

OLD POINT FINANCIAL CORP  
Form 10-Q  
November 14, 2012

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

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

Commission File Number: 000-12896

OLD POINT FINANCIAL CORPORATION  
(Exact name of registrant as specified in its charter)

VIRGINIA  
(State or other jurisdiction of incorporation or organization)

54-1265373  
(I.R.S. Employer Identification No.)

1 West Mellen Street, Hampton, Virginia 23663  
(Address of principal executive offices) (Zip Code)

(757) 728-1200  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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Indicate by check mark 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

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

4,959,009 shares of common stock (\$5.00 par value) outstanding as of October 31, 2012

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OLD POINT FINANCIAL CORPORATION

FORM 10-Q

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

Old Point Financial Corporation and Subsidiaries  
Consolidated Balance Sheets

	September 30, 2012 (unaudited)	December 31, 2011
Assets		
Cash and due from banks	\$ 14,206,468	\$ 9,523,279
Interest-bearing due from banks	34,657,124	13,977,625
Federal funds sold	712,811	1,353,752
Cash and cash equivalents	49,576,403	24,854,656
Securities available-for-sale, at fair value	312,420,450	236,598,688
Securities held-to-maturity (fair value approximates \$620,373 and \$1,525,624)	615,000	1,515,000
Restricted securities	2,561,900	3,451,000
Loans, net of allowance for loan losses of \$7,300,855 and \$8,497,731	456,242,657	511,829,008
Premises and equipment, net	31,079,465	30,263,937
Bank-owned life insurance	21,627,402	21,593,464
Foreclosed assets, net of valuation allowance of \$1,913,573 and \$1,851,160	6,841,857	9,390,130
Other assets	6,920,744	10,007,712
Total assets	\$ 887,885,878	\$ 849,503,595
Liabilities & Stockholders' Equity		
Deposits:		
Noninterest-bearing deposits	\$ 176,190,771	\$ 163,639,321
Savings deposits	247,765,416	232,348,196
Time deposits	307,718,253	294,891,492
Total deposits	731,674,440	690,879,009
Overnight repurchase agreements	37,265,471	35,000,910
Term repurchase agreements	1,277,783	1,480,103
Federal Home Loan Bank advances	25,000,000	35,000,000
Accrued expenses and other liabilities	2,272,553	1,278,858
Total liabilities	797,490,247	763,638,880
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$5 par value, 10,000,000 shares authorized; 4,959,009 and 4,959,009 shares issued and outstanding	24,795,045	24,795,045
Additional paid-in capital	16,391,043	16,309,983
Retained earnings	47,156,113	45,109,268
Accumulated other comprehensive income (loss), net	2,053,430	(349,581 )
Total stockholders' equity	90,395,631	85,864,715

Total liabilities and stockholders' equity	\$	887,885,878	\$	849,503,595
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See Notes to Consolidated Financial Statements.

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Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012 (unaudited)	2011	2012 (unaudited)	2011
<b>Interest and Dividend Income:</b>				
Interest and fees on loans	\$ 6,494,629	\$ 7,923,224	\$ 20,313,095	\$ 24,516,542
Interest on due from banks	16,871	2,772	43,151	4,070
Interest on federal funds sold	401	6,855	1,164	21,011
<b>Interest on securities:</b>				
Taxable	1,229,204	1,010,473	3,830,104	2,809,242
Tax-exempt	201,758	31,843	443,967	109,250
Dividends and interest on all other securities	15,364	16,756	60,556	48,852
<b>Total interest and dividend income</b>	<b>7,958,227</b>	<b>8,991,923</b>	<b>24,692,037</b>	<b>27,508,967</b>
<b>Interest Expense:</b>				
Interest on savings deposits	95,052	101,393	283,291	309,742
Interest on time deposits	975,014	1,070,753	2,914,970	3,480,563
Interest on federal funds purchased, securities sold under agreements to repurchase and other borrowings	6,479	17,170	37,524	87,859
Interest on Federal Home Loan Bank advances	337,550	429,717	1,187,642	1,275,138
<b>Total interest expense</b>	<b>1,414,095</b>	<b>1,619,033</b>	<b>4,423,427</b>	<b>5,153,302</b>
<b>Net interest income</b>	<b>6,544,132</b>	<b>7,372,890</b>	<b>20,268,610</b>	<b>22,355,665</b>
Provision for loan losses	750,000	600,000	1,950,000	2,900,000
<b>Net interest income, after provision for loan losses</b>	<b>5,794,132</b>	<b>6,772,890</b>	<b>18,318,610</b>	<b>19,455,665</b>
<b>Noninterest Income:</b>				
Income from fiduciary activities	776,615	713,946	2,396,266	2,244,842
Service charges on deposit accounts	1,050,152	1,090,057	3,153,461	3,156,810
Other service charges, commissions and fees	853,989	726,866	2,531,050	2,285,238
Income from bank-owned life insurance	693,745	207,984	1,142,626	612,900
Gain on sale of available-for-sale securities, net	619,936	386,091	1,703,805	437,046
Other operating income	111,195	75,802	327,157	218,874
<b>Total noninterest income</b>	<b>4,105,632</b>	<b>3,200,746</b>	<b>11,254,365</b>	<b>8,955,710</b>
<b>Noninterest Expense:</b>				
Salaries and employee benefits	5,259,880	4,834,750	15,440,042	14,360,119
Occupancy and equipment	1,110,635	1,090,300	3,273,568	3,226,185
Data processing	448,854	358,774	1,222,757	1,025,173
FDIC insurance	284,042	271,462	851,194	942,941
Customer development	189,037	223,733	595,925	663,203
Legal and audit expense	174,672	176,161	582,784	539,188

