

Village Bank & Trust Financial Corp.  
Form 10-Q  
August 14, 2013

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
 QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2013

TRANSITION REPORT UNDER SECTION 13 OR 15(d)  
OF THE EXCHANGE ACT

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-50765

VILLAGE BANK AND TRUST FINANCIAL CORP.  
(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction of  
incorporation or organization)

16-1694602  
(I.R.S. Employer  
Identification No.)

15521 Midlothian Turnpike, Midlothian,  
Virginia  
(Address of principal executive offices)

23113  
(Zip code)

804-897-3900  
(Registrant's telephone number, including area code)

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

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

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

|  |   |
|--|---|
| Large Accelerated Filer <input type="checkbox"/>   | Accelerated Filer <input type="checkbox"/>                    |
| Non-Accelerated Filer <input type="checkbox"/> (Do not check if smaller reporting company) | Smaller Reporting Company <input checked="" type="checkbox"/> |

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

4,251,795 shares of common stock, \$4.00 par value, outstanding as of August 6, 2013

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## PART I – FINANCIAL INFORMATION

## ITEM 1 – FINANCIAL STATEMENTS

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Balance Sheets  
June 30, 2013 (Unaudited) and December 31, 2012

|   | June 30,<br>2013 | December 31,<br>2012 |
|---|------------------|----------------------|
| <b>Assets</b>   |                  |                      |
| Cash and due from banks   | \$ 11,880,261    | \$ 13,945,105        |
| Federal funds sold  | 36,085,297       | 39,185,837           |
| Total cash and cash equivalents   | 47,965,558       | 53,130,942           |
| Investment securities available for sale  | 58,066,627       | 25,154,046           |
| Loans held for sale   | 19,759,383       | 24,188,384           |
| <b>Loans</b>  |                  |                      |
| Outstandings  | 305,616,025      | 354,910,266          |
| Allowance for loan losses   | (9,609,777 )     | (10,807,827 )        |
| Deferred fees and costs   | 735,523          | 787,823              |
|   | 296,741,771      | 344,890,262          |
| Premises and equipment, net   | 23,679,346       | 25,815,342           |
| Accrued interest receivable   | 1,796,514        | 1,676,518            |
| Bank owned life insurance   | 6,671,315        | 6,575,018            |
| Other real estate owned   | 22,043,634       | 20,203,691           |
| Other assets  | 7,259,084        | 8,453,169            |
|   | \$483,983,232    | \$510,087,372        |
| <b>Liabilities and Stockholders' Equity</b>   |                  |                      |
| <b>Liabilities</b>  |                  |                      |
| <b>Deposits</b>   |                  |                      |
| Noninterest bearing demand  | \$ 60,572,546    | \$ 57,049,348        |
| Interest bearing  | 358,422,792      | 379,273,614          |
|   | 418,995,338      | 436,322,962          |
| Federal Home Loan Bank advances   | 23,000,000       | 28,000,000           |
| Long-term debt - trust preferred securities   | 8,764,000        | 8,764,000            |
| Other borrowings  | 4,425,432        | 4,851,811            |
| Accrued interest payable  | 1,033,000        | 911,635              |
| Other liabilities   | 5,674,622        | 6,272,163            |
| Total liabilities   | 461,892,392      | 485,122,571          |
| <b>Stockholders' equity</b>   |                  |                      |
| Preferred stock, \$4 par value, \$1,000 liquidation preference,<br>1,000,000 shares authorized, 14,738 shares issued and outstanding  | 58,952           | 58,952               |
| Common stock, \$4 par value - 10,000,000 shares authorized;<br>4,251,795 shares issued and outstanding at June 30, 2013<br>4,251,795 shares issued and outstanding at December 31, 2012 | 17,007,180       | 17,007,180           |

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|                                      |               |               |
|--------------------------------------|---------------|---------------|
| Additional paid-in capital           | 40,705,740    | 40,705,257    |
| Retained earnings (deficit)          | (33,538,205 ) | (33,173,525 ) |
| Common stock warrant                 | 732,479       | 732,479       |
| Discount on preferred stock          | (124,698 )    | (198,993 )    |
| Accumulated other comprehensive loss | (2,750,608 )  | (166,549 )    |
| Total stockholders' equity           | 22,090,840    | 24,964,801    |
|                                      | \$483,983,232 | \$510,087,372 |

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Operations  
Three and Six Months Ended June 30 2013 and 2012  
(Unaudited)

|   | Three Months Ended June<br>30, |             | Six Months Ended June 30, |              |
|---|--------------------------------|-------------|---------------------------|--------------|
|   | 2013                           | 2012        | 2013                      | 2012         |
| Interest income   |                                |             |                           |              |
| Loans   | \$4,622,050                    | \$5,614,263 | \$9,765,001               | \$11,513,471 |
| Investment securities   | 238,816                        | 215,196     | 426,915                   | 365,545      |
| Federal funds sold  | 27,899                         | 11,621      | 53,014                    | 32,553       |
| Total interest income   | 4,888,765                      | 5,841,080   | 10,244,930                | 11,911,569   |
| Interest expense  |                                |             |                           |              |
| Deposits  | 950,224                        | 1,245,465   | 1,992,608                 | 2,604,018    |
| Borrowed funds  | 218,952                        | 244,135     | 443,345                   | 535,121      |
| Total interest expense  | 1,169,176                      | 1,489,600   | 2,435,953                 | 3,139,139    |
| Net interest income   | 3,719,589                      | 4,351,480   | 7,808,977                 | 8,772,430    |
| Provision for loan losses                                     | -                              | 6,660,000   | 823,000                   | 8,395,000    |
| Net interest income (loss) after provision<br>for loan losses | 3,719,589                      | (2,308,520) | 6,985,977                 | 377,430      |
| Noninterest income  |                                |             |                           |              |
| Service charges and fees                                      | 633,782                        | 540,335     | 1,145,286                 | 1,047,978    |
| Gain on sale of loans   | 2,372,400                      | 2,191,229   | 4,328,117                 | 3,941,892    |
| Gain on sale of assets  | -                              | -           | 598,182                   | -            |
| Gain on sale of investment securities                         | 126,812                        | 99,470      | 216,879                   | 263,677      |
| Rental income   | 214,329                        | 182,199     | 426,959                   | 393,197      |
| Other   | 110,303                        | 121,896     | 296,608                   | 211,855      |
| Total noninterest income                                      | 3,457,626                      | 3,135,129   | 7,012,031                 | 5,858,599    |
| Noninterest expense   |                                |             |                           |              |
| Salaries and benefits   | 3,519,142                      | 3,305,869   | 6,958,550                 | 6,404,093    |
| Occupancy   | 513,237                        | 579,931     | 1,070,166                 | 1,160,800    |
| Equipment   | 179,274                        | 202,616     | 357,129                   | 407,980      |
| Supplies  | 118,310                        | 105,311     | 223,582                   | 197,213      |
| Professional and outside services                             | 637,417                        | 733,909     | 1,323,777                 | 1,369,291    |
| Advertising and marketing                                     | 79,260                         | 47,983      | 142,561                   | 124,046      |
| Expenses related to foreclosed real estate                    | 751,867                        | 677,848     | 2,274,501                 | 1,796,623    |
| Other operating expenses                                      | 789,612                        | 1,027,500   | 1,569,680                 | 2,030,721    |
| Total noninterest expense                                     | 6,588,119                      | 6,680,967   | 13,919,946                | 13,490,767   |
| Net income (loss) before income taxes                         | 589,096                        | (5,854,358) | 78,062                    | (7,254,738 ) |
| Income tax expense (benefit)                                  | -                              | 3,881,914   | -                         | 3,881,914    |

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|  |           |               |             |                |
|--|-----------|---------------|-------------|----------------|
| Net income (loss)                                      | 589,096   | (9,736,272)   | 78,062      | (11,136,652)   |
| Preferred stock dividends and amortization of discount | 221,414   | 185,449       | 442,742     | 405,898        |
| Net income (loss) available to common shareholders     | \$367,682 | \$(9,921,721) | \$(364,680) | \$(11,542,550) |
| Earnings (loss) per share, basic                       | \$0.09    | \$(2.33)      | \$(0.09)    | \$(2.72)       |
| Earnings (loss) per share, diluted                     | \$0.09    | \$(2.33)      | \$(0.09)    | \$(2.72)       |

See accompanying notes to consolidated financial statements.



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Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Changes in Comprehensive Income (Loss)  
Three and Six Months Ended June 30, 2013 and 2012  
(Unaudited)

|   | Three Months Ended June 30, |                                     |               |               |                                     |               |
|---|-----------------------------|-------------------------------------|---------------|---------------|-------------------------------------|---------------|
|   | Amount                      | 2013<br>Tax<br>Expense<br>(Benefit) | Total         | Amount        | 2012<br>Tax<br>Expense<br>(Benefit) | Total         |
| Net income (loss)   | \$589,096                   | \$-                                 | \$589,096     | \$(5,854,358) | \$3,881,914                         | \$(9,736,272) |
| Other comprehensive income (loss)                                 |                             |                                     |               |               |                                     |               |
| Unrealized holding gains (losses) arising during the period       | (3,726,023)                 | (1,266,848)                         | (2,459,175)   | 1,046,534     | 355,822                             | 690,712       |
| Reclassification adjustment for gains (losses) realized in income | (126,812 )                  | (43,116 )                           | (83,696 )     | (99,470 )     | (33,820 )                           | (65,650 )     |
| Minimum pension adjustment  | 3,250                       | 1,105                               | 2,145         | 3,250         | 1,105                               | 2,145         |
| Total other comprehensive income (loss)                           | (3,849,585)                 | (1,308,859)                         | (2,540,726)   | 950,314       | 323,107                             | 627,207       |
| Total comprehensive income (loss)                                 | \$(3,260,489)               | \$(1,308,859)                       | \$(1,951,630) | \$(4,904,044) | \$4,205,021                         | \$(9,109,065) |

|   | Six Months Ended June 30, |                                     |             |               |                                     |                |
|---|---------------------------|-------------------------------------|-------------|---------------|-------------------------------------|----------------|
|   | Amount                    | 2013<br>Tax<br>Expense<br>(Benefit) | Total       | Amount        | 2012<br>Tax<br>Expense<br>(Benefit) | Total          |
| Net income (loss)   | \$78,062                  | \$-                                 | \$78,062    | \$(7,254,738) | \$3,881,914                         | \$(11,136,652) |
| Other comprehensive income (loss)                                 |                           |                                     |             |               |                                     |                |
| Unrealized holding gains (losses) arising during the period       | (3,704,862)               | (1,259,653)                         | (2,445,209) | 665,929       | 226,416                             | 439,513        |
| Reclassification adjustment for gains (losses) realized in income | (216,879 )                | (73,739 )                           | (143,140 )  | (263,677 )    | (89,650 )                           | (174,027 )     |
| Minimum pension adjustment  | 6,500                     | 2,210                               | 4,290       | 6,500         | 2,210                               | 4,290          |
| Total other comprehensive income (loss)                           | (3,915,241)               | (1,331,182)                         | (2,584,059) | 408,752       | 138,976                             | 269,776        |

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|                                      |                |                |                |                |              |                 |
|--------------------------------------|----------------|----------------|----------------|----------------|--------------|-----------------|
| Total comprehensive<br>income (loss) | \$ (3,837,179) | \$ (1,331,182) | \$ (2,505,997) | \$ (6,845,986) | \$ 4,020,890 | \$ (10,866,876) |
|--------------------------------------|----------------|----------------|----------------|----------------|--------------|-----------------|

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Stockholders' Equity  
Six Months Ended June 30, 2013 and 2012  
(Unaudited)

|   | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings<br>(Deficit) | Warrant   | Discount<br>on<br>Preferred<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(loss) | Total        |
|---|--------------------|-----------------|----------------------------------|-----------------------------------|-----------|--------------------------------------|---|--------------|
| Balance,<br>December 31,<br>2012  | \$58,952           | \$17,007,180    | \$40,705,257                     | \$(33,173,525)                    | \$732,479 | \$(198,993)                          | \$(166,549 )  | \$24,964,801 |
| Amortization<br>of preferred<br>stock<br>discount   | -                  |                 |                                  | (74,295 )                         | -         | 74,295                               |   | -            |
| Preferred<br>stock dividend   | -                  | -               |                                  | (368,447 )                        | -         | -                                    | -   | (368,447 )   |
| Stock based<br>compensation   |                    |                 | 483                              |                                   |           |                                      |   | 483          |
| Minimum<br>pension<br>adjustment<br>(net of income<br>taxes of<br>\$2,917)  | -                  | -               | -                                | -                                 | -         | -                                    | 4,290   | 4,290        |
| Net income  | -                  | -               | -                                | 78,062                            | -         | -                                    | -   | 78,062       |
| Change in<br>unrealized<br>gain (loss) on<br>investment securities<br>available-for-sale,<br>net of<br>reclassification<br>and tax effect | -                  | -               | -                                | -                                 | -         | -                                    | (2,588,349)   | (2,588,349 ) |
| Balance, June<br>30, 2013   | \$58,952           | \$17,007,180    | \$40,705,740                     | \$(33,538,205)                    | \$732,479 | \$(124,698)                          | \$(2,750,608)   | \$22,090,840 |
| Balance,<br>December 31,<br>2011  | \$58,952           | \$16,973,512    | \$40,732,178                     | \$(21,895,557)                    | \$732,479 | \$(346,473)                          | \$(7,449 )  | \$36,247,642 |

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|  |          |              |              |   |                |           |             |              |
|--|----------|--------------|--------------|---|----------------|-----------|-------------|--------------|
| Amortization of preferred stock discount   | -        |              | (73,552)     | ) | -              | 73,552    |             | -            |
| Preferred stock dividend   | -        | -            | (332,336)    | ) | -              | -         | -           | (332,336)    |
| Issuance of common stock   | -        | 33,668       | (33,668)     | ) | -              | -         | -           | -            |
| Stock based compensation   |          |              | 5,511        |   |                |           |             | 5,511        |
| Minimum pension adjustment (net of income taxes of \$2,917)  | -        | -            | -            |   | -              | -         | 4,290       | 4,290        |
| Net loss   | -        | -            | -            |   | (11,136,652)   | -         | -           | (11,136,652) |
| Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification and tax effect | -        | -            | -            |   | -              | -         | 265,486     | 265,486      |
| Balance, June 30, 2012   | \$58,952 | \$17,007,180 | \$40,704,021 |   | \$(33,438,097) | \$732,479 | \$(272,921) | \$262,327    |
|  |          |              |              |   |                |           |             | \$25,053,941 |

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Cash Flows  
Six Months Ended June 30, 2013 and 2012  
(Unaudited)

|   | 2013          | 2012            |
|---|---------------|-----------------|
| <b>Cash Flows from Operating Activities</b>   |               |                 |
| Net income (loss)   | \$78,062      | \$(11,136,652 ) |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |               |                 |
| Depreciation and amortization   | 655,794       | 764,926         |
| Deferred income taxes   | (39,413 )     | (4,290,620 )    |
| Valuation allowance   | -             | 6,281,101       |
| Provision for loan losses   | 823,000       | 8,395,000       |
| Write-down of other real estate owned   | 645,725       | 943,560         |
| Gain on securities sold   | (216,879 )    | (263,677 )      |
| Gain on loans sold  | (4,328,117 )  | (3,941,892 )    |
| Gain on sale of premises and equipment  | (598,182 )    | -               |
| Loss on sale of other real estate owned   | 234,674       | 43,618          |
| Stock compensation expense  | 483           | 5,511           |
| Proceeds from sale of mortgage loans  | 150,969,801   | 140,739,661     |
| Origination of mortgage loans for sale  | (142,212,683) | (140,358,872)   |
| Amortization of premiums and accretion of discounts on securities, net                      | 186,752       | 130,888         |
| (Increase) decrease in interest receivable  | (119,996 )    | 136,377         |
| Increase in bank owned life insurance   | (96,297 )     | (94,030 )       |
| Decrease in other assets  | 2,571,181     | 5,901,368       |
| Increase in interest payable  | 121,365       | 111,534         |
| Decrease in other liabilities   | (965,988 )    | (4,021,113 )    |
| Net cash provided by (used in) operating activities   | 7,709,282     | (653,312 )      |
| <b>Cash Flows from Investing Activities</b>   |               |                 |
| Purchases of available for sale securities  | (52,134,093 ) | (36,395,416 )   |
| Proceeds from the sale or calls of available for sale securities                            | 15,329,897    | 28,804,399      |
| Proceeds from maturities and principal payments of available for sale securities            | -             | 1,593,068       |
| Net decrease in loans   | 42,394,400    | 14,634,257      |
| Proceeds from sale of other real estate owned   | 2,210,749     | 1,129,343       |
| Purchases of premises and equipment   | 396,760       | (224,896 )      |
| Proceeds from sale of premises and equipment  | 1,681,624     | -               |
| Net cash provided by investing activities   | 9,879,337     | 9,540,755       |
| <b>Cash Flows from Financing Activities</b>   |               |                 |
| Net decrease in deposits  | (17,327,624 ) | (35,101,144 )   |
| Net decrease in Federal Home Loan Bank Advances   | (5,000,000 )  | (8,750,000 )    |
| Net decrease in other borrowings  | (426,379 )    | (716,317 )      |
| Net cash used in financing activities   | (22,754,003 ) | (44,567,461 )   |
| Net decrease in cash and cash equivalents   | (5,165,384 )  | (35,680,018 )   |
| Cash and cash equivalents, beginning of period  | 53,130,942    | 62,786,016      |

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|  |              |              |
|--|--------------|--------------|
| Cash and cash equivalents, end of period                 | \$47,965,558 | \$27,105,998 |
| Supplemental Schedule of Non Cash Activities             |              |              |
| Real estate owned assets acquired in settlement of loans | \$4,931,091  | \$10,616,434 |
| Dividends on preferred stock accrued                     | \$364,680    | \$332,336    |

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary  
Notes to Condensed Consolidated Financial Statements  
Three and Six Months Ended June 30, 2013 and 2012  
(Unaudited)

Note 1 - Principles of presentation

Village Bank and Trust Financial Corp. (the “Company”) is the holding company of Village Bank (the “Bank”). The consolidated financial statements include the accounts of the Company, the Bank and the Bank’s three wholly-owned subsidiaries, Village Bank Mortgage Company, Village Insurance Agency, Inc., and Village Financial Services Company. All material intercompany balances and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying condensed consolidated financial statements of the Company have been prepared on the accrual basis in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, all adjustments that are, in the opinion of management, necessary for a fair presentation have been included. The results of operations for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results to be expected for the full year ending December 31, 2013. The unaudited interim financial statements should be read in conjunction with the audited financial statements and notes to financial statements that are presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission.

Note 2 - Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheets and statements of income for the period. Actual results could differ significantly from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses and the related provision.

Note 3 - Earnings (loss) per common share

The following table presents the basic and diluted earnings per share computations:

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|   | Three Months Ended June |               | Six Months Ended June 30, |                |
|---|-------------------------|---------------|---------------------------|----------------|
|   | 2013                    | 30,<br>2012   | 2013                      | 2012           |
| <b>Numerator</b>  |                         |               |                           |                |
| Net income (loss) - basic and diluted                               | \$589,096               | \$(9,736,272) | \$78,062                  | \$(11,136,652) |
| Preferred stock dividend and accretion                              | 221,414                 | 185,449       | 442,742                   | 405,898        |
| Net income (loss) available to common shareholders                  | \$367,682               | \$(9,921,721) | \$(364,680)               | \$(11,542,550) |
| <b>Denominator</b>  |                         |               |                           |                |
| Weighted average shares outstanding - basic                         | 4,251,795               | 4,250,579     | 4,251,795                 | 4,250,579      |
| Dilutive effect of common stock options and restricted stock awards | 2,292                   | -             | 2,292                     | -              |
| Weighted average shares outstanding - diluted                       | 4,254,087               | 4,250,579     | 4,254,087                 | 4,250,579      |
| <b>Earnings (loss) per share - basic and diluted</b>                |                         |               |                           |                |
| Earnings (loss) per share - basic                                   | \$0.09                  | \$(2.33)      | \$(0.09)                  | \$(2.72)       |
| Effect of dilutive common stock options                             | -                       | -             | -                         | -              |
| Earnings (loss) per share - diluted                                 | \$0.09                  | \$(2.33)      | \$(0.09)                  | \$(2.72)       |

Outstanding options and warrants to purchase common stock were considered in the computation of diluted earnings per share for the periods presented. Stock options for 247,630 shares of common stock were not included in computing diluted earnings per share for the three and six months ended June 30, 2013 and 2012 because their effects were anti-dilutive. Warrants for 499,029 shares of common stock were not included in computing earnings per share in 2013 and 2012 because their effects were also anti-dilutive.

