FINANCIAL STATEMENTS

F&M FINANCIAL CORPORATION AND SUBSIDIARY

Consolidated Financial Statements

December 31, 2005 and 2004

(With Independent Auditors' Report Thereon)

KPMG LLP
Suite 900
55 Beattie Place
Greenville, SC 29601-2106

Independent Auditors' Report

The Board of Directors and Stockholders
F&M Financial Corporation:

We have audited the accompanying consolidated balance sheets of F&M Financial Corporation and subsidiary (the Corporation) as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of F&M Financial Corporation and subsidiary as of December 31, 2005 and 2004, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

March 17, 2006

KPMG LLP, a U.S. limited liability partnership, is the U.S.
member firm of KPMG International, a Swiss cooperative.

F & M FINANCIAL CORPORATION AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 2005 and 2004

(In thousands, except share data)

Assets		**2005**	**2004**
Cash and due from banks	$	13,127	11,682
Interest-bearing bank deposits		14,368	11,470
Available-for-sale securities (amortized cost of $32,517 in 2005 and $32,808 in 2004; $31,132 in 2005 and $30,728 in 2004 were pledged as collateral)		34,376	35,202
FHLB stock, at cost		3,773	2,507
Loans held for sale		486	162
Loans		416,716	342,000
Less allowance for loan losses		(5,252)	(4,834)
Loans, net		411,464	337,166
Premises and equipment, net		21,283	19,039
Other assets		7,444	6,689
Total assets	$	506,321	423,917
Liabilities and Stockholders' Equity			
Deposits:			
Demand:			
Noninterest-bearing	$	61,304	55,048
Interest-bearing		106,919	102,308
Savings		25,753	27,733
Time, $100,000 or more		104,665	62,016
Other time		75,492	73,265
Total deposits		374,133	320,370
FHLB borrowings		65,000	39,000
Repurchase agreements		14,758	15,540
Other liabilities		6,525	6,009
Total liabilities		460,416	380,919
Stockholders' equity:			
Common stock, $5 par value. Authorized 5,000,000 shares; issued and outstanding 1,565,554 shares in 2005 and 1,575,244 shares in 2004		7,828	7,876
Additional paid in capital		76	183
Retained earnings		36,886	33,503
Accumulated other comprehensive income:			
Unrealized gain on securities, net		1,115	1,436
Total stockholders' equity		45,905	42,998
Total liabilities and stockholders' equity	$	506,321	423,917

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY

Consolidated Statements of Income

Years ended December 31, 2005 and 2004

(In thousands, except per share data)

		2005	2004
Interest income:			
Loans	$	25,985	20,253
Securities:			
U. S. Government agency obligations		652	573
State, county, and municipal obligations		622	695
Other interest and dividend income		322	148
Total interest income		27,581	21,669
Interest expense:			
Time deposits, $100,000 and over		2,670	1,256
Other deposits		3,332	2,357
Repurchase agreements		251	183
FHLB borrowings		1,215	358
Total interest expense		7,468	4,154
Net interest income		20,113	17,515
Provision for loan losses		890	675
Net interest income after provision for loan losses		19,223	16,840
Other operating income:			
Service charges on deposit accounts		2,493	2,606
Brokerage related fees		610	568
Other fees and commissions		1,139	938
Mortgage banking income, net		394	288
Other		105	94
Total other operating income		4,741	4,494
Other operating expenses:			
Compensation and employee benefits		9,455	8,405
Occupancy		1,663	1,274
Equipment		1,741	1,643
Insurance		203	177
Professional services		324	409
Stationery and supplies		483	490
Other		2,573	2,333
Total other operating expenses		16,442	14,731
Income before income tax expense		7,522	6,603
Income tax expense		2,508	2,199
Net income	$	5,014	4,404
Basic earnings per share	$	3.19	2.79
Diluted earnings per share		3.09	2.71

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY

Consolidated Statements of Stockholders' Equity

Years ended December 31, 2005 and 2004

(In thousands, except per share data)

		Common stock	Additional paid in capital	Retained earnings	Accumulated other comprehensive income, net	Total stockholders' equity
Balance at December 31, 2003	$	7,930	472	30,425	1,618	40,445
Comprehensive income:						
Net income		—	—	4,404	—	4,404
Unrealized loss on securities, net		—	—	—	(182)	(182)
Total comprehensive income						4,222
Cash dividends of $0.84 per share		—	—	(1,326)	—	(1,326)
Stock options exercised		24	49	—	—	73
Shares repurchased		(78)	(338)	—	—	(416)
Balance at December 31, 2004		7,876	183	33,503	1,436	42,998
Comprehensive income:						
Net income		—	—	5,014	—	5,014
Unrealized loss on securities, net					(321)	(321)
Total comprehensive income						4,693
Cash dividends of $0.90 per share		—	—	(1,413)	—	(1,413)
Stock options exercised		35	104	—	—	139
Shares repurchased		(83)	(211)	(218)	—	(512)
Balance at December 31, 2005	$	7,828	76	36,886	1,115	45,905

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY

Consolidated Statements of Cash Flows

Years ended December 31, 2005 and 2004

(In thousands)

		2005	2004
Cash flows from operating activities:			
Net income	$	5,014	4,404
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses		890	675
Depreciation and amortization		2,024	1,733
Amortization (accretion) of securities premiums (discounts), net		(32)	72
Amortization and impairment losses on mortgage servicing rights		160	220
Loss on sale of premises and equipment		5	3
Gain on sale of loans		(183)	(151)
Loss on the sale of other assets		46	55
Deferred income tax (benefit) expense		333	(281)
Decrease (increase) in other assets		(1,052)	400
(Decrease) in other liabilities		516	(397)
Proceeds from sales of loans held for sale		16,590	12,209
Origination of loans held for sale		(16,731)	(11,873)
Net cash provided by operating activities		7,580	7,069
Cash flows from investing activities:			
Proceeds from maturities and issuer calls of available-for-sale securities		5,302	10,698
Purchase of available-for-sale securities		(4,979)	(10,175)
Origination of loans, net of principal collected		(75,899)	(56,960)
Purchase of FHLB stock		(1,266)	(1,135)
Purchases and sales of premises and equipment, net		(4,273)	(3,298)
Proceeds from sales of other real estate and other assets		683	446
Net cash used in investing activities		(80,432)	(60,424)
Cash flows from financing activities:			
Net increase in time deposits		44,876	10,633
Net increase in other deposits		8,887	13,444
Net increase (decrease) in repurchase agreements		(782)	720
Increase in FHLB borrowings		26,000	21,500
Proceeds from exercise of stock options		139	73
Cash paid to repurchase shares		(512)	(416)
Cash dividends paid		(1,413)	(1,326)
Net cash provided by financing activities		77,195	44,628
Increase (decrease) in cash and cash equivalents		4,343	(8,727)
Cash and cash equivalents at beginning of year		23,152	31,879
Cash and cash equivalents at end of year	$	27,495	23,152
Supplemental disclosure of cash flow information:			
Cash paid during the year for interest	$	7,141	4,083
Cash paid during the year for income taxes		2,418	2,112
Supplemental schedule of noncash investing and financing activities:			
Loans transferred to other real estate	$	711	597
Unrealized loss on securities held for sale, net		(321)	(182)

See accompanying notes to consolidated financial statements.

(1) Summary of Significant Accounting Policies

F&M Financial Corporation (F&M) is a one-bank holding company of which Farmers and Merchants Bank (the Bank) is a wholly owned subsidiary. The Bank is engaged in general commercial banking in Rowan and Cabarrus Counties, North Carolina and operates under the banking laws of North Carolina and the Rules and Regulations of the Federal Deposit Insurance Corporation. The Bank has three wholly owned subsidiaries, F&M Real Estate Properties, Inc., F&M Investment Services, Inc. and F&M Mortgage Corporation. F&M Real Estate Properties, Inc.'s assets consist principally of premises and equipment which are leased to the Bank. F&M Investment Services, Inc. offers securities brokerage and insurance services. F&M Mortgage Corporation's primary business is to originate loans and sell them into the secondary market.

The following is a description of the significant accounting and reporting policies F&M Financial Corporation follows in preparing and presenting its consolidated financial statements.

(a) Basis of Presentation

The consolidated financial statements include the accounts of F&M Financial Corporation, the Bank, F&M Real Estate Properties, Inc., F&M Investment Services, Inc. and F&M Mortgage Corporation (collectively referred to as the Corporation). In consolidation, all significant intercompany items and transactions have been eliminated.

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, as well as the amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

(b) Investment Securities

The Corporation has determined that all of their securities should be categorized as available-for-sale, and accordingly, such securities are reported at fair value, with any unrealized gains or losses, net of taxes, shown as a separate component of stockholders' equity in accumulated other comprehensive income. The Corporation intends to hold these available-for-sale securities for an indefinite period of time but may sell them prior to maturity. The fair value of the securities is determined by a third party as of the date of the reporting period.

Securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss.

Gains and losses on sales of securities are recognized when realized on a specific identification basis. Premiums and discounts are amortized into interest income using a level yield method.

(c) FHLB Stock

Federal law requires a member institution of the Federal Home Loan Bank (FHLB) System to hold common stock of its district FHLB according to predetermined formulas. This stock is pledged to

secure FHLB borrowings. No ready market exists for the stock and it has no quoted market value. Accordingly, the FHLB stock is carried at cost.

(d) Loans held for sale

Mortgage loans held for sale are valued at the lower of cost or fair value as determined by outstanding commitments from investors or current investor yield requirements calculated on an aggregate loan basis. Gains or losses resulting from sales of mortgage loans are recognized when the proceeds are received from investors.

(e) Loans

Loans are carried at net book value. Interest income is recognized on the accrual basis. The accrual of interest income is discontinued on loans (including impaired loans) which become 90 days past due as to principal or interest unless they are well secured and in the process of collection. Any cash receipts related to nonaccrual loans (including impaired loans) are applied to the principal balance. Loans are returned to accrual status when management determines, based on an evaluation of the underlying collateral together with the borrower's payment record and financial condition, that the borrower has the ability and intent to meet the contractual obligations of the loan agreement.

Account balances are charged off against the allowance after all means of collections have been exhausted and the potential recovery is considered remote.

Loan origination and commitment fees, as well as certain direct loan origination and commitment costs are deferred and amortized as a yield adjustment over the lives of the related loans using the interest method.

The Corporation uses the allowance method in providing for loan losses. The provision for loan losses is based upon management's estimate of the amount needed to maintain the allowance for loan losses at an adequate level to cover known and inherent risk of loss in the loan portfolio. In determining the provision amount, management gives consideration to current economic conditions, the growth and composition of the loan portfolio, the relationship of the allowance for loan losses to outstanding loans, 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. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize changes to the allowance based on their judgments of information available to them at the time of their examination.

(Continued)

Management considers loans to be impaired when based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors that influence management's judgments include, but are not limited to, loan payment pattern, source of repayment, and value of collateral. The major sources for identification of loans to be evaluated for impairment include past due and nonaccrual reports, internally generated lists of loans of certain risk grades, and regulatory reports of examination. Impaired loans are measured using either the discounted expected cash flow method using the original effective interest rate or the value of collateral method. Smaller balance, homogeneous groups of loans are evaluated collectively for impairment.

(f) ***Foreclosed Properties***

Foreclosed properties are included in other assets and represent real estate acquired through foreclosure or deed in lieu thereof and are carried at the lower of cost or fair value, less estimated costs to sell. Generally such properties are appraised annually and the carrying value, if greater than the appraised value, is adjusted with a charge to income.

(g) ***Premises and Equipment***

Premises and equipment are carried at cost less accumulated depreciation. Depreciation is calculated principally on the straight-line method over the estimated useful lives of the assets. The useful lives range from three to seven years for furniture and equipment, from fifteen to forty years for buildings, and four to six years for automobiles.

(h) ***Income Taxes***

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(i) ***Cash and Cash Equivalents***

Cash and cash equivalents include cash and due from banks and interest-bearing bank deposits. Cash and cash equivalents have maturities of three months or less.

(Continued)

(j) Mortgage Servicing Rights

The Corporation records mortgage servicing rights on loans that it acquires or originates and subsequently sells. The amount recorded is an estimate of the allocated cost of the loans to the mortgage servicing rights and to the mortgage loans based on relative fair values. The Corporation determines the fair value of the mortgage servicing rights using a method that approximates the present value of estimated net future servicing revenues less the estimated cost that would fairly compensate a substitute servicer to service the loans. The cost allocated to the servicing rights is amortized in proportion to and over the period of estimated net future cash flows related to servicing income. The Corporation periodically evaluates the mortgage servicing rights for impairment by disaggregating the portfolio into its predominant risk characteristics (primarily prepayment risk). The Corporation establishes a valuation allowance where it is determined that there is impairment in the mortgage servicing rights. Subsequent increases in impairment will result in additions to the valuation allowance, whereas subsequent decreases will result in reductions of the valuation allowance. In no event can the mortgage servicing rights be increased above their amortized cost basis.

(k) Stock-Based Compensation

The Company applies the intrinsic-value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations including FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25*, to account for its fixed-plan stock options. Under this method, compensation expense is recorded only if on the date of grant the market price of the underlying stock exceeded the exercise price. FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and FASB Statement No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of FASB Statement No. 123*, established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As permitted by existing accounting standards, the Company has elected to continue to apply the intrinsic-value-based method of accounting described above, and has adopted only the disclosure requirements of Statement 123, as amended. The following table illustrates the effect on net income if the fair-value-based method had been applied to all outstanding and unvested awards in each period.

(Continued)

(m) *Comprehensive Income*

Comprehensive income includes net income and all changes to the Corporation's equity, with the exception of transactions with shareholders (other comprehensive income). The Corporation's only component of other comprehensive income is the change in unrealized gains and losses on available-for-sale securities. The Corporation's total comprehensive income for the years ended December 31, 2005 and 2004 is $4,693 and $4,222, respectively. Information concerning the Corporation's other comprehensive loss for the years ended December 31, 2005 and 2004 is as follows:

		2005			2004	
	Before tax amount	Tax effect	After tax amount	Before tax amount	Tax effect	After tax amount
Unrealized losses on securities:						
Unrealized holding losses arising during the period	$ (535)	(214)	(321)	(302)	(120)	(182)
Less reclassification adjustment for gains (losses) realized in net income	—	—	—	—	—	—
Other comprehensive loss	$ (535)	(214)	(321)	(302)	(120)	(182)

(n) *Recent Accounting Pronouncements*

In 2005, the Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations – An Interpretation of SFAS No. 143", ("FIN 47"), that requires entities to recognize legal and conditional asset retirement obligations. The implementation of FIN 47 did not have any impact on the Company's consolidated financial position or results of operations.