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Other outside service fees	135,881	163,336	429,248	464,174
Advertising	138,733	131,340	430,345	417,874
Employee professional development	125,844	136,185	455,828	448,392
Postage and courier expense	118,179	123,365	361,490	366,649
Foreclosed assets expense	143,807	151,399	311,172	399,269
Loss on write-down/sale of foreclosed assets	99,960	368,213	736,594	825,763
Other operating expense	522,706	509,492	1,557,371	1,525,371
Total noninterest expense	8,752,230	8,538,510	26,248,318	25,204,301
Income before income taxes	1,147,534	1,435,126	3,324,657	3,207,074
Income tax expense	73,346	391,847	533,961	783,841
Net income	\$ 1,074,188	\$ 1,043,279	\$ 2,790,696	\$ 2,423,233

Basic Earnings per Share:

Average shares outstanding	4,959,009	4,957,623	4,959,009	4,950,056
Net income per share of common stock	\$ 0.22	\$ 0.21	\$ 0.56	\$ 0.49

Diluted Earnings per Share:

Average shares outstanding	4,959,009	4,957,623	4,959,009	4,950,056
Net income per share of common stock	\$ 0.22	\$ 0.21	\$ 0.56	\$ 0.49

See Notes to Consolidated Financial Statements.



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Old Point Financial Corporation  
Consolidated Statements of Comprehensive Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012 (unaudited)	2011	2012 (unaudited)	2011
Net income	\$ 1,074,188	\$ 1,043,279	\$ 2,790,696	\$ 2,423,233
Other comprehensive income, net of tax				
Unrealized gains on securities				
Unrealized holding gains arising during the period	3,882,973	971,423	5,344,731	3,987,701
Less reclassification adjustment for gains recognized in income	(619,936 )	(386,091 )	(1,703,805)	(437,046 )
Less tax expense	(1,109,433)	(199,013 )	(1,237,915)	(1,207,223)
Net unrealized gains on securities	2,153,604	386,319	2,403,011	2,343,432
Other comprehensive income	2,153,604	386,319	2,403,011	2,343,432
Comprehensive income	\$ 3,227,792	\$ 1,429,598	\$ 5,193,707	\$ 4,766,665

See Notes to Consolidated Financial Statements.

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Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Changes in Stockholders' Equity

(unaudited)	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
<b>NINE MONTHS ENDED SEPTEMBER 30, 2012</b>						
Balance at beginning of period	4,959,009	\$ 24,795,045	\$ 16,309,983	\$45,109,268	\$ (349,581 )	\$ 85,864,715
Net income	0	0	0	2,790,696	0	2,790,696
Other comprehensive income, net of tax	0	0	0	0	2,403,011	2,403,011
Stock compensation expense	0	0	81,060	0	0	81,060
Cash dividends (\$0.15 per share)	0	0	0	(743,851 )	0	(743,851 )
Balance at end of period	4,959,009	\$ 24,795,045	\$ 16,391,043	\$47,156,113	\$ 2,053,430	\$ 90,395,631

**NINE MONTHS ENDED SEPTEMBER 30, 2011**

Balance at beginning of period	4,936,989	\$24,684,945	\$16,026,062	\$42,809,769	\$(2,569,127)	\$80,951,649
Net income	0	0	0	2,423,233	0	2,423,233
Other comprehensive income, net of tax	0	0	0	0	2,343,432	2,343,432
Exercise of stock options	22,020	110,100	174,105	0	0	284,205
Stock compensation expense	0	0	82,466	0	0	82,466
Cash dividends (\$0.15 per share)	0	0	0	(742,563 )	0	(742,563 )
Balance at end of period	4,959,009	\$24,795,045	\$16,282,633	\$44,490,439	\$(225,695 )	\$85,342,422

See Notes to Consolidated Financial Statements.

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Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2012	2011
	(unaudited)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$2,790,696	\$2,423,233
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,411,040	1,364,475
Provision for loan losses	1,950,000	2,900,000
Net gain on sale of available-for-sale securities	(1,703,805 )	(437,046 )
Net amortization of securities	1,142,043	152,189
Net (gain) loss on disposal of premises and equipment	396	(1,294 )
Net loss on write-down/sale of foreclosed assets	736,594	825,763
Income from bank owned life insurance	(1,142,626 )	(612,900 )
Stock compensation expense	81,060	82,466
Deferred tax expense	110,235	860,930
(Increase) decrease in other assets	1,653,149	(675,180 )
Increase in other liabilities	993,695	184,421
Net cash provided by operating activities	8,022,477	7,067,057
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of available-for-sale securities	(277,741,641)	(146,849,456)
Purchases of held-to-maturity securities	0	(2,000,000 )
Proceeds from sales of restricted securities	889,100	640,300
Proceeds from maturities and calls of securities	59,843,643	97,722,651
Proceeds from sales of available-for-sale securities	147,178,925	51,405,975
Decrease in loans made to customers	53,071,871	53,208,573
Proceeds from sales of foreclosed assets	2,461,219	772,601
Purchases of bank-owned life insurance	0	(2,750,000 )
Proceeds from payout on bank-owned life insurance policy	1,109,296	0
Purchases of premises and equipment	(2,226,964 )	(1,822,389 )
Net cash provided by (used in) investing activities	(15,414,551 )	50,328,255
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Increase in noninterest-bearing deposits	12,551,450	29,955,076
Increase in savings deposits	15,417,220	6,873,986
Increase (decrease) in time deposits	12,826,761	(25,640,915 )
Increase (decrease) in federal funds purchased, repurchase agreements and other borrowings	2,062,241	(50,036,100 )
Decrease in Federal Home Loan Bank advances	(10,000,000 )	0
Proceeds from exercise of stock options	0	284,205
Cash dividends paid on common stock	(743,851 )	(742,563 )
Net cash provided by (used in) financing activities	32,113,821	(39,306,311 )
Net increase in cash and cash equivalents	24,721,747	18,089,001
Cash and cash equivalents at beginning of period	24,854,656	28,431,149