#### Note 4 – Investment securities available for sale

At June 30, 2013 and December 31, 2012, all of our securities were classified as available-for-sale. The following table presents the composition of our investment portfolio at the dates indicated (dollars in thousands).



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|                             | Par Value | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value | Average Yield |   |
|-----------------------------|-----------|----------------|------------------------|-------------------------|----------------------|---------------|---|
| June 30, 2013               |           |                |                        |                         |                      |               |   |
| US Treasury                 |           |                |                        |                         |                      |               |   |
| Five to ten years           | \$8,000   | \$7,816        | \$-                    | \$(300)                 | \$7,516              | 2.13          | % |
|                             | 8,000     | 7,816          | -                      | (300)                   | 7,516                | 2.13          | % |
| US Government Agencies      |           |                |                        |                         |                      |               |   |
| One to Five years           | 2,000     | 2,006          | -                      | (76)                    | 1,930                | 0.81          | % |
| Five to ten years           | 31,625    | 33,838         | -                      | (2,175)                 | 31,663               | 1.74          | % |
| More than ten years         | 2,000     | 1,982          | -                      | (179)                   | 1,803                | 2.22          | % |
|                             | 35,625    | 37,826         | -                      | (2,430)                 | 35,396               | 1.71          | % |
| Mortgage-backed securities  |           |                |                        |                         |                      |               |   |
| More than ten years         | 1,201     | 1,253          | 9                      | (1)                     | 1,261                | 1.10          | % |
| Total                       | 1,201     | 1,253          | 9                      | (1)                     | 1,261                | 1.10          | % |
| Municipals                  |           |                |                        |                         |                      |               |   |
| Five to ten years           | 6,155     | 6,726          | -                      | (501)                   | 6,225                | 2.72          | % |
| More than ten years         | 6,780     | 8,476          | -                      | (807)                   | 7,669                | 3.34          | % |
| Total                       | 12,935    | 15,202         | -                      | (1,308)                 | 13,894               | 3.06          | % |
| Total investment securities | \$57,761  | \$62,098       | \$9                    | \$(4,040)               | \$58,067             | 2.08          | % |
| December 31, 2012           |           |                |                        |                         |                      |               |   |
| US Government Agencies      |           |                |                        |                         |                      |               |   |
| More than ten years         | \$10,500  | \$11,394       | \$8                    | \$(15)                  | \$11,387             | 2.27          | % |
|                             | 10,500    | 11,394         | 8                      | (15)                    | 11,387               | 2.27          | % |
| Mortgage-backed securities  |           |                |                        |                         |                      |               |   |
| More than ten years         | 1,744     | 1,830          | 1                      | (2)                     | 1,829                | 0.97          | % |
| Total                       | 1,744     | 1,830          | 1                      | (2)                     | 1,829                | 0.97          | % |
| Municipals                  |           |                |                        |                         |                      |               |   |
| One to five years           | 1,000     | 1,100          | -                      | (22)                    | 1,078                | 3.25          | % |
| Five to ten years           | 3,500     | 4,031          | -                      | (47)                    | 3,984                | 2.29          | % |
| More than ten years         | 5,280     | 6,908          | 10                     | (42)                    | 6,876                | 2.70          | % |
| Total                       | 9,780     | 12,039         | 10                     | (111)                   | 11,938               | 2.61          | % |
| Total investment securities | \$22,024  | \$25,263       | \$19                   | \$(128)                 | \$25,154             | 2.34          | % |

Investment securities available for sale that have an unrealized loss position at June 30, 2013 and December 31, 2012 are detailed below (dollars in thousands).



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|   | Securities in a loss<br>Position for less than<br>12 Months |                      | Securities in a loss<br>Position for more than<br>12 Months |                      | Total         |                      |
|---|---|----------------------|---|----------------------|---------------|----------------------|
|   | Fair<br>Value   | Unrealized<br>Losses | Fair<br>Value   | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| June 30, 2013                               |   |                      |   |                      |               |                      |
| Investment Securities<br>available for sale |   |                      |   |                      |               |                      |
| US Treasuries                               | \$41,576  | \$(2,732 )           | \$-   | \$-                  | \$41,576      | \$(2,732 )           |
| Municipals                                  | 12,848  | (1,265 )             | 1,056   | (43 )                | 13,904        | (1,308 )             |
| Mortgage-backed securities                  | 155   | (1 )                 | -   | -                    | 155           | (1 )                 |
| Total                                       | \$54,579  | \$(3,998 )           | \$1,056   | \$(43 )              | \$55,635      | \$(4,041 )           |
| December 31, 2012                           |   |                      |   |                      |               |                      |
| Investment Securities<br>available for sale |   |                      |   |                      |               |                      |
| US Treasuries                               | \$4,378   | \$(15 )              | \$-   | \$-                  | \$4,378       | \$(15 )              |
| Municipals                                  | 8,064   | (111 )               | -   | -                    | 8,064         | (111 )               |
| Mortgage-backed securities                  | 167   | (2 )                 | -   | -                    | 167           | (2 )                 |
| Total                                       | \$12,609  | \$(128 )             | \$-   | \$-                  | \$12,609      | \$(128 )             |

Management does not believe that any individual unrealized loss as of June 30, 2013 and December 31, 2012 is other than a temporary impairment. These unrealized losses are attributable to changes in interest rates. As of June 30, 2013, management does not have the intent to sell any of the securities classified as available for sale and management believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

## Note 5 – Loans and allowance for loan losses

The following table presents the composition of our loan portfolio (excluding mortgage loans held for sale) at the dates indicated (dollars in thousands).

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|  | June 30, 2013 |       | December 31, 2012 |       |   |
|--|---------------|-------|-------------------|-------|---|
|  | Amount        | %     | Amount            | %     |   |
| Construction and land development:                                       |               |       |                   |       |   |
| Residential  | \$3,834,697   | 1.25  | % \$2,845,594     | 0.80  | % |
| Commercial   | 33,465,195    | 10.95 | % 41,209,831      | 11.61 | % |
| Total construction and land development                                  | 37,299,892    | 12.20 | % 44,055,425      | 12.41 | % |
| Commercial real estate:  |               |       |                   |       |   |
| Farmland   | 2,525,434     | 0.83  | % 2,581,297       | 0.73  | % |
| Commercial real estate - owner occupied                                  | 75,115,553    | 24.58 | % 92,772,532      | 26.14 | % |
| Commercial real estate - non-owner occupied                              | 45,796,011    | 14.98 | % 54,550,817      | 15.37 | % |
| Multifamily  | 8,851,723     | 2.90  | % 7,978,389       | 2.25  | % |
| Total commercial real estate   | 132,288,721   | 43.29 | % 157,883,035     | 44.49 | % |
| Consumer real estate:  |               |       |                   |       |   |
| Home equity lines  | 22,764,443    | 7.46  | % 25,521,397      | 7.19  | % |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 72,607,945    | 23.76 | % 80,788,425      | 22.76 | % |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 8,335,001     | 2.72  | % 9,517,245       | 2.68  | % |
| Total consumer real estate   | 103,707,389   | 33.94 | % 115,827,067     | 32.63 | % |
| Commercial and industrial loans<br>(except those secured by real estate) | 29,713,239    | 9.72  | % 34,384,117      | 9.69  | % |
| Consumer and other   | 2,606,784     | 0.85  | % 2,760,622       | 0.78  | % |
| Total Loans  | 305,616,025   | 100.0 | % 354,910,266     | 100.0 | % |
| Deferred loan cost (unearned income), net                                | 735,523       |       | 787,823           |       |   |
| Less: Allowance for loan losses  | (9,609,777 )  |       | (10,807,827 )     |       |   |
|  | \$296,741,771 |       | \$344,890,262     |       |   |

The Company assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

- Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. 1-4 assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
  - Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;
- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any, and;
- Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

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The following tables provide information on the risk rating of loans at the dates indicated:

|   | June 30, 2013     |                 |                 |                 | Total<br>Loans |
|---|-------------------|-----------------|-----------------|-----------------|----------------|
|   | Risk Rated<br>1-4 | Risk Rated<br>5 | Risk Rated<br>6 | Risk Rated<br>7 |                |
| Construction and land development                                     |                   |                 |                 |                 |                |
| Residential   | \$3,357,382       | \$382,201       | \$95,114        | \$-             | \$3,834,697    |
| Commercial  | 15,159,915        | 4,567,320       | 13,737,960      | -               | 33,465,195     |
| Total construction and land development                               | 18,517,297        | 4,949,521       | 13,833,074      | -               | 37,299,892     |
| Commercial real estate:   |                   |                 |                 |                 |                |
| Farmland  | 1,512,641         |                 | 1,012,793       | -               | 2,525,434      |
| Commercial real estate - owner occupied                               | 46,416,935        | 17,809,011      | 10,889,607      | -               | 75,115,553     |
| Commercial real estate - non-owner occupied                           | 17,333,161        | 13,636,558      | 14,570,225      | 256,067         | 45,796,011     |
| Multifamily   | 5,389,777         | 1,064,366       | 2,397,580       | -               | 8,851,723      |
| Total commercial real estate  | 70,652,514        | 32,509,935      | 28,870,205      | 256,067         | 132,288,721    |
| Consumer real estate:   |                   |                 |                 |                 |                |
| Home equity lines   | 17,657,346        | 1,601,877       | 3,505,220       | -               | 22,764,443     |
| Secured by 1-4 family residential, secured by first deeds of trust    | 44,814,224        | 12,718,523      | 15,075,198      | -               | 72,607,945     |
| Secured by 1-4 family residential, secured by second deeds of trust   | 6,431,064         | 215,053         | 1,688,884       | -               | 8,335,001      |
| Total consumer real estate  | 68,902,634        | 14,535,453      | 20,269,302      | -               | 103,707,389    |
| Commercial and industrial loans (except those secured by real estate) | 21,631,565        | 2,657,891       | 5,423,783       | -               | 29,713,239     |
| Consumer and other  | 1,859,762         | 159,974         | 587,048         | -               | 2,606,784      |
| Total Loans   | \$181,563,772     | \$54,812,774    | \$68,983,412    | \$256,067       | \$305,616,025  |

## December 31, 2012

|   | December 31, 2012 |                 |                 |                 | Total<br>Loans |
|---|-------------------|-----------------|-----------------|-----------------|----------------|
|   | Risk Rated<br>1-4 | Risk Rated<br>5 | Risk Rated<br>6 | Risk Rated<br>7 |                |
| Construction and land development:          |                   |                 |                 |                 |                |
| Residential                                 | \$2,173,885       | \$671,709       | \$-             | \$-             | \$2,845,594    |
| Commercial                                  | 17,638,646        | 7,496,950       | 16,074,235      | -               | 41,209,831     |
| Total construction and land development     | 19,812,531        | 8,168,659       | 16,074,235      | -               | 44,055,425     |
| Commercial real estate:                     |                   |                 |                 |                 |                |
| Farmland                                    | 1,531,808         | -               | 1,049,489       | -               | 2,581,297      |
| Commercial real estate - owner occupied     | 63,772,277        | 19,273,229      | 9,727,026       | -               | 92,772,532     |
| Commercial real estate - non-owner occupied | 24,199,053        | 15,671,633      | 14,170,546      | 509,585         | 54,550,817     |

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|  |                   |                  |                  |               |                   |
|--|-------------------|------------------|------------------|---------------|-------------------|
| Multifamily  | 5,438,427         | 1,739,283        | 800,679          | -             | 7,978,389         |
| Total commercial real estate   | 94,941,565        | 36,684,145       | 25,747,740       | 509,585       | 157,883,035       |
| Consumer real estate:  |                   |                  |                  |               |                   |
| Home equity lines  | 20,180,206        | 2,015,248        | 3,325,943        | -             | 25,521,397        |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 49,659,724        | 11,235,261       | 19,893,440       | -             | 80,788,425        |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 7,385,394         | 342,770          | 1,789,081        | -             | 9,517,245         |
| Total consumer real estate   | 77,225,324        | 13,593,279       | 25,008,464       | -             | 115,827,067       |
| Commercial and industrial loans<br>(except those secured by real estate) | 26,712,028        | 2,590,735        | 5,081,354        | -             | 34,384,117        |
| Consumer and other   | 2,446,304         | 261,140          | 53,178           | -             | 2,760,622         |
| <br>Total Loans  | <br>\$221,137,752 | <br>\$61,297,958 | <br>\$71,964,971 | <br>\$509,585 | <br>\$354,910,266 |

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The following table presents the aging of the recorded investment in past due loans and leases as of the dates indicated:

|  | June 30, 2013          |                        |                               |                   |              |                | Recorded<br>Investment<br>><br>90<br>Days<br>and<br>Accruing |
|--|------------------------|------------------------|-------------------------------|-------------------|--------------|----------------|--|
|  | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>Than<br>90<br>Days | Total Past<br>Due | Current      | Total<br>Loans |  |
| Construction and<br>land development:  |                        |                        |                               |                   |              |                |  |
| Residential  | \$ -                   | \$ -                   | \$ -                          | \$ -              | \$ 3,834,697 | \$ 3,834,697   | \$ -   |
| Commercial   | 629,510                | -                      | -                             | 629,510           | 32,835,685   | 33,465,195     | -  |
| Total<br>construction and<br>land development  | 629,510                | -                      | -                             | 629,510           | 36,670,382   | 37,299,892     | -  |
| Commercial real<br>estate:   |                        |                        |                               |                   |              |                |  |
| Farmland   | -                      | -                      | -                             | -                 | 2,525,434    | 2,525,434      | -  |
| Commercial real<br>estate - owner<br>occupied  | 371,631                | 2,010,478              | -                             | 2,382,109         | 72,733,444   | 75,115,553     | -  |
| Commercial real<br>estate - non-owner<br>occupied  | 1,134,180              | 225,637                | -                             | 1,359,817         | 44,436,194   | 45,796,011     | -  |
| Multifamily  | -                      | -                      | -                             | -                 | 8,851,723    | 8,851,723      | -  |
| Total commercial<br>real estate  | 1,505,811              | 2,236,115              | -                             | 3,741,926         | 128,546,795  | 132,288,721    | -  |
| Consumer real<br>estate:   |                        |                        |                               |                   |              |                |  |
| Home equity lines<br>Secured by 1-4<br>family residential,<br>secured by first<br>deeds of trust | -                      | 78,334                 | -                             | 78,334            | 22,686,109   | 22,764,443     | -  |
| Secured by 1-4<br>family residential,<br>secured by second<br>deeds of trust                     | 829,190                | 719,980                | -                             | 1,549,170         | 71,058,775   | 72,607,945     | -  |
| Total consumer<br>real estate  | 231,636                | -                      | -                             | 231,636           | 8,103,365    | 8,335,001      | -  |
|  | 1,060,826              | 798,314                | -                             | 1,859,140         | 101,848,249  | 103,707,389    | -  |

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|   |                     |                     |             |                     |                       |                       |             |
|---|---------------------|---------------------|-------------|---------------------|-----------------------|-----------------------|-------------|
| Commercial and industrial loans (except those secured by real estate) | 375,181             | 2,573,786           | -           | 2,948,967           | 26,764,272            | 29,713,239            | -           |
| Consumer and other  | 243,352             | -                   | -           | 243,352             | 2,363,432             | 2,606,784             | -           |
| <b>Total Loans</b>  | <b>\$ 3,814,680</b> | <b>\$ 5,608,215</b> | <b>\$ -</b> | <b>\$ 9,422,895</b> | <b>\$ 296,193,130</b> | <b>\$ 305,616,025</b> | <b>\$ -</b> |

December 31, 2012

|   | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current      | Total Loans  | Recorded Investment > 90 Days and Accruing |
|---|---------------------|---------------------|----------------------|----------------|--------------|--------------|--|
| Construction and land development:          |                     |                     |                      |                |              |              |  |
| Residential                                 | \$ -                | \$ -                | \$ -                 | \$ -           | \$ 2,845,594 | \$ 2,845,594 | \$ -                                       |
| Commercial                                  | 76,351              | 10,709              | -                    | 87,060         | 41,122,771   | 41,209,831   | -  |
| Total construction and land development     | 76,351              | 10,709              | -                    | 87,060         | 43,968,365   | 44,055,425   | -  |
| Commercial real estate:                     |                     |                     |                      |                |              |              |  |
| Farmland                                    | -                   | -                   | -                    | -              | 2,581,297    | 2,581,297    | -  |
| Commercial real estate - owner occupied     | 708,278             | 377,563             | -                    | 1,085,841      | 91,686,691   | 92,772,532   | -  |
| Commercial real estate - non-owner occupied | 1,094,906           | 714,655             | -                    | 1,809,561      | 52,741,256   | 54,550,817   | -  |
| Multifamily                                 | -                   | -                   | -                    | -              | 7,978,389    | 7,978,389    | -  |
| Total commercial real estate                | 1,803,184           | 1,092,218           | -                    | 2,895,402      | 154,987,633  | 157,883,035  | -  |
| Consumer real estate:                       |                     |                     |                      |                |              |              |  |
| Home equity lines                           | 110,614             | 24,746              | 16,130               | 151,490        | 25,369,907   | 25,521,397   | 16,130                                     |
| Secured by 1-4 family residential,          | 645,807             | 1,507,073           | -                    | 2,152,880      | 78,635,545   | 80,788,425   | -  |



|   |              |              |            |              |                |                |            |
|---|--------------|--------------|------------|--------------|----------------|----------------|------------|
| secured by first deeds of trust                                       |              |              |            |              |                |                |            |
| Secured by 1-4 family residential, secured by second deeds of trust   | 157,816      | 50,016       | 50,000     | 257,832      | 9,259,413      | 9,517,245      | 50,000     |
| Total consumer real estate  | 914,237      | 1,581,835    | 66,130     | 2,562,202    | 113,264,865    | 115,827,067    | 66,130     |
| Commercial and industrial loans (except those secured by real estate) | 40,171       | 31,057       | 49,139     | 120,367      | 34,263,750     | 34,384,117     | 49,139     |
| Consumer and other  | 4,286        | 36,030       | -          | 40,316       | 2,720,306      | 2,760,622      | -          |
| Total Loans   | \$ 2,838,229 | \$ 2,751,849 | \$ 115,269 | \$ 5,705,347 | \$ 349,204,919 | \$ 354,910,266 | \$ 115,269 |

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Loans are considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Loans evaluated individually for impairment include non-performing loans, such as loans on non-accrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Impaired loans are set forth in the following table as of the dates indicated

|  | June 30, 2013          |                                |                      |
|--|------------------------|--------------------------------|----------------------|
|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no related allowance recorded                                       |                        |                                |                      |
| Construction and land development  |                        |                                |                      |
| Commercial   | \$5,073,644            | \$7,343,364                    | \$-                  |
| Total construction and land development                                  | 5,073,644              | 7,343,364                      | -                    |
| Commercial real estate   |                        |                                |                      |
| Farmland   | -                      | -                              | -                    |
| Commercial real estate - owner occupied                                  | 1,390,425              | 1,405,425                      | -                    |
| Commercial real estate - non-owner occupied                              | 12,477,771             | 12,675,771                     | -                    |
| Multifamily  | 3,020,236              | 3,020,236                      | -                    |
| Total commercial real estate   | 16,888,432             | 17,101,432                     | -                    |
| Consumer real estate   |                        |                                |                      |
| Home equity lines  | 1,257,335              | 1,311,999                      | -                    |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 10,333,851             | 10,909,071                     | -                    |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 1,027,833              | 1,197,490                      | -                    |
| Total consumer real estate   | 12,619,019             | 13,418,560                     | -                    |
| Commercial and industrial loans<br>(except those secured by real estate) | 608,207                | 778,641                        | -                    |
| Consumer and other   | 521,821                | 521,821                        | -                    |
|  | \$35,711,123           | \$39,163,818                   | \$-                  |
| With an allowance recorded   |                        |                                |                      |
| Construction and land development:                                       |                        |                                |                      |
| Residential  | \$-                    | \$-                            | \$-                  |
| Commercial   | 3,226,804              | 3,226,804                      | 791,657              |
| Total construction and land development                                  | 3,226,804              | 3,226,804                      | 791,657              |

