014 and 2013 were $13,381,941 and $3,804,425, respectively.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 6 ALLOWANCE FOR LOAN LOSSES:

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

December 31, 2014 (in thousands)	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance	Individually Evaluated for Impairment	Collectively Evaluated for Impairment
Allowance for loan losses:							
Construction/Land Development	$ 4,007	$ 1,611	$ 223	$ 2,119	$ 4,738	$ 1,469	$ 3,269
Farmland	(2)	-	-	2	-	-	-
Real Estate	400	208	-	431	623	101	522
Multi-Family	-	-	-	-	-	-	-
Commercial Real Estate	777	-	108	(759)	126	47	79
Home Equity – closed end	157	-	-	31	188	-	188
Home Equity – open end	476	80	-	(242)	154	-	154
Commercial & Industrial – Non-Real Estate	1,464	385	356	(224)	1,211	-	1,211
Consumer	156	33	33	58	214	-	214
Dealer Finance	628	107	6	809	1,336	-	1,336
Credit Cards	121	46	35	25	135	-	135
Total	$ 8,184	$ 2,470	$ 761	$ 2,250	$ 8,725	$ 1,617	$ 7,108

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

December 31, 2013 (in thousands)	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance	Individually Evaluated for Impairment	Collectively Evaluated for Impairment
Allowance for loan losses:							
Construction/Land Development	$ 2,771	$ 2,127	$ 40	$ 3,323	$ 4,007	$ 1,560	$ 2,447
Farmland	(2)	-	-	-	(2)	-	(2)
Real Estate	924	173	-	(351)	400	154	246
Multi-Family	(37)	-	-	37	-	-	-
Commercial Real Estate	1,113	201	42	(177)	777	282	495
	360	159	-	(44)	157	17	140

Home Equity – closed end							
Home Equity – open end	659	68	29	(144)	476	9	467
Commercial & Industrial – Non-Real Estate	2,113	986	127	210	1,464	-	1,464
Consumer	51	173	14	264	156	-	156
Dealer Finance	72	17	-	573	628	-	628
Credit Cards	130	121	28	84	121	-	121
Total	$ 8,154	$ 4,025	$ 280	$ 3,775	$ 8,184	$ 2,022	$ 6,162

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 6 ALLOWANCE FOR LOAN LOSSES (CONTINUED):

Recorded Investment in Loan Receivables (in thousands):

December 31, 2014	Loan Receivable	Individually Evaluated for Impairment	Collectively Evaluated for Impairment
Construction/Land Development	$ 67,181	$ 17,958	$ 49,223
Farmland	12,507	-	12,507
Real Estate	162,249	1,067	161,182
Multi-Family	11,775	-	11,775
Commercial Real Estate	122,305	2,097	120,208
Home Equity – closed end	9,394	-	9,394
Home Equity –open end	52,182	1,649	50,533
Commercial & Industrial – Non-Real Estate	28,161	191	27,970
Consumer	9,110	-	9,110
Dealer Finance	40,633		40,633
Credit Cards	2,705	-	2,705
Total	$ 518,202	$ 22,962	$ 495,240

December 31, 2013	Loan Receivable	Individually Evaluated for Impairment	Collectively Evaluated for Impairment
Construction/Land Development	$ 68,512	$ 12,251	$ 56,261
Farmland	13,197	1,459	11,738
Real Estate	154,628	1,194	153,434
Multi-Family	11,797	-	11,797
Commercial Real Estate	113,415	1,669	111,746
Home Equity – closed end	10,228	488	9,740
Home Equity –open end	47,358	100	47,258
Commercial & Industrial – Non-Real Estate	25,903	242	25,661
Consumer	10,163	2	10,161
Dealer Finance	20,572		20,572
Credit Cards	2,680	-	2,680
Total	$ 478,453	$ 17,405	$ 461,048

Aging of Past Due Loans Receivable (in thousands)

	30-59 Days Past due	60-89 Days Past Due	Greater than 90 Days	Non-Accrual Loans	Total Past Due	Current	Total Loan Receivable