FASB Staff Position ("FSP") FSP FAS 115-1, "The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments" was issued in 2005 and codified the guidance set forth in Emerging Issues Task Force ("EITF") Topic D-44 and clarified that an investor should recognize an impairment loss no later than when the impairment is deemed other than temporary, even if a decision to sell has not been made. FSP FAS 115-1 was effective for other-than-temporary impairment analysis conducted in periods beginning after September 15, 2005. Adoption of this standard did not have a significant impact on F&M's stockholder's equity or results of operations

In December 2004, the FASB issued FASB Statement No. 123 (revised 2004), *Share-Based Payment,* which addresses the accounting for transactions in which an entity exchanges its equity instruments for goods or services, with a primary focus on transactions in which an entity obtains employee services in share-based payment transactions. This Statement is a revision to Statement 123 and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and its related implementation guidance. This Statement will require measurement of the cost of employee services received in exchange for stock compensation based on the grant-date fair value of the employee

stock options. Incremental compensation costs arising from subsequent modifications of awards after the grant date must be recognized. The Company will adopt this Statement on January 1, 2006 under the modified prospective method of application. Under that method, the Company will recognize compensation costs for new grants of share-based awards, awards modified after the effect date, and the remaining portion of the fair value of the unvested awards at the adoption date. The impact of the new statement on the consolidated financial statements has not been determined as of December 31, 2005, other than the pro-forma impacts presented above.

In May 2005, the FASB issued FASB Statement No. 154, *Accounting Changes and Error Corrections*. Statement 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. This statement will be effective for the Company for all accounting changes and any error corrections occurring after January 1, 2006.

(2) Available-for-Sale Securities

Available-for-sale securities at December 31, 2005 and 2004 consist of the following:

	2005			
	Amortized cost	Gross unrealized Gains	Gross unrealized Losses	Fair value
U.S. Government agencies	$ 20,999	—	(244)	20,755
State, county, and municipal obligations	9,982	395	—	10,377
Equity securities	1,536	1,742	(34)	3,244
	$ 32,517	2,137	(278)	34,376

	2004			
	Amortized cost	Gross unrealized Gains	Gross unrealized Losses	Fair value
U.S. Government agencies	$ 18,521	26	(111)	18,436
State, county, and municipal obligations	12,737	729	—	13,466
Equity securities	1,550	1,780	(30)	3,300
	$ 32,808	2,535	(141)	35,202

(Continued)

The following table shows available-for-sale securities held by the Corporation by maturity category at December 31, 2005:

		Amortized cost	Fair value
Due in one year or less	$	15,289	15,178
Due after one year through five years		9,367	9,359
Due after five years through ten years		4,811	4,990
Due after ten years		1,514	1,605
Equity securities		1,536	3,244
Total	$	32,517	34,376

There were no sales of available-for-sale securities in 2005 and 2004.

At December 31, 2005 and 2004, the Corporation had pledged available-for-sale-securities with an aggregate fair value of approximately $31,132 and $30,728, respectively, to secure public deposits and repurchase agreements. The carrying amounts of the securities were $30,900 and $30,160 at December 31, 2005 and 2004, respectively.

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2005 and 2004, were as follows:

		December 31, 2005					
		Less than 12 months		12 months or Longer		Total	
		Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. Government Agencies	$	489	9	20,267	235	20,756	244
Equity securities		43	4	256	30	299	34
	$	532	13	20,523	265	21,055	278

		December 31, 2004					
		Less than 12 months		12 months or Longer		Total	
		Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. Government Agencies	$	12,495	111	—	—	12,495	111
Equity securities		70	2	175	28	245	30
	$	12,565	113	175	28	12,740	141

The unrealized losses on investments on U.S. Government Agencies at December 31, 2005 relate to 26 securities and were caused by interest rate increases. The unrealized losses on investments in U.S. Government Agencies at December 31, 2004 relate to 18 securities and were caused by interest rate

increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment.

The unrealized losses on equity securities at December 31, 2005 consist of 10 investments in bank stocks. The unrealized losses on equity securities at December 31, 2004 consist of 6 investments in bank stocks. The Corporation has the ability to hold these securities until there is a market price recovery.

(3) Loans

A summary of loans at December 31, 2005 and 2004 follows:

		2005	2004
Real estate – residential	$	164,818	143,038
Real estate – commercial		161,745	117,674
Commercial and other		43,509	36,171
Construction and development		27,944	31,782
Installment and individual		18,049	12,601
Cash reserve		1,599	1,556
Deferred loan fees, net		(948)	(822)
	$	416,716	342,000

Changes in the allowance for loan losses are as follows:

		2005	2004
Balance, beginning of year	$	4,834	4,395
Provision for loan losses		890	675
Loans charged-off		(546)	(317)
Recoveries		74	81
Balance, end of year	$	5,252	4,834

The Corporation's lending activities consist primarily of loans to customers in the Corporation's primary market area consisting of Rowan County, North Carolina and surrounding counties, and, accordingly, credit risk is affected by local economic conditions. The real estate and construction and development loan portfolios include loans on property, which can be affected by the condition of the local real estate market.

At December 31, 2005 and 2004, nonaccrual loans (including total impaired loans) totaled $1,460 and $2,059, respectively, all of which had a related allowance. The related allowance for loan losses on these loans was $212 and $444, respectively. The average recorded investment in impaired loans for the years ended December 31, 2005 and 2004 was approximately $1,505 and $1,820, respectively. For the years ended December 31, 2005 and 2004, the Corporation did not recognize any interest income on nonaccrual or impaired loans. Loans more than 90 days past due and still accruing interest were $652 and $877 at

(Continued)

December 31, 2005 and 2004, respectively. Loans past due between 30 and 90 days were 3% and 4% of total loans at December 31, 2005 and 2004, respectively. The Corporation considers these delinquent loans in estimating the allowance for loan losses.

A summary of the lending activity to officers, directors, and their related interests follows:

		2005	2004
Balance, beginning of year	$	1,997	1,681
Additions		3,381	1,257
Repayments		(1,480)	(941)
Balance, end of year	$	3,898	1,997

Such loans were made on substantially the same terms as those prevailing at the time for comparable transactions with other borrowers. Management does not believe these loans involve more than the normal risks of collectibility.

(4) Premises and Equipment

Premises and equipment consist of the following at December 31, 2005 and 2004:

		2005	2004
Land	$	4,341	3,114
Buildings		15,302	12,235
Construction in progress		2,733	3,990
Furniture and equipment		9,888	9,443
Automobiles		133	131
		32,397	28,913
Less accumulated depreciation		11,114	9,874
Premises and equipment, net	$	21,283	19,039

(Continued)

(5) Mortgage Servicing Rights

The following is an analysis of capitalized mortgage servicing rights for the years ended December 31:

		2005	2004
Balance, beginning of year	$	530	681
Capitalized servicing rights		93	69
Amortization		(160)	(186)
Impairment write-downs		—	(34)
Balance, end of year	$	463	530

Mortgage loans serviced for others with unpaid principal balances of approximately $126,160 and $133,798 at December 31, 2005 and 2004, respectively, are not included in the accompanying consolidated balance sheets.

The Corporation's total mortgage banking income for the years ended December 31, 2005 and 2004 was $394 and $288. Gains on sales of loans were $183 and $151 for 2005 and 2004, respectively, including $93 in 2005 and $69 in 2004 as a result of capitalized mortgage servicing rights. Fees earned for servicing loans, net of amortization and impairment write-downs, were $211 and $137 in 2005 and 2004, respectively.

(6) Deposits

At December 31, 2005, the scheduled maturities of all time deposits are as follows:

2006	$	133,036
2007		39,238
2008		3,710
2009		3,314
2010 and thereafter		859
Total time deposits	$	180,157

(7) Repurchase Agreements

Repurchase agreements represent securities that are sold by the Corporation under an agreement to repurchase and generally mature daily. The securities underlying the agreements remain under the Corporation's control. The repurchase agreements averaged approximately $14,490 and $16,387 in 2005 and 2004, respectively. The average interest rate paid on repurchase agreements during 2005 and 2004 was 1.62% and 1.12%, respectively. The maximum amount outstanding at any month end during 2005 and 2004 was $19,441 and $18,252, respectively.

(8) FHLB Borrowings

The Bank has an agreement with the FHLB under which it can borrow up to 30% of the Bank's total assets, or $151,896 at December 31, 2005. At December 31, 2005 and 2004, there were $65,000 and $39,000 of borrowings outstanding, as follows:

Maturity	Average Rate at December, 31, 2005		December 31, 2005	December 31, 2004
Overnight	4.50%	$	36,000	14,000
2005	—		—	15,000
2006	3.60%		22,000	7,000
2007	4.04%		2,000	—
2008	4.18%		2,000	—
2011	4.47%		3,000	3,000
		$	65,000	39,000

The borrowings maturing in 2011 are callable at the option of the FHLB. The Corporation has the ability to prepay all of its FHLB borrowings, subject to the payment of a prepayment penalty that is based on current interest rates.

The Corporation has entered into a blanket collateral agreement with the FHLB whereby the Corporation maintains, free of other encumbrances, qualifying mortgages (as defined) with unpaid principal balances at least equal to, when discounted at 75% of the unpaid principal balance, 100% of the total FHLB borrowings. The Corporation's FHLB stock is also pledged as collateral for the borrowings.

(9) Income Taxes

Income tax expense (benefit) for the years ended December 31, 2005 and 2004 was allocated as follows:

		2005	2004
Net income	$	2,508	2,199
Stockholders' equity, for changes in unrealized holding gains on available-for-sale securities recognized for financial reporting purposes		(214)	(120)
	$	2,294	2,079

(Continued)

(10) Employee Benefits

The Corporation has available to its employees a benefit plan which was created by combining an existing defined contribution profit sharing plan and an employee stock ownership plan (ESOP). In addition, the Corporation added a 401(k) provision to the combined plan calling the plan a KSOP. Substantially all employees of the Corporation who work 1,000 hours per year and have attained the age of 18 are covered under the defined contribution KSOP. The Corporation may make discretionary matching contributions up to 100% of participant contributions, up to the first 6% of a participant's compensation, to the 401(k). During 2005 and 2004, the Corporation matched 25% of participant contributions, up to 6% of the participant's compensation. Participants in the 401(k) vest immediately with respect to all contributions.

The Corporation makes contributions to the ESOP portion of the plan based on management's evaluation of performance. Originally the Corporation made contributions in the form of Corporation stock, however, during 2005 and 2004 the Corporation's contributions were made in the form of cash which participants were able to invest at their own discretion in one of several plan investment options. The Corporation expenses the amount of their annual contributions to the ESOP. Participants in the ESOP vest over a seven year period; beginning after 3 years, the participant becomes 20% vested, and the vesting percentage increases 20% each year thereafter.

Approximate expenses related to these plans were as follows:

		2005	2004
401(k) plan	$	75	67
ESOP		363	347
Total	$	438	414

Common stock of the Corporation previously contributed to the ESOP has a put feature available to the ESOP participants since the stock is not "readily tradable on an established market". The put feature permits the participants to sell their common shares obtained from the ESOP to the Corporation at the fair market value of such shares. At December 31, 2005 and 2004, there were 44,181 and 46,785 shares, respectively in the ESOP.

The Corporation provides a salary continuation plan for three officers. Participants in the plan are eligible to receive an annual retirement benefit beginning at age 65 equal to a prescribed percentage of their present annual salary. Currently, such percentages range from 45% to 65%. The retirement benefit will be paid in monthly installments for fifteen years following retirement. As of December 31, 2005 and 2004, the Corporation had related accrued liabilities of approximately $2,389 and $2,189, respectively.

(Continued)

(11) Common Stock

The Corporation has stock option agreements in which options are periodically granted to directors and employees of the Corporation, at a price equal to the fair market value of the shares at the date of grant. The option agreements vary with some having immediate vesting, while others have service requirements of up to 24 years before the options are 100% vested.

Of the granted options, 151,304 are outstanding at December 31, 2005, of which 38,085 are currently exercisable. The exercise prices for the options outstanding at December 31, 2005 range from $12.00 to $30.50 per share. The weighted average remaining contractual life of options outstanding at December 31, 2005 is approximately 8 years. The following is a summary of the options outstanding at December 31, 2005:

Option price	Options outstanding	Exercisable	Contractual remaining life
$ 12.00	6,000	6,000	1 year
14.20	1,500	1,500	2 years
16.75	1,500	1,500	3 1/3 years
16.75	1,200	1,200	5 years
20.50	69,575	23,925	6 years
25.25	16,778	—	7 years
25.25	52,501	3,960	8 years
30.50	2,250	—	10 years
	151,304	38,085	

The following data summarizes the option activity related to the grants discussed above:

	Number of options		Average exercise price per share
	Available for future grants	Granted options	
As of December 31, 2003	111,271	160,839	$ 21.92
Granted	—	—	—
Exercised	—	(4,800)	15.18
As of December 31, 2004	111,271	156,039	22.13
Granted	(2,250)	2,250	30.50
Exercised	—	(6,985)	19.90
As of December 31, 2005	109,021	151,304	$ 22.36

(Continued)

The Corporation has elected to continue to measure compensation cost relative to these plans using APB No. 25 (APB 25), as permitted by SFAS No. 123. The disclosure of the pro forma net income and earnings per share as if the fair value based accounting method of SFAS No. 123 had been used to account for stock-based compensation is required for awards granted after December 31, 1994 and is provided in note 1.

(12) Commitments and Guarantees

In the normal course of business there are outstanding commitments for extension of credit which are not reflected in the consolidated financial statements. At December 31, 2005 and 2004, preapproved but unused lines of credit and other loan commitments were approximately $108,558 and $104,278 of which $50,274 and $46,954 related to home equity lines of credit. At December 31, 2005 and 2004, the Corporation had $1,255 and $405 in commitments to originate and to sell loans held for sale, respectively. The fair value of these commitments was not material.

Additionally, the Corporation has outstanding letters of credit, which are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. The Corporation would incur a credit loss in the event that the counterparty draws on the commitment and subsequently fails to perform under the terms of the lending agreement. The Corporation's maximum exposure to credit loss in the event of nonperformance by the counterparties for commitments on standby letters of credit is represented by the contract amount of those instruments. At December 31, 2005 and 2004 the maximum risk of potential loss under standby letters of credit was $1,766 and $1,451, respectively. At December 31, 2005, the Corporation has recorded no liability for the current carrying amount of the obligation to perform as a guarantor, as such amounts are not considered material.