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|  |              |              |             |
|--|--------------|--------------|-------------|
| Commercial real estate:  |              |              |             |
| Farmland   | 1,012,793    | 1,012,793    | 808,000     |
| Commercial real estate - owner occupied                                  | 8,338,879    | 8,477,879    | 502,963     |
| Commercial real estate - non-owner occupied                              | 2,260,044    | 2,260,044    | 136,734     |
| Multifamily  | -            | -            | -           |
| Total commercial real estate   | 11,611,716   | 11,750,716   | 1,447,697   |
| Consumer real estate:  |              |              |             |
| Home equity lines  | 264,342      | 264,342      | 35,581      |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,467,796    | 1,467,796    | 87,343      |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 136,292      | 136,292      | 35,364      |
| Total consumer real estate   | 1,868,430    | 1,868,430    | 158,288     |
| Commercial and industrial loans<br>(except those secured by real estate) | 537,032      | 537,032      | 77,577      |
| Consumer and other   | -            | -            | -           |
|  | \$17,243,982 | \$17,382,982 | \$2,475,219 |
| <br>   |              |              |             |
| Total  |              |              |             |
| Construction and land development  |              |              |             |
| Commercial   | \$8,300,448  | \$10,570,168 | \$791,657   |
| Total construction and land development                                  | 8,300,448    | 10,570,168   | 791,657     |
| Commercial real estate   |              |              |             |
| Farmland   | 1,012,793    | 1,012,793    | 808,000     |
| Commercial real estate - owner occupied                                  | 9,729,304    | 9,883,304    | 502,963     |
| Commercial real estate - non-owner occupied                              | 14,737,815   | 14,935,815   | 136,734     |
| Multifamily  | 3,020,236    | 3,020,236    | -           |
| Total commercial real estate   | 28,500,148   | 28,852,148   | 1,447,697   |
| Consumer real estate   |              |              |             |
| Home equity lines  | 1,521,677    | 1,576,341    | 35,581      |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 11,801,647   | 12,376,867   | 87,343      |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 1,164,125    | 1,333,782    | 35,364      |
| Total consumer real estate   | 14,487,449   | 15,286,990   | 158,288     |
| Commercial and industrial loans<br>(except those secured by real estate) | 1,145,239    | 1,315,673    | 77,577      |
| Consumer and other   | 521,821      | 521,821      | -           |
|  | \$52,955,105 | \$56,546,800 | \$2,475,219 |

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|  | December 31, 2012      |                                |                      |
|--|------------------------|--------------------------------|----------------------|
|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no related allowance recorded                                       |                        |                                |                      |
| Construction and land development  |                        |                                |                      |
| Commercial   | \$8,254,440            | \$13,625,670                   | \$-                  |
| Total construction and land development                                  | 8,254,440              | 13,625,670                     | -                    |
| Commercial real estate   |                        |                                |                      |
| Farmland   | 1,049,489              | 1,049,489                      | -                    |
| Commercial real estate - owner occupied                                  | 8,250,071              | 8,715,684                      | -                    |
| Commercial real estate - non-owner occupied                              | 13,777,787             | 14,124,016                     | -                    |
| Multifamily  | 2,825,274              | 2,825,274                      | -                    |
| Total commercial real estate   | 25,902,621             | 26,714,463                     | -                    |
| Consumer real estate   |                        |                                |                      |
| Home equity lines  | 1,939,020              | 1,938,005                      | -                    |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 10,686,435             | 10,928,024                     | -                    |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 601,805                | 861,158                        | -                    |
| Total consumer real estate   | 13,227,260             | 13,727,187                     | -                    |
| Commercial and industrial loans<br>(except those secured by real estate) | 858,136                | 1,421,196                      | -                    |
| Consumer and other   | 50,415                 | 50,390                         | -                    |
|  | \$48,292,872           | \$55,538,906                   | \$-                  |
|  |                        |                                |                      |
| With an allowance recorded   |                        |                                |                      |
| Construction and land development  |                        |                                |                      |
| Commercial   | \$430,828              | \$430,828                      | \$62,643             |
| Total construction and land development                                  | 430,828                | 430,828                        | 62,643               |
| Commercial real estate:  |                        |                                |                      |
| Farmland   |                        |                                |                      |
| Commercial real estate - owner occupied                                  | 2,940,647              | 3,261,584                      | 663,330              |
| Commercial real estate - non-owner occupied                              | 1,434,195              | 1,434,195                      | 508,704              |
| Multifamily  | -                      | -                              | -                    |
| Total commercial real estate   | 4,374,842              | 4,695,779                      | 1,172,034            |
| Consumer real estate:  |                        |                                |                      |
| Home equity lines  | -                      | -                              | -                    |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,155,027              | 1,155,027                      | 20,896               |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 338,345                | 386,629                        | 43,456               |
| Total consumer real estate   | 1,493,372              | 1,541,656                      | 64,352               |
| Commercial and industrial loans<br>(except those secured by real estate) | 182,840                | 182,840                        | 39,243               |
| Consumer and other   | -                      | -                              | -                    |

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|  |              |              |             |
|--|--------------|--------------|-------------|
|  | \$6,481,882  | \$6,851,103  | \$1,338,272 |
| Total  |              |              |             |
| Construction and land development  |              |              |             |
| Commercial   | \$8,685,268  | \$14,056,498 | \$62,643    |
| Total construction and land development                                  | 8,685,268    | 14,056,498   | 62,643      |
| Commercial real estate   |              |              |             |
| Farmland   | 1,049,489    | 1,049,489    | -           |
| Commercial real estate - owner occupied                                  | 11,190,718   | 11,977,268   | 663,330     |
| Commercial real estate - non-owner occupied                              | 15,211,982   | 15,558,211   | 508,704     |
| Multifamily  | 2,825,274    | 2,825,274    | -           |
| Total commercial real estate   | 30,277,463   | 31,410,242   | 1,172,034   |
| Consumer real estate   |              |              |             |
| Home equity lines  | 1,939,020    | 1,938,005    | -           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 11,841,462   | 12,083,051   | 20,896      |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 940,150      | 1,247,787    | 43,456      |
| Total consumer real estate   | 14,720,632   | 15,268,843   | 64,352      |
| Commercial and industrial loans<br>(except those secured by real estate) | 1,040,976    | 1,604,036    | 39,243      |
| Consumer and other   | 50,415       | 50,390       | -           |
|  | \$54,774,754 | \$62,390,009 | \$1,338,272 |

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The following is a summary of average recorded investment in impaired loans with and without a valuation allowance and interest income recognized on those loans for the periods indicated:

|  | For the Three Months<br>Ended June 30, 2013 |                                  | For the Six Months<br>Ended June 30, 2013 |                                  |
|--|---|----------------------------------|---|----------------------------------|
|  | Average<br>Recorded<br>Investment           | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment         | Interest<br>Income<br>Recognized |
| Impaired loans with no related allowance recorded                        |   |                                  |   |                                  |
| Construction and land development  |   |                                  |   |                                  |
| Commercial   | \$5,505,282                                 | \$45,927                         | \$5,858,854                               | \$106,102                        |
| Total construction and land development                                  | 5,505,282                                   | 45,927                           | 5,858,854                                 | 106,102                          |
| Commercial real estate   |   |                                  |   |                                  |
| Farmland   | -   | -                                | -   | -                                |
| Commercial real estate - owner occupied                                  | 1,638,681                                   | -                                | 1,895,790                                 | 48,996                           |
| Commercial real estate - non-owner occupied                              | 14,748,805                                  | 207,349                          | 14,836,748                                | 413,541                          |
| Multifamily  | 777,570                                     |                                  | 774,830                                   | 39,204                           |
| Total commercial real estate   | 17,165,056                                  | 207,349                          | 17,507,368                                | 501,741                          |
| Consumer real estate   |   |                                  |   |                                  |
| Home equity lines  | 1,632,092                                   | 22,959                           | 1,257,335                                 | 22,959                           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 10,627,341                                  | 114,279                          | 10,418,614                                | 262,208                          |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 961,906                                     | 23,632                           | 1,034,064                                 | 30,421                           |
| Total consumer real estate   | 13,221,339                                  | 160,870                          | 12,710,013                                | 315,588                          |
| Commercial and industrial loans<br>(except those secured by real estate) | 692,148                                     | 6,177                            | 664,191                                   | 15,121                           |
| Consumer and other   | 246,735                                     | 3,645                            | 523,556                                   | 4,737                            |
|  | \$36,830,560                                | \$423,968                        | \$37,263,982                              | \$943,289                        |
| Impaired loans with an allowance recorded                                |   |                                  |   |                                  |
| Construction and land development:                                       |   |                                  |   |                                  |
| Commercial   | \$2,023,323                                 | \$50,476                         | \$3,276,859                               | \$52,104                         |
| Total construction and land development                                  | 2,023,323                                   | 50,476                           | 3,276,859                                 | 52,104                           |
| Commercial real estate:  |   |                                  |   |                                  |
| Farmland   | 694,138                                     | -                                | 1,044,218                                 | 1,100                            |
| Commercial real estate - owner occupied                                  | 7,315,545                                   | 156,177                          | 8,023,436                                 | 255,844                          |
| Commercial real estate - non-owner occupied                              | 1,782,966                                   | 59,713                           | 2,260,044                                 | 59,713                           |
| Total commercial real estate   | 9,792,649                                   | 215,890                          | 11,327,698                                | 316,657                          |
| Consumer real estate:  |   |                                  |   |                                  |
| Home equity lines  | 269,450                                     | -                                | 269,450                                   | 6,792                            |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,482,544                                   | 7,938                            | 1,482,496                                 | 14,014                           |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 44,443                                      | 4,261                            | 136,292                                   | 4,261                            |

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|  |              |           |              |             |
|--|--------------|-----------|--------------|-------------|
| Total consumer real estate   | 1,796,437    | 12,199    | 1,888,238    | 25,067      |
| Commercial and industrial loans<br>(except those secured by real estate) | 98,288       | 2,947     | 159,142      | 4,237       |
|  | \$13,710,697 | \$281,512 | \$16,651,937 | \$398,065   |
| Total  |              |           |              |             |
| Construction and land development  |              |           |              |             |
| Commercial   | \$7,528,605  | \$96,403  | \$9,135,713  | \$158,206   |
| Total construction and land development                                  | 7,528,605    | 96,403    | 9,135,713    | 158,206     |
| Commercial real estate   |              |           |              |             |
| Farmland   | 694,138      | -         | 1,044,218    | 1,100       |
| Commercial real estate - owner occupied                                  | 8,954,226    | 156,177   | 9,919,226    | 304,840     |
| Commercial real estate - non-owner occupied                              | 16,531,771   | 267,062   | 17,096,792   | 473,254     |
| Multifamily  | 777,570      | -         | 774,830      | 39,204      |
| Total commercial real estate   | 26,957,705   | 423,239   | 28,835,066   | 818,398     |
| Consumer real estate   |              |           |              |             |
| Home equity lines  | 1,901,542    | 22,959    | 1,526,785    | 29,751      |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 12,109,885   | 122,217   | 11,901,110   | 276,222     |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 1,006,349    | 27,893    | 1,170,356    | 34,682      |
| Total consumer real estate   | 15,017,776   | 173,069   | 14,598,251   | 340,655     |
| Commercial and industrial loans<br>(except those secured by real estate) | 790,436      | 9,124     | 823,333      | 19,358      |
| Consumer and other   | 246,735      | 3,645     | 523,556      | 4,737       |
|  | \$50,541,257 | \$705,480 | \$53,915,919 | \$1,341,354 |

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|  | For the Three Months<br>Ended June 30, 2012 |                                  | For the Six Months<br>Ended June 30, 2012 |                                  |
|--|---|----------------------------------|---|----------------------------------|
|  | Average<br>Recorded<br>Investment           | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment         | Interest<br>Income<br>Recognized |
| Impaired loans with no related allowance recorded                        |   |                                  |   |                                  |
| Construction and land development  |   |                                  |   |                                  |
| Residential  | \$1,301,243                                 | \$7,401                          | \$978,503                                 | \$11,741                         |
| Commercial   | 17,785,898                                  | 55,716                           | 21,838,440                                | 181,033                          |
| Total construction and land development                                  | 19,087,141                                  | 63,117                           | 22,816,943                                | 192,774                          |
| Commercial real estate   |   |                                  |   |                                  |
| Farmland   | 524,745                                     | 15,405                           | 1,049,489                                 | 15,405                           |
| Commercial real estate - owner occupied                                  | 9,571,973                                   | 73,330                           | 9,609,792                                 | 225,959                          |
| Commercial real estate - non-owner occupied                              | 8,599,009                                   | 110,449                          | 9,118,068                                 | 240,093                          |
| Multifamily  | 777,933                                     | 27,298                           | 942,216                                   | 27,298                           |
| Total commercial real estate   | 19,473,660                                  | 226,482                          | 20,719,565                                | 508,755                          |
| Consumer real estate   |   |                                  |   |                                  |
| Home equity lines  | 1,639,963                                   | 27,955                           | 1,887,350                                 | 32,979                           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 11,593,774                                  | 125,304                          | 13,101,708                                | 230,755                          |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 754,922                                     | 10,430                           | 1,021,578                                 | 18,112                           |
| Total consumer real estate   | 13,988,659                                  | 163,689                          | 16,010,636                                | 281,846                          |
| Commercial and industrial loans<br>(except those secured by real estate) |   |                                  |   |                                  |
| Consumer and other   | 1,524,274                                   | 13,297                           | 1,792,752                                 | 21,909                           |
|  | 199,919                                     | 445                              | 38,578                                    | 1,093                            |
|  | \$54,273,653                                | \$467,030                        | \$61,378,474                              | \$1,006,377                      |
| Impaired loans with an allowance recorded                                |   |                                  |   |                                  |
| Construction and land development:                                       |   |                                  |   |                                  |
| Commercial   | \$5,092,484                                 | \$9,016                          | \$9,656,982                               | \$9,016                          |
| Total construction and land development                                  | 5,092,484                                   | 9,016                            | 9,656,982                                 | 9,016                            |
| Commercial real estate:  |   |                                  |   |                                  |
| Farmland   |   |                                  |   |                                  |
| Commercial real estate - owner occupied                                  | 6,864,617                                   | 31,174                           | 7,438,497                                 | 46,386                           |
| Commercial real estate - non-owner occupied                              | 3,406,420                                   | 21,158                           | 5,043,459                                 | 35,586                           |
| Multifamily  | -   | -                                | -   | -                                |
| Total commercial real estate   | 10,271,037                                  | 52,332                           | 12,481,956                                | 81,972                           |
| Consumer real estate:  |   |                                  |   |                                  |
| Home equity lines  | 434,976                                     | 3,995                            | 472,476                                   | 4,151                            |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 3,555,198                                   | 27,332                           | 4,656,755                                 | 44,009                           |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 58,710                                      | 508                              | 117,420                                   | 1,684                            |



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|  |              |           |              |             |
|--|--------------|-----------|--------------|-------------|
| Total consumer real estate   | 4,048,884    | 31,835    | 5,246,651    | 49,844      |
| Commercial and industrial loans<br>(except those secured by real estate) | 1,873,540    | 25,072    | 1,873,540    | 32,588      |
| Consumer and other   | -            | -         | -            | -           |
|  | \$21,285,945 | \$118,255 | \$29,259,129 | \$173,420   |
| Total  |              |           |              |             |
| Construction and land development  |              |           |              |             |
| Residential  | \$1,301,243  | \$7,401   | \$978,503    | \$11,741    |
| Commercial   | 22,878,382   | 64,732    | 31,495,422   | 190,049     |
| Total construction and land development                                  | 24,179,625   | 72,133    | 32,473,925   | 201,790     |
| Commercial real estate   |              |           |              |             |
| Farmland   | 524,745      | 15,405    | 1,049,489    | 15,405      |
| Commercial real estate - owner occupied                                  | 16,436,590   | 104,504   | 17,048,289   | 272,345     |
| Commercial real estate - non-owner occupied                              | 12,005,429   | 131,607   | 14,161,527   | 275,679     |
| Multifamily  | 777,933      | 27,298    | 942,216      | 27,298      |
| Total commercial real estate   | 29,744,697   | 278,814   | 33,201,521   | 590,727     |
| Consumer real estate   |              |           |              |             |
| Home equity lines  | 2,074,939    | 31,950    | 2,359,826    | 37,130      |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 15,148,972   | 152,636   | 17,758,463   | 274,764     |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 813,632      | 10,938    | 1,138,998    | 19,796      |
| Total consumer real estate   | 18,037,543   | 195,524   | 21,257,287   | 331,690     |
| Commercial and industrial loans<br>(except those secured by real estate) | 3,397,814    | 38,369    | 3,666,292    | 54,497      |
| Consumer and other   | 199,919      | 445       | 38,578       | 1,093       |
|  | \$75,559,598 | \$585,285 | \$90,637,603 | \$1,179,797 |

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Included in impaired loans are loans classified as troubled debt restructurings (TDRs). A modification of a loan's terms constitutes a TDR if the creditor grants a concession to the borrower for economic or legal reasons related to the borrower's financial difficulties that it would not otherwise consider. For loans classified as impaired TDRs, the Company further evaluates the loans as performing or nonperforming. If, at the time of restructure, the loan is not considered nonaccrual, it will be classified as performing. TDRs originally classified as nonperforming are able to be reclassified as performing if, subsequent to restructure, they experience six months of payment performance according to the restructured terms. The following is a summary of performing and nonaccrual TDRs and the related specific valuation allowance by portfolio segment as of the dates indicated:

|  | Three Months Ended June 30, 2013 |             |             | Specific<br>Valuation<br>Allowance |
|--|----------------------------------|-------------|-------------|------------------------------------|
|  | Total                            | Performing  | Nonaccrual  |                                    |
| Construction and land development  |                                  |             |             |                                    |
| Commercial   | \$2,820,664                      | \$1,756,914 | \$1,063,750 | \$527,484                          |
| Total construction and land development                                  | 2,820,664                        | 1,756,914   | 1,063,750   | 527,484                            |
| Commercial and industrial loans<br>(except those secured by real estate) | 382,545                          | -           | 382,545     | 36,764                             |
|  | \$3,203,209                      | \$1,756,914 | \$1,446,295 | \$564,248                          |

|  | Six Months Ended June 30, 2013 |              |             | Specific<br>Valuation<br>Allowance |
|--|--------------------------------|--------------|-------------|------------------------------------|
|  | Total                          | Performing   | Nonaccrual  |                                    |
| Construction and land development  |                                |              |             |                                    |
| Commercial   | \$6,231,352                    | \$4,324,695  | \$1,906,657 | \$582,084                          |
| Total construction and land development                                  | 6,231,352                      | 4,324,695    | 1,906,657   | 582,084                            |
| Commercial real estate   |                                |              |             |                                    |
| Commercial real estate - owner occupied                                  | 7,627,826                      | 7,161,572    | 466,254     | 362,445                            |
| Commercial real estate - non-owner occupied                              | 13,806,504                     | 12,644,373   | 1,162,131   | 136,734                            |
| Multifamily  | 3,020,236                      | 3,020,236    | -           | -                                  |
| Total commercial real estate   | 24,454,566                     | 22,826,181   | 1,628,385   | 499,179                            |
| Consumer real estate   |                                |              |             |                                    |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 7,205,569                      | 3,648,382    | 3,557,187   | 49,610                             |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 349,192                        | 349,192      | -           | -                                  |
| Total consumer real estate   | 7,554,761                      | 3,997,574    | 3,557,187   | 49,610                             |
| Commercial and industrial loans<br>(except those secured by real estate) | 644,047                        | 122,848      | 521,199     | 40,904                             |
|  | \$38,884,726                   | \$31,271,298 | \$7,613,428 | \$1,171,777                        |

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|  | December 31, 2012 |              |             | Specific<br>Valuation<br>Allowance |
|--|-------------------|--------------|-------------|------------------------------------|
|  | Total             | Performing   | Nonaccrual  |                                    |
| Construction and land development  |                   |              |             |                                    |
| Commercial   | \$6,116,248       | \$3,728,403  | \$2,387,845 | \$-                                |
| Total construction and land development                                  | 6,116,248         | 3,728,403    | 2,387,845   | -                                  |
| Commercial real estate   |                   |              |             |                                    |
| Commercial real estate - owner occupied                                  | 8,881,257         | 6,373,122    | 2,508,135   | 3,321                              |
| Commercial real estate - non-owner occupied                              | 13,266,992        | 12,805,727   | 461,265     | -                                  |
| Multifamily  | 2,825,274         | 2,825,274    | -           | -                                  |
| Total commercial real estate   | 24,973,523        | 22,004,123   | 2,969,400   | 3,321                              |
| Consumer real estate   |                   |              |             |                                    |
| Home equity lines  | -                 | -            | -           | -                                  |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 7,011,329         | 3,431,124    | 3,580,205   | 15,633                             |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 338,344           | -            | 338,344     | 43,456                             |
| Total consumer real estate   | 7,349,673         | 3,431,124    | 3,918,549   | 59,089                             |
| Commercial and industrial loans<br>(except those secured by real estate) | 380,427           | 5,803        | 374,624     | 39,243                             |
| Total  | \$38,819,871      | \$29,169,453 | \$9,650,418 | \$101,653                          |

The following table provides information about TDRs identified during the indicated periods:

|  | Three Months Ended<br>June 30, 2013 |   |  |
|--|-------------------------------------|---|--|
|  | Number of<br>Loans                  | Pre-<br>Modification<br>Recorded<br>Balance | Post-<br>Modification<br>Recorded<br>Balance |
| Construction and land development  |                                     |   |  |
| Commercial   | 5                                   | \$ 2,820,664                                | \$ 2,820,664                                 |
| Total construction and land development                                  | 5                                   | 2,820,664                                   | 2,820,664                                    |
| Commercial and industrial loans<br>(except those secured by real estate) | 1                                   | 382,545                                     | 382,545                                      |
| Consumer and other   | -                                   | -   | -  |
|  | 6                                   | \$ 3,203,209                                | \$ 3,203,209                                 |

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|   | Number of<br>Loans | Three Months Ended<br>June 30, 2012         |  |
|---|--------------------|---|--|
|   |                    | Pre-<br>Modification<br>Recorded<br>Balance | Post-<br>Modification<br>Recorded<br>Balance |
| Construction and land development                                   |                    |   |  |
| Commercial  | 4                  | \$ 625,764                                  | \$ 625,764                                   |
| Total construction and land development                             | 4                  | 625,764                                     | 625,764                                      |
| Commercial real estate:   |                    |   |  |
| Farmland  |                    | -   | -  |
| Commercial real estate - owner occupied                             | 1                  | 1,398,661                                   | 1,398,661                                    |
| Commercial real estate - non-owner occupied                         | 1                  | 2,626,306                                   | 2,626,306                                    |
| Multifamily   | -                  | -   | -  |
| Total commercial real estate  | 2                  | 4,024,967                                   | 4,024,967                                    |
| Consumer real estate  |                    |   |  |
| Secured by 1-4 family residential, secured by first deeds of trust  | 2                  | 416,598                                     | 416,598                                      |
| Secured by 1-4 family residential, secured by second deeds of trust | -                  | -   | -  |
| Total consumer real estate  | 2                  | 416,598                                     | 416,598                                      |
|   | 8                  | \$ 5,067,329                                | \$ 5,067,329                                 |

There were no TDRs in default identified for the three month period ended June 30, 2013 and June 30, 2012.