			(excluding non-accrual)				
December 31, 2014							
Construction/Land Development	$ 205	$ 166	$ -	$ 4,508	$ 4,879	$ 62,302	$ 67,181
Farmland	-	-	-	-	-	12,507	12,507
Real Estate	5,085	635	-	973	6,693	155,556	162,249
Multi-Family	-	-	-	-	-	11,775	11,775
Commercial Real Estate	747	-	-	1,165	1,912	120,393	122,305
Home Equity – closed end	162	15	-	10	187	9,207	9,394
Home Equity – open end	730	25	-	143	898	51,284	52,182
Commercial & Industrial – Non-Real Estate	-	-	-	14	14	28,147	28,161
Consumer	290	9	-	-	299	8,811	9,110
Dealer Finance	696	189	-	161	1,046	39,587	40,633
Credit Cards	36	-	1	-	37	2,668	2,705
Total	$ 7,951	$ 1,039	$ 1	$ 6,974	$ 15,965	$ 502,237	$ 518,202

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 6 ALLOWANCE FOR LOAN LOSSES (CONTINUED):

	30-59 Days Past due	60-89 Days Past Due	Greater than 90 Days (excluding non-accrual)	Non-Accrual Loans	Total Past Due	Current	Total Loan Receivable
December 31, 2013							
Construction/Land Development	$ 167	$ 735	$ -	$ 8,556	$ 9,458	$ 59,054	$ 68,512
Farmland	-	-	-	-	-	13,197	13,197
Real Estate	4,659	920	246	1,407	7,232	147,396	154,628
Multi-Family	107	-	-	-	107	11,690	11,797
Commercial Real Estate	858	-	-	1,474	2,332	111,083	113,415
Home Equity – closed end	122	79	10	180	391	9,837	10,228
Home Equity – open end	549	39	51	222	861	46,497	47,358
Commercial & Industrial – Non-Real Estate	148	20	4	416	588	25,315	25,903
Consumer	169	71	5	-	245	9,918	10,163
Dealer Finance	335	72	11	-	418	20,154	20,572
Credit Cards	21	3	-	-	24	2,656	2,680
Total	$ 7,135	$ 1,939	$ 327	$ 12,255	$ 21,656	$ 456,797	$ 478,453

CREDIT QUALITY INDICATORS (in thousands)
AS OF DECEMBER 31, 2014
Corporate Credit Exposure
Credit Risk Profile by Creditworthiness Category

	Grade 1 Minimal Risk	Grade 2 Modest Risk	Grade 3 Average Risk	Grade 4 Acceptable Risk	Grade 5 Marginally Acceptable	Grade 6 Watch	Grade 7 Substandard	Grade 8 Doubtful
Construction/Land Development	$-	$165	$8,460	$24,227	$9,605	$3,815	$20,909	$-
Farmland	68	-	1,640	3,451	5,228	-	2,120	-
Real Estate	-	629	60,290	66,464	23,934	7,083	3,849	-
Multi-Family	-	468	4,145	2,183	4,979	-	-	-
Commercial Real Estate	-	1,687	22,800	65,653	19,058	10,571	2,536	-
Home Equity – closed end	-	-	4,327	3,090	1,812	154	11	-

Home Equity – open end	-	1,555	13,433	28,425	4,309	1,936	2,524	-	
Commercial & Industrial (Non-Real Estate)	643	74	4,692	18,039	3,948	735	30	-	
Total	$711	$4,578	$119,787	$211,532	$72,873	$24,294	$31,979	$-	$

Consumer Credit Exposure
Credit Risk Profile Based on Payment Activity

	Credit Cards	Consumer
Performing	$2,704	$49,582
Non performing	1	161
Total	$2,705	$49,743

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F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 6 ALLOWANCE FOR LOAN LOSSES (CONTINUED):

CREDIT QUALITY INDICATORS (in thousands)
AS OF DECEMBER 31, 2013
Corporate Credit Exposure
Credit Risk Profile by Creditworthiness Category

	Grade 1 Minimal Risk	Grade 2 Modest Risk	Grade 3 Average Risk	Grade 4 Acceptable Risk	Grade 5 Marginally Acceptable	Grade 6 Watch	Grade 7 Substandard	Grade 8 Doubtful
Construction/Land Development	$-	$-	$3,166	$25,657	$11,116	$2,946	$25,627	$-
Farmland	69	-	1,406	5,206	4,816	143	1,557	-
Real Estate	-	562	68,241	52,190	19,037	7,821	6,777	-
Multi-Family	-	668	4,442	2,275	4,412	-	-	-
Commercial Real Estate	-	1,897	18,062	55,350	21,677	13,406	3,023	-
Home Equity – closed end	-	-	4,574	3,117	1,870	281	386	-
Home Equity – open end	-	1,482	13,308	26,734	4,840	327	667	-
Commercial & Industrial (Non-Real Estate)	815	92	3,631	16,265	3,108	1,516	476	-
Total	$884	$4,701	$116,830	$186,794	$70,876	$26,440	$38,513	$-