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. If these commitments are drawn, the Corporation will obtain collateral if it is deemed necessary based on management's credit evaluation of the counterparty. Management believes that these commitments can be funded through normal operations.

(13) Fair Value of Financial Instruments

The Corporation is required under SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* to disclose in its financial statements the fair value of all financial instruments, including assets and liabilities both on- and off-balance sheet, for which it is practicable to estimate such fair value. Fair value estimates, methods, and assumptions as of December 31, 2005 and 2004 for the Corporation are set forth below and are subject to the following limitations.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

(Continued)

Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets or liabilities not considered financial instruments include deferred tax assets and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered.

The Corporation's fair value methods and assumptions are as follows:

- *Cash and due from banks, interest-bearing bank deposits, FHLB stock, accrued interest receivable, repurchase agreements, and accrued interest payable* – the carrying value is a reasonable estimate of fair value.
- *Available-for-sale securities* – fair value is based on available quoted market prices or quoted market prices for similar securities if a quoted market price is not available.
- *Loans held for sale* – fair value of loans held for sale is determined by outstanding commitments from investors or current investor yield requirements calculated on an aggregate loan basis.
- *Loans, net* – the carrying value for variable rate loans is a reasonable estimate of fair value due to contractual interest rates based on prime. Fair value for fixed rate loans is estimated based upon discounted future cash flows using discount rates comparable to rates currently offered for such loans.
- *Deposit accounts* – the fair value of certificates of deposit is estimated using rates currently offered for deposits of similar remaining maturities. The fair value of all other deposit account types is the amount payable on demand at year-end.
- *FHLB borrowings* – the carrying value of variable rate FHLB borrowings is considered to approximate fair value. The fair values for fixed rate borrowings are estimated based upon discounted future cash flows using discount rates comparable to rates currently charged for such borrowings.
- *Commitments to extend credit and standby letters of credit* – the large majority of the Corporation's loan commitments are at variable rates and, therefore, are subject to minimal interest rate risk exposure. Therefore, the fair value for these financial instruments is considered to approximate the carrying value.

Based on the limitations, methods, and assumptions noted above, the estimated fair values of the Corporation's financial instruments at December 31, 2005 and 2004 are as follows:

	2005		2004	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets:				
Cash and due from banks	$ 13,127	13,127	11,682	11,682
Interest bearing bank deposits	14,368	14,368	11,470	11,470
Available-for-sale securities	34,376	34,376	35,202	35,202
FHLB stock	3,773	3,773	2,507	2,507
Loans held for sale	486	486	162	162
Loans, net	411,464	411,698	337,166	337,336
Accrued interest receivable	2,501	2,501	1,850	1,850
Financial liabilities:				
Deposit accounts	$ 374,133	374,996	320,370	320,574
FHLB borrowings	65,000	64,894	39,000	39,136
Repurchase agreements	14,758	14,758	15,540	15,540
Accrued interest payable	685	685	358	358

(14) Regulatory Matters

The Corporation and the Bank are subject to various regulatory capital requirements administered by the FDIC and the North Carolina Office of the Commissioner of Banks (the Commissioner). The primary source of funds for the payment of dividends by the Corporation is dividends received from the Bank. The Bank may pay dividends only out of undivided profits as determined pursuant to North Carolina General Statutes Section 53-87. At December 31, 2005, subject to FDIC capital requirement limitations, the Bank had undivided profits of approximately $7,800 which were eligible for the payment of dividends without obtaining prior approval from the Commissioner.

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

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2005, that the Corporation and the Bank meet all capital adequacy requirements to which it is subject.

As of December 31, 2005, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed any of the Corporation's and/or Bank's categories.

The Corporation's and Bank's required and actual capital amounts and ratios are presented in the table below.

	Actual		For capital adequacy purposes		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2005:						
Total capital (to risk weighted assets):						
Corporation	$ 51,436	11.5%	$ 35,659 ≥	8.0%	$ N/A	
Bank	47,714	10.8%	35,466 ≥	8.0%	44,333 ≥	10.0%
Tier 1 capital (to risk weighted assets):						
Corporation	45,415	10.2%	17,829 ≥	4.0%	N/A	
Bank	42,462	9.6%	17,733 ≥	4.0%	22,166 ≥	5.0%
Tier 1 capital (to average assets):						
Corporation	45,415	9.4%	19,402 ≥	4.0%	N/A	
Bank	42,462	8.8%	19,329 ≥	4.0%	24,161 ≥	5.0%
As of December 31, 2004:						
Total capital (to risk weighted assets):						
Corporation	$ 47,828	12.2%	$ 31,259 ≥	8.0%	$ N/A	
Bank	43,884	11.3%	31,064 ≥	8.0%	38,829 ≥	10.0%
Tier 1 capital (to risk weighted assets):						
Corporation	42,206	10.8%	15,629 ≥	4.0%	N/A	
Bank	39,050	10.1%	15,532 ≥	4.0%	19,415 ≥	5.0%
Tier 1 capital (to average assets):						
Corporation	42,206	10.3%	16,422 ≥	4.0%	N/A	
Bank	39,050	9.5%	16,422 ≥	4.0%	20,527 ≥	5.0%

F&M FINANCIAL CORPORATION

FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

ElliottDavis
Accountants and Business Advisors

Elliott Davis, PLLC
200 East Broad Street
P.O. Box 6286
Greenville, SC 29606-6286

Phone 864.242.3370
Fax 864.232.7161

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
F&M Financial Corporation

We have audited the accompanying consolidated balance sheet of F&M Financial Corporation and Subsidiary (the "Corporation") as of December 31, 2006, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of the Corporation for the year ended December 31, 2005, were audited by other auditors whose report, dated March 17, 2006, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2006 consolidated financial statements referred to above present fairly, in all material respects, the financial position of F&M Financial Corporation and Subsidiary as of December 31, 2006, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Greenville, South Carolina
April 12, 2007

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2006 AND 2005
(in thousands, except share data)

	2006	2005
Assets		
Cash and due from banks	$ 14,811	$ 13,048
Interest-bearing bank deposits	23,202	14,447
Available for sale securities (amortized cost of $30,536 in 2006 and $32,517 in 2005; $28,889 in 2006 and $31,132 in 2005 were pledged as collateral)	32,471	34,376
FHLB stock, at cost	4,380	3,773
Loans held for sale	1,319	486
Loans	453,787	416,716
Less allowance for loan losses	(5,686)	(5,252)
Loans, net	448,101	411,464
Premises and equipment, net	22,776	21,283
Other assets	7,464	7,444
Total assets	**$ 554,524**	**$ 506,321**
Liabilities and Stockholders' Equity		
Deposits:		
Demand:		
Noninterest-bearing	$ 65,719	$ 58,551
Interest-bearing	109,829	106,919
Savings	25,824	25,753
Time, $100,000 or more	109,818	104,665
Other time	97,093	76,534
Total deposits	408,283	372,422
FHLB borrowings	75,000	65,000
Repurchase agreements	12,518	14,758
Other liabilities	8,760	8,236
Total liabilities	504,561	460,416
Commitments and contingencies - note 12		
Stockholders' equity		
Common stock, $5 par value. Authorized 5,000,000 shares; issued and outstanding 1,567,149 shares in 2006 and 1,565,554 shares in 2005	7,836	7,828
Additional paid in capital	21	76
Retained earnings	40,945	36,886
Accumulated other comprehensive income:		
Unrealized gain on securities, net	1,161	1,115
Total stockholders' equity	49,963	45,905
Total liabilities and stockholders' equity	**$ 554,524**	**$ 506,321**

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2006 and 2005
(in thousands, except share data)

	2006	2005
Interest income:		
Loans	$ 33,945	$ 25,985
Securities:		
Government sponsored enterprises	839	652
State, county, and municipal obligations	447	622
Other interest and dividend income	468	427
Total interest income	35,699	27,686
Interest expense:		
Time deposits, $100,000 and over	6,321	2,670
Other deposits	5,288	3,332
Repurchase agreements	228	251
FHLB borrowings	1,775	1,215
Total interest expense	13,612	7,468
Net interest income	22,087	20,218
Provision for loan losses	1,100	890
Net interest income after provision for loan losses	20,987	19,328
Other operating income:		
Service charges on deposit accounts	2,540	2,493
Brokerage related fees	771	610
Other fees and commissions	1,483	1,139
Mortgage banking income, net	447	394
Gain on sale of available for sale investment securities	248	-
Total other operating income	5,489	4,636
Other operating expenses:		
Compensation and employee benefits	10,484	9,455
Occupancy	1,636	1,663
Equipment	1,717	1,741
Insurance	232	203
Professional services	393	324
Stationary and supplies	491	483
Other	2,931	2,573
Total other operating expenses	17,884	16,442
Income before income tax expense	8,592	7,522
Income tax expense	2,959	2,508
Net income	$ 5,633	$ 5,014
Basic earnings per share	$ 3.59	$ 3.19
Diluted earnings per share	3.48	3.09

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Years ended December 31, 2006 and 2005
(in thousands, except share data)

	Common Stock		Additional paid in capital	Retained earnings	Accumulated other comprehensive income, net	Total stockholders' equity
	Shares	Amount				
Balance at December 31, 2004	1,575,244	$ 7,876	$ 183	$ 33,503	$ 1,436	$ 42,998
Comprehensive income:						
Net income		-	-	5,014	-	5,014
Unrealized loss on securities, net					(321)	(321)
Total comprehensive income						4,693
Cash dividends of $0.90 per share		-	-	(1,413)	-	(1,413)
Stock options exercised	6,985	35	104	-	-	139
Shares repurchased	(16,675)	(83)	(211)	(218)	-	(512)
Balance at December 31, 2005	1,565,554	7,828	76	36,886	1,115	45,905
Comprehensive income:						
Net income		-	-	5,633	-	5,633
Unrealized gain on securities, net		-	-	-	46	46
Total comprehensive income						5,679
Cash dividends of $0.96 per share		-	-	(1,506)	-	(1,506)
Stock options exercised	8,575	43	80	-	-	123
Shares repurchased	(6,980)	(35)	(135)	(68)	-	(238)
Balance at December 31, 2006	1,567,149	$ 7,836	$ 21	$ 40,945	$ 1,161	$ 49,963

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2006 and 2005
(in thousands)

	2006	2005
Cash flows from operating activities:		
Net income	$ 5,633	$ 5,014
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,100	890
Depreciation and amortization	1,916	2,024
Amortization (accretion) of securities premiums (discounts), net	25	(32)
Amortization and impairment losses on mortgage servicing rights	189	160
Loss on sale of premises and equipment	-	5
Gain on sale of loans	(294)	(183)
Gain on sale of available for sale securities	(248)	-
Loss on the sale of other assets	-	46
Deferred income tax (benefit) expense	(527)	333
Increase in other assets	(361)	(1,052)
Increase in other liabilities	524	516
Proceeds from sales of loans held for sale	20,744	16,590
Origination of loans held for sale	(21,465)	(16,731)
Net cash provided by operating activities	7,236	7,580
Cash flows from investing activities:		
Proceeds from maturities and sales of available for sale securities	17,622	5,302
Purchase of available for sale securities	(15,418)	(4,979)
Origination of loans, net of principal collected	(52,376)	(75,899)
Proceeds from portfolio loan sales	14,900	-
Purchase of FHLB stock	(607)	(1,266)
Purchases and sales of premises and equipment, net	(3,409)	(4,273)
Proceeds from sale of other real estate and other assets	570	683
Net cash used in investing activities	(38,718)	(80,432)
Cash flows from financing activities:		
Net increase in time deposits	25,712	44,876
Net increase in other deposits	10,149	8,887
Net decrease in repurchase agreements	(2,240)	(782)
Increase in FHLB borrowings	10,000	26,000
Proceeds from exercise of stock options	123	139
Cash paid to repurchase shares	(238)	(512)
Cash dividends paid	(1,506)	(1,413)
Net cash provided by financing activities	42,000	77,195
Increase in cash and cash equivalents	10,518	4,343
Cash and cash equivalents at beginning of year	27,495	23,152
Cash and cash equivalents at end of year	**$ 38,013**	**$ 27,495**
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	$ 11,032	$ 7,141
Cash paid during the year for income taxes	2,839	2,418
Supplemental schedule of noncash investing and financing activities:		
Loans transferred to other real estate	$ 261	$ 711
Unrealized gain (loss) on securities held for sale, net	46	(321)

See accompanying notes to consolidated financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

F&M Financial Corporation (F&M) is a one-bank holding company of which Farmers and Merchants Bank (the "Bank") is a wholly owned subsidiary. The Bank is engaged in general commercial banking in Rowan and Cabarrus Counties, North Carolina and operates under the banking laws of North Carolina and the Rules and Regulations of the Federal Deposit Insurance Corporation. The Bank has three wholly owned subsidiaries, F&M Real Estate Properties, Inc., F&M Investment Services, Inc. and F&M Mortgage Corporation. F&M Real Estate Properties, Inc.'s assets consist principally of premises and equipment which are leased to the Bank. F&M Investment Services, Inc. offers securities brokerage and insurance services. F&M Mortgage Corporation's primary business is to originate loans and sell them into the secondary market.

The following is a description of the significant accounting and reporting policies F&M Financial Corporation follows in preparing and presenting its consolidated financial statements.

Basis of Presentation

The consolidated financial statements include the accounts of F&M Financial Corporation, the Bank, F&M Real Estate Properties, Inc., F&M Investment Services, Inc. and F&M Mortgage Corporation (collectively referred to as the Corporation). In consolidation, all significant intercompany items and transactions have been eliminated.

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, as well as the amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

Investment Securities

The Corporation has determined that all of their securities should be categorized as available for sale, and accordingly, such securities are reported at fair value, with any unrealized gains or losses, net of taxes, shown as a separate component of stockholders' equity in accumulated other comprehensive income. The Corporation intends to hold these available for sale securities for an indefinite period of time but may sell them prior to maturity. The fair value of the securities is determined by a third party as of the date of the reporting period.

Securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss.

Gains and losses on sales of securities are recognized when realized on a specific identification basis. Premiums and discounts are amortized into interest income using a level yield method.

FHLB Stock

Federal law requires a member institution of the Federal Home Loan Bank (FHLB) System to hold common stock of its district FHLB according to predetermined formulas. This stock is pledged to secure FHLB borrowings. No ready market exists for the stock and it has no quoted market value. Accordingly, the FHLB stock is carried at cost.

(Continued)

Loans held for sale

Mortgage loans held for sale are valued at the lower of cost or fair value as determined by outstanding commitments from investors or current investor yield requirements calculated on an aggregate loan basis. Gains or losses resulting from sales of mortgage loans are recognized when the proceeds are received from investors.