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|   | Six Months Ended<br>June 30, 2012 |   |  |
|---|-----------------------------------|---|--|
|   | Number of<br>Loans                | Pre-<br>Modification<br>Recorded<br>Balance | Post-<br>Modification<br>Recorded<br>Balance |
| Construction and land development                                     |                                   |   |  |
| Residential   | 5                                 | \$ 360,343                                  | \$ 360,343                                   |
| Commercial  | 17                                | 4,890,578                                   | 4,890,578                                    |
| Total construction and land development                               | 22                                | 5,250,921                                   | 5,250,921                                    |
| Commercial real estate  |                                   |   |  |
| Commercial real estate - non-owner occupied                           | 3                                 | 5,185,649                                   | 5,185,649                                    |
| Multifamily   | -                                 | -   | -  |
| Total commercial real estate  | 3                                 | 5,185,649                                   | 5,185,649                                    |
| Consumer real estate  |                                   |   |  |
| Home equity lines   | 1                                 | 349,192                                     | 349,192                                      |
| Secured by 1-4 family residential, secured by first deeds of trust    | 36                                | 3,578,561                                   | 3,578,561                                    |
| Secured by 1-4 family residential, secured by second deeds of trust   | 1                                 | 69,815                                      | 69,815                                       |
| Total consumer real estate  | 38                                | 3,997,568                                   | 3,997,568                                    |
| Commercial and industrial loans (except those secured by real estate) | 6                                 | 269,659                                     | 269,659                                      |
|   | 69                                | \$ 14,703,797                               | \$ 14,703,797                                |

|   | Six Months Ended<br>June 30, 2012 |                     |
|---|-----------------------------------|---------------------|
|   | Number of<br>Loans                | Recorded<br>Balance |
| Defaults on TDRs  |                                   |                     |
| Construction and land development                                     |                                   |                     |
| Residential   | 4                                 | 357,843             |
| Commercial  | 18                                | 6,295,206           |
| Total construction and land development                               | 22                                | 6,653,049           |
| Commercial real estate  |                                   |                     |
| Commercial real estate - owner occupied                               | 3                                 | 537,029             |
| Commercial real estate - non-owner occupied                           | 1                                 | 1,200,035           |
| Multifamily   | 4                                 | 1,737,064           |
| Total commercial real estate  |                                   |                     |
| Consumer real estate  |                                   |                     |
| Home equity lines   | 1                                 | 343,937             |
| Secured by 1-4 family residential, secured by first deeds of trust    | 31                                | 3,910,895           |
| Secured by 1-4 family residential, secured by second deeds of trust   | 1                                 | 69,815              |
| Total consumer real estate  | 33                                | 4,324,647           |
| Commercial and industrial loans (except those secured by real estate) | 5                                 | 263,107             |
| Total   | 64                                | \$ 12,977,867       |

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|   | Six Months Ended<br>June 30, 2013 |   |  | Year Ended<br>December 31, 2012 |   |  |
|---|-----------------------------------|---|--|---------------------------------|---|--|
|   | Number<br>of<br>Loans             | Pre-<br>Modification<br>Recorded<br>Balance | Post-<br>Modification<br>Recorded<br>Balance | Number<br>of<br>Loans           | Pre-<br>Modification<br>Recorded<br>Balance | Post-<br>Modification<br>Recorded<br>Balance |
| Construction and land development                                     |                                   |   |  |                                 |   |  |
| Commercial  | 6                                 | \$ 3,025,165                                | \$ 3,025,165                                 | 6                               | \$ 653,612                                  | \$ 653,612                                   |
| Total construction and land development                               | 6                                 | 3,025,165                                   | 3,025,165                                    | 6                               | \$ 653,612                                  | 653,612                                      |
| Commercial real estate  |                                   |   |  |                                 |   | -  |
| Farmland  |                                   | -   | -  |                                 |   | -  |
| Commercial real estate - owner occupied                               | 4                                 | 274,353                                     | 274,353                                      | 1                               | 522,715                                     | 522,715                                      |
| Commercial real estate - non-owner occupied                           | -                                 | -   | -  | 6                               | 2,102,231                                   | 2,102,231                                    |
| Total commercial real estate  | 4                                 | 274,353                                     | 274,353                                      | 7                               | 2,624,946                                   | 2,624,946                                    |
| Consumer real estate  |                                   |   |  |                                 |   |  |
| Secured by 1-4 family residential, secured by first deeds of trust    | 4                                 | 435,131                                     | 435,131                                      | 25                              | 5,570,245                                   | 5,570,245                                    |
| Secured by 1-4 family residential, secured by second deeds of trust   | -                                 | -   | -  | 1                               | 338,344                                     | 338,344                                      |
| Total consumer real estate  | 4                                 | 435,131                                     | 435,131                                      | 26                              | 5,908,589                                   | 5,908,589                                    |
| Commercial and industrial loans (except those secured by real estate) | 1                                 | 382,545                                     | 382,545                                      | 1                               | 117,813                                     | 117,813                                      |
| Total   | 15                                | 4,117,194                                   | 4,117,194                                    | 40                              | 9,304,960                                   | 9,304,960                                    |

|   | Six Months Ended<br>June 30, 2013 |                     | Year Ended<br>December 31, 2012 |                     |
|---|-----------------------------------|---------------------|---------------------------------|---------------------|
|   | Number<br>of<br>Loans             | Recorded<br>Balance | Number<br>of<br>Loans           | Recorded<br>Balance |
| Defaults on TDRs                        |                                   |                     |                                 |                     |
| Construction and land development       |                                   |                     |                                 |                     |
| Commercial                              | -                                 | \$ -                | 8                               | \$ 2,387,845        |
| Total construction and land development | -                                 | -                   | 8                               | 2,387,845           |
| Commercial real estate                  |                                   |                     |                                 |                     |
| Commercial real estate - owner occupied | 1                                 | 597,890             | 2                               | 2,053,276           |

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|  |   |              |    |              |
|--|---|--------------|----|--------------|
| Commercial real estate -<br>non-owner occupied                                 | - | -            | 1  | 461,265      |
| Multifamily  | 1 | 597,890      | 3  | 2,514,541    |
| Total commercial real estate   |   |              |    |              |
| Consumer real estate   |   |              |    |              |
| Secured by 1-4 family<br>residential,<br>secured by first deeds of trust       | 3 | 1,212,515    | 8  | 3,302,827    |
| Secured by 1-4 family<br>residential,<br>secured by second deeds of<br>trust   | - | -            | 1  | 338,344      |
| Total consumer real estate   | 3 | 1,212,515    | 9  | 3,641,171    |
| Commercial and industrial<br>loans<br>(except those secured by real<br>estate) | - | -            | 4  | 257,136      |
| Total  | 4 | \$ 1,810,405 | 24 | \$ 8,800,693 |

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Activity in the allowance for loan losses is as follows for the periods indicated:

|  | Allowance for Loan Losses |                                    |                      |                  | Ending<br>Balance  |
|--|---------------------------|------------------------------------|----------------------|------------------|--------------------|
|  | Beginning<br>Balance      | Provision<br>for<br>Loan<br>Losses | Charge-offs          | Recoveries       |                    |
| Three Months Ended June 30, 2013   |                           |                                    |                      |                  |                    |
| Construction and land development  |                           |                                    |                      |                  |                    |
| Residential  | \$495,192                 | \$-                                | \$-                  | \$100,450        | \$595,642          |
| Commercial   | 4,542,126                 | -                                  | (11,051 )            | 246,458          | 4,777,533          |
| Commercial real estate   |                           |                                    |                      |                  |                    |
| Farmland   | 808,000                   | -                                  | -                    | -                | 808,000            |
| Commercial real estate - owner occupied                                  | 1,222,485                 | -                                  | (139,000 )           | 42,649           | 1,126,134          |
| Commercial real estate - non-owner<br>occupied                           | 560,784                   | -                                  | (253,517 )           | -                | 307,267            |
| Multifamily  | 23,434                    | -                                  | -                    | -                | 23,434             |
| Consumer real estate   |                           |                                    |                      |                  |                    |
| Home equity lines  | 603,678                   | -                                  | (189,007 )           | -                | 414,671            |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,022,995                 | -                                  | (531,861 )           | 13,008           | 504,142            |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 11,622                    | -                                  | -                    | 2,246            | 13,868             |
| Commercial and industrial loans<br>(except those secured by real estate) | 929,199                   | -                                  | (62,412 )            | 79,627           | 946,414            |
| Consumer and other   | 100,450                   | -                                  | (10,466 )            | 2,688            | 92,672             |
| <b>Total</b>   | <b>\$10,319,965</b>       | <b>\$-</b>                         | <b>\$(1,197,314)</b> | <b>\$487,126</b> | <b>\$9,609,777</b> |
| Three Months Ended June 30, 2012   |                           |                                    |                      |                  |                    |
| Construction and land development  |                           |                                    |                      |                  |                    |
| Residential  | \$629,376                 | \$705,264                          | \$(735,536 )         | \$450            | \$599,554          |
| Commercial   | 6,279,552                 | 508,283                            | (2,226,005 )         | 500              | 4,562,330          |
| Commercial real estate   |                           |                                    |                      |                  |                    |
| Farmland   | -                         | -                                  | -                    | -                | -                  |
| Commercial real estate - owner occupied                                  | 1,846,730                 | 954,663                            | (280,486 )           | -                | 2,520,907          |
| Commercial real estate - non-owner<br>occupied                           | 762,385                   | 860,313                            | (222,605 )           | -                | 1,400,093          |
| Multifamily  | 91,775                    | 953                                | -                    | -                | 92,728             |
| Consumer real estate   |                           |                                    |                      |                  |                    |
| Home equity lines  | 770,598                   | 174,830                            | (169,321 )           | 626              | 776,733            |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,341,501                 | 2,301,071                          | (1,623,629 )         | 20,004           | 2,038,947          |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 335,352                   | 41,730                             | (5,970 )             | 4,440            | 375,552            |
| Commercial and industrial loans<br>(except those secured by real estate) | 2,181,803                 | 951,701                            | (895,380 )           | 107,121          | 2,345,245          |
| Consumer and other   | 122,881                   | 161,192                            | (132,510 )           | 2,070            | 153,633            |



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|       |              |             |               |           |              |
|-------|--------------|-------------|---------------|-----------|--------------|
| Total | \$14,361,953 | \$6,660,000 | \$(6,291,442) | \$135,211 | \$14,865,722 |
|-------|--------------|-------------|---------------|-----------|--------------|

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|  | Beginning<br>Balance | Allowance for Loan Losses          |               |            | Ending<br>Balance |
|--|----------------------|------------------------------------|---------------|------------|-------------------|
|  |                      | Provision<br>for<br>Loan<br>Losses | Charge-offs   | Recoveries |                   |
| Six Months Ended June 30, 2013   |                      |                                    |               |            |                   |
| Construction and land development  |                      |                                    |               |            |                   |
| Residential  | \$494,742            | \$-                                | \$-           | \$100,900  | \$595,642         |
| Commercial   | 4,611,410            | 15,000                             | (95,335 )     | 246,458    | 4,777,533         |
| Commercial real estate   |                      |                                    |               |            |                   |
| Farmland   | -                    | 808,000                            | -             | -          | 808,000           |
| Commercial real estate - owner occupied                                  | 1,358,863            | -                                  | (275,379 )    | 42,650     | 1,126,134         |
| Commercial real estate - non-owner occupied                              | 816,852              | -                                  | (509,585 )    | -          | 307,267           |
| Multifamily  | 23,434               | -                                  | -             | -          | 23,434            |
| Consumer real estate   |                      |                                    |               |            |                   |
| Home equity lines  | 658,135              | -                                  | (243,664 )    | 200        | 414,671           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,358,102            | -                                  | (874,994 )    | 21,034     | 504,142           |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 223,307              | -                                  | (214,720 )    | 5,281      | 13,868            |
| Commercial and industrial loans<br>(except those secured by real estate) | 1,161,654            | -                                  | (351,243 )    | 136,003    | 946,414           |
| Consumer and other   | 101,328              | -                                  | (14,229 )     | 5,573      | 92,672            |
| Total  | \$10,807,827         | \$823,000                          | \$(2,579,149) | \$558,099  | \$9,609,777       |
| Six Months Ended June 30, 2012   |                      |                                    |               |            |                   |
| Construction and land development  |                      |                                    |               |            |                   |
| Residential  | \$704,728            | \$688,712                          | \$(794,786 )  | \$900      | \$599,554         |
| Commercial   | 6,798,177            | 1,536,857                          | (3,773,205 )  | 501        | 4,562,330         |
| Commercial real estate   |                      |                                    |               |            |                   |
| Farmland   | -                    | -                                  | -             | -          | -                 |
| Commercial real estate - owner occupied                                  | 1,496,466            | 1,333,927                          | (309,486 )    | -          | 2,520,907         |
| Commercial real estate - non-owner occupied                              | 1,548,899            | 164,343                            | (313,354 )    | 205        | 1,400,093         |
| Multifamily  | 406,635              | (313,907 )                         | -             | -          | 92,728            |
| Consumer real estate   |                      |                                    |               |            |                   |
| Home equity lines  | 860,307              | 206,929                            | (291,820 )    | 1,317      | 776,733           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,881,470            | 2,666,051                          | (2,589,378)   | 80,804     | 2,038,947         |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 397,504              | 170,024                            | (196,609 )    | 4,633      | 375,552           |
| Commercial and industrial loans<br>(except those secured by real estate) | 1,655,713            | 1,710,826                          | (1,155,782)   | 134,488    | 2,345,245         |
| Consumer and other   | 321,525              | 231,238                            | (402,305 )    | 3,175      | 153,633           |
| Total  | \$16,071,424         | \$8,395,000                        | \$(9,826,725) | \$226,023  | \$14,865,722      |



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|  | Beginning<br>Balance | Allowance for Loan Losses          |                |            | Ending<br>Balance |
|--|----------------------|------------------------------------|----------------|------------|-------------------|
|  |                      | Provision<br>for<br>Loan<br>Losses | Charge-offs    | Recoveries |                   |
| Year Ended December 31, 2012   |                      |                                    |                |            |                   |
| Construction and land development  |                      |                                    |                |            |                   |
| Residential  | \$704,728            | \$542,067                          | \$(797,286 )   | \$45,233   | \$494,742         |
| Commercial   | 6,798,177            | 3,444,160                          | (5,645,064 )   | 14,137     | 4,611,410         |
| Commercial real estate   |                      |                                    |                |            |                   |
| Farmland   | -                    | -                                  | -              | -          | -                 |
| Commercial real estate - owner occupied                                  | 1,496,466            | 623,552                            | (961,155 )     | 200,000    | 1,358,863         |
| Commercial real estate - non-owner<br>occupied                           | 1,548,899            | (300,898 )                         | (431,354 )     | 205        | 816,852           |
| Multifamily  | 406,635              | (373,238 )                         | (9,963 )       | -          | 23,434            |
| Consumer real estate   |                      |                                    |                |            |                   |
| Home equity lines  | 860,307              | 668,614                            | (883,848 )     | 13,062     | 658,135           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 1,881,470            | 2,610,905                          | (3,220,072 )   | 85,799     | 1,358,102         |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 397,504              | 468,192                            | (663,135 )     | 20,746     | 223,307           |
| Commercial and industrial loans<br>(except those secured by real estate) | 1,655,713            | 1,230,555                          | (1,879,517 )   | 154,903    | 1,161,654         |
| Consumer and other   | 321,525              | 181,091                            | (408,302 )     | 7,014      | 101,328           |
| Total  | \$16,071,424         | \$9,095,000                        | \$(14,899,696) | \$541,099  | \$10,807,827      |

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Loans were evaluated for impairment as follows for the periods indicated:

|  | Loans Evaluated for Impairment |                      |                      |
|--|--------------------------------|----------------------|----------------------|
|  | Individually                   | Collectively         | Total                |
| <b>Six Months Ended June 30, 2013</b>                                    |                                |                      |                      |
| Construction and land development  |                                |                      |                      |
| Residential  | \$576,000                      | \$3,258,697          | \$3,834,697          |
| Commercial   | 21,446,891                     | 12,018,304           | 33,465,195           |
| Commercial real estate   |                                |                      |                      |
| Farmland   | 1,347,677                      | 1,177,757            | 2,525,434            |
| Commercial real estate - owner occupied                                  | 51,852,533                     | 23,263,020           | 75,115,553           |
| Commercial real estate - non-owner occupied                              | 34,585,239                     | 11,210,772           | 45,796,011           |
| Multifamily  | 6,684,151                      | 2,167,572            | 8,851,723            |
| Consumer real estate   |                                |                      |                      |
| Home equity lines  | 1,968,634                      | 20,795,809           | 22,764,443           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 12,419,966                     | 60,187,979           | 72,607,945           |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 545,416                        | 7,789,585            | 8,335,001            |
| Commercial and industrial loans<br>(except those secured by real estate) | 12,177,424                     | 17,535,815           | 29,713,239           |
| Consumer and other   | -                              | 2,606,784            | 2,606,784            |
| <b>Total</b>   | <b>\$143,603,931</b>           | <b>\$162,012,094</b> | <b>\$305,616,025</b> |
| <b>Year Ended December 31, 2012</b>                                      |                                |                      |                      |
| Construction and land development  |                                |                      |                      |
| Residential  | \$1,247,709                    | \$1,597,885          | \$2,845,594          |
| Commercial   | 27,351,857                     | 13,857,974           | 41,209,831           |
| Commercial real estate   |                                |                      |                      |
| Farmland   | 1,391,501                      | 1,189,796            | 2,581,297            |
| Commercial real estate - owner occupied                                  | 67,167,587                     | 25,604,945           | 92,772,532           |
| Commercial real estate - non-owner occupied                              | 41,801,577                     | 12,749,240           | 54,550,817           |
| Multifamily  | 6,461,639                      | 1,516,750            | 7,978,389            |
| Consumer real estate   |                                |                      |                      |
| Home equity lines  | 2,185,040                      | 23,336,357           | 25,521,397           |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 15,526,551                     | 65,261,874           | 80,788,425           |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 557,600                        | 8,959,645            | 9,517,245            |
| Commercial and industrial loans<br>(except those secured by real estate) | 15,101,291                     | 19,282,826           | 34,384,117           |
| Consumer and other   | -                              | 2,760,622            | 2,760,622            |
| <b>Total</b>   | <b>\$178,792,352</b>           | <b>\$176,117,914</b> | <b>\$354,910,266</b> |



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## Note 6 – Deposits

Deposits as of June 30, 2013 and December 31, 2012 were as follows:

|                                     | June 30, 2013 |       | December 31, 2012 |       |   |
|-------------------------------------|---------------|-------|-------------------|-------|---|
|                                     | Amount        | %     | Amount            | %     |   |
| Demand accounts                     | \$60,572,546  | 14.5  | % \$57,049,348    | 13.1  | % |
| Interest checking accounts          | 42,512,454    | 10.1  | % 45,861,199      | 10.5  | % |
| Money market accounts               | 66,403,772    | 15.8  | % 66,007,160      | 15.1  | % |
| Savings accounts                    | 20,565,473    | 4.9   | % 20,922,112      | 4.8   | % |
| Time deposits of \$100,000 and over | 106,224,844   | 25.4  | % 113,332,481     | 26.0  | % |
| Other time deposits                 | 122,716,249   | 29.3  | % 133,150,662     | 30.5  | % |
| Total                               | \$418,995,338 | 100.0 | % \$436,322,962   | 100.0 | % |

## Note 7 – Trust preferred securities

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, \$5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at June 30, 2013 was 2.42%. The securities were redeemable at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. No amounts have been redeemed at June 30, 2013 and there are no plans to do so. The principal asset of the Trust is \$5.2 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

During the third quarter of 2007, Village Financial Statutory Trust II, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On September 20, 2007, \$3.6 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a five year fixed interest rate of 6.29% payable quarterly, converting after five years to a LIBOR-indexed floating rate of interest (three-month LIBOR plus 1.40%) which adjusts, and is also payable, quarterly. The securities may be redeemed at par at any time commencing in December 2012 until the securities mature in 2037. The principal asset of the Trust is \$3.6 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion. The portion of the Trust Preferred Capital Notes not considered as Tier 1 capital may be included in Tier 2 capital.