Consumer Credit Exposure
Credit Risk Profile Based on Payment Activity

	Credit Cards	Consumer
Performing	$2,680	$30,719
Non performing	-	16
Total	$2,680	$30,735

Description of loan grades:

Grade 1 – Minimal Risk: Excellent credit, superior asset quality, excellent debt capacity and coverage, and recognized management capabilities.

Grade 2 – Modest Risk: Borrower consistently generates sufficient cash flow to fund debt service, excellent credit, above average asset quality and liquidity.

Grade 3 – Average Risk: Borrower generates sufficient cash flow to fund debt service. Employment (or business) is stable with good future trends. Credit is very good.

Grade 4 – Acceptable Risk: Borrower's cash flow is adequate to cover debt service; however, unusual expenses or capital expenses must by covered through additional long term debt. Employment (or business) stability is reasonable, but future trends may exhibit slight weakness. Credit history is good. No unpaid judgments or collection items appearing on credit report.

Grade 5 – Marginally acceptable: Credit to borrowers who may exhibit declining earnings, may have leverage that is materially above industry averages, liquidity may be marginally acceptable. Employment or business stability may be weak or deteriorating. May be currently performing as agreed, but would be adversely affected by developing factors such as layoffs, illness, reduced hours or declining business prospects. Credit history shows weaknesses, past dues, paid or disputed collections and judgments, but does not include borrowers that are currently past due on obligations or with unpaid, undisputed judgments.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 6 ALLOWANCE FOR LOAN LOSSES (CONTINUED):

Grade 6 – Watch: Loans are currently protected, but are weak due to negative balance sheet or income statement trends. There may be a lack of effective control over collateral or the existence of documentation deficiencies. These loans have potential weaknesses that deserve management's close attention. Other reasons supporting this classification include adverse economic or market conditions, pending litigation or any other material weakness. Existing loans that become 60 or more days past due are placed in this category pending a return to current status.

Grade 7 – Substandard: Loans having well-defined weaknesses where a payment default and or loss is possible, but not yet probable. Cash flow is inadequate to service the debt under the current payment, or terms, with prospects that the condition is permanent. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the borrower and there is the likelihood that collateral will have to be liquidated and/or guarantor(s) called upon to repay the debt. Generally, the loan is considered collectible as to both principal and interest, primarily because of collateral coverage, however, if the deficiencies are not corrected quickly; there is a probability of loss.

Grade 8 – Doubtful: The loan has all the characteristics of a substandard credit, but available information indicates it is unlikely the loan will be repaid in its entirety. Cash flow is insufficient to service the debt. It may be difficult to project the exact amount of loss, but the probability of some loss is great. Loans are to be placed on non-accrual status when any portion is classified doubtful.

NOTE 7 TROUBLED DEBT RESTRUCTURING

In the determination of the allowance for loan losses, management considers troubled debt restructurings and subsequent defaults in these restructurings by adjusting the loan grades of such loans, which figure into the environmental factors associated with the allowance. Defaults resulting in charge-offs affect the historical loss experience ratios which are a component of the allowance calculation. Additionally, specific reserves may be established on restructured loans evaluated individually.

During the twelve months ended December 31, 2014, the Bank modified 3 loans that were considered to be troubled debt restructurings. These modifications include rate adjustments, revisions to amortization schedules, suspension of principal payments for a temporary period, re-advancing funds to be applied as payments to bring the loan(s) current, or any combination thereof.

(in thousands)	Number of Contracts	December 31, 2014 Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real Estate	2	$ 179	$ 179
Consumer	1	22	22
		$ 201	$ 201

As of December 31, 2014, there was one loans restructured in the previous twelve months, in default. This was a real estate loan of $97,000. A restructured loan is considered in default when it becomes 90 days past due.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 7 TROUBLED DEBT RESTRUCTURING (CONTINUED):

During the twelve months ended December 31, 2013, the Bank modified 4 loans that were considered to be troubled debt restructurings. These modifications include rate adjustments, revisions to amortization schedules, suspension of principal payments for a temporary period, re-advancing funds to be applied as payments to bring the loan(s) current, or any combination thereof.