Loans

Loans are carried at net book value. Interest income is recognized on the accrual basis. The accrual of interest income is discontinued on loans (including impaired loans) which become 90 days past due as to principal or interest unless they are well secured and in the process of collection. Any cash receipts related to nonaccrual loans (including impaired loans) are applied to the principal balance. Loans are returned to accrual status when management determines, based on an evaluation of the underlying collateral together with the borrower's payment record and financial condition, that the borrower has the ability and intent to meet the contractual obligations of the loan agreement.

Account balances are charged off against the allowance after all means of collections have been exhausted and the potential recovery is considered remote.

Loan origination and commitment fees, as well as certain direct loan origination and commitment costs are deferred and amortized as a yield adjustment over the lives of the related loans using the interest method.

The Corporation uses the allowance method in providing for loan losses. The provision for loan losses is based upon management's estimate of the amount needed to maintain the allowance for loan losses at an adequate level to cover known and inherent risk of loss in the loan portfolio. In determining the provision amount, management gives consideration to current economic conditions, the growth and composition of the loan portfolio, the relationship of the allowance for loan losses to outstanding loans, 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. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize changes to the allowance based on their judgments of information available to them at the time of their examination.

Management considers loans to be impaired when based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors that influence management's judgments include, but are not limited to, loan payment pattern, source of repayment, and value of collateral. The major sources for identification of loans to be evaluated for impairment include past due and nonaccrual reports, internally generated lists of loans of certain risk grades, and regulatory reports of examination. Impaired loans are measured using either the discounted expected cash flow method using the original effective interest rate or the value of collateral method. Smaller balance, homogeneous groups of loans are evaluated collectively for impairment.

(Continued)

Foreclosed Properties

Foreclosed properties are included in other assets and represent real estate acquired through foreclosure or deed in lieu thereof and are carried at the lower of cost or fair value, less estimated costs to sell. Generally such properties are appraised annually and the carrying value, if greater than the appraised value, is adjusted with a charge to income.

Premises and Equipment

Premises and equipment are carried at cost less accumulated depreciation. Depreciation is calculated principally on the straight-line method over the estimated useful lives of the assets. The useful lives range from three to seven years for furniture and equipment, from fifteen to forty years for buildings, and four to six years for automobiles.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Cash and Cash Equivalents

Cash and cash equivalents include cash and due from banks and interest-bearing bank deposits. Cash and cash equivalents have maturities of three months or less.

Mortgage Servicing Rights

The Corporation records mortgage servicing rights on loans that it acquires or originates and subsequently sells. The amount recorded is an estimate of the allocated cost of the loans to the mortgage servicing rights and to the mortgage loans based on relative fair values. The Corporation determines the fair value of the mortgage servicing rights using a method that approximates the present value of estimated net future servicing revenues less the estimated cost that would fairly compensate a substitute servicer to service the loans. The cost allocated to the servicing rights is amortized in proportion to and over the period of estimated net future cash flows related to servicing income. The Corporation periodically evaluates the mortgage servicing rights for impairment by disaggregating the portfolio into its predominant risk characteristics (primarily prepayment risk). The Corporation establishes a valuation allowance where it is determined that there is impairment in the mortgage servicing rights. Subsequent increases in impairment will result in additions to the valuation allowance, whereas subsequent decreases will result in reductions of the valuation allowance. In no event can the mortgage servicing rights be increased above their amortized cost basis.

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Stock-Based Compensation

In December 2004 the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123R, *Share- Based Payments* (SFAS No. 123R), which is a revision of SFAS 123, *Accounting for Stock-Based Compensation.* SFAS No. 123R requires that all share-based payments to employees, including grants of employee stock options, be valued at fair value on the grant date and be expensed over the applicable vesting period. SFAS No. 123R also requires that the tax benefits in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as currently required. The proforma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. The provisions of this statement became effective for the Corporation on January 1, 2006. The Corporation will transition to SFAS No. 123R on a prospective basis. Under this prospective basis, compensation costs will be recognized in the financial statements over the requisite service period for all new or modified share-based payments granted after January 1, 2006, based on the grant-date fair value. The Corporation will continue to account for any portion of previously granted awards for which the requisite service has not been rendered ("nonvested awards") and are outstanding as of January 1, 2006, using the accounting principle originally applied to those awards, APB Opinion No. 25, *Accounting for Stock Issued to Employees.* The future financial impact of the adoption of SFAS No. 123R will depend on the type, amount, timing and vesting provisions of the share-based compensation granted in the future.

There were no options granted in 2006 and 2,250 options granted in 2005. The fair value of options granted during 2005 was $3.11 and was estimated using the minimum value method described in SFAS No. 123 with the following assumptions: dividend yield of 2.9%, expected option life of 10 years, and risk free interest rate of 4.40%.

Earnings Per Share

Basic EPS is computed by dividing net income by the weighted average number of shares of common stock outstanding for the year. Diluted net income per share reflects the potential dilution that could occur if the Corporation's dilutive stock options were exercised. The numerators of the basic EPS computations are the same as the numerators of the diluted EPS computations for both years presented. A reconciliation of the denominator of the basic EPS computation to the denominator of the diluted EPS computations is as follows:

	Years ended December 31,	
	2006	2005
Basic EPS denominator - weighted average number of common shares outstanding	$ 1,568,998	$ 1,569,543
Dilutive effect arising from assumed exercise of stock options	51,347	50,814
Diluted EPS denominator	$ 1,620,345	$ 1,620,357

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Comprehensive Income

Comprehensive income includes net income and all changes to the Corporation's equity, with the exception of transactions with shareholders (other comprehensive income). The Corporation's only component of other comprehensive income is the change in unrealized gains and losses on available for sale securities. The Corporation's total comprehensive income for the years ended December 31, 2006 and 2005 is $5,679 and $4,693, respectively. Information concerning the Corporation's other comprehensive loss for the years ended December 31, 2006 and 2005, is as follows:

	2006			2005		
	Before tax amount	Tax effect	After tax amount	Before tax amount	Tax effect	After tax amount
Unrealized losses on securities:						
Unrealized holding gains (losses) arising during the period	$ 267	$ 106	$ 161	$ (535)	$ (214)	$ (321)
Less reclassification adjustment for gains (losses) realized in net income	191	76	115	-	-	-
Other comprehensive loss	$ 76	$ 30	$ 46	$ (535)	$ (535)	$ (321)

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and / or disclosure of financial information by the Corporation.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This Statement resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*. FAS 155 permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest only-strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends Statement 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Corporation does not believe that the adoption of SFAS No. 155 will have a material impact on its financial position, results of operations or cash flows.

(Continued)

Recent Accounting Pronouncements (Continued)

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140.* This Statement amends FASB No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract; requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable; permits an entity to choose its subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities; at its initial adoption, permits a one-time reclassification of available for sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available for sale securities under Statement No. 115, provided that the available for sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value; and requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. An entity should adopt SFAS No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006. The Corporation does not believe the adoption of SFAS No. 156 will have a material impact on its financial position, results of operations or cash flows.

In July 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in enterprises' financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Corporation is currently analyzing the effects of FIN 48 on its financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This standard does not require any new fair value measurements, but rather eliminates inconsistencies found in various prior pronouncements. SFAS No. 157 is effective for the Corporation on January 1, 2008 and is not expected to have a significant impact on its financial position, results of operations or cash flows.

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Recent Accounting Pronouncements (Continued)

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which amends SFAS No. 87 and SFAS No. 106 to require recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS No. 158, gains and losses, prior service costs and credits, and any remaining transition amounts under SFAS No. 87 and SFAS No. 106 that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects, until they are amortized as a component of net periodic cost. The measurement date — the date at which the benefit obligation and plan assets are measured — is required to be the Corporation's fiscal year end. SFAS No. 158 is effective for privately-held companies for fiscal years ending after June 15, 2007, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. The Corporation does not have a defined benefit pension plan. Therefore, SFAS No. 158 will not impact the Corporation's financial conditions or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115.* This statement permits, but does not require, entities to measure many financial instruments at fair value. The objective is to provide entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Entities electing this option will apply it when the entity first recognizes an eligible instrument and will report unrealized gains and losses on such instruments in current earnings. This statement 1) applies to all entities, 2) specifies certain election dates, 3) can be applied on an instrument-by-instrument basis with some exceptions, 4) is irrevocable and 5) applies only to entire instruments. One exception is demand deposit liabilities which are explicitly excluded as qualifying for fair value. With respect to SFAS No. 115, available for sale and held to maturity securities at the effective date are eligible for the fair value option at that date. If the fair value option is elected for those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment and thereafter, such securities will be accounted for as trading securities. SFAS No. 159 is effective for the Corporation on January 1, 2008. Earlier adoption is permitted in 2007 if the Corporation also elects to apply the provisions of SFAS No. 157, *Fair Value Measurement.* The Corporation is currently analyzing the fair value option provided under SFAS No. 159.

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Recent Accounting Pronouncements (Continued)

In September, 2006, The FASB ratified the consensuses reached by the FASB's Emerging Issues Task Force ("EITF") relating to EITF 06-4 *Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements.* EITF 06-4 addresses employer accounting for endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods should recognize a liability for future benefits in accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pension,* or Accounting Principles Board ("APB") Opinion No. 12, *Omnibus Opinion—1967.* EITF 06-4 is effective for fiscal years beginning after December 15, 2007. Entities should recognize the effects of applying this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. The Corporation is currently analyzing the effect of adoption of EITF 06-4 on its financial position, results of operations and cash flows.

In September 2006, the FASB ratified the consensus reached related to EITF 06-5, *Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance.* EITF 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF 06-5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The Corporation is currently analyzing the effect of adoption of EITF 06-5 on its financial position, results of operations and cash flows.

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

NOTE 2 - AVAILABLE FOR SALE SECURITIES

Available for sale securities at December 31, 2006 and 2005, consist of the following:

	2006			
	Amortized	Gross unrealized		
	cost	Gains	Losses	Fair value
Government sponsored enterprises	$ 21,464	$ 33	$ (74)	$ 21,423
State, county, and municipal obligations	7,946	254	(3)	8,197
Equity securities	1,126	1,725	-	2,851
	$ 30,536	$ 2,012	$ (77)	$ 32,471

	2005			
	Amortized	Gross unrealized		
	cost	Gains	Losses	Fair value
Government sponsored enterprises	$ 20,999	$ -	$ (244)	$ 20,755
State, county, and municipal obligations	9,982	395	-	10,377
Equity securities	1,536	1,742	(34)	3,244
	$ 32,517	$ 2,137	$ (278)	$ 34,376

The following table shows available for sale securities held by the Corporation by maturity category at December 31, 2006:

	Amortized Cost	Fair Value
Due in one year or less	$ 10,951	$ 11,008
Due after one year through five years	17,676	17,830
Due after five years through ten years	399	396
Due after ten years	384	386
Equity securities	1,126	2,851
Total	$ 30,536	$ 32,471

Sales of securities available for sale with aggregate proceeds of $547 resulted in gross gains of $252 and gross losses of $4 during 2006. There were no sales of available for sale securities in 2005.

At December 31, 2006 and 2005, the Corporation had pledged available for sale securities with an aggregate fair value of approximately $28,889 and $31,132, respectively, to secure public deposits and repurchase agreements. The carrying amounts of the securities were $28,760 and $30,900 at December 31, 2006 and 2005, respectively.

(Continued)

NOTE 2 - AVAILABLE FOR SALE SECURITIES, Continued

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2006 and 2005, were as follows:

	December 31, 2006					
	Less than 12 months		12 months or Longer		Total	
	Fair Value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Government sponsored enterprises	$ 3,385	$ 10	$ 5,931	$ 67	$ 9,316	$ 77
Equity securities	-	-	-	-	-	-
	$ 3,385	$ 10	$ 5,931	$ 67	$ 9,316	$ 77

	December 31, 2005					
	Less than 12 months		12 months or Longer		Total	
	Fair Value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Government sponsored enterprises	$ 489	$ 9	$ 20,267	$ 235	$ 20,756	$ 244
Equity securities	43	4	256	30	299	34
	$ 532	$ 13	$ 20,523	$ 265	$ 21,055	$ 278

The unrealized losses on investments of Government sponsored enterprises at December 31, 2006, relate to 12 securities and were caused by interest rate increases. The unrealized losses on investments of Government sponsored enterprises at December 31, 2005 relate to 26 securities and were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment.

There were no unrealized losses on equity securities at December 31, 2006. The unrealized losses on equity securities at December 31, 2005, consist of 10 investments in bank stocks. The Corporation has the ability to hold these securities until there is a market price recovery.

NOTE 3 - LOANS

A summary of loans at December 31, 2006 and 2005 follows:

	2006	2005
Real estate - residential	$ 158,221	$ 164,818
Real estate - commercial	198,949	161,745
Commercial and other	48,960	43,509
Construction and development	32,479	27,944
Installment and individual	14,411	18,049
Cash reserve	1,776	1,599
Deferred loan fees, net	(1,009)	(948)
	$ 453,787	$ 416,716

(Continued)

NOTE 3 – LOANS, Continued

Changes in the allowance for loan losses are as follows:

	2006	2005
Balance, beginning of year	$ 5,252	$ 4,834
Provision for loan losses	1,100	890
Loans charged-off	(763)	(546)
Recoveries	97	74
Balance, end of year	$ 5,686	$ 5,252

The Corporation's lending activities consist primarily of loans to customers in the Corporation's primary market area consisting of Rowan County, North Carolina and surrounding counties, and, accordingly, credit risk is affected by local economic conditions. The real estate and construction and development loan portfolios include loans on property, which can be affected by the condition of the local real estate market.

At December 31, 2006 and 2005, nonaccrual loans (including total impaired loans) totaled $3,067 and $1,460, respectively, all of which had a specific allowance in the related allowance for loan losses. The related allowance for loan losses on these loans was $493 and $212, respectively. The average recorded investment in impaired loans for the years ended December 31, 2006 and 2005 was approximately $1,941 and $1,505, respectively. For the years ended December 31, 2006 and 2005, the Corporation did not recognize any interest income on nonaccrual or impaired loans. Loans more than 90 days past due and still accruing interest were $398 and $652 at December 31, 2006 and 2005, respectively. Loans past due between 30 and 90 days were 2.6% and 3.0% of total loans at December 31, 2006 and 2005, respectively. The Corporation considers these delinquent loans in estimating the allowance for loan losses.