Cash and cash equivalents at end of period	\$49,576,403	\$46,520,150
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**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION**

Cash payments for:

Interest	\$4,526,922	\$5,374,688
Income tax	\$600,000	\$0

**SUPPLEMENTAL SCHEDULE OF NONCASH TRANSACTIONS**

Unrealized gain on securities available-for-sale	\$3,640,925	\$3,550,655
Loans transferred to foreclosed assets	\$564,480	\$2,197,810

See Notes to Consolidated Financial Statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. General

The accompanying unaudited consolidated financial statements of Old Point Financial Corporation (the Company) and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at September 30, 2012 and December 31, 2011, the results of operations and statements of comprehensive income for the three and nine months ended September 30, 2012 and 2011, and statements of changes in stockholders' equity and of cash flows for the nine months ended September 30, 2012 and 2011. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2011 annual report on Form 10-K. Certain previously reported amounts have been reclassified to conform to current period presentation.

AVAILABLE INFORMATION

The Company maintains a website on the Internet at [www.oldpoint.com](http://www.oldpoint.com). The Company makes available free of charge, on or through its website, its proxy statements, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission (SEC). The information available on the Company's Internet website is not part of this Form 10-Q or any other report filed by the Company with the SEC. The public may read and copy any documents the Company files at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The Company's SEC filings can also be obtained on the SEC's website on the Internet at [www.sec.gov](http://www.sec.gov).

SUBSEQUENT EVENTS

In accordance with ASC 855-10, "Subsequent Events," the Company evaluates subsequent events that have occurred after the balance sheet date but before the financial statements are issued. There are two types of subsequent events: (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) nonrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

The Company is expanding the building of a current branch office. The Company signed a contract with a general contractor on April 19, 2012. The contract entitles the contractor to \$2.1 million for Phase I of the construction, which includes site work and construction of the building shell. The Company signed an amendment to the contract with the general contractor on October 16, 2012 for the remainder of the construction. The revised contract entitles the contractor to \$12.2 million for the construction of the building. As of the writing of this quarterly report on Form 10-Q, \$1.0 million had been disbursed to the contractor. The Company anticipates that the project will likely cost between \$13.0 million and \$15.0 million over the next one to one and a half years.

Other than those discussed above, the Company did not identify any recognized or nonrecognized subsequent events that would have required adjustment to or disclosure in the financial statements.

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## Note 2. Securities

Amortized costs and fair values of securities held-to-maturity as of the dates indicated are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
September 30, 2012				
Obligations of U.S. Government agencies	\$ 470	\$ 4	\$ 0	\$ 474
Obligations of state and political subdivisions	145	1	0	146
Total	\$ 615	\$ 5	\$ 0	\$ 620
December 31, 2011				
Obligations of U.S. Government agencies	\$ 1,370	\$ 8	\$ 0	\$ 1,378
Obligations of state and political subdivisions	145	3	0	148
Total	\$ 1,515	\$ 11	\$ 0	\$ 1,526

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Amortized costs and fair values of securities available-for-sale as of the dates indicated are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
September 30, 2012				
Obligations of U.S.				
Government agencies	\$ 30,675	\$ 1,337	\$ 0	\$ 32,012
Obligations of state and political subdivisions	32,989	643	(77 )	33,555
Mortgage-backed securities	241,206	4,050	0	245,256
Money market investments	1,198	0	0	1,198
Corporate bonds and other securities	400	0	(1 )	399
Total	\$ 306,468	\$ 6,030	\$ (78 )	\$ 312,420
December 31, 2011				
U.S. Treasury securities	\$ 250	\$ 0	\$ 0	\$ 250
Obligations of U.S.				
Government agencies	117,848	1,706	0	119,554
Obligations of state and political subdivisions	11,999	266	(4 )	12,261
Mortgage-backed securities	102,884	396	(52 )	103,228
Money market investments	1,306	0	0	1,306
Total	\$ 234,287	\$ 2,368	\$ (56 )	\$ 236,599

**OTHER-THAN-TEMPORARILY IMPAIRED SECURITIES**

Management assesses whether the Company intends to sell or it is more-likely-than-not that the Company will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired and that the Company does not intend to sell and will not be required to sell prior to recovery of the amortized cost basis, the Company separates the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income.

The present value of expected future cash flows is determined using the best-estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best-estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds, and structural support, including subordination and guarantees.

The Company has a process in place to identify debt securities that could potentially have a credit or interest-rate related impairment that is other-than-temporary. This process involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts, and cash flow projections as indicators of credit issues. On a quarterly basis, management reviews all securities to determine whether an other-than-temporary decline in value exists and whether losses should be recognized. Management considers relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other-than-temporary. Relevant facts and circumstances considered include: (a) the extent and length of time the fair value has been below cost; (b) the reasons for the decline in value; (c) the financial position and access to capital of the issuer, including the current and future impact of any specific events; and (d) for fixed maturity securities, the Company's intent to sell a security or whether it is more-likely-than-not the Company will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and for equity securities, the Company's ability and intent to hold the security for a period of time that allows for the recovery in value.