(in thousands)	Number of Contracts	December 31, 2013 Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Construction/Land Development	1	$ 937	$ 937
Real Estate	1	50	50
Commercial Real Estate	1	312	312
Commercial & Industrial – Non- Real Estate	1	201	201
		$ 1,500	$ 1,500

As of December 31, 2013, there were no loans restructured in the previous twelve months, in default. A restructured loan is considered in default when it becomes 90 days past due.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 8 BANK PREMISES AND EQUIPMENT

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

	2014	2013
Land	$ 1,418,003	$ 1,418,003
Buildings and improvements	6,793,644	6,771,867
Furniture and equipment	6,479,815	5,963,779
	14,691,462	14,153,649
Less - accumulated depreciation	(8,233,208)	(7,628,592)
Net	$ 6,458,254	$ 6,525,057

Provisions for depreciation of $612,116 in 2014, $581,625 in 2013, and $597,920 in 2012 were charged to operations.

NOTE 9 OTHER REAL ESTATE OWNED

The tables below reflect OREO activity for 2014 and 2013:

Other Real Estate Owned	2014	2013
Balance beginning of year	$ 2,628,418	$ 2,883,947
Property acquired at foreclosure	2,914,958	1,337,890
Capital improvements on foreclosed property	48,961	11,329
Sale of other real estate owned financed by Bank	(780,097)	(569,245)
Sales of foreclosed properties	(1,029,452)	(964,149)
Valuation adjustments	(275,635)	(71,354)
Balance as of December 31	$ 3,507,153	$ 2,628,418

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 10 DEPOSITS:

The composition of deposits at December 31, 2014 and 2013 was as follows:

	December 31, 2014	December 31, 2013
Noninterest bearing demand deposits	$ 112,197,722	$ 92,396,921
Savings and interest bearing demand deposits:		
Interest checking accounts	119,593,529	117,456,275
Savings accounts	64,249,199	58,292,273
Time Deposits:		
Balances of less than $100,000	115,651,329	126,330,053
Balances of $100,000 and more	79,812,757	69,673,722
Total Deposits	$ 491,504,536	$ 464,149,244

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

2015	$ 92,047,350
2016	58,857,584
2017	16,213,687
2018	15,150,944
2019 and after	13,194,521
Total	$ 195,464,086

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 11 SHORT-TERM DEBT:

Short-term debt information is summarized as follows:

	Maximum Outstanding at any Month End		Outstanding at Year End		Average Balance Outstanding	Weighted Average Interest Rate		Year End Interest Rate	
2014									
Federal funds purchased	$	491,000	$	-	$ 7,704	.001	%	.61	%
FHLB short term		10,000 ,000		10,000,000	27,397	.001	%	.17	%
Securities sold under agreements to repurchase		5,066,238		4,358,492	3,837,612	.23	%	.24	%
Totals			$	14,358,492	$ 3,872,713	.23	%	.23	%
2013									
Federal funds purchased	$	-	$	-	$ 42,838	.01	%	.97	%
FHLB short term		17,500,000		-	2,938,356	.23	%	.49	%
Securities sold under agreements to repurchase		3,522,999		3,423,078	3,190,186	.14	%	.28	%
Totals			$	3,423,078	$ 6,171,380	.38	%	.39	%
2012									
Federal funds purchased	$	9,283,000	$	9,283,000	$ 776,617	.51	%	.90	%
FHLB short term		32,500,000		22,500,000	8,088,798	.46	%	.37	%
Securities sold under agreements to repurchase		4,773,045		2,814,352	3,949,934	.35	%	.38	%
Totals			$	34,597,352	$ 12,815,349	.41	%	.41	%

Repurchase agreements are secured transactions with customers and generally mature the day following the date sold. Federal funds purchased are unsecured overnight borrowings from other financial institutions. FHLB daily rate credit, which is secured by the loan portfolio, is a variable rate loan that acts as a line of credit to meet financing needs.