The obligations of the Company with respect to the issuance of the Trust Preferred Capital Notes constitute a full and unconditional guarantee by the Company of the Trust's obligations with respect to the Trust Preferred Capital Notes. Subject to certain exceptions and limitations, the Company may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related Trust Preferred Capital Notes and require a deferral of common dividends. In consideration of our agreements with our regulators, which require regulatory approval to make interest payments on





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these securities, the Company has deferred an aggregate of \$768,740 in interest payments on the junior subordinated debt securities as of June 30, 2013. The Company has been deferring interest payments since June 2011. Although we elected to defer payment of the interest due, the amount has been accrued and is included in interest expense in the consolidated statement of operations.

## Note 8 – Stock incentive plan

The Company has a stock incentive plan which authorizes the issuance of up to 555,000 shares of common stock to assist the Company in recruiting and retaining key personnel.

The following table summarizes stock options outstanding under the stock incentive plan at the indicated dates:

|  | Six Months Ended June 30,                |                               |                    |         |  |                               |                    |      |
|--|--|-------------------------------|--------------------|---------|--|-------------------------------|--------------------|------|
|  | 2013                                     |                               |                    | 2012    |  |                               |                    |      |
|  | Weighted<br>Average<br>Exercise<br>Price | Fair<br>Value<br>Per<br>Share | Intrinsic<br>Value |         | Weighted<br>Average<br>Exercise<br>Price | Fair<br>Value<br>Per<br>Share | Intrinsic<br>Value |      |
| Options                                  |  |                               |                    | Options |  |                               |                    |      |
| Options outstanding, beginning of period | 255,630                                  | \$ 9.48                       | \$ 4.70            |         | 264,980                                  | \$ 9.48                       | \$ 4.70            |      |
| Granted                                  | -  | -                             | -                  |         | -  | -                             | -                  |      |
| Forfeited                                | (3,000 )                                 | 7.70                          | 4.99               |         | (3,450 )                                 | 4.98                          | 3.12               |      |
| Exercised                                | -  | -                             | -                  |         | -  | -                             | -                  |      |
| Options outstanding, end of period       | 252,630                                  | \$ 9.57                       | \$ 4.64            | \$ -    | 261,530                                  | \$ 9.71                       | \$ 4.73            | \$ - |
| Options exercisable, end of period       | 247,630                                  |                               |                    |         | 261,530                                  |                               |                    |      |

The fair value of the stock is calculated under the same methodology as stock options and the expense is recognized over the vesting period. Unamortized stock-based compensation related to nonvested share based compensation arrangements granted under the Incentive Plan as of June 30, 2013 and 2012 was \$2,007 and \$1,666 respectively. The time based unamortized compensation of \$2,007 is expected to be recognized over a weighted average period of 2.08 years.

Stock-based compensation expense was \$483 and \$5,511 for the six months ended June 30, 2013 and 2012, respectively.

## Note 9 — Fair value

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a

principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transaction involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are independent, knowledgeable, able to transact and willing to transact.

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FASB Codification Topic 820: Fair Value Measurements and Disclosures establishes a hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair values hierarch is as follows:

Level 1 Inputs — Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 Inputs — Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 Inputs- Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods to determine the fair value of each type of financial instrument:

Securities: Fair values for securities available-for-sale are obtained from an independent pricing service. The prices are not adjusted. The independent pricing service uses industry-standard models to price U.S. Government agency obligations and mortgage backed securities that consider various assumptions, including time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Securities of obligations of state and political subdivisions are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. Substantially all assumptions used by the independent pricing service are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace (Levels 1 and 2).

Impaired loans: The fair values of impaired loans are measured for impairment using the fair value of the collateral for collateral-dependent loans on a nonrecurring basis. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than two years old, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal if deemed significant using observable market data. Likewise, values for inventory and account receivables collateral are based on financial statement balances or aging reports (Level 3). Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Real Estate Owned: Real estate owned assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, real estate owned assets are carried at net realizable value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring level 3.

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Assets and liabilities measured at fair value under Topic 820 on a recurring and non-recurring basis are summarized below for the indicated dates:

|                                  | Carrying Value | Fair Value Measurement at June 30, 2013 Using (In thousands)   |                                   |   |
|----------------------------------|----------------|--|-----------------------------------|---|
|                                  |                | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets - Recurring     |                |  |                                   |   |
| US Government Agencies           | \$42,912       | \$4,218  | \$38,694                          | \$ -                                      |
| MBS                              | 1,261          | -  | 1,261                             | -   |
| Municipals                       | 13,894         | -  | 13,894                            | -   |
| Residential loans held for sale  | 19,759         | -  | 19,759                            | -   |
|                                  |                |  | -                                 |   |
| Financial Assets - Non-Recurring |                |  |                                   |   |
| Impaired loans                   | 52,957         | -  | 45,907                            | 7,050                                     |
| Real estate owned                | 22,044         | -  | 21,048                            | 996                                       |

|                                  | Carrying Value | Fair Value Measurement at December 31, 2012 Using (In thousands) |                                   |   |
|----------------------------------|----------------|--|-----------------------------------|---|
|                                  |                | Quoted Prices in Active Markets for Identical Assets (Level 1)   | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets - Recurring     |                |  |                                   |   |
| US Government Agencies           | \$11,387       | \$5,000  | \$6,387                           | \$ -                                      |
| MBS                              | 1,829          | -  | 1,829                             | -   |
| Municipals                       | 11,938         | 2,918  | 9,020                             | -   |
| Residential loans held for sale  | 24,188         | -  | 24,188                            | -   |
| Financial Assets - Non-Recurring |                |  |                                   |   |
| Impaired loans                   | 54,775         | -  | 47,016                            | 7,759                                     |
| Real estate owned                | 20,204         | -  | 18,675                            | 1,529                                     |

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The following table presents qualitative information about level 3 fair value measurements for financial instruments measured at fair value at June 30, 2013:

|  | Fair Value Estimate | Valuation Techniques<br>(In thousands)  | Unobservable Input                                | Range<br>(Weighted Average) |
|--|---------------------|---|---|-----------------------------|
| Impaired Loans -Real Estate Secured      | \$ 5,961            | Appraisal (1)<br>or<br>Internal Valuation (2)   | Appraisal Adjustments<br>Liquidation Expenses (3) | 10%-30 %                    |
| Impaired Loans - Non-Real Estate Secured | \$ 1,089            | Appraisal (1)<br>or<br>Discounted Cash Flow Appraisal (1)<br>or<br>Internal Valuation (2) | Appraisal Adjustments<br>Liquidation Expenses (3) | 10%-20 %                    |
| Real Estate Owned                        | \$ 996              | Valuation (2)   | Appraisal Adjustments<br>Liquidation Expenses (3) | 7%-30 %                     |

(1) Fair Value is generally determined through independent appraisals of the underlying collateral, which generally included various level 3 inputs which are not identifiable

(2) Internal valuations may be conducted to determine Fair Value for assets with nominal carrying balances

(3) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses

The following table presents the changes in the Level 3 fair value category for the six months ended June 30, 2013.

|  | Impaired Loans | Real Estate Owned<br>(In thousands) | Total Assets |
|--|----------------|-------------------------------------|--------------|
| Balance at December 31, 2012                 | \$ 7,759       | \$ 1,529                            | \$ 9,288     |
| Total realized and unrealized gains (losses) |                |                                     |              |
| Included in earnings                         | -              | (224 )                              | (224 )       |
| Included in other comprehensive income       | -              | -                                   | -            |
| Net transfers in and/or out of Level 3       | (709 )         | (309 )                              | (1,018 )     |
| Balance at June 30, 2013                     | \$ 7,050       | \$ 996                              | \$ 8,046     |

In general, fair value of securities is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon market prices determined by an outside, independent entity that primarily uses as inputs, observable market-based parameters. Fair value of loans held for sale is based upon internally developed models that primarily use as inputs, observable market-based parameters. Valuation adjustments may be

made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly and or quarter valuation process.

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Cash and cash equivalents – The carrying amount of cash and cash equivalents approximates fair value.

Investment securities – The fair value of investment securities available-for-sale is estimated based on bid quotations received from independent pricing services for similar assets. The carrying amount of other investments approximates fair value.

Loans – For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. For all other loans, fair values are calculated by discounting the contractual cash flows using estimated market discount rates which reflect the credit and interest rate risk inherent in the loans, or by using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Deposits – The fair value of deposits with no stated maturity, such as demand, interest checking and money market, and savings accounts, is equal to the amount payable on demand at year-end. The fair value of certificates of deposit is based on the discounted value of contractual cash flows using the rates currently offered for deposits of similar remaining maturities.

Borrowings – The fair value of borrowings is based on the discounted value of contractual cash flows using the rates currently offered for borrowings of similar remaining maturities

Accrued interest – The carrying amounts of accrued interest receivable and payable approximate fair value.

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Village Bank  
Fair Value - Financial Instruments Summary  
June 30, 2013

|   |  | June 30,<br>2013  |                         | December 31,<br>2012 |                         |
|---|--|-------------------|-------------------------|----------------------|-------------------------|
|   | Level in<br>Fair<br>Value<br>Hierarchy | Carrying<br>Value | Estimated<br>Fair Value | Carrying<br>Value    | Estimated<br>Fair Value |
| Financial assets                            |  |                   |                         |                      |                         |
| Cash  | Level 1                                | \$ 11,880,261     | \$ 11,880,261           | \$ 13,945,105        | \$ 13,945,105           |
| Cash equivalents                            | Level 2                                | 36,085,297        | 36,085,297              | 39,185,837           | 39,185,837              |
| Investment securities<br>available for sale | Level 1                                | 4,217,587         | 4,217,587               | 7,918,420            | 7,918,420               |
| Investment securities<br>available for sale | Level 2                                | 53,849,040        | 53,849,040              | 17,235,626           | 17,235,626              |
| Federal Home Loan<br>Bank stock             | Level 2                                | 1,642,300         | 1,642,300               | 2,121,900            | 2,121,900               |
| Loans held for sale                         | Level 2                                | 19,759,383        | 19,759,383              | 24,188,384           | 24,188,384              |
| Loans                                       | Level 2                                | 243,784,485       | 251,039,010             | 290,115,508          | 294,476,846             |
| Impaired loans                              | Level 2                                | 45,906,895        | 45,906,895              | 47,016,065           | 47,016,065              |
| Impaired loans                              | Level 3                                | 7,050,391         | 7,050,391               | 7,758,689            | 7,758,689               |
| Other real estate<br>owned                  | Level 2                                | 21,047,658        | 21,047,658              | 18,675,164           | 18,675,164              |
| Other real estate<br>owned                  | Level 3                                | 995,976           | 995,976                 | 1,528,527            | 1,528,527               |
| Bank owned life<br>insurance                | Level 3                                | 6,671,315         | 6,671,315               | 6,575,018            | 6,575,018               |
| Accrued interest<br>receivable              | Level 2                                | 1,796,514         | 1,796,514               | 1,676,518            | 1,676,518               |
| Financial liabilities                       |  |                   |                         |                      |                         |
| Deposits                                    | Level 2                                | 418,995,338       | 421,493,892             | 436,322,962          | 437,644,329             |
| FHLB borrowings                             | Level 2                                | 23,000,000        | 23,275,451              | 28,000,000           | 28,424,029              |
| Trust preferred<br>securities               | Level 2                                | 8,764,000         | 7,274,120               | 8,764,000            | 7,537,040               |
| Other borrowings                            | Level 2                                | 4,425,432         | 4,425,432               | 4,851,811            | 4,851,811               |
| Accrued interest<br>payable                 | Level 2                                | 1,033,000         | 1,033,000               | 911,635              | 911,635                 |



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Note 10 – Capital Purchase Program

On May 1, 2009, as part of the Capital Purchase Program established by the U.S. Department of the Treasury (the “Treasury”) under the Emergency Economic Stabilization Act of 2008 (“EESA”), the Company entered into a Letter Agreement and Securities Purchase Agreement—Standard Terms (collectively, the “Purchase Agreement”) with the Treasury, pursuant to which the Company sold (i) 14,738 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$4.00 per share, having a liquidation preference of \$1,000 per share (the “Preferred Stock”) and (ii) a warrant (the “Warrant”) to purchase 499,029 shares of the Company’s common stock at an initial exercise price of \$4.43 per share, subject to certain anti-dilution and other adjustments, for an aggregate purchase price of \$14,738,000 in cash. The fair value of the preferred stock was estimated using discounted cash flow methodology at an assumed market equivalent rate of 13%, with 20 quarterly payments over a five year period. The fair value of the warrant was estimated using the Black-Scholes option pricing model, with assumptions of 25% volatility, a risk-free rate of 2.03%, a yield of 6.162% and an estimated life of 5 years. The value attributed to the warrant is being accreted as a discount on the preferred stock using the effective interest rate method over five years.

The Preferred Stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% until May 1, 2014 and 9% thereafter, unless the shares are redeemed by the Company. The Preferred Stock is generally non-voting, other than on certain matters that could adversely affect the Preferred Stock.

The Warrant is immediately exercisable. The Warrant provides for the adjustment of the exercise price and the number of shares of common stock issuable upon exercise pursuant to customary anti-dilution provisions, such as upon stock splits or distributions of securities or other assets to holders of common stock, and upon certain issuances of common stock at or below a specified price relative to the then-current market price of common stock. The Warrant expires ten years from the issuance date. Pursuant to the Purchase Agreement, the Treasury has agreed not to exercise voting power with respect to any shares of common stock issued upon exercise of the Warrant.

As required by the Federal Reserve Bank of Richmond, the Company notified the U.S. Treasury in May 2011 that the Company was going to defer the payment of the quarterly cash dividend of \$184,225 due on May 16, 2011, and subsequent quarterly payments, on the Fixed Rate Cumulative Perpetual Preferred Stock, Series A. The total arrearage on such preferred stock as of June 30, 2013 was \$1,750,137. This amount has been accrued for and is included in other liabilities in the consolidated balance sheet.

In June 2012 the Treasury asked to allow an observer at the Company’s meetings of its board of directors. The observer started attending board meetings in August 2012. The Treasury has the contractual right to nominate up to two members to the board of directors upon the Company’s sixth missed dividend payment. The Company has deferred nine dividend payments as of June 30, 2013. However, Treasury has not indicated that it will nominate two directors to the board of directors.

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



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## Note 11 – Commitments and contingencies

Off-balance-sheet risk – The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the financial statements. The contract amounts of these instruments reflect the extent of involvement that the Company has in particular classes of instruments.

The Company's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit, and to potential credit loss associated with letters of credit issued, is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for loans and other such on-balance sheet instruments.

The Company had outstanding the following approximate off-balance-sheet financial instruments whose contract amounts represent credit risk at the dates indicated:

|  | June 30,<br>2013 | December 31,<br>2012 |
|--|------------------|----------------------|
| Undisbursed credit lines                     | \$ 35,450,000    | \$ 35,780,000        |
| Commitments to extend<br>or originate credit | 20,106,000       | 25,016,000           |
| Standby letter of credit                     | 3,213,000        | 3,314,000            |
| Total commitments to<br>extend credit        | \$ 58,769,000    | \$ 64,110,000        |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. Historically, many commitments expire without being drawn upon; therefore, the total commitment amounts shown in the above table are not necessarily indicative of future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, as deemed necessary by the Company upon extension of credit is based on management's credit evaluation of the customer. Collateral held varies but may include personal or income-producing commercial real estate, accounts receivable, inventory and equipment.

Concentrations of credit risk – All of the Company's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Company's market area. Although the Company is building a diversified loan portfolio, a substantial portion of its clients' ability to honor contracts is reliant upon the economic stability of the Richmond, Virginia area, including the real estate markets in the area. The concentrations of credit by type of loan are set forth in Note 5. The distribution of commitments to extend credit approximates the distribution of loans outstanding.

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Consent Order – In February 2012, the Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (“Consent Agreement”) with the Federal Deposit Insurance Corporation and the Virginia Bureau of Financial Institutions (the “Supervisory Authorities”), and the Supervisory Authorities have issued the related Consent Order (the “Order”) effective February 3, 2012. The description of the Consent Agreement and the Order is set forth below:

**Management.** The Order requires that the Bank have and retain qualified management, including at a minimum a chief executive officer, senior lending officer and chief operating officer, with qualifications and experience commensurate with their assigned duties and responsibilities within 90 days from the effective date of the order. Within 30 days of the effective date of the Order, the Bank must retain a bank consultant to develop a written analysis and assessment of the Bank’s management and staffing needs for the purpose of providing qualified management for the Bank. Within 30 days from receipt of the consultant’s management report, the Bank must formulate a written management plan that incorporates the findings of the management report, a plan of action in response to each recommendation contained in the management report, and a timeframe for completing each action.

**Capital Requirements.** Within 90 days from the effective date of the Order and during the life of the Order, the Bank must have Tier 1 capital equal to or greater than 8 percent of its total assets, and total risk-based capital equal to or greater than 11 percent of the Bank’s total risk-weighted assets. Within 90 days from the effective date of the Order, the Bank must submit a written capital plan to the Supervisory Authorities. The capital plan must include a contingency plan in the event that the Bank fails to maintain the minimum capital ratios required in the Order, submit a capital plan that is acceptable to the Supervisory Authorities, or implement or adhere to the capital plan.

**Charge-offs.** The Order requires the Bank to eliminate from its books, by charge-off or collection, all assets or portions of assets classified “Loss” and 50 percent of those classified “Doubtful”. If an asset is classified “Doubtful”, the Bank may, in the alternative, charge off the amount that is considered uncollectible in accordance with the Bank’s written analysis of loan or lease impairment. The Order also prevents the Bank from extending, directly or indirectly, any additional credit to, or for the benefit of, any borrower who has a loan or other extension of credit from the Bank that has been charged off or classified, on whole or in part, “loss” or “doubtful” and is uncollected. The Bank may not extend, directly or indirectly, any additional credit to any borrower who has a loan or other extension of credit from the Bank that has been classified “substandard.” These limitations do not apply if the Bank’s failure to extend further credit to a particular borrower would be detrimental to the best interests of the Bank.

**Asset Growth.** While the Order is in effect, the Bank must notify the Supervisory Authorities at least 60 days prior to undertaking asset growth that exceeds 10% or more per year or initiating material changes in asset or liability composition. The Bank’s asset growth cannot result in noncompliance with the capital maintenance provisions of the Order unless the Bank receives prior written approval from the Supervisory Authorities.

**Restriction on Dividends and Other Payments.** While the Order is in effect, the Bank cannot declare or pay dividends, pay bonuses, or pay any form of payment outside the ordinary course of business resulting in a reduction of capital without the prior written approval of the Supervisory Authorities. In addition, the Bank cannot make any distributions of interest, principal, or other sums on subordinated debentures without prior written approval of the Supervisory Authorities.

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Brokered Deposits. The Order provides that the Bank may not accept, renew, or roll over any brokered deposits unless it is in compliance with the requirements of the FDIC regulations governing brokered deposits. These regulations prohibit undercapitalized institutions from accepting, renewing, or rolling over any brokered deposits and also prohibit undercapitalized institutions from soliciting deposits by offering an effective yield that exceeds by more than 75 basis points the prevailing effective yields on insured deposits of comparable maturity in the institution's market area. An "adequately capitalized" institution may not accept, renew, or roll over brokered deposits unless it has applied for and been granted a waiver by the FDIC.