A summary of the lending activity to officers, directors, and their related interests follows:

	2006	2005
Balance, beginning of year	$ 3,898	$ 1,997
Additions	4,541	3,381
Repayments	(2,971)	(1,480)
Balance, end of year	$ 5,468	$ 3,898

Such loans were made on substantially the same terms as those prevailing at the time for comparable transactions with other borrowers. Management does not believe these loans involve more than the normal risks of collectibility.

NOTE 4 - PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31, 2006 and 2005:

	2006	2005
Land	$ 4,341	$ 4,341
Buildings	18,776	15,302
Construction in progress	1,292	2,733
Furniture and equipment	10,731	9,888
Automobiles	132	133
	35,272	32,397
Less accumulated depreciation	12,496	11,114
Premises and equipment, net	$ 22,776	$ 21,283

NOTE 5 - MORTGAGE SERVICING RIGHTS

The following is an analysis of capitalized mortgage servicing rights, included in other assets, for the years ended December 31:

	2006	2005
Balance, beginning of year	$ 463	$ 530
Capitalized servicing rights	184	93
Amortization	(189)	(160)
Impairment write-downs	-	-
Balance, end of year	$ 458	$ 463

Mortgage loans serviced for others with unpaid principal balances of approximately $144,513 and $126,160 at December 31, 2006 and 2005, respectively, are not included in the accompanying consolidated balance sheets.

The Corporation's total mortgage banking income for the years ended December 31, 2006 and 2005, was $447 and $394. Gains on sales of loans were $294 and $183 for 2006 and 2005, respectively, including $184 in 2006 and $93 in 2005 as a result of capitalized mortgage servicing rights. Fees earned for servicing loans, net of amortization and impairment write-downs, were $153 and $211 in 2006 and 2005, respectively.

NOTE 6 - DEPOSITS

At December 31, 2006, the scheduled maturities of all time deposits are as follows:

2007	$ 123,172
2008	41,911
2009	32,188
2010	827
2011 and thereafter	8,813
Total time deposits	$ 206,911

NOTE 7 - REPURCHASE AGREEMENTS

Repurchase agreements represent securities that are sold by the Corporation under an agreement to repurchase and generally mature daily. The securities underlying the agreements remain under the Corporation's control. The repurchase agreements averaged approximately $14,084 and $14,490 in 2006 and 2005, respectively. The average interest rate paid on repurchase agreements during 2006 and 2005 was 1.49% and 1.62%, respectively. The maximum amount outstanding at any month end during 2006 and 2005 was $22,243 and $19,441, respectively.

NOTE 8 - FHLB BORROWINGS

The Bank has an agreement with the FHLB under which it can borrow up to 30% of the Bank's total assets, or $165,563 at December 31, 2006. The Bank's borrowing capacity has been reduced by a $15,000 letter of credit used to secure public deposits as required or permitted by law. At December 31, 2006 and 2005, there were $75,000 and $65,000 of borrowings outstanding, as follows:

Maturity	Average Rate at December 31, 2006	December 31, 2006	December 31, 2005
Overnight	5.50%	$ 40,000	$ 36,000
2006	-%	-	22,000
2007	5.26%	33,000	5,000
2008	4.18%	2,000	2,000
		$ 75,000	$ 65,000

The Corporation has entered into a blanket collateral agreement with the FHLB whereby the Corporation maintains, free of other encumbrances, qualifying mortgages (as defined) with unpaid principal balances at least equal to, when discounted at 75% of the unpaid principal balance, 100% of the total FHLB borrowings. The Corporation's FHLB stock is also pledged as collateral for the borrowings.

NOTE 9 - INCOME TAXES

Income tax expense (benefit) for the years ended December 31, 2006 and 2005 was allocated as follows:

	2006	2005
Net income	$ 2,959	$ 2,508
Stockholders' equity, for changes in unrealized holding gains on available for sale securities recognized for financial reporting purposes	30	(214)
	$ 2,989	$ 2,294

Income tax expense (benefit) allocated to net income consists of the following:

	Current	Deferred	Total
2006:			
Federal	$ 3,129	$ (449)	$ 2,680
State	357	(78)	279
	$ 3,486	$ (527)	$ 2,959
2005:			
Federal	$ 2,021	$ 277	$ 2,298
State	154	56	210
	$ 2,175	$ 333	$ 2,508

The income taxes payable (refundable) were $(10) and $162 at December 31, 2006 and 2005, respectively.

The reconciliation of federal income tax rates to the effective income tax rates for each of the years in the two-year period ended December 31, 2006, is as follows:

	2006	2005
Statutory federal income tax rate	34.0%	34.0%
Increase (decrease) in tax rates resulting from:		
State and local income taxes, net of federal income tax benefit	2.1	1.8
Tax exempt income	(1.7)	(3.0)
Other, net	-	0.5
Effective rate	34.4%	33.3%

(Continued)

NOTE 9 – INCOME TAXES, Continued

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities, included in other assets, at December 31, 2006 and 2005 are presented below:

	2006	2005
Deferred income tax assets:		
Loan loss reserves	$ 2,039	$ 1,842
Deferred compensation	1,317	1,127
Other	23	123
Total gross deferred tax assets	3,379	3,092
Less valuation allowance	-	-
Net deferred tax assets	3,379	3,092
Deferred income tax liabilities:		
Unrealized gain on securities available for sale	(774)	(744)
Financial reporting basis of FHLB stock in excess of tax basis	(16)	(16)
Depreciable basis of fixed assets	(1,127)	(1,482)
Tax versus book basis on loans	(177)	(178)
Other	(148)	(32)
Total gross deferred income tax liabilities	(2,242)	(2,452)
Net deferred income tax asset	$ 1,137	$ 640

A portion of the change in the net deferred income tax asset relates to unrealized gains and losses on securities available for sale. The related deferred income tax expense of $30 has been recorded directly to stockholders' equity through accumulated other comprehensive income. The balance of the change results from the current period deferred income tax benefit of $527 which is included in income tax expense.

There was no valuation allowance for deferred tax assets as of December 31, 2006 and 2005. There was no change in the valuation allowance during 2006 or 2005. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. In order to fully realize the deferred tax asset, the Corporation will need to generate future taxable income prior to the expiration of the deferred tax assets governed by the tax code. Based upon the level of historical taxable income and projections for future taxable income over the periods which the deferred tax assets are deductible, management believes it is more likely than not the Corporation will realize the benefits of these deductible differences. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

(Continued)

NOTE 10 - EMPLOYEE BENEFITS

The Corporation has available to its employees a benefit plan which was created by combining an existing defined contribution profit sharing plan and an employee stock ownership plan (ESOP). In addition, the Corporation added a 401(k) provision to the combined plan calling the plan a KSOP. Substantially all employees of the Corporation who work 1,000 hours per year and have attained the age of 18 are covered under the defined contribution KSOP. The Corporation may make discretionary matching contributions up to 100% of participant contributions, up to the first 6% of a participant's compensation, to the 401(k). During 2006 and 2005, the Corporation matched 25% of participant contributions, up to 6% of the participant's compensation. Participants in the 401(k) vest immediately with respect to all contributions.

The Corporation makes contributions to the ESOP portion of the plan based on management's evaluation of performance. Originally the Corporation made contributions in the form of Corporation stock, however, during 2006 and 2005 the Corporation's contributions were made in the form of cash which participants were able to invest at their own discretion in one of several plan investment options. The Corporation expenses the amount of their annual contributions to the ESOP. Participants in the ESOP vest over a seven year period; beginning after 3 years, the participant becomes 20% vested, and the vesting percentage increases 20% each year thereafter.

Approximate expenses related to these plans were as follows:

	2006	2005
401(k) plan	$ 86	$ 75
ESOP	403	363
Total	$ 489	$ 438

Common stock of the Corporation previously contributed to the ESOP has a put feature available to the ESOP participants since the stock is not "readily tradable on an established market". The put feature permits the participants to sell their common shares obtained from the ESOP to the Corporation at the fair market value of such shares. At December 31, 2006 and 2005, there were 44,101 and 44,181 shares, respectively in the ESOP.

The Corporation provides a salary continuation plan for three officers. Participants in the plan are eligible to receive an annual retirement benefit beginning at age 65 equal to a prescribed percentage of their present annual salary. Currently, such percentages range from 45% to 65%. The retirement benefit will be paid in monthly installments for fifteen years following retirement. As of December 31, 2006 and 2005, the Corporation had related accrued liabilities of approximately $2,839 and $2,389, respectively.

NOTE 11 – STOCK OPTIONS

The Corporation has stock option agreements in which options are periodically granted to directors and employees of the Corporation, at a price equal to the fair market value of the shares at the date of grant. The option agreements vary with some having immediate vesting, while others have service requirements of up to 24 years before the options are 100% vested.

(Continued)

NOTE 11 – STOCK OPTIONS, Continued

Of the granted options, 142,729 are outstanding at December31, 2006, of which 55,455 are currently exercisable. The exercise prices for the options outstanding at December 31, 2006 range from $14.20 to $30.50 per share. The weighted average remaining contractual life of options outstanding at December 31, 2006 is approximately 7.6 years. The following is a summary of the options outstanding at December 31, 2006:

Option price	Options outstanding	Exercisable	Contractual remaining life
$ 14.20	1,500	1,500	1 year
16.75	1,500	1,500	2 1/3 years
16.75	600	600	3 years
20.50	67,600	37,725	5 years
25.25	16,778	-	22 years
25.25	52,501	11,880	7 years
30.50	2,250	2,250	8 1/2 years
	142,729	55,455	

The following data summarizes the option activity related to the grants discussed above:

	Number of options		Average
	Available for future grants	Granted options	exercise price per share
As of December 31, 2004	111,271	156,039	22.13
Granted	(2,250)	2,250	30.50
Exercised	-	(6,985)	19.90
As of December 31, 2005	109,021	151,304	22.36
Granted	-	-	-
Exercised	-	(8,575)	14.29
As of December 31, 2006	109,021	142,729	22.85

NOTE 12 - COMMITMENTS AND GUARANTEES

In the normal course of business there are outstanding commitments for extension of credit which are not reflected in the consolidated financial statements. At December 31, 2006 and 2005, preapproved but unused lines of credit and other loan commitments were approximately $120,101 and $108,558 of which $56,298 and $50,274 related to home equity lines of credit. At December31, 2006 and 2005, the Corporation had $556 and $1,255 in commitments to originate and to sell loans held for sale, respectively. The fair value of these commitments was not material.

(Continued)

NOTE 12 – NOTE 12, Continued

Additionally, the Corporation has outstanding letters of credit, which are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. The Corporation would incur a credit loss in the event that the counterparty draws on the commitment and subsequently fails to perform under the terms of the lending agreement. The Corporation's maximum exposure to credit loss in the event of nonperformance by the counterparties for commitments on standby letters of credit is represented by the contract amount of those instruments. At December 31, 2006 and 2005 the maximum risk of potential loss under standby letters of credit was $3,913 and $1,766, respectively. At December 31, 2006, the Corporation has recorded no liability for the current carrying amount of the obligation to perform as a guarantor, as such amounts are not considered material.

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. If these commitments are drawn, the Corporation will obtain collateral if it is deemed necessary based on management's credit evaluation of the counterparty. Management believes that these commitments can be funded through normal operations.

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Corporation is required under SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* to disclose in its financial statements the fair value of all financial instruments, including assets and liabilities both on- and off-balance sheet, for which it is practicable to estimate such fair value. Fair value estimates, methods, and assumptions as of December 31, 2006 and 2005 for the Corporation are set forth below and are subject to the following limitations.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets or liabilities not considered financial instruments include deferred tax assets and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered.

(Continued)

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS, (Continued)

The Corporation's fair value methods and assumptions are as follows:

- *Cash and due from banks, interest-bearing bank deposits, FHLB stock, accrued interest receivable, repurchase agreements, and accrued interest payable* - the carrying value is a reasonable estimate of fair value.

- *Available for sale securities* - fair value is based on available quoted market prices or quoted market prices for similar securities if a quoted market price is not available.

- *Loans held for sale* - fair value of loans held for sale is determined by outstanding commitments from investors or current investor yield requirements calculated on an aggregate loan basis.

- *Loans, net* - the carrying value for variable rate loans is a reasonable estimate of fair value due to contractual interest rates based on prime. Fair value for fixed rate loans is estimated based upon discounted future cash flows using discount rates comparable to rates currently offered for such loans.

- *Deposit accounts*- the fair value of certificates of deposit is estimated using rates currently offered for deposits of similar remaining maturities. The fair value of all other deposit account types is the amount payable on demand at year-end.

- *FHLB borrowings* - the carrying value of variable rate FHLB borrowings is considered to approximate fair value. The fair values for fixed rate borrowings are estimated based upon discounted future cash flows using discount rates comparable to rates currently charged for such borrowings.

- *Commitments to extend credit and standby letters of credit* - the large majority of the Corporation's loan commitments are at variable rates and, therefore, are subject to minimal interest rate risk exposure. Therefore, the fair value for these financial instruments is considered to approximate the commitment amount.

Based on the limitations, methods, and assumptions noted above, the estimated fair values of the Corporation's financial instruments at December 31, 2006 and 2005 are as follows:

(Continued)

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS, Continued

	2006		2005	
	Carrying amount	Fair value	Carrying Amount	Fair value
Financial assets:				
Cash and due from banks	$ 14,811	$ 14,811	$ 13,048	$ 13,048
Interest bearing bank deposits	23,202	23,202	14,447	14,447
Available for sale securities	32,471	32,471	34,376	34,376
FHLB stock	4,380	4,380	3,773	3,773
Loans held for sale	1,319	1,319	486	486
Loans, net	448,101	444,534	411,464	411,698
Accrued interest receivable	2,943	2,943	2,501	2,501
Financial liabilities:				
Deposit accounts	408,283	407,903	$ 374,133	374,996
FHLB borrowings	75,000	74,957	65,000	64,894
Repurchase agreements	12,518	12,518	14,758	14,758
Accrued interest payable	1,263	1,263	685	685

NOTE 14 - REGULATORY MATTERS

The Corporation and the Bank are subject to various regulatory capital requirements administered by the FDIC and the North Carolina Office of the Commissioner of Banks (the "Commissioner"). The primary source of funds for the payment of dividends by the Corporation is dividends received from the Bank. The Bank may pay dividends only out of undivided profits as determined pursuant to North Carolina General Statutes Section 53-87. At December 31, 2006, subject to FDIC capital requirement limitations, the Bank had undivided profits of approximately $10,276 which were eligible for the payment of dividends without obtaining prior approval from the Commissioner.

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

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2006, that the Corporation and the Bank meet all capital adequacy requirements to which it is subject.

As of December 31, 2006, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed any of the Corporation's and/or Bank's categories.