As of December 31, 2014, the Company had unsecured lines of credit with correspondent banks totaling $26,000,000, which may be used in the management of short-term liquidity.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
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NOTE 12 LONG-TERM DEBT:

The Company borrowed $10,000,000 from the Federal Home Loan Bank of Atlanta (FHLB) in 2014 to fund loan growth and extend maturities at lower rates. There were no new borrowings from FHLB in 2013 and 2012. The interest rates on the notes payable are fixed at the time of the advance and range from 2.00% to 2.56%; the weighted average interest rate was 2.33% and 3.37% at December 31, 2014 and 2013, respectively. The balance of these obligations at December 31, 2014 and December 31, 2013 were $9,875,000 and $11,500,000, respectively. The long-term debt is secured by qualifying mortgage loans owned by the Company.

In August 2009, the Company began to issue Subordinated debt agreements with local investors bearing terms of seven to ten years. Interest rates are fixed on the notes for the full term but vary by maturity. Rates range from 7.0% on the seven year note to 8.05% on the ten year note. As of December 31, 2014 all of the subordinated debt agreements had been redeemed and/or converted to Preferred stock. The balance outstanding as of December 31, 2013 was $10,191,000. Due to their terms (greater than five years) and priority (subordinate to deposits and other borrowings) this debt was counted with capital for purposes of calculating the Total Risk Based Capital Ratio. All of the subordinated debt agreements were either redeemed or converted to Preferred stock in December 2014.

The maturities of long-term Federal Home Loan Bank borrowings as of December 31, 2014 are as follows:

2015		$ 500,000
2016		500,000
2017		500,000
2018		500,000
Thereafter		7,875,000
	Total	$ 9,875,000

NOTE 13 INCOME TAX EXPENSE:

The components of the income tax expense are as follows:

	2014	2013	2012
Current expense			
Federal	$ 2,385,958	$ 1,338,439	$ 2,590,130
Deferred (benefit) expense			
Federal	505,684	636,452	(412,621)
State	9,854	(67,594)	(82,112)
Total Deferred (benefit) expense	515,538	568,858	(494,733)
Total Income Tax Expense	$ 2,901,496	$ 1,907,297	$ 2,095,397

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
December 31, 2014 and 2013

NOTE 13 INCOME TAX EXPENSE (CONTINUED):

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

Deferred Tax Assets:	2014	2013
Allowance for loan losses	$ 2,201,291	$ 1,788,360
Split Dollar Life Insurance	4,440	4,440
Nonqualified deferred compensation	594,132	527,909
Low income housing partnerships losses	308,539	-
Securities impairment	-	532,211
Core deposit amortization	72,188	298,019
State historic tax credits	-	26,432
Other real estate owned	3,746	3,746
Pension plan	1,199,686	470,091
Total Assets	$ 4,384,022	$ 3,651,208

Deferred Tax Liabilities:	2014	2013
Unearned low income housing credits	$ 523,769	$ 661,841
Depreciation	320,743	363,946
Pension	1,864,964	1,423,461
Goodwill tax amortization	853,880	791,771
Securities available for sale	1,272	(6,339)
Other	-	(74,926)
Total Liabilities	3,564,628	3,159,754
Net Deferred Tax Asset (included in Other Assets on Balance Sheet)	$ 819,394	$ 491,454

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

	2014	2013	2012
Tax expense at federal statutory rates	$ 2,959,056	$ 2,251,851	$ 2,378,804
Increases (decreases) in taxes resulting from:			
State income taxes, net	8,659	9,229	6,132
Partially exempt income	(54,529)	(44,676)	(49,828)
Tax-exempt income	(190,192)	(197,482)	(188,932)
Prior year LIH credits	(21,787)	(61,768)	97,857
Deferred Tax Asset Valuation Allowance	396,440	-	-
Other	(196,151)	(49,857)	(148,636)
Total Income Tax Expense	$ 2,901,496	$ 1,907,297	$ 2,095,397

Management evaluated the likelihood of recognizing the Company’s deferred tax asset. Based on the evidence supporting this asset, it was decided to record a partial valuation allowance against the asset on the Company’s books in the amount of $781,936 and $385,496 for the years ended 2014 and 2013. A deferred tax asset is created from the difference between book income using Generally Accepted Accounting Principles and taxable income.

The Corporation has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with accounting guidance related to income taxes.