The Company has not recorded impairment charges on securities for the quarter or nine months ended September 30, 2012 or the year ended December 31, 2011.

#### TEMPORARILY IMPAIRED SECURITIES

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are deemed to be temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of the dates indicated. The Company had no held-to-maturity securities with unrealized losses at September 30, 2012 or December 31, 2011.

September 30, 2012

	Less Than Twelve Months		More Than Twelve Months		Gross Unrealized Losses	Total		Number of Securities
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value		Fair Value	Fair Value	
(in thousands)								
Securities Available-for-Sale								
Obligations of state and political subdivisions	\$ 77	\$ 5,414	\$ 0	\$ 0	\$ 77	\$ 5,414		10
Corporate bonds and other securities	1	298	0	0	1	298		3
Total securities available-for-sale	\$ 78	\$ 5,712	\$ 0	\$ 0	\$ 78	\$ 5,712		\$ 13





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	Less Than Twelve Months		December 31, 2011 More Than Twelve Months		Total		Number of Securities
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Securities							
Available-for-Sale							
Debt securities:							
Obligations of state and political subdivisions	\$ 4	\$ 1,706	\$ 0	\$ 0	\$ 4	\$ 1,706	2
Mortgage-backed securities	52	29,364	0	0	52	29,364	3
Total securities available-for-sale	\$ 56	\$ 31,070	\$ 0	\$ 0	\$ 56	\$ 31,070	5

Certain investments within the Company's portfolio had unrealized losses at September 30, 2012 and December 31, 2011, as shown in the tables above. The unrealized losses were caused by increases in market interest rates. Because the Company does not intend to sell the investments and management believes it is unlikely that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider the investments to be other-than-temporarily impaired at September 30, 2012 or December 31, 2011.

**Restricted Securities**

The restricted security category is comprised of stock in the Federal Home Loan Bank of Atlanta (FHLB) and the Federal Reserve Bank (FRB). These stocks are classified as restricted securities because their ownership is restricted to certain types of entities and the securities lack a market. Therefore, FHLB and FRB stock is carried at cost and evaluated for impairment. When evaluating these stocks for impairment, their value is determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. Restricted stock is viewed as a long-term investment and management believes that the Company has the ability and the intent to hold this stock until its value is recovered.

**Note 3. Loans and the Allowance for Loan Losses**

The following is a summary of the balances in each class of the Company's loan portfolio as of the dates indicated:

	September 30, 2012	December 31, 2011
	(in thousands)	
Mortgage loans on real estate:		
Residential 1-4 family	\$ 74,965	\$ 77,588
Commercial	270,772	288,108
Construction	13,789	19,981
Second mortgages	14,758	16,044
Equity lines of credit	32,288	34,220
Total mortgage loans on real estate	406,572	435,941

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Commercial loans	25,800	35,015
Consumer loans	13,904	17,041
Other	17,268	32,330
Total loans	463,544	520,327
Less: Allowance for loan losses	(7,301 )	(8,498 )
Loans, net of allowance and deferred fees	\$ 456,243	\$ 511,829

Overdrawn deposit accounts are reclassified as loans and included in the Other category in the table above. Overdrawn deposit accounts totaled \$937 thousand and \$583 thousand at September 30, 2012 and December 31, 2011, respectively.

#### CREDIT QUALITY INFORMATION

The Company uses internally-assigned risk grades to estimate the capability of borrowers to repay the contractual obligations of their loan agreements as scheduled or at all. The Company's internal risk grade system is based on experiences with similarly graded loans. Credit risk grades are updated at least quarterly as additional information becomes available, at which time management analyzes the resulting scores to track loan performance.

The Company's internally assigned risk grades are as follows:

- Pass: Loans are of acceptable risk.
- Other Assets Especially Mentioned (OAEM): Loans have potential weaknesses that deserve management's close attention.
- Substandard: Loans reflect significant deficiencies due to several adverse trends of a financial, economic or managerial nature.
- Doubtful: Loans have all the weaknesses inherent in a substandard loan with added characteristics that make collection or liquidation in full based on currently existing facts, conditions and values highly questionable or improbable.
- Loss: Loans have been charged off because they are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

Index**CREDIT QUALITY INFORMATION**

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- Loss: Loans have been charged off because they are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

The following table presents credit quality exposures by internally assigned risk ratings as of the dates indicated:

Credit Quality Information As of September 30, 2012 (in thousands)					
	Pass	OAEM	Substandard	Doubtful	Total
Mortgage loans on real estate:					
Residential 1-4 family	\$ 68,837	\$ 913	\$ 5,215	\$ 0	\$ 74,965
Commercial	254,391	4,844	11,537	0	270,772
Construction	10,250	386	3,153	0	13,789
Second mortgages	14,150	244	364	0	14,758
Equity lines of credit	31,492	232	564	0	32,288
Total mortgage loans on real estate	379,120	6,619	20,833	0	406,572
Commercial loans	23,623	1,136	1,041	0	25,800
Consumer loans	13,757	0	147	0	13,904
Other	17,268	0	0	0	17,268
Total	\$ 433,768	\$ 7,755	\$ 22,021	\$ 0	\$ 463,544

Credit Quality Information As of December 31, 2011 (in thousands)					
	Pass	OAEM	Substandard	Doubtful	Total
Mortgage loans on real estate:					
Residential 1-4 family	\$ 74,839	\$ 677	\$ 2,072	\$ 0	\$ 77,588
Commercial	258,610	11,803	17,695	0	288,108
Construction	19,548	396	37	0	19,981
Second mortgages	15,212	0	832	0	16,044
Equity lines of credit	33,390	182	648	0	34,220
Total mortgage loans on real estate	401,599	13,058	21,284	0	435,941
Commercial loans	29,455	4,295	1,265	0	35,015
Consumer loans	16,955	0	86	0	17,041

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Other	32,330	0	0	0	32,330
Total	\$ 480,339	\$ 17,353	\$ 22,635	\$ 0	\$ 520,327

As of September 30, 2012 and December 31, 2011 the Company did not have any loans internally classified as Loss.