(Continued)

NOTE 14 - REGULATORY MATTERS, Continued

The Corporation's and Bank's required and actual capital amounts and ratios are presented in the table below.

	Actual		For capital adequacy purposes			To be well capitalized under Prompt corrective action provisions		
	Amount	Ratio	Amount		Ratio	Amount		Ratio
As of December 31, 2006:								
Total capital (to risk weighted assets):								
Corporation	$ 55,900	11.3%	$ 39,627	≥	8.0%	$ N/A	≥	
Bank	52,690	10.7%	39,467	≥	8.0%	49,334	≥	10.0%
Tier I capital (to risk weighted assets):								
Corporation	49,438	10.0%	19,813	≥	4.0%	N/A	≥	
Bank	47,004	9.5%	19,733	≥	4.0%	24,667	≥	5.0%
Tier I capital (to average assets):								
Corporation	49,438	9.4%	21,051	≥	4.0%	N/A	≥	
Bank	47,004	8.9%	21,116	≥	4.0%	26,395	≥	5.0%
As of December 31, 2005:								
Total capital (to risk weighted assets):								
Corporation	$ 51,436	11.5%	$ 35,659	≥	8.0%	$ N/A	≥	
Bank	47,714	10.8%	35,466	≥	8.0%	44,333	≥	10.0%
Tier I capital (to risk weighted assets):								
Corporation	45,415	10.2%	17,829	≥	4.0%	N/A	≥	
Bank	42,462	9.6%	17,733	≥	4.0%	22,166	≥	5.0%
Tier I capital (to average assets):								
Corporation	45,415	9.4%	19,402	≥	4.0%	N/A	≥	
Bank	42,462	8.8%	19,329	≥	4.0%	24,161	≥	5.0%

F&M FINANCIAL CORPORATION

REPORT ON CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

F&M FINANCIAL CORPORATION

TABLE OF CONTENTS

	Page
INDEPENDENT AUDITORS' REPORT	1
CONSOLIDATED FINANCIAL STATEMENTS	
Balance sheets	2
Statements of income	3
Statements of stockholders' equity	4
Statements of cash flows	5
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS	6 - 22

ElliottDavis
Accountants and Business Advisors

1300 South Mint Street
Suite 300
Charlotte, NC 28203

Phone 704.333.8881
Fax 704.333.2905

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
F&M Financial Corporation

We have audited the accompanying consolidated balance sheets of F&M Financial Corporation and subsidiary (the "Corporation") as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of F&M Financial Corporation and subsidiary as of December 31, 2007, and 2006 and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Elliott Davis PLLC

Greenville, South Carolina
March 28, 2008

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2007 AND 2006
(in thousands, except share data)

	2007	2006
Assets		
Cash and due from banks	$ 13,105	$ 14,811
Interest-bearing bank deposits	27,824	23,202
Available for sale securities (amortized cost of $33,594 in 2007 and $30,536 in 2006; $29,252 in 2007 and $28,889 in 2006 were pledged as collateral)	35,187	32,471
FHLB stock, at cost	5,709	4,380
Loans held for sale	760	1,319
Loans	524,161	453,787
Less allowance for loan losses	(6,298)	(5,686)
Loans, net	517,863	448,101
Premises and equipment, net	25,253	22,776
Other assets	8,329	7,464
Total assets	**$ 634,030**	**$ 554,524**
Liabilities and Stockholders' Equity		
Deposits		
Demand		
Noninterest-bearing	$ 67,522	$ 65,719
Interest-bearing	102,443	109,829
Savings	24,154	25,824
Time, $100,000 or more	114,973	109,818
Other time	133,662	97,093
Total deposits	442,754	408,283
Federal funds purchased	10,000	-
FHLB borrowings	104,800	75,000
Repurchase agreements	14,822	12,518
Other liabilities	7,984	8,760
Total liabilities	580,360	504,561
Commitments and contingencies - Note 12		
Stockholders' equity		
Common stock, $5 par value. Authorized 5,000,000 shares; issued and outstanding 1,559,466 shares in 2007 and 1,567,149 shares in 2006	7,797	7,836
Additional paid in capital	112	21
Retained earnings	44,805	40,945
Accumulated other comprehensive income		
Unrealized gain on securities, net	956	1,161
Total stockholders' equity	53,670	49,963
Total liabilities and stockholders' equity	**$ 634,030**	**$ 554,524**

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2007 and 2006
(in thousands, except share data)

	2007	2006
Interest income:		
Loans	$ 37,385	$ 33,945
Securities:		
Government sponsored enterprises	1,262	839
State, county, and municipal obligations	393	447
Other interest and dividend income	481	468
Total interest income	39,521	35,699
Interest expense:		
Time deposits, $100,000 and over	5,662	6,321
Other deposits	7,446	5,288
Repurchase agreements	235	228
FHLB borrowings	3,186	1,775
Total interest expense	16,529	13,612
Net interest income	22,992	22,087
Provision for loan losses	1,243	1,100
Net interest income after provision for loan losses	21,749	20,987
Other operating income:		
Service charges on deposit accounts	2,448	2,540
Brokerage related fees	1,028	771
Other fees and commissions	1,597	1,483
Mortgage banking income, net	401	447
Gain on sale of available for sale investment securities	317	248
Total other operating income	5,791	5,489
Other operating expenses:		
Compensation and employee benefits	11,048	10,484
Occupancy	1,786	1,636
Equipment	1,751	1,717
Insurance	242	232
Professional services	552	393
Stationary and supplies	510	491
Other	2,945	2,931
Total other operating expenses	18,834	17,884
Income before income tax expense	8,706	8,592
Income tax expense	3,033	2,959
Net income	$ 5,673	$ 5,633
Basic earnings per share	$ 3.63	$ 3.59
Diluted earnings per share	3.52	3.48

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Years ended December 31, 2007 and 2006
(in thousands, except share data)

	Common Stock		Additional paid in capital	Retained earnings	Accumulated other comprehensive income, net	Total stockholders' equity
	Shares	Amount				
Balance at December 31, 2005	1,565,554	$ 7,828	$ 76	$ 36,886	$ 1,115	$ 45,905
Comprehensive income:						
Net income		-	-	5,633	-	5,633
Unrealized gain on securities, net		-	-	-	46	46
Total comprehensive income						5,679
Cash dividends of $0.96 per share		-	-	(1,506)	-	(1,506)
Stock options exercised	8,575	43	80	-	-	123
Shares repurchased	(6,980)	(35)	(135)	(68)	-	(238)
Balance at December 31, 2006	1,567,149	7,836	21	40,945	1,161	49,963
Comprehensive income:						
Net income				5,673		5,673
Unrealized loss on securities, net					(205)	(205)
Total comprehensive income						5,468
Cash dividends of $1.02 per share				(1,594)		(1,594)
Stock based compensation			100			100
Tax benefit related to exercise of stock options			45			45
Stock options exercised	2,100	10	23			33
Shares repurchased	(9,783)	(49)	(77)	(219)		(345)
Balance at December 31, 2007	1,559,466	$ 7,797	$ 112	$ 44,805	$ 956	$ 53,670

See accompanying notes to consolidated financial statements.

F & M FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2007 and 2006
(in thousands)

	2007	2006
Cash flows from operating activities:		
Net income	$ 5,673	$ 5,633
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,243	1,100
Depreciation	2,109	1,916
Stock based compensation	100	-
Amortization (accretion) of securities premiums (discounts), net	(19)	25
Amortization and impairment losses on mortgage servicing rights	217	189
Loss on sale of premises and equipment	5	-
Gain on sale of loans	(251)	(294)
Gain on sale of available for sale securities	(317)	(248)
Deferred income tax benefit	(627)	(527)
Increase in other assets	(1,202)	(361)
Increase in other liabilities	(776)	524
Proceeds from sales of loans held for sale	14,406	20,744
Origination of loans held for sale	(13,596)	(21,465)
Net cash provided by operating activities	6,965	7,236
Cash flows from investing activities:		
Proceeds from maturities and sales of available for sale securities	7,983	17,622
Purchase of available for sale securities	(10,568)	(15,418)
Origination of loans, net of principal collected	(70,601)	(52,376)
Proceeds from portfolio loan sales	-	14,900
Purchase of FHLB stock	(1,329)	(607)
Purchases and sales of premises and equipment, net	(4,591)	(3,409)
Proceeds from sale of other real estate and other assets	388	570
Net cash used in investing activities	(78,718)	(38,718)
Cash flows from financing activities:		
Net increase in time deposits	41,724	25,712
Net (decrease) increase in other deposits	(7,253)	10,149
Net (decrease) increase in repurchase agreements	2,304	(2,240)
Increase in Federal funds purchased	10,000	-
Increase in FHLB borrowings	29,800	10,000
Proceeds from exercise of stock options	33	123
Cash paid to repurchase shares	(345)	(238)
Cash dividends paid	(1,594)	(1,506)
Net cash provided by financing activities	74,669	42,000
Increase in cash and cash equivalents	2,916	10,518
Cash and cash equivalents at beginning of year	38,013	27,495
Cash and cash equivalents at end of year	**$ 40,929**	**$ 38,013**
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	$ 16,313	$ 11,032
Cash paid during the year for income taxes	2,893	2,839
Supplemental schedule of noncash investing and financing activities:		
Loans transferred to other real estate	$ 404	$ 261
Unrealized gain (loss) on securities available for sale, net	(15)	46

See accompanying notes to consolidated financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

F&M Financial Corporation (F&M) is a one-bank holding company of which Farmers and Merchants Bank (the "Bank") is a wholly owned subsidiary. The Bank is engaged in general commercial banking in Rowan and Cabarrus Counties, North Carolina and operates under the banking laws of North Carolina and the Rules and Regulations of the Federal Deposit Insurance Corporation. The Bank had three wholly owned subsidiaries, F&M Real Estate Properties, Inc., F&M Investment Services, Inc. and F&M Mortgage Corporation. F&M Real Estate Properties, Inc.'s assets consist principally of premises and equipment which are leased to the Bank. F&M Investment Services, Inc. offers securities brokerage and insurance services. F&M Mortgage Corporation's primary business is to originate loans and sell them into the secondary market. During the year, F&M Real Estate Properties, Inc. and F&M Mortgage Corporation were dissolved into F&M Bank.

The following is a description of the significant accounting and reporting policies F&M Financial Corporation follows in preparing and presenting its consolidated financial statements.

Basis of Presentation

The consolidated financial statements include the accounts of F&M Financial Corporation, the Bank, and F&M Investment Services, Inc. (collectively referred to as the Corporation). In consolidation, all significant intercompany items and transactions have been eliminated.

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, as well as the amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

Investment Securities

The Corporation has determined that all of their securities should be categorized as available for sale, and accordingly, such securities are reported at fair value, with any unrealized gains or losses, net of taxes, shown as a separate component of stockholders' equity in accumulated other comprehensive income. The Corporation intends to hold these available for sale securities for an indefinite period of time but may sell them prior to maturity. The fair value of the securities is determined by a third party as of the date of the reporting period.

Securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss.

Gains and losses on sales of securities are recognized when realized on a specific identification basis. Premiums and discounts are amortized into interest income using a level yield method.

FHLB Stock

Federal law requires a member institution of the Federal Home Loan Bank (FHLB) System to hold common stock of its district FHLB according to predetermined formulas. This stock is pledged to secure FHLB borrowings. No ready market exists for the stock and it has no quoted market value. Accordingly, the FHLB stock is carried at cost.

(Continued)

Loans held for sale

Mortgage loans held for sale are valued at the lower of cost or fair value as determined by outstanding commitments from investors or current investor yield requirements calculated on an aggregate loan basis. Gains or losses resulting from sales of mortgage loans are recognized when the proceeds are received from investors.

Loans

Loans are carried at net book value. Interest income is recognized on the accrual basis. The accrual of interest income is discontinued on loans (including impaired loans) which become 90 days past due as to principal or interest unless they are well secured and in the process of collection. Any cash receipts related to nonaccrual loans (including impaired loans) are applied to the principal balance. Loans are returned to accrual status when management determines, based on an evaluation of the und erlying collateral together with the borrower's payment record and financial condition, that the borrower has the ability and intent to meet the contractual obligations of the loan agreement.

Account balances are charged off against the allowance after all means of collections have been exhausted and the potential recovery is considered remote.

Loan origination and commitment fees, as well as certain direct loan origination and commitment costs are deferred and amortized as a yield adjustment over the lives of the related loans using the interest method.

The Corporation uses the allowance method in providing for loan losses. The provision for loan losses is based upon management's estimate of the amount needed to maintain the allowance for loan losses at an adequate level to cover known and inherent risk of loss in the loan portfolio. In determining the provision amount, management gives consideration to current economic conditions, the growth and composition of the loan portfolio, the relationship of the allowance for loan losses to outstanding loans, 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. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize changes to the allowance based on their judgments of information available to them at the time of their examination.

Management considers loans to be impaired when based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors that influence management's judgments include, but are not limited to, loan payment pattern, source of repayment, and value of collateral. The major sources for identification of loans to be evaluated for impairment include past due and nonaccrual reports, internally generated lists of loans of certain risk grades, and regulatory reports of examination. Impaired loans are measured using either the discounted expected cash flow method using the original effective interest rate or the value of collateral method. Smaller balance, homogeneous groups of loans are evaluated collectively for impairment.

Foreclosed properties

Foreclosed properties are included in other assets and represent real estate acquired through foreclosure or deed in lieu thereof and are carried at the lower of cost or fair value, less estimated costs to sell. Generally such properties are appraised annually and the carrying value, if greater than the appraised value, is adjusted with a charge to income.

(Continued)

Premises and equipment

Premises and equipment are carried at cost less accumulated depreciation. Depreciation is calculated principally on the straight-line method over the estimated useful lives of the assets. The useful lives range from three to seven years for furniture and equipment, from fifteen to forty years for buildings, and four to six years for automobiles.

Income taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Cash and cash equivalents

Cash and cash equivalents include cash and due from banks and interest-bearing bank deposits. Cash and cash equivalents have maturities of three months or less.

Mortgage servicing rights

The Corporation records mortgage servicing rights on loans that it acquires or originates and subsequently sells. The amount recorded is an estimate of the allocated cost of the loans to the mortgage servicing rights and to the mortgage loans based on relative fair values. The Corporation determines the fair value of the mortgage servicing rights using a method that approximates the present value of estimated net future servicing revenues less the estimated cost that would fairly compensate a substitute servicer to service the loans. The cost allocated to the servicing rights is amortized in proportion to and over the period of estimated net future cash flows related to servicing income. The Corporation periodically evaluates the mortgage servicing rights for impairment by disaggregating the portfolio into its predominant risk characteristics (primarily prepayment risk). The Corporation establishes a valuation allowance where it is determined that there is impairment in the mortgage servicing rights. Subsequent increases in impairment will result in additions to the valuation allowance, whereas subsequent decreases will result in reductions of the valuation allowance. In no event can the mortgage servicing rights be increased above their amortized cost basis.