The Corporation and its subsidiaries file federal income tax returns and state income tax returns. With few exceptions, the Corporation is no longer subject to federal or state income tax examinations by tax authorities for years before 2011.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
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NOTE 14 EMPLOYEE BENEFITS:

The Bank has a qualified noncontributory defined benefit pension plan which covers substantially all of its employees. The benefits are primarily based on years of service and earnings.

The following table provides a reconciliation of the changes in the benefit obligations and fair value of plan assets for 2014, 2013 and 2012:

	2014	2013	2012
Change in Benefit Obligation			
Benefit obligation, beginning	$ 7,933,568	$ 8,931,940	$ 7,296,932
Service cost	501,032	599,933	518,634
Interest cost	377,706	350,314	327,924
Actuarial gain (loss)	2,030,583	(1,300,094)	1,066,019
Benefits paid	(65,474)	(648,525)	(277,569)
Benefit obligation, ending	$ 10,777,415	$ 7,933,568	$ 8,931,940
Change in Plan Assets			
Fair value of plan assets, beginning	$ 9,687,226	$ 8,123,437	$ 6,760,513
Actual return on plan assets	562,093	1,462,314	890,493
Employer contribution	1,500,000	750,000	750,000
Benefits paid	(65,474)	(648,525)	(277,569)
Fair value of plan assets, ending	11,683,845	9,687,226	8,123,437
Funded status at the end of the year	$ 906,430	$ 1,753,658	$ (808,503)

The fair value of plan assets is measured based on the fair value hierarchy as discussed in Note 21, “Fair Value Measurements” to the Consolidated Financial Statements. The valuations are based on third party data received as of the balance sheet date. All plan assets are considered Level 1 assets, as quoted prices exist in active markets for identical assets.

F & M Bank Corp. and Subsidiaries
Notes to the Consolidated Financial Statements
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NOTE 14 EMPLOYEE BENEFITS (CONTINUED):

	2014	2013	2012
Amount recognized in the Balance Sheet			
Accrued prepaid benefit cost	$ 4,434,917	$ 3,136,277	$ 2,888,390
Unfunded pension benefit obligation under ASC 325-960	(3,528,487)	(1,382,619)	(3,696,893)
Amount recognized in accumulated other comprehensive income			
Net Gain/(Loss)	$ (3,616,087)	$ (1,485,455)	$ (3,814,965)
Prior service cost	87,600	102,836	118,072
Net obligation at transition	-	-	-
Amount recognized	(3,528,487)	(1,382,619)	(3,696,893)
Deferred Taxes	1,199,686	470,090	1,256,944
Amount recognized in accumulated comprehensive income	$ (2,328,801)	$ (912,529)	$ (2,439,949)
(Accrued) Prepaid benefit detail			
Benefit obligation	$ (10,777,415)	$ (7,933,568)	$ (8,931,940)
Fair value of assets	11,683,845	9,687,226	8,123,437
Unrecognized net actuarial loss	3,616,087	1,485,455	3,814,965
Unrecognized transition obligation			
Unrecognized prior service cost	(87,600)	(102,836)	(118,072)
Prepaid (accrued) benefits	$ 4,434,917	$ 3,136,277	$ 2,888,390
Components of net periodic benefit cost			
Service cost	$ 501,032	$ 599,933	$ 518,634
Interest cost	377,706	350,314	327,924
Expected return on plan assets	(698,252)	(636,081)	(540,069)
Amortization of prior service cost	(15,236)	(15,236)	(15,236)
Amortization of transition obligation			
Recognized net actuarial (gain) loss	36,110	203,183	173,222
Net periodic benefit cost	$ 201,360	$ 502,113	$ 464,475
Additional disclosure information			
Accumulated benefit obligation	$ 7,543,340	$ 5,474,048	$ 6,214,325
Vested benefit obligation	$ 7,408,014	$ 5,388,808	$ 6,087,194
Discount rate used for net pension cost	5.00 %	4.00 %	4.50 %
Discount rate used for disclosure	4.00 %	5.00 %	4.00 %
Expected return on plan assets	7.50 %	8.00 %	8.00 %
Rate of compensation increase	3.00 %	3.00 %	3.00 %
Average remaining service (years)	14	14	14

Funding Policy

It is the Bank's policy to contribute at least the annual pension cost each year as determined by the plan administrator. In some years the Bank will contribute additional amounts up to the maximum tax deductible amount depending on a variety of factors including liquidity and expected return on plan assets. The Company's contributions for 2014, 2013 and 2012 were $1,500,000, $750,000, and $750,000, respectively. Based on current information, the 2015 contribution will be $750,000 and pension cost for 2015 will be approximately $386,000.