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## AGE ANALYSIS OF PAST DUE LOANS BY CLASS

All classes of loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Interest and fees continue to accrue on past due loans until the date the loan is placed in nonaccrual status, if applicable. The following table includes an aging analysis of the recorded investment in past due loans as of the dates indicated. Also included in the table below are loans that are 90 days or more past due as to interest and principal and still accruing interest, because they are well-secured and in the process of collection. Loans in nonaccrual status that are also past due are included in the aging categories in the table below.

## Age Analysis of Past Due Loans as of September 30, 2012

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Total Current Loans (1)	Total Loans	Recorded Investment > 90 Days Past Due and Accruing
	(in thousands)						
Mortgage loans on real estate:							
Residential 1-4 family	\$ 3,396	\$ 0	\$ 831	\$ 4,227	\$ 70,738	\$ 74,965	\$ 224
Commercial	1,179	883	1,918	3,980	266,792	270,772	0
Construction	36	0	2,976	3,012	10,777	13,789	0
Second mortgages	0	0	272	272	14,486	14,758	0
Equity lines of credit	60	0	381	441	31,847	32,288	15
Total mortgage loans on real estate	4,671	883	6,378	11,932	394,640	406,572	239
Commercial loans	100	160	0	260	25,540	25,800	0
Consumer loans	202	47	15	264	13,640	13,904	15
Other	44	9	3	56	17,212	17,268	3
Total	\$ 5,017	\$ 1,099	\$ 6,396	\$ 12,512	\$ 451,032	\$ 463,544	\$ 257

(1) For purposes of this table, Total Current Loans includes loans that are 1 - 29 days past due.

## Age Analysis of Past Due Loans as of December 31, 2011

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 or More Days Past Due	Total Past Due	Total Current Loans (1)	Total Loans	Recorded Investment > 90 Days Past Due and Accruing
	(in thousands)						
Mortgage loans on real estate:							
Residential 1-4 family	\$ 75	\$ 0	\$ 627	\$ 702	\$ 76,886	\$ 77,588	\$ 0
Commercial	0	0	1,123	1,123	286,985	288,108	510
Construction	148	0	0	148	19,833	19,981	0
Second mortgages	104	0	469	573	15,471	16,044	0
Equity lines of credit	159	0	369	528	33,692	34,220	0
Total	486	0	2,588	3,074	432,867	435,941	510

## Total mortgage loans on real estate

Commercial loans	101	0	0	101	34,914	35,015	0
Consumer loans	58	89	2	149	16,892	17,041	2
Other	44	0	5	49	32,281	32,330	5
Total	\$ 689	\$ 89	\$ 2,595	\$ 3,373	\$ 516,954	\$ 520,327	\$ 517

(1) For purposes of this table, Total Current Loans includes loans that are 1 - 29 days past due.

Past due loans increased \$9.1 million between December 31, 2011 and September 30, 2012. Of this increase, \$6.4 million was due to increases in nonaccrual loans that were also past due. Of the \$9.3 million in past due nonaccrual loans at September 30, 2012, all but \$502 thousand have been written down to their net realizable value. At December 31, 2011, loans past due, excluding loans on nonaccrual status, were at \$1.3 million or 0.25% of total loans, the lowest year-end level since December 31, 2008. At September 30, 2012, loans past due, excluding loans on nonaccrual status, were \$3.3 million or 0.71% of total loans.

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## NONACCRUAL LOANS

The Company generally places non-consumer loans in nonaccrual status when the full and timely collection of interest or principal becomes uncertain, part of the principal balance has been charged off and no restructuring has occurred or the loan reaches 90 days past due, unless the credit is well-secured and in the process of collection. Under regulatory rules, consumer loans, which are loans to individuals for household, family and other personal expenditures, and loans secured by 1-4 family residential properties are not required to be placed in nonaccrual status. Although consumer loans and loans secured by 1-4 family residential property are not required to be placed in nonaccrual status, the Company may place a consumer loan or loan secured by 1-4 family residential property in nonaccrual status, if necessary to avoid a material overstatement of interest income.

Generally, consumer loans not secured by real estate are placed in nonaccrual status only when part of the principal has been charged off. These loans are charged off or written down to the net realizable value of the collateral when deemed uncollectible, due to bankruptcy or other factors, or when they are past due based on loan product, industry practice, terms and other factors.

When management places a loan in nonaccrual status, the accrued unpaid interest receivable is reversed against interest income and the loan is accounted for by the cash or cost recovery method, until it qualifies for return to accrual status or is charged off. Generally, management returns a loan to accrual status if (a) all delinquent interest and principal payments become current under the terms of the loan agreement or (b) the loan is both well-secured and in the process of collection and collectability is no longer doubtful.