Stock-based compensation

In December 2004 the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123R, *Share Based Payments* (SFAS No. 123R), which is a revision of SFAS 123, *Accounting for Stock-Based Compensation*. SFAS No. 123R requires that all share-based payments to employees, including grants of employee stock options, be valued at fair value on the grant date and be expensed over the applicable vesting period. SFAS No. 123R also requires that the tax benefits in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as currently required. The proforma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. The provisions of this statement became effective for the Corporation on January 1, 2006. The Corporation transitioned to SFAS No. 123R on a prospective basis. Under this prospective basis, compensation costs are recognized in the financial statements over the requisite service period for all new or modified share-based payments granted or modified after January 1, 2006, based on the grant-date fair value. The Corporation will continue to account for any portion of previously granted awards for which the requisite service has not been rendered ("nonvested awards") and are outstanding as of January 1, 2006, using the accounting

(Continued)

principle originally applied to those awards, APB Opinion No. 25, Accounting for Stock Issued to *Employees*. The future financial impact of the adoption of SFAS No. 123R will depend on the type, amount, timing and vesting provisions of the share-based compensation granted in the future.

There were 82,000 options granted in 2007 and none in 2006. The fair value of options granted during 2007 was $7.00 and was estimated using Black-Scholes pricing model described in SFAS No. 123 with the following assumptions: dividend yield of 3%, volatility of 15.5%, expected option life of 10 years, and risk free interest rate of 4.50%.

Earnings per share

Basic EPS is computed by dividing net income by the weighted average number of shares of common stock outstanding for the year. Diluted net income per share reflects the potential dilution that could occur if the Corporation's dilutive stock options were exercised. The numerators of the basic EPS computations are the same as the numerators of the diluted EPS computations for both years presented. A reconciliation of the denominator of the basic EPS computation to the denominator of the diluted EPS computations is as follows:

	Years ended December 31,	
	2007	2006
Basic EPS denominator - weighted average number of common shares outstanding	1,563,751	1,568,998
Dilutive effect arising from assumed exercise of stock options	49,602	51,347
Diluted EPS denominator	1,613,353	1,620,345

Comprehensive income

Comprehensive income includes net income and all changes to the Corporation's equity, with the exception of transactions with shareholders (other comprehensive income). The Corporation's only component of other comprehensive income is the change in unrealized gains and losses on available for sale securities. The Corporation's total comprehensive income for the years ended December 31, 2007 and 2006 is $5,468 and $5,679, respectively. Information concerning the Corporation's other comprehensive income (loss) for the years ended December 31, 2007 and 2006, is as follows:

	2007			2006		
	Before tax amount	Tax effect	After tax amount	Before tax amount	Tax effect	After tax amount
Unrealized gains (losses) on securities:						
Unrealized holding gains (losses) arising during the period	$ (25)	$ (10)	$ (9)	$ 267	$ 106	$ 161
Less reclassification adjustment for (gains) losses realized in net income	(317)	(127)	(196)	191	76	115
Other comprehensive income (loss)	$ (342)	$ (137)	$ (205)	$ 76	$ 30	$ 46

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Recent accounting pronouncements

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and/ or disclosure of financial information by the Corporation.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This standard does not require any new fair value measurements, but rather eliminates inconsistencies found in various prior pronouncements. SFAS No. 157 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company's financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115" ("SFAS 159"). This statement permits, but does not require, entities to measure many financial instruments at fair value. The objective is to provide entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Entities electing this option will apply it when the entity first recognizes an eligible instrument and will report unrealized gains and losses on such instruments in current earnings. This statement 1) applies to all entities, 2) specifies certain election dates, 3) can be applied on an instrument-by-instrument basis with some exceptions, 4) is irrevocable and 5) applies only to entire instruments. One exception is demand deposit liabilities which are explicitly excluded as qualifying for fair value. With respect to SFAS 115, available-for-sale and held-to-maturity securities at the effective date are eligible for the fair value option at that date. If the fair value option is elected for those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment and thereafter, such securities will be accounted for as trading securities. SFAS 159 is effective for the Company on January 1, 2008. The Company is currently analyzing the fair value option that is permitted, but not required, under SFAS 159.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations," ("SFAS 141(R)") which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS 141(R) is effective for acquisitions by the Company taking place on or after January 1, 2009. Early adoption is prohibited. Accordingly, a calendar year-end company is required to record and disclose business combinations following existing accounting guidance until January 1, 2009. The Company will assess the impact of SFAS 141(R) if and when a future acquisition occurs.

In July 2006, the FASB issued FASB Interpretation No. 48 ("FIN No. 48"), Accounting for Uncertainty in Income Taxes. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in enterprises' financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. A recently issued FASB Staff Position defers the effective date for the Company until January 1, 2009. The Company is currently evaluating the impact of FIN No. 48 on its financial position, results of operations or cash flows.

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

In September, 2006 The FASB ratified the consensuses reached by the FASB's Emerging Issues Task Force ("EITF") relating to EITF No. 06-4 Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF No. 06-4 addresses employer accounting for endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods should recognize a liability for future benefits in accordance with SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, or Accounting Principles Board ("APB") Opinion No. 12, Omnibus Opinion-1967. EITF No. 06-4 is effective for fiscal years beginning after December 15, 2007. Entities should recognize the effects of applying this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. The Company does not believe the adoption of EITF 06-4 will have a material impact on its financial position, results of operations and cash flows.

In September 2006, the FASB ratified the consensus reached by the EITF relating to EITF No. 06-5, Accounting for Purchases of Life Insurance-Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance". EITF No. 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF No. 06-5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). EITF No. 06-5 is effective for fiscal years beginning after December 15, 2007. The Company does not believe the adoption of EITF 06-5 will have a material impact on its financial position, results of operations and cash flows.

In June 2007, the FASB ratified the consensus reached by the EITF with respect to EITF 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards" ("EITF 06-11"). Under EITF 06-11, a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified nonvested equity shares, nonvested equity share units and outstanding equity share options should be recognized as an increase in additional paid-in capital. This EITF is to be applied prospectively to the income tax benefits that result from dividends on equity-classified employee share-based payment awards that are declared beginning in 2008, and interim periods within those fiscal years. Early application is permitted. The Company does not believe the adoption of EITF 06-11 will have a material impact on its financial position, results of operations or cash flows.

NOTE 2 - AVAILABLE FOR SALE SECURITIES

Available for sale securities at December 31, 2007 and 2006, consist of the following:

	2007			
	Amortized	Gross unrealized		
	cost	Gains	Losses	Fair value
Government sponsored enterprises	$ 24,980	$ 498	$ (2)	$ 25,476
State, county, and municipal obligations	7,677	221	-	7,898
Equity securities	937	894	(18)	1,813
	$ 33,594	**$ 1,613**	**$ (20)**	**$ 35,187**

(Continued)

Loving, Kelly Luongo

From: Ratteree, Jane

Sent: Thursday, January 22, 2009 9:50 PM

To: Loving, Kelly Luongo

Subject: F&M Litigation Disclosure

A general description would be Case No. 08-CVS-2800, General Court of Justice, Superior Court Division, Cabarrus County, NC. Plaintiffs are Estate of Timothy Alan Hurst, by and through Christian P. Cherry as Collector; Jeffery Wayne Henley a/k/a Jeffrey Wayne Henley; and Beverly Henley. Farmers & Merchants Bank a/k/a F&M Bank is named as a defendant, along with several other defendants.

The complaint seeks declaratory relief against F&M, requesting a declaration that F&M's deed of trust securing indebtedness of Moorehead I, LLC in the amount of $3.4 million is invalid, because of a defect in the deed transferring title from the plaintiffs to Moorehead I, LLC. F&M's deed of trust was insured by Investors Title Insurance Company, which is defending F&M in the suit. Counsel representing F&M is:

James K. Pendergrass, Jr.
1511 Sunday Drive, Suite 220
Raleigh, North Carolina 27607
Telephone: 919-510-9559
Fax: 919-510-0190
jpendergrass@pendergrasslawfirm.com

Hope this helps. Let me know if something more is needed. Thanks.

Jane S. Ratteree, Esq.
Robinson, Bradshaw & Hinson, P.A.
101 North Tryon Street, Suite 1900
Charlotte, NC 28246
Phone: (704) 377-8362
Fax: (704) 373-3962

This message is intended only for the use of the addressee and may contain information that is PRIVILEGED and CONFIDENTIAL, and/or may contain ATTORNEY WORK PRODUCT. If you are not the intended recipient, you are hereby notified that any dissemination of this communication is strictly prohibited. If you have received this communication in error, please erase all copies of the message and attachments and notify us immediately. Thank you.

NOTE 2 - AVAILABLE FOR SALE SECURITIES, Continued

	2006			
	Amortized	Gross unrealized		
	cost	Gains	Losses	Fair value
Government sponsored enterprises	$ 21,464	$ 33	$ (74)	$ 21,423
State, county, and municipal obligations	7,946	254	(3)	8,197
Equity securities	1,126	1,725	-	2,851
	$ 30,536	$ 2,012	$ (77)	$ 32,471

The following table shows available for sale securities held by the Corporation by maturity category at December 31, 2007:

	Amortized Cost	Fair Value
Due in one year or less	$ 10,588	$ 10,693
Due after one year through five years	20,793	21,369
Due after five years through ten years	891	923
Due after ten	385	389
Equity securities	937	1,813
Total	$ 33,594	$ 35,187

Sales of securities available for sale with aggregate proceeds of $718 and $547 resulted in gross gains of $317 and $252 and gross losses of $0 and $4 during 2007 and 2006, respectively.

At December 31, 2007 and 2006, the Corporation had pledged available for sale securities with an aggregate fair value of approximately $29,252 and $28,889, respectively, to secure public deposits and repurchase agreements. The carrying amounts of the securities were $28,665 and $28,760 at December 31, 2007 and 2006, respectively.

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2007 and 2006, were as follows:

	December 31, 2007					
	Less than 12 months		12 months or Longer		Total	
	Fair Value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Government sponsored enterprises	$ -	$ -	$ 996	$ 2	$ 996	$ 2
Equity securities	60	18	-	-	60	18
	$ 60	$ 18	$ 996	$ 2	$ 1,056	$ 20

(Continued)

NOTE 2 - AVAILABLE FOR SALE SECURITIES, Continued

	December 31, 2006					
	Less than 12 months		12 months or Longer		Total	
	Fair Value	Unrealized Losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Government sponsored enterprises	$ 3,385	$ 10	$ 5,931	$ 67	$ 9,316	$ 77

The unrealized losses on investments of Government sponsored enterprises at December 31, 2007, relate to 2 securities and were caused by interest rate fluctuations. The unrealized losses on investments of Government sponsored enterprises at December 31, 2006 relate to 12 securities and were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment.

The unrealized losses on equity securities at December 31, 2007 relate to investments in three bank stocks. The Corporation has the ability to hold these securities until there is a market price recovery.

NOTE 3 - LOANS

A summary of loans at December 31, 2007 and 2006 follows:

	December 31,	
	2007	2006
Real estate - residential	$ 155,867	$ 158,221
Real estate - commercial	259,619	198,949
Commercial and other	54,275	48,960
Construction and development	42,125	32,479
Installment and individual	11,852	14,411
Cash reserve	1,702	1,776
Deferred loan fees, net	(1,279)	(1,009)
	$ 524,161	$ 453,787

Changes in the allowance for loan losses are as follows:

	Years ended December 31,	
	2007	2006
Balance, beginning of year	$ 5,686	$ 5,252
Provision for loan losses	1,243	1,100
Loans charged-off	(755)	(763)
Recoveries	124	97
Balance, end of year	$ 6,298	$ 5,686

(Continued)

NOTE 3 - LOANS, Continued

The Corporation's lending activities consist primarily of loans to customers in the Corporation's primary market area consisting of Rowan County, North Carolina and surrounding counties, and, accordingly, credit risk is affected by local economic conditions. The real estate and construction and development loan portfolios include loans on property, which can be affected by the condition of the local real estate market.

At December 31, 2007 and 2006, non-accrual loans (including total impaired loans) totaled $2,421 and $3,067, respectively, all of which had a specific allowance in the related allowance for loan losses. The related allowance for loan losses on these loans was $547 and $493, respectively. The average recorded investment in impaired loans for the years ended December 31, 2007 and 2006 was approximately $3,006 and $1,941, respectively. For the years ended December 31, 2007 and 2006, the Corporation did not recognize any interest income on nonaccrual or impaired loans. Loans more than 90 days past due and still accruing interest were $737 and $398 at December 31, 2007 and 2006, respectively. Loans past due between 30 and 90 days were 3.2% and 2.6% of total loans at December 31, 2007 and 2006, respectively. The Corporation considers these delinquent loans in estimating the allowance for loan losses.

A summary of the lending activity to officers, directors, and their related interests follows:

	2007	2006
Balance, beginning of year	$ 5,468	$ 3,898
Additions	624	4,541
Repayments	(1,141)	(2,971)
Balance, end of year	$ 4,951	$ 5,468

Such loans were made on substantially the same terms as those prevailing at the time for comparable transactions with other borrowers. Management does not believe these loans involve more than the normal risks of collectibility.

NOTE 4 - PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31, 2007 and 2006:

	2007	2006
Land	$ 4,645	$ 4,341
Buildings	21,510	18,776
Construction in progress	1,660	1,292
Furniture and equipment	10,284	10,731
Automobiles	136	132
	38,235	35,272
Less accumulated depreciation	12,982	12,496
Premises and equipment, net	$ 25,253	$ 22,776

Depreciation expense was $2,109 and $1,916 for the years ended December 31, 2007 and 2006, respectively.

NOTE 5 - MORTGAGE SERVICING RIGHTS

The following is an analysis of capitalized mortgage servicing rights, included in other assets, for the years ended December 31:

	2007	2006
Balance, beginning of year	$ 458	$ 463
Capitalized servicing rights	74	184
Amortization	(217)	(189)
Impairment write-downs	-	-
Balance, end of year	$ 315	$ 458

Mortgage loans serviced for others with unpaid principal balances of approximately $138,399 and $144,513 at December 31, 2007 and 2006, respectively, are not included in the accompanying consolidated balance sheets.