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NOTE 14 EMPLOYEE BENEFITS (CONTINUED):

Long-Term Rate of Return

The plan sponsor selects the expected long-term rate of return on assets assumption in consultation with their advisors and the plan actuary, and with concurrence from their auditor. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation) for the major asset classes held or anticipated to be held by the trust. Undue weight is not given to recent experience, which may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further – solely for this purpose the plan is assumed to continue in force and not terminate during the period during which the assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

Asset Allocation

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

	2014		2013	
Mutual funds - equity	61	%	62	%
Mutual funds –fixed income	39	%	38	%
Cash and equivalents	0	%	0	%

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

Estimated Future Benefit Payments

2015	$ 1,017,602
2016	148,021
2017	65,614
2018	1,234,133
2019	681,525
2020-2024	4,526,371
	$ 7,673,266

Employee Stock Ownership Plan (ESOP)

The Company sponsors an ESOP which provides stock ownership to substantially all employees of the Bank. The Plan provides total vesting upon the attainment of five years of service. Contributions to the plan are made at the discretion of the Board of Directors and are allocated based on the compensation of each employee relative to total compensation paid by the Bank. All shares issued and held by the Plan are considered outstanding in the computation of earnings per share. Dividends on Company stock are allocated and paid to participants at least annually. Shares of Company stock, when distributed, have restrictions on transferability. The Company contributed $360,000 in 2014, $360,000 in 2013, and $270,000 in 2012 to the Plan and charged this expense to operations. The shares held by the ESOP totaled 188,396 and 176,485 at December 31, 2014 and 2013, respectively.

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NOTE 14 EMPLOYEE BENEFITS (CONTINUED):

401K Plan

The Company sponsors a 401(k) savings plan under which eligible employees may choose to save up to 20 percent of their salary on a pretax basis, subject to certain IRS limits. Under the Safe Harbor rules employees are automatically enrolled at 3% (in the third year this increases by 1% per year up to 6%) of their salary unless elected otherwise. The Company matches a hundred percent of the first 1% contributed by the employee and fifty percent from 2% to 6% of employee contributions. Vesting in the contributions made by the Company is 100% after two years of service. Contributions under the plan amounted to $190,057, $183,468 and $165,724 in 2014, 2013 and 2012, respectively.

Deferred Compensation Plan

The Company has a nonqualified deferred compensation plan for several of its key employees and directors. The Company may make annual contributions to the plan, and the employee or director has the option to defer a portion of their salary or bonus based on qualifying annual elections. Contributions to the plan totaled $100,000 in 2014, $90,000 in 2013 and $85,000 in 2012.

NOTE 15 CONCENTRATIONS OF CREDIT:

The Company had cash deposits in other commercial banks totaling $1,731,223 and $1,512,428 at December 31, 2014 and 2013, respectively.

The Company grants commercial, residential real estate and consumer loans to customers located primarily in the northwestern portion of the State of Virginia. Loan concentration areas greater than 25% of capital include land development. Collateral required by the Company is determined on an individual basis depending on the purpose of the loan and the financial condition of the borrower. Approximately 84% of the loan portfolio is secured by real estate.

NOTE 16 COMMITMENTS:

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

	2014	2013
Commitments to loan money	$ 120,922,771	$ 103,782,380
Standby letters of credit	2,077,870	985,331

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

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. Collateral required, if any, upon extension of credit is based on management's credit evaluation of the borrower's ability to pay. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment.

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NOTE 16 COMMITMENTS (CONTINUED):

The Bank leases three of its branch offices, both of its loan production offices and a future branch site under long term lease arrangements which had initial terms of either three, five or ten years. Lease expense was $120,728, $121,025 and $95,558 for 2014, 2013 and 2012, respectively. As of December 31, 2014, the required lease payments for the next five years are as follows:

2015	$135,909
2016	79,762
2017	56,791
2018	44,359
2019	45,468

NOTE 17 ON BALANCE SHEET DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES:

Derivative Financial Instruments

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

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

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

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

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

		2014		2013
Notional amount	$	87,782	$	91,223
Fair market value of contracts		32,795		30,741

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