Written Plans and Other Material Terms. Under the terms of the Order, the Bank is required to prepare and submit the following written plans or reports to the FDIC and the Commissioner:

- Plan to improve liquidity, contingency funding, interest rate risk, and asset liability management
- Plan to reduce assets of \$250,000 or greater classified "doubtful" and "substandard"
- Revised lending and collection policy to provide effective guidance and control over the Bank's lending and credit administration functions
- Effective internal loan review and grading system
- Policy for managing the Bank's other real estate
- Business/strategic plan covering the overall operation of the Bank
- Plan and comprehensive budget for all categories of income and expense for the year 2011
- Policy and procedures for managing interest rate risk
- Assessment of the Bank's information technology function

Under the Order, the Bank's board of directors has agreed to increase its participation in the affairs of the Bank, including assuming full responsibility for the approval of policies and objectives for the supervision of all of the Bank's activities. The Bank must also establish a board committee to monitor and coordinate compliance with the Order.

The Order will remain in effect until modified or terminated by the Supervisory Authorities.

While subject to the Consent Order, we expect that our management and board of directors will be required to focus considerable time and attention on taking corrective actions to comply with the terms. In addition, certain provisions of the Consent Order described above could adversely impact the Company's businesses and results of operations.

Written Agreement – In June 2012, the Company entered into a written agreement ("Written Agreement") with the Federal Reserve Bank of Richmond ("Reserve Bank"). Under the terms of the Written Agreement, the Company has agreed to develop and submit to the Reserve Bank for approval within the time periods specified therein written plans to maintain sufficient capital and correct any violations of section 23A of the Federal Reserve Act and Regulation W. In addition, the Company will submit a written statement of its planned sources and uses of cash for debt service, operation expenses, and other purposes.



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The Company also has agreed that it will not, without prior regulatory approval:

- pay or declare any dividends;
- take any other form of payment representing a reduction in Bank's capital;
- make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities;
- incur, increase or guarantee any debt;
- purchase or deem any shares of its stock.

Since entering into the Order and the Written Agreement, the Company has taken numerous steps to comply with the terms of the consent order.

Note 12 – Income Taxes

The net deferred tax asset is included in other assets on the balance sheet. Accounting Standards Codification Topic 740, Income Taxes, requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. Management considers both positive and negative evidence and analyzes changes in near-term market conditions as well as other factors which may impact future operating results. In making such judgments, significant weight is given to evidence that can be objectively verified. The deferred tax assets are analyzed quarterly for changes affecting realization. Management determined that as of June 30, 2013, the objective negative evidence represented by the Company's recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance for all the net deferred tax asset that is dependent on future earnings of the Company of approximately \$10,158,000.

Note 13 – Recent accounting pronouncements

In February 2013, the Financial Accounting Standards Board (FASB) issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, which is intended to improve the reporting of reclassifications out of accumulated other comprehensive income. The ASU requires an entity to report, either on the face of the income statement or in the notes to the financial statements, the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in the income statement if the amount being reclassified is required to be reclassified in its entirety to net income. For other amounts that are not required to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other required disclosures that provide additional detail about those amounts. This ASU is effective prospectively in the first quarter of 2013, and is not expected to have a material effect on the Company's consolidated financial statements. See Statement of Changes in Comprehensive income (loss).

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ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Caution about forward-looking statements

In addition to historical information, this report may contain forward-looking statements. For this purpose, any statement, that is not a statement of historical fact may be deemed to be a forward-looking statement. These forward-looking statements may include statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy and financial and other goals. Forward-looking statements often use words such as "believes," "expects," "plans," "may," "will," "should," "projects," "contemplates," "anticipates," "forecasts" or other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, and actual results could differ materially from historical results or those anticipated by such statements.

There are many factors that could have a material adverse effect on the operations and future prospects of the Company including, but not limited to:

- the inability of the Bank to comply with the requirements of agreements with its regulators;
- the inability to reduce nonperforming assets consisting of nonaccrual loans and foreclosed real estate;
  - our inability to improve our regulatory capital position;
- the risks of changes in interest rates on levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities;
  - changes in assumptions underlying the establishment of allowances for loan losses, and other estimates;
- changes in market conditions, specifically declines in the residential and commercial real estate market, volatility and disruption of the capital and credit markets, soundness of other financial institutions we do business with;
  - risks inherent in making loans such as repayment risks and fluctuating collateral values;
- a decline in loan volume of Village Bank Mortgage Corporation as a result of the activity in the residential real estate market;
- legislative and regulatory changes, including the Dodd-Frank Act Wall Street Reform and Consumer Protection Act and other changes in banking, securities, and tax laws and regulations and their application by our regulators, and changes in scope and cost of FDIC insurance and other coverages;
- exposure to repurchase loans sold to investors for which borrowers failed to provide full and accurate information on or related to their loan application or for which appraisals have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor;
  - the effects of future economic, business and market conditions;
    - governmental monetary and fiscal policies;
    - changes in accounting policies, rules and practices;
    - maintaining capital levels adequate to remain well capitalized;
  - reliance on our management team, including our ability to attract and retain key personnel;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
  - demand, development and acceptance of new products and services;
    - problems with technology utilized by us;
    - changing trends in customer profiles and behavior; and
  - other factors described from time to time in our reports filed with the SEC.



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These risks and uncertainties should be considered in evaluating the forward-looking statements contained herein, and readers are cautioned not to place undue reliance on such statements. Any forward-looking statement speaks only as of the date on which it is made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which it is made. In addition, past results of operations are not necessarily indicative of future results.

### General

The Company's primary source of earnings is net interest income, and its principal market risk exposure is interest rate risk. The Company is not able to predict market interest rate fluctuations and its asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on the Company's results of operations and financial condition.

Although we endeavor to minimize the credit risk inherent in the Company's loan portfolio, we must necessarily make various assumptions and judgments about the collectability of the loan portfolio based on our experience and evaluation of economic conditions. If such assumptions or judgments prove to be incorrect, the current allowance for loan losses may not be sufficient to cover loan losses and additions to the allowance may be necessary, which would have a negative impact on net income. Over the last four years, the Company has recorded record provisions for loan losses due primarily to deteriorating quality of loans collateralized by real estate located in its principal market area.

There is intense competition in all areas in which the Company conducts its business. The Company competes with banks and other financial institutions, including savings and loan associations, savings banks, finance companies, and credit unions. Many of these competitors have substantially greater resources and lending limits and provide a wider array of banking services. To a limited extent, the Company also competes with other providers of financial services, such as money market mutual funds, brokerage firms, consumer finance companies and insurance companies. Competition is based on a number of factors, including prices, interest rates, services, availability of products and geographic location.

Beginning in 2012, our business strategy included efforts to reduce our total assets and liabilities due to a continued depressed economy as well as capital limitations at the time. These efforts resulted in declines of approximately \$72 million in total assets and approximately \$60 million in total liabilities in 2012. With the sale of a branch completed in the first quarter of 2013, we further reduced our total assets by approximately \$26 million and liabilities by approximately \$23 million. This strategy helped strengthen our regulatory capital ratios in 2012 and through the second quarter of 2013. While we do not anticipate significant growth for the remainder of 2013, we do not expect to continue our efforts to reduce total assets and liabilities.

### Results of operations

The following represents management's discussion and analysis of the financial condition of the Company at June 30, 2013 and December 31, 2012 and the results of operations for the Company for the three and six months ended June 30, 2013 and 2012. This discussion should be read in conjunction with the Company's condensed consolidated financial statements and the notes thereto appearing elsewhere in this Quarterly report.

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## Income statement analysis

## Summary

For the three months ended June 30, 2013, the Company had net income of \$589,000 and net income available to common shareholders of \$368,000 or \$0.09 per fully diluted share, compared to net loss of \$(9,736,000) and net loss available to common shareholders of \$(9,922,000), or \$(2.33) per fully diluted share, for the same period in 2012. For the six months ended June 30, 2013, the Company had a net income totaling \$78,000 and a net loss available to common shareholders of \$(365,000), or \$(0.09) per fully diluted share, compared to net loss totaling \$(11,137,000) and a net loss available to common shareholders of \$(11,543,000), or \$(2.72) per share on a fully diluted share, for the same period in 2012. This represents increases in net income before the accrual of preferred stock dividends of \$10,325,000 and \$11,215,000, for the three and six month periods, respectively.

The components of these increases in net income before accrual of preferred stock dividends are presented following:

|  | Three Months<br>Ended<br>June 30, 2013 | Six Months<br>Ended<br>June 30, 2013 |
|--|--|--------------------------------------|
| Decrease in net interest income            | \$ (632,000 )                          | \$ (963,000 )                        |
| Decrease in provision for loan losses      | 6,660,000                              | 7,572,000                            |
| Increase in noninterest income             | 322,000                                | 1,153,000                            |
| Decrease (increase) in noninterest expense | 93,000                                 | (429,000 )                           |
| Decrease in income tax expense             | 3,882,000                              | 3,882,000                            |
|  | \$ 10,325,000                          | \$ 11,215,000                        |

The primary drivers in the improvement in our profitability were the decline in the provision for loan losses and the decrease in tax expense. The decrease in the provision for loan losses was attributable to an improving loan portfolio as well as a decline in need due to the decline in total loans. This is consistent with the first quarter of 2013. However, as we resolve nonperforming loans through foreclosure, costs associated with foreclosed real estate will continue to be a significant expense. The decrease in income tax expense was due to management's determination in 2012 that a valuation allowance was necessary on its deferred tax asset which resulted in income tax expense.

The decrease in net interest income was primarily a result of a decline in our loan portfolio in line with our asset reduction strategy. The increase in noninterest income is attributable to the gain on sale of a branch of \$598,000 in the first quarter of 2013 and increased gain on sale of loans by our mortgage company. Our mortgage company's profit increased in the first six months of 2013 compared to the same period of 2012 by \$203,000 as a result of closing \$142,213,000 in mortgage loans for the first two quarters of 2013 compared to \$140,359,000 for the same period in 2012.



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Net interest income

Net interest income, which represents the difference between interest earned on interest-earning assets and interest incurred on interest-bearing liabilities, is the Company's primary source of earnings. Net interest income can be affected by changes in market interest rates as well as the level and composition of assets, liabilities and shareholder's equity. Net interest spread is the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities. The net yield on interest-earning assets ("net interest margin") is calculated by dividing tax equivalent net interest income by average interest-earning assets. Generally, the net interest margin will exceed the net interest spread because a portion of interest earning assets are funded by various noninterest-bearing sources, principally noninterest-bearing deposits and shareholders' equity.

Net interest income for the second quarter of \$3,720,000 represents a decrease of \$(632,000), or 15%, compared to the second quarter of 2012, and a decrease of \$(369,000), or 9%, compared to the first quarter of 2013.

Compared to the second quarter of 2012, average interest-earning assets for the second quarter of 2013 decreased by \$50,974,000, or 11%. The decrease in interest-earning assets was due primarily to decreases in portfolio loans of \$89,039,000, offset by increases in investment securities of \$7,996,000 and federal funds sold of \$29,287,000. This decline in average interest earning assets is consistent with our asset reduction strategy.

Net interest income of \$7,809,000 for the first six months of 2013 represents a decrease of \$(964,000), or 11%, compared to the same period in 2012.

Compared to the first six months of 2012, average interest-earning assets for the same period of 2013 decreased by \$58,167,000, or 12%. The decrease in interest-earning assets was due primarily to decreases in portfolio loans of \$81,706,000, offset by increases in investment securities of \$3,388,000 and federal funds sold of \$18,214,000. This decline in average interest earning assets is consistent with our asset reduction strategy.

Average interest-bearing liabilities for the second quarter of 2013 decreased by \$40,262,000, or 9%, compared to the second quarter of 2012. The decrease in interest-bearing liabilities was due to declines in average deposits of \$32,539,000. The average cost of interest-bearing liabilities decreased to 1.21% for the six months ended 2013 from 1.41% for the six months ended 2012. The principal reason for the decrease in liability costs was the maintenance of short-term interest rates at a low level by the Federal Reserve. The continuing low interest rates have allowed us to reduce our costs of funds as certificates of deposit and borrowings mature. See our discussion of interest rate sensitivity below for more information.

The Company's net interest margin is not a measurement under accounting principles generally accepted in the United States, but it is a common measure used by the financial services industry to determine how profitably earning assets are funded. Our net interest margin over the last several quarters is provided in the following table:

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| Quarter Ended      | Net<br>Interest<br>Margin |
|--------------------|---------------------------|
| June 30, 2012      | 3.65%                     |
| September 30, 2012 | 3.70%                     |
| December 31, 2012  | 4.25%                     |
| March 31, 2013     | 3.79%                     |
| June 30, 2013      | 3.50%                     |

The significant increase in the net interest margin in the fourth quarter of 2012 is attributable to the recapture of interest on returning approximately \$14.4 million of nonaccrual loans to accrual status during the quarter. The decline in the net interest margin for the second quarter of 2013 is primarily a result of a decline in portfolio loans of \$18,388,000 during the period. Portfolio loans are our highest yielding asset and the current lending environment is very competitive.

The following table illustrates average balances of total interest-earning assets and total interest-bearing liabilities for the periods indicated, showing the average distribution of assets, liabilities, shareholders' equity and related income, expense and corresponding weighted-average yields and rates. The average balances used in these tables and other statistical data were calculated using daily average balances. We had no tax exempt assets for the periods presented.

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(in thousands)

|   | Three Months Ended June 30, 2013 |                                |                             |   | Three Months Ended June 30, 2012 |                                |                             |   |
|---|----------------------------------|--------------------------------|-----------------------------|---|----------------------------------|--------------------------------|-----------------------------|---|
|   | Average<br>Balance               | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate |   | Average<br>Balance               | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate |   |
| Loans net of deferred fees  | \$316,134                        | \$4,476                        | 5.68                        | % | \$405,173                        | \$5,448                        | 5.39                        | % |
| Loans held for sale   | 16,904                           | 146                            | 3.46                        | % | 16,122                           | 166                            | 4.13                        | % |
| Investment securities   | 44,239                           | 239                            | 2.17                        | % | 36,243                           | 215                            | 2.38                        | % |
| Federal funds and other   | 49,347                           | 28                             | 0.23                        | % | 20,060                           | 12                             | 0.24                        | % |
| Total interest earning assets   | 426,624                          | 4,889                          | 4.60                        | % | 477,598                          | 5,841                          | 4.91                        | % |
| Allowance for loan losses and<br>deferred fees  | (9,797                           | )                              |                             |   | (14,161                          | )                              |                             |   |
| Cash and due from banks   | 12,180                           |                                |                             |   | 13,796                           |                                |                             |   |
| Premises and equipment, net   | 23,857                           |                                |                             |   | 26,428                           |                                |                             |   |
| Other assets  | 36,768                           |                                |                             |   | 37,444                           |                                |                             |   |
| Total assets  | \$489,632                        |                                |                             |   | \$541,105                        |                                |                             |   |
| Interest bearing deposits   |                                  |                                |                             |   |                                  |                                |                             |   |
| Interest checking   | \$42,383                         | \$27                           | 0.26                        | % | \$42,711                         | \$36                           | 0.34                        | % |
| Money market  | 65,307                           | 49                             | 0.30                        | % | 68,860                           | 70                             | 0.41                        | % |
| Savings   | 20,299                           | 17                             | 0.34                        | % | 17,752                           | 22                             | 0.50                        | % |
| Certificates  | 230,822                          | 857                            | 1.49                        | % | 262,106                          | 1,118                          | 1.71                        | % |
| Total   | 358,811                          | 950                            | 1.06                        | % | 391,429                          | 1,246                          | 1.28                        | % |
| Borrowings  | 39,260                           | 219                            | 2.24                        | % | 44,941                           | 244                            | 2.18                        | % |
| Total interest bearing liabilities  | 398,071                          | 1,169                          | 1.18                        | % | 436,370                          | 1,490                          | 1.37                        | % |
| Noninterest bearing deposits  | 58,585                           |                                |                             |   | 64,405                           |                                |                             |   |
| Other liabilities   | 8,043                            |                                |                             |   | 5,295                            |                                |                             |   |
| Total liabilities   | 464,699                          |                                |                             |   | 506,070                          |                                |                             |   |
| Equity capital  | 24,933                           |                                |                             |   | 35,034                           |                                |                             |   |
| Total liabilities and capital   | \$489,632                        |                                |                             |   | \$541,104                        |                                |                             |   |
| Net interest income before<br>provision for<br>loan losses  |                                  | \$3,720                        |                             |   |                                  | \$4,351                        |                             |   |
| Interest spread - average yield<br>on interest<br>earning assets, less average rate<br>on<br>interest bearing liabilities |                                  |                                | 3.42                        | % |                                  |                                | 3.54                        | % |

Annualized net interest margin  
(net  
interest income expressed as  
percentage of average earning  
assets)

3.50 %

3.65 %

45

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Table of ContentsAverage Balance Sheets  
(in thousands)

|   | Six Months Ended June 30, 2013 |                         |                       |   | Six Months Ended June 30, 2012 |                         |                       |   |
|---|--------------------------------|-------------------------|-----------------------|---|--------------------------------|-------------------------|-----------------------|---|
|   | Average Balance                | Interest Income/Expense | Annualized Yield Rate |   | Average Balance                | Interest Income/Expense | Annualized Yield Rate |   |
| Loans net of deferred fees  | \$330,797                      | \$9,453                 | 5.76                  | % | \$412,503                      | \$11,217                | 5.47                  | % |
| Loans held for sale   | 16,554                         | 312                     | 3.80                  | % | 14,617                         | 297                     | 4.08                  | % |
| Investment securities   | 37,163                         | 427                     | 2.32                  | % | 33,775                         | 366                     | 2.18                  | % |
| Federal funds and other   | 47,572                         | 53                      | 0.22                  | % | 29,358                         | 32                      | 0.22                  | % |
| Total interest earning assets   | 432,086                        | 10,245                  | 4.78                  | % | 490,253                        | 11,912                  | 4.89                  | % |
|   |                                |                         |                       |   | -                              |                         |                       |   |
| Allowance for loan losses and deferred fees   | (10,202 )                      |                         |                       |   | (13,020 )                      |                         |                       |   |
| Cash and due from banks   | 12,667                         |                         |                       |   | 14,553                         |                         |                       |   |
| Premises and equipment, net   | 24,689                         |                         |                       |   | 26,569                         |                         |                       |   |
| Other assets  | 37,371                         |                         |                       |   | 35,348                         |                         |                       |   |
|   |                                |                         |                       |   | -                              |                         |                       |   |
| Total assets  | \$496,611                      |                         |                       |   | \$553,703                      |                         |                       |   |
|   |                                |                         |                       |   | -                              |                         |                       |   |
| Interest bearing deposits   |                                |                         |                       |   | \$-                            |                         |                       |   |
| Interest checking   | \$42,854                       | \$62                    | 0.29                  | % | 42,439                         | \$76                    | 0.36                  | % |
| Money market  | 65,797                         | 110                     | 0.34                  | % | 71,141                         | 146                     | 0.41                  | % |
| Savings   | 20,601                         | 40                      | 0.39                  | % | 16,969                         | 43                      | 0.51                  | % |
| Certificates  | 238,323                        | 1,781                   | 1.51                  | % | 269,565                        | 2,339                   | 1.74                  | % |
| Total   | 367,575                        | 1,993                   | 1.09                  | % | 400,114                        | 2,604                   | 1.31                  | % |
| Borrowings  | 39,457                         | 443                     | 2.26                  | % | 47,180                         | 535                     | 2.28                  | % |
| Total interest bearing liabilities  | 407,032                        | 2,436                   | 1.21                  | % | 447,294                        | 3,139                   | 1.41                  | % |
| Noninterest bearing deposits  | 56,910                         |                         |                       |   | 63,808                         |                         |                       |   |
| Other liabilities   | 7,577                          |                         |                       |   | 4,423                          |                         |                       |   |
| Total liabilities   | 471,519                        |                         |                       |   | 515,525                        |                         |                       |   |
| Equity capital  | 25,092                         |                         |                       |   | 38,177                         |                         |                       |   |
| Total liabilities and capital   | \$496,611                      |                         |                       |   | \$553,702                      |                         |                       |   |
| Net interest income before provision for loan losses  |                                | \$7,809                 |                       |   |                                | \$8,773                 |                       |   |
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities |                                |                         | 3.57                  | % |                                |                         | 3.48                  | % |
| Annualized net interest margin (net   |                                |                         |                       |   |                                |                         |                       |   |



interest income expressed as  
percentage of average earning  
assets)

3.64 %

3.60 %

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### Provision for loan losses

The Company did not record a provision for loan losses for the three months ended June 30, 2013 compared to \$6,660,000 for the three months ended June 30, 2012. The provision for loan losses for the six months ended June 30, 2012 was \$823,000 compared to \$8,395,000 for the six months ended June 30, 2012. The declines in the provision for loan losses for the first three and six month periods of 2013 were primarily driven by an \$82 million decline in loans outstanding from June 30, 2012 to June 30, 2013 as well as a decline in the impairment on specific nonperforming loans. While we are encouraged by this decline in the provision for loan losses, overall asset quality continues to be a concern as there continues to be uncertainty in the economy and the level of nonperforming assets remains significant.