The Corporation's total mortgage banking income for the years ended December 31, 2007 and 2006, was $401 and $447, respectively. Gains on sales of loans were $251 and $294 for 2007 and 2006, respectively, including $74 in 2007 and $184 in 2006 as a result of capitalized mortgage servicing rights. Fees earned for servicing loans, net of amortization and impairment write-downs, were $150 and $153 in 2007 and 2006, respectively.

NOTE 6 - DEPOSITS

At December 31, 2007, the scheduled maturities of all time deposits are as follows:

2008	$ 226,120
2009	14,773
2010	6,578
2011	982
2012 and thereafter	182
Total time deposits	$ 248,635

NOTE 7 - REPURCHASE AGREEMENTS

Repurchase agreements represent securities that are sold by the Corporation under an agreement to repurchase and generally mature daily. The securities underlying the agreements remain under the Corporation's control. The repurchase agreements averaged approximately $14,133 and $14,084 in 2007 and 2006, respectively. The average interest rate paid on repurchase agreements during 2007 and 2006 was 1.66% and 1.49%, respectively. The maximum amount outstanding at any month end during 2007 and 2006 was $15,496 and $22,243, respectively.

NOTE 8 - FHLB BORROWINGS

The Bank has an agreement with the FHLB under which it can borrow up to 30% of the Bank's total assets, or $189,746 at December 31, 2007. The Bank's borrowing capacity has been reduced by a $15,000 letter of credit used to secure public deposits as required or permitted by law. At December 31, 2007 and 2006, there were $104,800 and $75,000 of borrowings outstanding, as follows:

Maturity	Average Rate at December 31, 2007	December 31, 2007		December 31, 2006	
Overnight	4.40%	$	77,800	$	40,000
2007	5.26%		N/A		33,000
2008	4.56%		17,000		2,000
2009	3.98%		10,000		-
		$	**104,800**	**$**	**75,000**

The Corporation has entered into a blanket collateral agreement with the FHLB whereby the Corporation maintains, free of other encumbrances, qualifying mortgages (as defined) with unpaid principal balances at least equal to, when discounted at 75% of the unpaid principal balance, 100% of the total FHLB borrowings. The Corporation's FHLB stock is also pledged as collateral for the borrowings.

NOTE 9 - INCOME TAXES

Income tax expense (benefit) allocated to net income consists of the following:

	Current		Deferred		Total	
2007:						
Federal	$	3,192	$	(483)	$	2,709
State		468		(144)		324
	$	**3,660**	**$**	**(627)**	**$**	**3,033**
2006:						
Federal	$	3,129	$	(449)	$	2,680
State		357		(78)		279
	$	**3,486**	**$**	**(527)**	**$**	**2,959**

Income taxes payable were $388 and $10 at December 31, 2007 and 2006, respectively.

(Continued)

NOTE 9 - INCOME TAXES, Continued

The reconciliation of federal income tax rates to the effective income tax rates for each of the years in the two-year period ended December 31, 2007, is as follows:

	2007	2006
Statutory federal income tax rate	34.0%	34.0%
Increase (decrease) in tax rates resulting from:		
State and local income taxes, net of federal income tax benefit	3.1	2.1
Tax exempt income	(1.6)	(1.7)
Other, net	(0.7)	-
Effective rate	34.8%	34.4%

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities, included in other assets, at December 31, 2007 and 2006 are presented below:

	2007	2006
Deferred income tax assets:		
Loan loss reserves	$ 2,309	$ 2,039
Deferred compensation	1,472	1,317
Other	197	23
Net deferred tax assets	3,978	3,379
Deferred income tax liabilities:		
Unrealized gain on securities available for sale	(637)	(774)
Financial reporting basis of FHLB stock in excess of tax basis	(16)	(16)
Depreciable basis of fixed assets	(1,008)	(1,127)
Tax versus book basis on loans	(121)	(177)
Other	(295)	(148)
Total gross deferred income tax liabilities	(2,077)	(2,242)
Net deferred income tax asset	$ 1,901	$ 1,137

A portion of the change in the net deferred income tax asset relates to unrealized gains and losses on securities available for sale. The related deferred income tax expense of $137 has been recorded directly to stockholders' equity through accumulated other comprehensive income. The balance of the change results from the current period deferred income tax benefit of $627 which is included in income tax expense.

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

NOTE 10 - EMPLOYEE BENEFITS

The Corporation has available to its employees a benefit plan which was created by combining an existing defined contribution profit sharing plan and an employee stock ownership plan (ESOP). In addition, the Corporation added a 401(k) provision to the combined plan calling the plan a KSOP. Substantially all employees of the Corporation who work 1,000 hours per year and have attained the age of 18 are covered under the defined contribution KSOP. The Corporation may make discretionary matching contributions up to 100% of participant contributions, up to the first 6% of a participant's compensation, to the 401(k). During 2007 and 2006, the Corporation matched 25% of participant contributions, up to 6% of the participant's compensation. Participants in the 401(k) vest immediately with respect to all contributions.

The Corporation makes contributions to the ESOP portion of the plan based on management's evaluation of performance. Originally the Corporation made contributions in the form of Corporation stock, however, during 2007 and 2006 the Corporation's contributions were made in the form of cash which participants were able to invest at their own discretion in one of several plan investment options. The Corporation expenses the amount of their annual contributions to the ESOP. Participants in the ESOP vest over a seven year period; beginning after 3 years, the participant becomes 20% vested, and the vesting percentage increases 20% each year thereafter.

Approximate expenses related to these plans were as follows:

	2007	2006
401(k) plan	$ 90	$ 86
ESOP	434	403
Total	$ 524	$ 489

Common stock of the Corporation previously contributed to the ESOP has a put feature available to the ESOP participants since the stock is not "readily tradable on an established market". The put feature permits the participants to sell their common shares obtained from the ESOP to the Corporation at the fair market value of such shares. At December 31, 2007 and 2006, there were 42,851 and 44,101 shares, respectively in the ESOP.

The Corporation provides a salary continuation plan for three officers. Participants in the plan are eligible to receive an annual retirement benefit beginning at age 65 equal to a prescribed percentage of their present annual salary. Currently, such percentages range from 45% to 65%. The retirement benefit will be paid in monthly installments for fifteen years following retirement. As of December 31, 2007 and 2006, the Corporation had related accrued liabilities of approximately $3,096 and $2,839, respectively. The bank has indirectly and partially funded the retirement benefits through the purchase of life insurance. The cash surrender value of life insurance at December 31, 2007 and 2006 was $1,669 and $1,403, respectively.

NOTE 11 - STOCK OPTIONS

The Corporation has stock option agreements in which options are periodically granted to directors and employees of the Corporation, at a price equal to the fair market value of the shares at the date of grant. The option agreements vary with some having immediate vesting, while others have service requirements of up to 24 years before the options are 100% vested.

Of the granted options, 222,629 are outstanding at December 31, 2007, of which 53,355 are currently exercisable. The exercise prices for the options outstanding at December 31, 2007 range from $16.75 to $35.40 per share. The weighted average remaining contractual life of options outstanding at December 31, 2007 is approximately 7.79 years. The following is a summary of the options outstanding at December 31, 2007:

(Continued)

NOTE 11– STOCK OPTIONS, Continued

Option price		Options outstanding	Exercisable	Contractual remaining life
$	16.75	1,500	1,500	1 1/3 years
	16.75	600	600	2 years
	20.50	67,000	37,125	4 years
	25.25	16,778	-	21 years
	25.25	52,501	11,880	6 years
	30.50	2,250	2,250	7 ½ years
	35.40	82,000	-	9 ½ years
		222,629	53,355	

The following data summarizes the option activity related to the grants discussed above:

	Number of options		Average exercise price per share	
	Available for future grants	Granted options		
As of December 31, 2005	109,021	151,304	$	22.36
Granted	-	-		-
Exercised	-	(8,575)		14.29
As of December 31, 2006	109,021	142,729		22.85
Granted	(82,000)	82,000		35.40
Exercised	-	(2,100)		16.00
As of December 31, 2007	27,021	222,629		27.53

NOTE 12 - COMMITMENTS AND GUARANTEES

In the normal course of business there are outstanding commitments for extension of credit which are not reflected in the consolidated financial statements. At December 31, 2007 and 2006, pre-approved but unused lines of credit and other loan commitments were approximately $144,265 and $120,101, of which $59,784 and $56,298 related to home equity lines of credit. At December 31, 2007 and 2006, the Corporation had $1,141 and $556 in commitments to originate and to sell loans held for sale, respectively. The fair value of these commitments was not material.

Additionally, the Corporation has outstanding letters of credit, which are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. The Corporation would incur a credit loss in the event that the counterparty draws on the commitment and subsequently fails to perform under the terms of the lending agreement. The Corporation's maximum exposure to credit loss in the event of nonperformance by the counterparties for commitments on standby letters of credit is represented by the contract amount of those instruments. At December 31, 2007 and 2006 the maximum risk of potential loss under standby letters of credit was $6,054 and $3,913, respectively. At December 31, 2007, the Corporation has recorded no liability for the current carrying amount of the obligation to perform as a guarantor, as such amounts are not considered material.

(Continued)

NOTE 12 - COMMITMENTS AND GUARANTEES, Continued

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. If these commitments are drawn, the Corporation will obtain collateral if it is deemed necessary based on management's credit evaluation of the counterparty. Management believes that these commitments can be funded through normal operations.

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Corporation is required under SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* to disclose in its financial statements the fair value of all financial instruments, including assets and liabilities both on- and off-balance sheet, for which it is practicable to estimate such fair value. Fair value estimates, methods, and assumptions as of December 31, 2007 and 2006 for the Corporation are set forth below and are subject to the following limitations.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets or liabilities not considered financial instruments include deferred tax assets and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered.

The Corporation's fair value methods and assumptions are as follows:

- *Cash and due from banks, interest-bearing bank deposits, FHLB stock, accrued interest receivable, repurchase agreements, and accrued interest payable* - the carrying value is a reasonable estimate of fair value.
- *Available for sale securities* - fair value is based on available quoted market prices or quoted market prices for similar securities if a quoted market price is not available.
- *Loans held for sale* - fair value of loans held for sale is determined by outstanding commitments from investors or current investor yield requirements calculated on an aggregate loan basis.
- *Loans, net* - the carrying value for variable rate loans is a reasonable estimate of fair value due to contractual interest rates based on prime. Fair value for fixed rate loans is estimated based upon discounted future cash flows using discount rates comparable to rates currently offered for such loans.
- *Deposit accounts* - the fair value of certificates of deposit is estimated using rates currently offered for deposits of similar remaining maturities. The fair value of all other deposit account types is the amount payable on demand at year-end.

(Continued)

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS, Continued

- *Federal funds purchased* - the carrying value of the variable rate federal funds purchased is considered to approximate fair value due to the short term nature of these borrowings.

- *FHLB borrowings* - the carrying value of variable rate FHLB borrowings is considered to approximate fair value. The fair values for fixed rate borrowings are estimated based upon discounted future cash flows using discount rates comparable to rates currently charged for such borrowings.

- *Commitments to extend credit and standby letters of credit* - the large majority of the Corporation's loan commitments are at variable rates and, therefore, are subject to minimal interest rate risk exposure.

Therefore, the fair value for these financial instruments is considered to approximate the commitment amount. Based on the limitations, methods, and assumptions noted, the estimated fair values of the Corporation's financial instruments at December 31, 2007 and 2006 are as follows:

	2007		2006	
	Carrying amount	**Fair value**	**Carrying Amount**	**Fair value**
Financial assets:				
Cash and due from banks	$ 13,105	$ 13,105	$ 14,811	$ 14,811
Interest bearing bank deposits	27,824	27,824	23,202	23,202
Available for sale securities	35,187	35,187	32,471	32,471
FHLB stock	5,709	5,709	4,380	4,380
Loans held for sale	760	760	1,319	1,319
Loans, net	517,863	518,476	448,101	444,534
Accrued interest receivable	3,159	3,159	2,943	2,943
Financial liabilities:				
Deposit accounts	442,754	442,722	408,283	407,903
Federal funds purchased	10,000	10,000	-	-
FHLB borrowings	104,800	104,864	75,000	74,957
Repurchase agreements	14,822	14,822	12,518	12,518
Accrued interest payable	1,301	1,301	1,263	1,263

NOTE 14 - REGULATORY MATTERS

The Corporation and the Bank are subject to various regulatory capital requirements administered by the FDIC and the North Carolina Office of the Commissioner of Banks (the "Commissioner"). The primary source of funds for the payment of dividends by the Corporation is dividends received from the Bank. The Bank may pay dividends only out of undivided profits as determined pursuant to North Carolina General Statutes Section 53-87. At December 31, 2007, subject to FDIC capital requirement limitations, the Bank had undivided profits of approximately $14,297 which were eligible for the payment of dividends without obtaining prior approval from the Commissioner.

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

(Continued)

NOTE 14 - REGULATORY MATTERS, Continued

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2007, that the Corporation and the Bank meet all capital adequacy requirements to which it is subject.

As of December 31, 2007, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed any of the Corporation's and/or Bank's categories.

The Corporation's and Bank's required and actual capital amounts and ratios are presented in the table below.

	Actual		For capital adequacy purposes		To be well capitalized under Prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2007:						
Total capital (to risk weighted assets):						
Corporation	$ 59,549	10.7%	$ 44,446 ≥	8.0%	$ N/A ≥	
Bank	57,483	10.4%	44,360 ≥	8.0%	55,450 ≥	10.0%
Tier I capital (to risk weighted assets):						
Corporation	52,856	9.5%	22,223 ≥	4.0%	NA ≥	
Bank	51,185	9.2%	22,180 ≥	4.0%	27,725 ≥	5.0%
Tier I capital (to average assets):						
Corporation	52,856	8.9%	23,859 ≥	4.0%	NA ≥	
Bank	51,185	8.6%	23,810 ≥	4.0%	29,762 ≥	5.0%
As of December 31, 2006:						
Total capital (to risk weighted assets):						
Corporation	$ 55,900	11.3%	$39,627	8.0%	$ N/A	
Bank	52,690	10.7%	39,467 ≥	8.0%	49,334 ≥	10.0%
Tier I capital (to risk weighted assets):						
Corporation	49,438	10.0%	19,813 ≥	4.0%	N/A ≥	
Bank	47,004	9.5%	19,733 ≥	4.0%	24,667 ≥	5.0%
Tier I capital (to average assets):						
Corporation	49,438	9.4%	21,051 ≥	4.0%	N/A ≥	
Bank	47,004	8.9%	21,116 ≥	4.0%	26,395 ≥	5.0%