The following table presents loans in nonaccrual status by class of loan as of the dates indicated:

(in thousands)	Nonaccrual Loans by Class	
	September 30, 2012	December 31, 2011
Mortgage loans on real estate:		
Residential 1-4 family	\$ 3,752	\$ 748
Commercial	3,190	6,719
Construction	3,116	0
Second mortgages	272	499
Equity lines of credit	466	368
Total mortgage loans on real estate	10,796	8,334
Commercial loans	100	129
Consumer loans	5	12
Total	\$ 10,901	\$ 8,475

The following table presents the interest income that the Company would have earned under the original terms of its nonaccrual loans and the actual interest recorded by the Company on nonaccrual loans for the periods presented:

	Nine Months Ended September 30,	
	2012	2011
	(in thousands)	
Interest income that would have been recorded under original loan terms	\$ 823	\$ 1,202
Actual interest income recorded for the period	235	515
Reduction in interest income on nonaccrual loans	\$ 588	\$ 687





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The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-02 “A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring” (ASU 2011-02). The Company’s loan portfolio includes certain loans that have been modified in a troubled debt restructuring (TDR), where economic concessions have been granted to borrowers who are experiencing financial difficulties. These concessions typically result from the Company’s loss mitigation activities and could include reduction in the interest rate below current market rates, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection. A TDR that is on nonaccrual status or is 30 days or more past due is considered to be nonperforming. Beginning with the second quarter of 2012, the Company changed its method for determining when a TDR is considered to be nonperforming. Prior to the second quarter of 2012, the Company classified TDRs as nonperforming at the time of restructure and a TDR could only be returned to performing status after considering the borrower’s sustained repayment performance in accordance with the restructured terms for a reasonable period, generally six months. Beginning with the second quarter of 2012, the Company defines a TDR as nonperforming only if the TDR is in nonaccrual status or 30 days or more past due at the report date. The reason for this change is that the Company found that some new TDRs, including those with favorable repayment performance for a reasonable period prior to the restructuring, were being classified as nonperforming solely because six months had not yet passed since the restructuring.

When the Company modifies a loan, management evaluates any possible impairment as stated in the impaired loan section below.

The following table presents TDRs during the period indicated, by class of loan:

	Number of Modifications	Recorded Investment Prior to Modification	Recorded Investment After Modification	Current Investment on September 30, 2012
Mortgage loans on real estate:				
Residential 1-4 family	1	\$ 93	\$ 87	\$ 72
Commercial	3	3,486	2,928	2,782
Second mortgages	1	111	145	139
Total	5	\$ 3,690	\$ 3,160	\$ 2,993

Three loans in the table above were given principal reductions, with the principal forgiveness on these loans totaling \$530 thousand. Three loans were given below-market rates for debt with similar risk characteristics. One loan was given both a principal reduction and a below-market rate.

The following table presents TDRs for which there was a payment default as of September 30, 2012, where the default occurred within twelve months of restructuring.

Restructurings that Subsequently Defaulted  
As of September 30, 2012  
(in thousands)

Recorded  
Investment in

	Defaulting Loans
Mortgage loans on real estate:	
Commercial	\$ 253
Total	\$ 253

#### IMPAIRED LOANS

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming commercial loans and loans modified in a TDR. When management identifies a loan as impaired, the impairment is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, except when the sole or remaining source of repayment for the loan is the operation or liquidation of the collateral. In these cases, management uses the current fair value of the collateral, less selling costs, when foreclosure is probable, instead of the discounted cash flows. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

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When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is in nonaccrual status, all payments are applied to principal under the cost-recovery method. For financial statement purposes, the recorded investment in the loan is the actual principal balance reduced by payments that would otherwise have been applied to interest. When reporting information on these loans to the applicable customers, the unpaid principal balance is reported as if payments were applied to principal and interest under the original terms of the loan agreements. Therefore, the unpaid principal balance reported to the customer would be higher than the recorded investment in the loan for financial statement purposes. When the ultimate collectability of the total principal of the impaired loan is not in doubt and the loan is in nonaccrual status, contractual interest is credited to interest income when received under the cash-basis method.

The following table includes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable, as of the dates presented. Also presented are the average recorded investments in the impaired loans and the related amount of interest recognized for the periods presented. The average balances are calculated based on daily average balances.

	Impaired Loans by Class (in thousands)				Nine Months Ended September 30, 2012	
	Unpaid Principal Balance	As of September 30, 2012 Recorded Investment		Associated Allowance	Average Recorded Investment	Interest Income Recognized
		Without Valuation Allowance	With Valuation Allowance			
Mortgage loans on real estate:						
Residential 1-4 family	\$ 4,062	\$ 729	\$ 3,276	\$ 334	\$ 1,809	\$ 127
Commercial	11,495	5,124	3,488	138	10,313	211
Construction	3,834	3,117	0	0	3,404	(10 )
Second mortgages	483	372	48	6	510	5
Equity lines of credit	470	109	357	145	400	1
Total mortgage loans on real estate	\$ 20,344	\$ 9,451	\$ 7,169	\$ 623	\$ 16,436	\$ 334
Commercial loans	119	0	100	13	106	0
Consumer loans	21	21	0	0	26	2
Total	\$ 20,484	\$ 9,472	\$ 7,269	\$ 636	\$ 16,568	\$ 336

	Impaired Loans by Class (in thousands)				For the Year Ended December 31, 2011	
	Unpaid Principal Balance	As of December 31, 2011 Recorded Investment		Associated Allowance	Average Recorded Investment	Interest Income Recognized
		Without Valuation Allowance	With Valuation Allowance			
Mortgage loans on real estate:						
Residential 1-4 family	\$ 486	\$ 391	\$ 91	\$ 6	\$ 3,753	\$ 554
Commercial	8,263	4,734	3,371	968	8,911	456
Construction	0	0	0	0	0	0