### Noninterest income

Noninterest income increased from \$3,135,000 for the three months ended June 30, 2012 to \$3,458,000 for the three months ended June 30, 2013, an increase of \$323,000, or 10%. The increase in noninterest income is primarily a result of higher gains on loan sales from increased loan activity by our mortgage banking subsidiary of \$181,000, higher service charges and fees of \$93,000 and a gain on sale of securities of \$27,000. Noninterest income also increased from \$5,858,000 for the first six months of 2012 to \$7,012,000 for the first six months of 2013, an increase of \$1,153,000, or 20%. The increase in noninterest income is primarily a result of higher gains on sale of loans of \$386,000 and the gain on the sale of the Robious branch of \$598,000 in the first quarter of 2013.

Mortgage loan originations by our mortgage company increased only slightly by \$1,854,000, or 1%, for the first six months of 2013 compared to the same period in 2012. However, proceeds from the sale of mortgage loans increased by \$10,230,000 for the same comparative periods. Of the total loan production in 2013, 35% were refinancings of existing mortgages and 65% were for new home purchases. If rates were to continue to increase in 2013, mortgage production could be adversely affected.

### Noninterest expense

Noninterest expense for the three months ended June 30, 2013 was \$6,588,000 compared to \$6,681,000 for the three months ended June 30, 2012, a decrease of \$93,000, or 1%. The more significant decreases in noninterest expense occurred in expenses related to professional and outside services of \$96,000, loan underwriting of \$72,000, occupancy expense of \$67,000 and FDIC assessment of \$99,000. These declines were offset by increases in salaries and benefits of \$213,273 and expenses related to foreclosed real estate of \$74,000.

Noninterest expense for the six months ended June 30, 2013 totaled \$13,920,000, an increase of \$429,000, or 3%, from \$13,491,000 for the six months ended June 30, 2012. Expenses related to foreclosed real estate increased by \$478,000, and salaries and benefits increased by \$554,000. These increases were offset by decreases in loan underwriting of \$228,000, FDIC assessment of \$119,000, accounting and auditing expense of \$138,000 and occupancy expense of \$91,000.

### Income taxes

Certain items of income and expense are reported in different periods for financial reporting and tax return purposes. The tax effects of these temporary differences are recognized currently in the deferred income tax provision or benefit. Deferred tax assets or liabilities are computed based on the difference between the financial statement and income tax bases of assets and liabilities using the applicable enacted marginal tax rate.



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The net deferred tax asset is included in other assets on the balance sheet. Accounting Standards Codification Topic 740, Income Taxes, requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. Management considers both positive and negative evidence and analyzes changes in near-term market conditions as well as other factors which may impact future operating results. In making such judgments, significant weight is given to evidence that can be objectively verified. The deferred tax assets are analyzed quarterly for changes affecting realization. Management determined that as of December 31, 2012, the objective negative evidence represented by the Company’s recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance on its net deferred tax asset of approximately \$10,158,000. Based on quarterly analysis for changes affecting realization of the net deferred tax asset management believes that the valuation allowance established at December 31, 2012 is adequate and did not recognize any additional valuation allowance on its net deferred tax asset at June 30, 2013. The net operating losses available to offset future taxable income amounted to \$13,900,000 at June 30, 2013 and expire through 2030.

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Company recorded a franchise tax expense of \$82,000 the six months ended June 30, 2012. Due to the Company’s adjusted capital level we were not subject to franchise tax expense in the first six months of 2013.

## Balance Sheet Analysis

Our total assets decreased to \$483,983,000 at June 30, 2013 from \$510,087,000 at December 31, 2012, a decrease of \$26,104,000, or 5%. The branch sale discussed previously was the primary driver of this decline. Net portfolio loans decreased by \$48,148,000 during 2013, loans held for sale decreased by \$4,429,000, liquid assets (cash and due from banks, federal funds sold and investment securities available for sale) increased by \$27,747,000, and other real estate owned increased by \$1,840,000.

## Loans

A management objective is to maintain the quality of the loan portfolio. The Company seeks to achieve this objective by maintaining rigorous underwriting standards coupled with regular evaluation of the creditworthiness of and the designation of lending limits for each borrower. The portfolio strategies include seeking industry and loan size diversification in order to minimize credit exposure and originating loans in markets with which the Company is familiar.

The Company’s real estate loan portfolios, which represent approximately 89% of all loans, are secured by mortgages on real property located principally in the Commonwealth of Virginia. Sources of repayment are from the borrower’s operating profits, cash flows and liquidation of pledged collateral. The Company’s commercial loan portfolio represents approximately 10% of all loans. Loans in this category are typically made to individuals, small and medium-sized businesses and range between \$250,000 and \$2.5 million. Based on underwriting standards, commercial and industrial loans may be secured in whole or in part by collateral such as liquid assets, accounts receivable, equipment, inventory, and real property. The collateral securing any loan may depend on the type of loan and may vary in value based on market conditions. The remainder of our loan portfolio is in consumer loans which represent 1% of the total.

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The following table presents the composition of our loan portfolio (excluding mortgage loans held for sale) at the dates indicated.

|  | Loan Portfolio, Net<br>(In thousands) |       |   |                   |       |   |
|--|---------------------------------------|-------|---|-------------------|-------|---|
|  | June 30, 2013                         |       |   | December 31, 2012 |       |   |
|  | Amount                                | %     |   | Amount            | %     |   |
| Construction and land development  |                                       |       |   |                   |       |   |
| Residential  | \$3,835                               | 1.25  | % | \$2,845           | 0.80  | % |
| Commercial   | 33,465                                | 10.95 | % | 41,210            | 11.61 | % |
| Total construction and land development                                  | 37,300                                | 12.20 | % | 44,055            | 12.41 | % |
| Commercial real estate   |                                       |       |   |                   |       |   |
| Farmland   | 2,525                                 | 0.83  | % | 2,581             | 0.73  | % |
| Commercial real estate - owner occupied                                  | 75,116                                | 24.58 | % | 92,773            | 26.14 | % |
| Commercial real estate - non-owner occupied                              | 45,796                                | 14.98 | % | 54,551            | 15.37 | % |
| Multifamily  | 8,852                                 | 2.90  | % | 7,979             | 2.25  | % |
| Total commercial real estate   | 132,289                               | 43.29 | % | 157,884           | 44.49 | % |
| Consumer real estate   |                                       |       |   |                   |       |   |
| Home equity lines  | 22,764                                | 7.46  | % | 25,521            | 7.19  | % |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 72,608                                | 23.76 | % | 80,788            | 22.76 | % |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 8,335                                 | 2.72  | % | 9,517             | 2.68  | % |
| Total consumer real estate   | 103,707                               | 33.94 | % | 115,827           | 32.63 | % |
| Commercial and industrial loans<br>(except those secured by real estate) | 29,713                                | 9.72  | % | 34,384            | 9.69  | % |
| Consumer and other   | 2,607                                 | 0.85  | % | 2,761             | 0.78  | % |
| Total loans  | 305,616                               | 100.0 | % | 354,910           | 100.0 | % |
| Deferred loan cost (unearned income), net                                | 736                                   |       |   | 788               |       |   |
| Less: Allowance for loan losses  | (9,610 )                              |       |   | (10,808 )         |       |   |
|  | \$296,742                             |       |   | \$344,890         |       |   |

The decline in our total loan portfolio was primarily due to the branch sale which included the sale of approximately \$12 million in loans, as well as management's strategy to decrease our level of assets to improve our regulatory capital ratios and reduce our overhead expenses.

The Company assigns risk rating classifications to its loans. These risk ratings are divided into the following groups:

- Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. 1-4 assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
  - Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;
- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any, and;
-

Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

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Loans are considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Allowance for loan losses

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan portfolio. We maintain policies and procedures that address the systems of controls over the following areas of maintenance of the allowance: the systematic methodology used to determine the appropriate level of the allowance to provide assurance they are maintained in accordance with accounting principles generally accepted in the United States of America; the accounting policies for loan charge-offs and recoveries; the assessment and measurement of impairment in the loan portfolio; and the loan grading system.

The allowance reflects management's best estimate of probable losses within the existing loan portfolio and of the risk inherent in various components of the loan portfolio, including loans identified as impaired as required by FASB Codification Topic 310: Receivables. Loans evaluated individually for impairment include non-performing loans, such as loans on non-accrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment.

Loans are grouped by similar characteristics, including the type of loan, the assigned loan classification and the general collateral type. A loss rate reflecting the expected loss inherent in a group of loans is derived based upon historical net charge-off rates, the predominant collateral type for the group and the terms of the loan. The resulting estimate of losses for groups of loans is adjusted for relevant environmental factors and other conditions of the portfolio of loans and leases, including: borrower and industry concentrations; levels and trends in delinquencies, charge-offs and recoveries; changes in underwriting standards and risk selection; level of experience, ability and depth of lending management; and national and local economic conditions.

The amounts of estimated impairment for individually evaluated loans and groups of loans are added together for a total estimate of loan losses. This estimate of losses is compared to our allowance for loan losses as of the evaluation date and, if the estimate of losses is greater than the allowance, an additional provision to the allowance would be made. If the estimate of losses is less than the allowance, the degree to which the allowance exceeds the estimate is evaluated to determine whether the allowance falls outside a range of estimates. We recognize the inherent imprecision in estimates of losses due to various uncertainties and variability related to the factors used, and therefore a reasonable range around the estimate of losses is derived and used to ascertain whether the allowance is too high. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the financial statements.

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The allowance for loan losses at June 30, 2013 was \$9,610,000, compared to \$10,808,000 at December 31, 2012. The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) at June 30, 2013 and December 31, 2012 was 3.14% and 3.04%, respectively. The decrease in the allowance for loan losses for the first six months of 2013 was primarily a result of the decline in portfolio loans of \$49,294,000 as well as significant charge-offs recognized during the quarter for which specific provisions for loan losses had been previously provided. We believe the amount of the allowance for loan losses at June 30, 2013 is adequate to absorb the losses that can reasonably be anticipated from the loan portfolio at that date.



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The following table presents an analysis of the changes in the allowance for loan losses for the periods indicated (in thousands).

|  | Analysis of Allowance for Loan Losses<br>(In thousands) |          |
|--|---|----------|
|  | Six Months Ended<br>June 30,                            |          |
|  | 2013  | 2012     |
| Beginning balance  | \$10,808  | \$16,071 |
| Provision for loan losses  | 823   | 8,395    |
| Charge-offs  |   |          |
| Construction and land development  |   |          |
| Residential  | -   | (795 )   |
| Commercial   | (95 )   | (3,773 ) |
| Commercial real estate   |   |          |
| Farmland   | -   | -        |
| Commercial real estate - owner occupied                                  | (275 )  | (309 )   |
| Commercial real estate - non-owner occupied                              | (510 )  | (313 )   |
| Multifamily  |   |          |
| Consumer real estate   |   |          |
| Home equity lines  | (244 )  | (292 )   |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | (875 )  | (2,589 ) |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | (215 )  | (197 )   |
| Commercial and industrial loans<br>(except those secured by real estate) | (351 )  | (1,156 ) |
| Consumer and other   | (14 )   | (402 )   |
|  | (2,579 )  | (9,827 ) |
| Recoveries   |   |          |
| Construction and land development  |   |          |
| Residential  | 101   | 1        |
| Commercial   | 246   | 1        |
| Commercial real estate   |   |          |
| Farmland   | -   | -        |
| Commercial real estate - owner occupied                                  | 43  | -        |
| Commercial real estate - non-owner occupied                              | -   | -        |
| Multifamily  |   |          |
| Consumer real estate   |   |          |
| Home equity lines  | -   | 1        |
| Secured by 1-4 family residential,<br>secured by first deeds of trust    | 21  | 81       |
| Secured by 1-4 family residential,<br>secured by second deeds of trust   | 5   | 5        |
| Commercial and industrial loans<br>(except those secured by real estate) | 136   | 134      |
| Consumer and other   | 6   | 3        |
|  | 558   | 226      |
| Net charge-offs  | (2,021 )  | (9,601 ) |

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|   |           |   |           |   |
|---|-----------|---|-----------|---|
| Ending balance  | \$9,610   |   | \$14,866  |   |
| Loans outstanding at end of period (1)  | \$306,352 |   | \$393,787 |   |
| Ratio of allowance for loan losses as a percent of loans outstanding at end of period | 3.14      | % | 3.78      | % |
| Average loans outstanding for the period (1)  | \$330,797 |   | \$405,173 |   |
| Ratio of net charge-offs to average loans outstanding for the period                  | 0.61      | % | 2.37      | % |

(1) Loans are net of unearned income.

The allowance for loan losses as a percentage of net loans decreased from 3.78% at June 30, 2012 to 3.14% at June 30, 2013 primarily as a result of significant charge-offs recognized during the prior year for which specific provisions for loan losses had been previously provided.

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## Asset quality

The following table summarizes asset quality information at the dates indicated (dollars in thousands).

|   | June 30,<br>2013 | December<br>31,<br>2012 | June 30,<br>2012 |  |   |
|---|------------------|-------------------------|------------------|--|---|
| Nonaccrual loans  | \$21,686         | \$25,605                | \$56,632         |  |   |
| Foreclosed properties   | 22,044           | 20,204                  | 17,677           |  |   |
| Total nonperforming assets  | \$43,730         | \$45,809                | \$74,309         |  |   |
| Restructured loans still accruing   | \$31,271         | \$38,820                | \$12,655         |  |   |
| Loans past due 90 days and still accruing<br>(not included in nonaccrual loans above) | \$-              | \$115                   | \$199            |  |   |
| Nonperforming assets to loans at end of period(1)                                     | 14.3             | % 12.9                  | % 18.9           |  | % |
| Nonperforming assets to total assets  | 9.0              | % 9.0                   | % 14.1           |  | % |
| Allowance for loan losses to nonaccrual loans   | 44.3             | % 42.2                  | % 26.3           |  | % |

(1) Loans are net of deferred fees and costs.

The following table presents an analysis of the changes in nonperforming assets for the six months ended June 30, 2013 (dollars in thousands).

|                              | Nonaccrual<br>Loans | Foreclosed<br>Properties | Total     |
|------------------------------|---------------------|--------------------------|-----------|
| Balance December 31,<br>2012 | \$ 25,605           | \$ 20,204                | \$ 45,809 |
| Additions, net               | 7,050               | 189                      | 7,239     |
| Transfers to OREO            | (5,432 )            | 5,432                    | -         |
| Repayments                   | (2,965 )            | -                        | (2,965 )  |
| Charge-offs                  | (2,572 )            | (1,487 )                 | (4,059 )  |
| Sales                        | -                   | (2,294 )                 | (2,294 )  |
| Balance June 30, 2013        | \$ 21,686           | \$ 22,044                | \$ 43,730 |

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The following table presents an analysis of the changes in nonperforming assets for the twelve months ended June 30, 2013 (dollars in thousands).

|                       | Nonaccrual<br>Loans | Foreclosed<br>Properties | Total     |
|-----------------------|---------------------|--------------------------|-----------|
| Balance June 30, 2012 | \$ 56,632           | \$ 17,677                | \$ 74,309 |
| Additions, net        | 1,959               | 848                      | 2,807     |
| Transfers to OREO     | (15,341)            | 15,341                   | -         |
| Repayments            | (14,356)            | -                        | (14,356)  |
| Charge-offs           | (7,208 )            | (3,222 )                 | (10,430)  |
| Sales                 |                     | (8,600 )                 | (8,600 )  |
| Balance June 30, 2013 | \$ 21,686           | \$ 22,044                | \$ 43,730 |

Until a nonperforming restructured loan has performed in accordance with its restructured terms for a minimum of six months, it will remain on nonaccrual status.

Interest is accrued on outstanding loan principal balances, unless the Company considers collection to be doubtful. Commercial and unsecured consumer loans are designated as non-accrual when the Company considers collection of expected principal and interest doubtful. Mortgage loans and most other types of consumer loans past due 90 days or more may remain on accrual status if management determines that concern over our ability to collect principal and interest is not significant. When loans are placed in non-accrual status, previously accrued and unpaid interest is reversed against interest income in the current period and interest is subsequently recognized only to the extent cash is received. Interest accruals are resumed on such loans only when in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

Of the total nonaccrual loans of \$21,686,000 at June 30, 2013 that were considered impaired, 18 loans totaling \$6,381,000 had specific allowances for loan losses totaling \$1,931,000. This compares to \$25,605,000 in nonaccrual loans at December 31, 2012 of which 15 loans totaling \$4,648,000 had specific allowances for loan losses of \$1,338,000.

Cumulative interest income that would have been recorded had nonaccrual loans been performing would have been approximately \$1,231,000 and \$2,018,000 for the six months ended June 30, 2013 and 2012, respectively.

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## Deposits

Deposits as of June 30, 2013 and December 31, 2012 were as follows:

|                                     | June 30, 2013 |       |   | December 31, 2012 |       |   |
|-------------------------------------|---------------|-------|---|-------------------|-------|---|
|                                     | Amount        | %     |   | Amount            | %     |   |
| Demand accounts                     | \$60,572,546  | 14.5  | % | \$57,049,348      | 13.1  | % |
| Interest checking accounts          | 42,512,454    | 10.1  | % | 45,861,199        | 10.5  | % |
| Money market accounts               | 66,403,772    | 15.8  | % | 66,007,160        | 15.1  | % |
| Savings accounts                    | 20,565,473    | 4.9   | % | 20,922,112        | 4.8   | % |
| Time deposits of \$100,000 and over | 106,224,844   | 25.4  | % | 113,332,481       | 26.0  | % |
| Other time deposits                 | 122,716,249   | 29.3  | % | 133,150,662       | 30.5  | % |
| Total                               | \$418,995,338 | 100.0 | % | \$436,322,962     | 100.0 | % |

Total deposits decreased by \$17,628,000, or 4.0%, from \$436,323,000 at December 31, 2012 to \$421,419,000 at June 30, 2013, as compared to a decrease of \$35,101,000, or 7.2%, during the first six months of 2012. Checking and savings accounts decreased by \$182,000, money market accounts increased by \$397,000 and time deposits decreased by \$17,542,000. The decline in time deposits was a result of the branch sale as well as repricing maturing time deposits at rates below market for noncore depositors. The cost of our interest-bearing deposits declined to 1.09% for the first six months of 2013 compared to 1.31% for the first six months of 2012.

The variety of deposit accounts that we offer has allowed us to be competitive in obtaining funds and has allowed us to respond with flexibility to, although not to eliminate, the threat of disintermediation (the flow of funds away from depository institutions such as banking institutions into direct investment vehicles such as government and corporate securities). Our ability to attract and retain deposits, and our cost of funds, has been, and is expected to continue to be, significantly affected by money market conditions.

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### Borrowings

We utilize borrowings to supplement deposits when they are available at a lower overall cost to us or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank of Atlanta (“FHLB”), the Bank is required to own capital stock in the FHLB and is authorized to apply for borrowings from the FHLB. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses to which the advances may be put, as well as on the size of the advances and repayment provisions. Borrowings from the FHLB were \$23,000,000 and \$28,000,000 at June 30, 2013 and December 31, 2012 respectively. The FHLB advances are secured by the pledge of residential mortgage loans, investment securities and our FHLB stock.

### Capital resources

Stockholders’ equity at June 30, 2013 was \$22,901,000, compared to \$24,965,000 at December 31, 2012. On May 1, 2009, the Company received a \$14,738,000 investment by the United States Department of the Treasury under its Capital Purchase Program (the TARP Program). The TARP Program is a voluntary program designed to provide capital for healthy banks to improve the flow of funds from banks to their customers. Under the TARP Program, the Company issued to the Treasury \$14,738,000 of preferred stock and warrants to purchase 499,030 shares of the Company’s common stock at a purchase price of \$4.43 per share. The preferred stock issued by the Company under the TARP Capital Purchase Program carries a 5% dividend until May 1, 2014, and 9% thereafter, unless the shares are redeemed by the Company. The \$(2,874,000) decrease in equity during the first six months of 2013 was primarily due to an unrealized loss of \$(2,588,000) related to a decline in the market value of available for sale investments. This decline in the market value of available for sale securities is attributable to an increase in interest rates during the second quarter. As of June 30, 2013, we do not have the intent to sell any of these securities and we believe that it is more likely than not that we will not have to sell these securities before a recovery of cost. The Bank has significant resources of liquidity other than these securities that will allow us to hold them. Additionally, the securities could be pledged to obtain loans for liquidity if needed.

During the first quarter of 2005, the Company issued \$5.2 million in Trust Preferred Capital Notes to increase its regulatory capital and to help fund its expected growth in 2005. During the third quarter of 2007, the Company issued \$3.6 million in Trust Preferred Capital Notes to partially fund the construction of an 80,000 square foot building completed in 2008. The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion.