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Second mortgages	520	250	258	31	603	24
Equity lines of credit	371	369	0	0	392	21
Total mortgage loans on real estate	\$ 9,640	\$ 5,744	\$ 3,720	\$ 1,005	\$ 13,659	\$ 1,055
Commercial loans	142	19	110	23	130	2
Total	\$ 9,782	\$ 5,763	\$ 3,830	\$ 1,028	\$ 13,789	\$ 1,057

MONITORING OF LOANS AND EFFECT OF MONITORING FOR THE ALLOWANCE FOR LOAN LOSSES

Loan officers are responsible for continual portfolio analysis and prompt identification and reporting of problem loans, which includes assigning a risk grade to each applicable loan at its origination and revising such grade as the situation dictates. Loan officers maintain frequent contact with borrowers, which should enable the loan officer to identify potential problems before other personnel. In addition, meetings with loan officers and upper management are held to discuss problem loans and review risk grades. Nonetheless, in order to avoid over-reliance upon loan officers for problem loan identification, the Company's loan review system provides for review of loans and risk grades by individuals who are independent of the loan approval process. Risk grades and historical loss rates by risk grades are used as a component of the calculation of the allowance for loan losses.

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ALLOWANCE FOR LOAN LOSSES

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Company has segmented certain loans in the portfolio by product type. Loans are segmented into the following pools: commercial, real estate-construction, real estate-mortgage, consumer and other loans. The Company also sub-segments the real estate-mortgage segment into four classes: residential 1-4 family, commercial real estate, second mortgages and equity lines of credit. The Company uses an internally developed risk evaluation model in the estimation of the credit risk process. The model and assumptions used to determine the allowance are independently validated and reviewed to ensure that the theoretical foundation, assumptions, data integrity, computational processes and reporting practices are appropriate and properly documented.

Each portfolio segment has risk characteristics as follows:

- **Commercial:** Commercial loans carry risks associated with the successful operation of a business or project, in addition to other risks associated with the ownership of a business. The repayment of these loans may be dependent upon the profitability and cash flows of the business. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time and cannot be appraised with as much precision.
- **Real estate-construction:** Construction loans carry risks that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may at any point in time be less than the principal amount of the loan. Construction loans also bear the risk that the general contractor, who may or may not be the loan customer, may be unable to finish the construction project as planned because of financial pressure unrelated to the project.
- **Real estate-mortgage:** Residential mortgage loans and equity lines of credit carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral. Commercial real estate loans carry risks associated with the successful operation of a business if owner occupied. If non-owner occupied, the repayment of these loans may be dependent upon the profitability and cash flow from rent receipts.
- **Consumer loans:** Consumer loans carry risks associated with the continued credit-worthiness of the borrowers and the value of the collateral. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy.
- **Other loans:** Other loans are loans to mortgage companies, loans for purchasing or carrying securities, and loans to insurance, investment and finance companies. These loans carry risks associated with the successful operation of a business. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time, may depend on interest rates or may fluctuate in active trading markets.

To determine the balance of the allowance account for each segment of the loan portfolio, management pools each segment by risk grade individually and applies a historical loss percentage. At September 30, 2012 and December 31, 2011, the historical loss percentage was based on losses sustained in each segment of the portfolio over the previous eight quarters.

Management also provides an allocated component of the allowance for loans that are classified as impaired. An allocated allowance is established when the discounted value of future cash flows from the impaired loan (or the collateral value or observable market price of the impaired loan) is lower than the carrying value of that loan.

Based on credit risk assessments and management's analysis of qualitative factors, additional loss factors are applied to loan balances. These additional qualitative factors include: economic conditions, trends in growth, concentrations, changes in certain loans, changes in underwriting, changes in management and changes in the legal and regulatory environment.

The Company implemented two changes to the qualitative factors component of its allowance for loan loss in the second quarter of 2012. See the quarterly report on Form 10-Q for the second quarter of 2012, filed with the Securities

and Exchange Commission on August 14, 2012 for details. The Company implemented one change to the qualitative factors component of its allowance for loan loss in the third quarter of 2012. This change was made to the allocations for the qualitative factors for changes in past due loans, nonaccrual loans and loans risk rated substandard or doubtful. The allocation was increased to account for increases in past due and nonaccrual loans in the real estate categories, as seen in the tables above under “Age Analysis of Past Due Loans by Class.”

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## THE COMPANY'S ESTIMATION PROCESS

The allowance for loan losses is the accumulation of various components that are calculated based on independent methodologies. Management's estimate is based on certain observable, historical data that management believes are most reflective of the underlying credit losses being estimated. In addition, impaired loans are separately identified for evaluation and are measured based on the present value of expected future cash flows, the observable market price of the loans or the fair value of the collateral. Also, various qualitative factors are applied to each segment of the loan portfolio.

## ALLOWANCE FOR LOAN LOSSES BY SEGMENT

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses of \$7.3 million adequate to cover loan losses inherent in the loan portfolio at September 30, 2012.