The Company is currently prohibited by its Written Agreement with the Reserve Bank from making dividend or interest payments on the TARP program preferred stock or trust preferred capital notes without prior regulatory approval. In addition, the Consent Order with the FDIC and BFI provides that the Bank will not pay any dividends, pay bonuses or make any other form of payment outside the ordinary course of business resulting in a reduction in capital, without regulatory approval. At June 30, 2013, the aggregate amount of the Company’s total accrued but deferred dividend payments on TARP was \$1,750,137 and the interest payments on trust preferred capital notes was \$768,740.

In June 2012 as a result of the unpaid dividends, Treasury requested that an observer appointed by Treasury be allowed to attend the Company’s meetings of its board of directors. The observer started attending board meetings commencing in August 2012. Treasury has the contractual right to nominate up to two members to the board of directors upon the Company’s sixth deferred dividend payment. The Company has deferred nine dividend payments as of June 30, 2013. However, Treasury has not indicated at this time it will nominate two directors to our board.



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The Company is currently evaluating potential sources of additional capital, with the objective to become compliant with the capital requirements of the Consent Order as soon as practically possible. In addition the Company is considering various alternatives for the repayment of the preferred stock issued under the TARP Program. However, no assurance can be given that sources of new capital will be received.

The following table presents the composition of regulatory capital and the capital ratios for the Company at the dates indicated (dollars in thousands).

|   | June 30,<br>2013 |   | December<br>31,<br>2012 |   |
|---|------------------|---|-------------------------|---|
| Tier 1 capital                                    |                  |   |                         |   |
| Preferred stock                                   | \$59             |   | \$59                    |   |
| Common stock                                      | 17,007           |   | 17,007                  |   |
| Additional paid-in capital                        | 40,706           |   | 40,705                  |   |
| Retained earnings (deficit)                       | (33,538 )        |   | (33,174 )               |   |
| Warrant Surplus                                   | 732              |   | 732                     |   |
| Discount on preferred stock                       | (125 )           |   | (199 )                  |   |
| Qualifying trust preferred securities             | 3,216            |   | 3,306                   |   |
| Less intangible assets                            | (344 )           |   | (393 )                  |   |
| Disallowed Deferred tax asset                     | -                |   | -                       |   |
| Total equity                                      | 27,713           |   | 28,043                  |   |
| Total Tier 1 capital                              | 27,713           |   | 28,043                  |   |
| Tier 2 capital                                    |                  |   |                         |   |
| Qualifying trust preferred securities             | 5,548            |   | 5,458                   |   |
| Allowance for loan losses                         | 4,351            |   | 4,795                   |   |
| Total Tier 2 capital                              | 9,899            |   | 10,253                  |   |
| Total risk-based capital                          | 37,612           |   | 38,296                  |   |
| Risk-weighted assets                              | \$342,881        |   | \$377,572               |   |
| Average assets                                    | \$485,326        |   | \$505,046               |   |
| Capital ratios                                    |                  |   |                         |   |
| Leverage ratio (Tier 1 capital to average assets) | 5.71             | % | 5.55                    | % |
| Tier 1 capital to risk-weighted assets            | 8.08             | % | 7.43                    | % |
| Total capital to risk-weighted assets             | 10.97            | % | 10.14                   | % |
| Equity to total assets                            | 4.56             | % | 4.89                    | % |



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The following table presents the composition of regulatory capital and the capital ratios for the Bank at the dates indicated (dollars in thousands).

|   | June 30,<br>2013 |   | December<br>31,<br>2012 |   |
|---|------------------|---|-------------------------|---|
| Tier 1 capital                                    |                  |   |                         |   |
| Common stock                                      | 6,849            |   | 6,849                   |   |
| Additional paid-in capital                        | 55,407           |   | 55,406                  |   |
| Retained earnings (deficit)                       | (28,628 )        |   | (28,925 )               |   |
| Less intangible assets                            | (344 )           |   | (393 )                  |   |
| Total equity                                      | 33,284           |   | 32,937                  |   |
| Total Tier 1 capital                              | 33,284           |   | 32,937                  |   |
| <br>Tier 2 capital                                |                  |   |                         |   |
| Allowance for loan losses                         | 4,326            |   | 4,769                   |   |
| Total Tier 2 capital                              | 4,326            |   | 4,769                   |   |
| <br>Total risk-based capital                      | 37,610           |   | 37,706                  |   |
| <br>Risk-weighted assets                          | \$340,771        |   | \$375,451               |   |
| <br>Average assets                                | \$484,938        |   | \$505,150               |   |
| <br>Capital ratios                                |                  |   |                         |   |
| Leverage ratio (Tier 1 capital to average assets) | 6.86             | % | 6.52                    | % |
| Tier 1 capital to risk-weighted assets            | 9.77             | % | 8.77                    | % |
| Total capital to risk-weighted assets             | 11.04            | % | 10.04                   | % |
| Equity to total assets                            | 6.42             | % | 6.55                    | % |

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, under capitalized, significantly under capitalized, and critically under capitalized. The Bank met the ratio requirements to be categorized “well capitalized” institution as of June 30, 2013 and December 31, 2012. However, due to the minimum capital ratios required by the Consent Order, the Bank currently is considered “adequately capitalized”. The Consent Order requires the Bank to maintain a leverage ratio of at least 8% and a total capital to risk-weighted assets ratio of at least 11%. At June 30, 2013, the Bank’s leverage ratio was 6.86% and the total capital to risk weighted assets ratio was 11.04%. As required by the Consent Order, the Bank has provided a capital plan to the FDIC and BFI that demonstrates how the Bank will come into compliance with the required minimum capital ratios set forth in the Consent Order. When capital falls below the “well capitalized” requirement, consequences can include: new branch approval could be withheld; more frequent examinations by the FDIC; brokered deposits cannot be renewed without a waiver from the FDIC; and other potential limitations as described in FDIC Rules and Regulations sections 337.6 and 303, and FDIC Act section 29. In addition, the FDIC insurance assessment increases when an institution falls below the “well capitalized” classification.

## Liquidity

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

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At June 30, 2013, our liquid assets, consisting of cash, cash equivalents and investment securities available for sale totaled \$106,032,000, or 22% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, approximately \$9,636,000 of these securities are pledged against borrowings. Therefore, the related borrowings would need to be repaid prior to the securities being sold in order for these securities to be converted to cash.

Our holdings of liquid assets plus the ability to maintain and expand our deposit base and borrowing capabilities serve as our principal sources of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain two federal funds lines of credit with correspondent banks totaling \$22 million for which there were no borrowings against the lines at June 30, 2013.

At June 30, 2013, we had commitments to originate \$58,769,000 of loans. Fixed commitments to incur capital expenditures were less than \$25,000 at June 30, 2013. Certificates of deposit scheduled to mature in the 12-month period ending June 30, 2014 totaled \$96,574,000. We believe that a significant portion of such deposits will remain with us. We further believe that deposit growth, loan repayments and other sources of funds will be adequate to meet our foreseeable short-term and long-term liquidity needs.

Interest rate sensitivity

An important element of asset/liability management is the monitoring of our sensitivity to interest rate movements. In order to measure the effects of interest rates on our net interest income, management takes into consideration the expected cash flows from the securities and loan portfolios and the expected magnitude of the repricing of specific asset and liability categories. We evaluate interest sensitivity risk and then formulate guidelines to manage this risk based on management's outlook regarding the economy, forecasted interest rate movements and other business factors. Our goal is to maximize and stabilize the net interest margin by limiting exposure to interest rate changes.

Contractual principal repayments of loans do not necessarily reflect the actual term of our loan portfolio. The average lives of mortgage loans are substantially less than their contractual terms because of loan prepayments and because of enforcement of due-on-sale clauses, which gives us the right to declare a loan immediately due and payable in the event, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. In addition, certain borrowers increase their equity in the security property by making payments in excess of those required under the terms of the mortgage.

The sale of fixed rate loans is intended to protect us from precipitous changes in the general level of interest rates. The valuation of adjustable rate mortgage loans is not as directly dependent on the level of interest rates as is the value of fixed rate loans. As with other investments, we regularly monitor the appropriateness of the level of adjustable rate mortgage loans in our portfolio and may decide from time to time to sell such loans and reinvest the proceeds in other adjustable rate investments.

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The data in the following table reflects repricing or expected maturities of various assets and liabilities at June 30, 2013. The gap analysis represents the difference between interest-sensitive assets and liabilities in a specific time interval. Interest sensitivity gap analysis presents a position that existed at one particular point in time, and assumes that assets and liabilities with similar repricing characteristics will reprice at the same time and to the same degree.

Village Bank and Trust Financial Corp.  
Interest Rate Sensitivity GAP Analysis  
June 30, 2013  
(In thousands)

|  | Within 3<br>Months | 3 to 6<br>Months  | 6 to 12<br>Months  | 13 to 36<br>Months  | More than<br>36 Months | Total           |
|--|--------------------|-------------------|--------------------|---------------------|------------------------|-----------------|
| <b>Interest Rate Sensitive Assets</b>          |                    |                   |                    |                     |                        |                 |
| Loans (1)                                      |                    |                   |                    |                     |                        |                 |
| Fixed rate                                     | \$7,584            | \$6,159           | \$14,575           | \$17,898            | \$72,074               | \$118,290       |
| Variable rate                                  | 42,823             | 10,361            | 24,555             | 32,553              | 77,034                 | 187,326         |
| Investment securities                          | -                  | -                 | -                  | -                   | 58,067                 | 58,067          |
| Loans held for sale                            | 19,759             | -                 | -                  | -                   | -                      | 19,759          |
| Federal funds sold                             | 36,085             | -                 | -                  | -                   | -                      | 36,085          |
| <b>Total rate sensitive assets</b>             | <b>106,251</b>     | <b>16,520</b>     | <b>39,130</b>      | <b>50,451</b>       | <b>207,175</b>         | <b>419,527</b>  |
| <b>Cumulative rate sensitive assets</b>        | <b>106,251</b>     | <b>122,771</b>    | <b>161,901</b>     | <b>212,352</b>      | <b>419,527</b>         |                 |
| <b>Interest Rate Sensitive Liabilities</b>     |                    |                   |                    |                     |                        |                 |
| Interest checking                              | -                  | -                 | -                  | 42,512              | -                      | 42,512          |
| Money market accounts                          | 66,404             | -                 | -                  | -                   | -                      | 66,404          |
| Savings  | -                  | -                 | -                  | 20,565              | -                      | 20,565          |
| Certificates of deposit                        | 29,081             | 22,828            | 44,665             | 87,418              | 44,949                 | 228,941         |
| FHLB advances                                  | 5,000              | -                 | 5,000              | 13,000              | -                      | 23,000          |
| Trust Preferred Securities                     | -                  | -                 | -                  | -                   | 8,764                  | 8,764           |
| Other borrowings                               | 4,425              | -                 | -                  | -                   | -                      | 4,425           |
| <b>Total rate sensitive liabilities</b>        | <b>104,910</b>     | <b>22,828</b>     | <b>49,665</b>      | <b>163,495</b>      | <b>53,713</b>          | <b>394,611</b>  |
| <b>Cumulative rate sensitive liabilities</b>   | <b>104,910</b>     | <b>127,738</b>    | <b>177,403</b>     | <b>340,898</b>      | <b>394,611</b>         |                 |
| <b>Rate sensitivity gap for period</b>         | <b>\$1,341</b>     | <b>\$(6,308 )</b> | <b>\$(10,535 )</b> | <b>\$(113,044 )</b> | <b>\$153,462</b>       | <b>\$24,916</b> |
| <b>Cumulative rate sensitivity gap</b>         | <b>\$1,341</b>     | <b>\$(4,967 )</b> | <b>\$(15,502 )</b> | <b>\$(128,546 )</b> | <b>\$24,916</b>        |                 |
| <b>Ratio of cumulative gap to total assets</b> | <b>0.3</b>         | <b>% (1.0 )%</b>  | <b>(3.2 )%</b>     | <b>(26.6 )%</b>     | <b>5.1</b>             | <b>%</b>        |

|  |       |   |      |    |      |    |       |    |       |   |
|--|-------|---|------|----|------|----|-------|----|-------|---|
| Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities | 101.3 | % | 96.1 | %  | 91.3 | %  | 62.3  | %  | 106.3 | % |
| Ratio of cumulative gap to cumulative rate sensitive assets                        | 1.3   | % | (4.0 | )% | (9.6 | )% | (60.5 | )% | 5.9   | % |

(1) Includes nonaccrual loans of approximately \$21,686,000, which are spread throughout the categories.

At June 30, 2013, our balance sheet is asset sensitive for the first three months, meaning that our assets reprice more quickly than our liabilities during that period, and liability sensitive for the next thirty-three months, meaning that our liabilities will reprice more quickly than our assets during that period, with a ratio of cumulative gap to total assets ranging from a positive gap of 0.3% for the first three months to a negative gap of (26.6)% for thirteen to thirty six month period. A negative gap can adversely affect earnings in periods of increasing interest rates. Given the Federal Reserve's recent announcement that it will maintain short-term interest rates

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at current levels until the end of 2014, we do not expect interest rates to increase in the foreseeable future. However, we believe our balance sheet should be asset sensitive and, accordingly, we have adopted pricing policies to lengthen the maturities/repricing of our liabilities relative to the maturities/pricing of our assets.

### Critical accounting policies

#### General

The accounting and reporting policies of the Company and its subsidiary are in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and conform to general practices within the banking industry. The Company’s financial position and results of operations are affected by management’s application of accounting policies, including estimates, assumptions and judgments made to arrive at the carrying value of assets and liabilities, and amounts reported for revenues, expenses and related disclosures. Different assumptions in the application of these policies could result in material changes in the Company’s consolidated financial position and/or results of operations.

The more critical accounting and reporting policies include the Company’s accounting for the allowance for loan losses, troubled debt restructurings, real estate acquired in settlement of loans, and income taxes. The Company’s accounting policies are fundamental to understanding the Company’s consolidated financial position and consolidated results of operations.

The following is a summary of the Company’s critical accounting policies that are highly dependent on estimates, assumptions, and judgments.

#### Allowance for loan losses

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan portfolio. We maintain policies and procedures that address the systems of controls over the following areas of maintenance of the allowance: the systematic methodology used to determine the appropriate level of the allowance to provide assurance they are maintained in accordance with accounting principles generally accepted in the United States of America; the accounting policies for loan charge-offs and recoveries; the assessment and measurement of impairment in the loan portfolio; and the loan grading system.

The allowance reflects management’s best estimate of probable losses within the existing loan portfolio and of the risk inherent in various components of the loan portfolio, including loans identified as impaired as required by FASB Codification Topic 310: Receivables. Loans evaluated individually for impairment include non-performing loans, such as loans on non-accrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment.

Loans are grouped by similar characteristics, including the type of loan, the assigned loan classification and the general collateral type. A loss rate reflecting the expected loss inherent in a group of loans is derived based upon estimates of default rates for a given loan grade, the predominant collateral type for the group and the terms of the loan. The resulting estimate of losses for groups of loans is adjusted for relevant environmental factors and other conditions of the portfolio of loans and leases, including: borrower and industry concentrations; levels and trends in delinquencies, charge-offs and recoveries; changes in underwriting standards and risk selection; level of experience, ability and depth of lending management; and national and local economic conditions.



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The amounts of estimated impairment for individually evaluated loans and groups of loans are added together for a total estimate of loan losses. This estimate of losses is compared to our allowance for loan losses as of the evaluation date and, if the estimate of losses is greater than the allowance, an additional provision to the allowance would be made. If the estimate of losses is less than the allowance, the degree to which the allowance exceeds the estimate is evaluated to determine whether the allowance falls outside a range of estimates. If the estimate of losses is below the range of reasonable estimates, the allowance would be reduced by way of a credit to the provision for loan losses. We recognize the inherent imprecision in estimates of losses due to various uncertainties and variability related to the factors used, and therefore a reasonable range around the estimate of losses is derived and used to ascertain whether the allowance is too high. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the financial statements.

### Troubled debt restructurings

A loan is accounted for as a troubled debt restructuring if we, for economic or legal reasons, grant a concession to a borrower considered to be experiencing financial difficulties that we would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or balance of the loan, a reduction of accrued interest, an extension of the maturity date or renewal of the loan at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans. Accruing troubled debt restructurings are generally excluded from nonperforming loans as it is considered probable that all contractual principal and interest due under the restructured terms will be collected. Troubled debt restructurings generally remain categorized as nonperforming loans and leases until a six-month payment history has been maintained.

In accordance with current accounting guidance, loans modified as troubled debt restructurings are, by definition, considered to be impaired loans. Impairment for these loans is measured on a loan-by-loan basis similar to other impaired loans as described above under Allowance for loan losses. Certain loans modified as troubled debt restructurings may have been previously measured for impairment under a general allowance methodology (i.e., pooling), thus at the time the loan is modified as a troubled debt restructuring the allowance will be impacted by the difference between the results of these two measurement methodologies. Loans modified as troubled debt restructurings that subsequently default are factored into the determination of the allowance in the same manner as other defaulted loans.

### Real estate acquired in settlement of loans

Real estate acquired in settlement of loans represent properties acquired through foreclosure or physical possession. Write-downs to fair value less cost to sell of foreclosed assets at the time of transfer are charged to allowance for loan losses. Subsequent to foreclosure, the Company periodically evaluates the value of foreclosed assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. Subsequent declines in value are charged to operations. Fair value is based on an assessment of information available at the end of a reporting period and depends upon a number of factors, including historical experience, economic conditions, and issues specific to individual properties. The evaluation of these factors involves subjective estimates and judgments that may change.



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### Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this 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. 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. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established. Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if management projects lower levels of future taxable income. Management determined that as of December 31, 2012 and June 30, 2013, the objective negative evidence represented by the Company's recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance of \$10,158,000 and \$10,368,000 respectively, representing 100% of the net deferred tax asset at the indicated date.

### New accounting standards

In February 2013, the Financial Accounting Standards Board (FASB) issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, which is intended to improve the reporting of reclassifications out of accumulated other comprehensive income. The ASU requires an entity to report, either on the face of the income statement or in the notes to the financial statements, the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in the income statement if the amount being reclassified is required to be reclassified in its entirety to net income. For other amounts that are not required to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other required disclosures that provide additional detail about those amounts. This ASU is effective prospectively in the first quarter of 2013. The Company has included the required disclosures from ASU 2013-02 in the consolidated financial statements.

### Impact of inflation and changing prices

The Company's consolidated financial statements included herein have been prepared in accordance with generally accepted accounting principles in the United States, which require the Company to measure financial position and operating results primarily in terms of historical dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Company is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Company, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

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ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable.

ITEM 4 – CONTROLS AND PROCEDURES

The Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) as of June 30, 2013. Based on that evaluation, management concluded that the Company's disclosure controls and procedures were effective as of June 30, 2013 in ensuring that all material information required to be disclosed in reports that it files or submits under the Exchange Act is recorded, processed summarized and reported with the time periods specified in SEC rules and regulations and that such information is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. There were no changes in our internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company's last fiscal quarter that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

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PART II – OTHER INFORMATION

ITEM 1 – LEGAL PROCEEDINGS

Not applicable.

ITEM 1A – RISK FACTORS

There were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2012.

ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

In consideration of our agreements with our regulators, which require regulatory approval to make dividend payments on our preferred stock, the Company notified the U.S. Treasury in May 2011 that the Company was going to defer the payment of the quarterly cash dividend of \$184,225 due on May 16, 2011, and subsequent quarterly payments, on the Preferred Stock. The total arrearage on such preferred stock as of June 30, 2013 was \$1,750,137.

ITEM 4 – MINE SAFETY DISCOLOSURES

None

ITEM 5 – OTHER INFORMATION

Not applicable.

ITEM 6 – EXHIBITS

31.1 Certification of Chief Executive Officer

31.2 Certification of Chief Financial Officer

32.1 Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

101 The following materials from the Village Bank and Trust Financial Corp. Quarterly Report on Form 10-Q for the quarter ended June 30, 2013 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Stockholders' Equity, (iv) Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements



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SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

VILLAGE BANK AND TRUST FINANCIAL CORP.  
(Registrant)

Date: August 14,  
2013

By: /s/ Thomas W.  
Winfree  
T h o m a s W .  
Winfree  
President and  
Chief Executive  
Officer

Date: August 14,  
2013

By: /s/ C. Harri l  
Whitehurst, Jr.  
C . H a r r i l  
Whitehurst, Jr.  
S e n i o r V i c e  
President and  
Chief Financial  
Officer

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Exhibit Index

| Exhibit Number | Document   |
|----------------|--|
| <u>31.1</u>    | <u>Certification of Chief Executive Officer</u>  |
| <u>31.2</u>    | <u>Certification of Chief Financial Officer</u>  |
| <u>32.1</u>    | <u>Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350</u>   |
| 101            | The following materials from the Village Bank and Trust Financial Corp. Quarterly Report on Form 10-Q for the quarter ended June 30, 2013 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Stockholders' Equity, (iv) Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements |

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