The following table presents, by portfolio segment, the changes in the allowance for loan losses and the recorded investment in loans for the periods presented. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

## ALLOWANCE FOR LOAN LOSSES AND RECORDED INVESTMENT IN LOANS

(in thousands)

	Real Estate		Real Estate			
For the Nine Months Ended						
September 30, 2012	Commercial	Construction	Mortgage	Consumer	Other	Total
Allowance for Loan Losses:						
Balance at the beginning of period	\$ 1,011	\$ 323	\$ 6,735	\$ 300	\$ 129	\$ 8,498
Charge-offs	(86 )	(780 )	(2,232 )	(182 )	(130 )	(3,410 )
Recoveries	54	0	103	55	51	263
Provision for loan losses	(374 )	674	1,585	51	14	1,950
Ending balance	\$ 605	\$ 217	\$ 6,191	\$ 224	\$ 64	\$ 7,301
Ending balance individually evaluated for impairment	\$ 13	\$ 0	\$ 623	\$ 0	\$ 0	\$ 636
Ending balance collectively evaluated for impairment	592	217	5,568	224	64	6,665
Ending balance	\$ 605	\$ 217	\$ 6,191	\$ 224	\$ 64	\$ 7,301
Loan Balances:						
Ending balance individually evaluated for impairment	\$ 100	\$ 3,117	\$ 13,503	\$ 21	\$ 0	\$ 16,741
Ending balance collectively evaluated for impairment	25,700	10,672	379,280	13,883	17,268	446,803
Ending balance	\$ 25,800	\$ 13,789	\$ 392,783	\$ 13,904	\$ 17,268	\$ 463,544



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For the Year Ended		Real Estate -	Real Estate -			
December 31, 2011	Commercial	Construction	Mortgage	Consumer	Other	Total
Allowance for Loan Losses:						
Balance at the beginning of period	\$ 799	\$ 441	\$ 11,498	\$ 357	\$ 133	\$ 13,228
Charge-offs	(942 )	0	(7,822 )	(333 )	(210 )	(9,307 )
Recoveries	141	0	575	102	59	877
Provision for loan losses	1,013	(118 )	2,484	174	147	3,700
Ending balance	\$ 1,011	\$ 323	\$ 6,735	\$ 300	\$ 129	\$ 8,498
Ending balance individually evaluated for impairment						
	\$ 23	\$ 0	\$ 1,005	\$ 0	\$ 0	\$ 1,028
Ending balance collectively evaluated for impairment						
	988	323	5,730	300	129	7,470
Ending balance	\$ 1,011	\$ 323	\$ 6,735	\$ 300	\$ 129	\$ 8,498
Loan Balances:						
Ending balance individually evaluated for impairment						
	\$ 129	\$ 0	\$ 9,464	\$ 0	\$ 0	\$ 9,593
Ending balance collectively evaluated for impairment						
	34,886	19,981	406,496	17,041	32,330	510,734
Ending balance	\$ 35,015	\$ 19,981	\$ 415,960	\$ 17,041	\$ 32,330	\$ 520,327

## CHANGES IN ACCOUNTING METHODOLOGY

There were no changes in the Company's accounting methodology for the allowance for loan losses in the first nine months of 2012.

## Note 4. Share-Based Compensation

Share-based compensation arrangements include stock options, restricted stock awards, performance-based awards, stock appreciation rights and employee stock purchase plans. Accounting standards require all share-based payments to employees to be valued using a fair value method on the date of grant and to be expensed based on that fair value over the applicable vesting period.

There were no options granted in the first nine months of 2012.

On March 9, 2008, the Company's 1998 Stock Option Plan expired. Options to purchase 156,960 shares of common stock were outstanding under the Company's 1998 Stock Option Plan at September 30, 2012. The exercise price of each option equals the market price of the Company's common stock on the date of the grant and each option's maximum term is ten years.

Stock option activity for the nine months ended September 30, 2012 is summarized below:

Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
--------	--	---	---

	(in years)			
Options outstanding, January 1, 2012	165,710	\$21.64		
Granted	0	0		
Exercised	0	0		
Canceled or expired	(8,750 )	21.67		
Options outstanding, September 30, 2012	156,960	\$21.63	3.71	\$ 0
Options exercisable, September 30, 2012	138,718	\$21.84	3.53	\$ 0

The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on September 30, 2012. This amount changes based on changes in the market value of the Company's common stock. As of September 30, 2012, the outstanding options had no intrinsic value because the exercise prices of all outstanding options were above the market value of a share of the Company's common stock.

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No options were exercised during the nine months ended September 30, 2012.

As of September 30, 2012, there was \$1 thousand of unrecognized compensation cost related to nonvested options. This cost was recognized in October 2012.

## Note 5. Pension Plan

The Company provides pension benefits for eligible participants through a non-contributory defined benefit pension plan. The plan was frozen effective September 30, 2006; therefore, no additional participants will be added to the plan. The components of net periodic pension plan cost are as follows for the periods indicated:

Three months ended September 30,	2012	2011
	Pension Benefits	
Interest cost	\$ 72,889	\$ 76,031
Expected return on plan assets	(82,743 )	(104,964)
Loss related to early retirement plan	291,829	0
Amortization of net loss	84,330	42,585
Net periodic pension plan cost	\$ 366,305	\$ 13,652
Nine months ended September 30,	2012	2011
	Pension Benefits	
Interest cost	\$ 216,389	\$ 228,095
Expected return on plan assets	(277,743)	(314,893)
Loss related to early retirement plan	291,829	0
Amortization of net loss	196,830	127,756
Net periodic pension plan cost	\$ 427,305	\$ 40,958

The pension was in a loss position when the plan was frozen, with the loss amortized over several years. The Company offered an early retirement plan to certain employees in the first quarter of 2012, including to some employees who were eligible to receive pension benefits. The remaining unamortized loss associated with these employees' pensions was fully recognized in the third quarter of 2012, causing an additional \$292 thousand in pension expense.

At September 30, 2012, management had not yet determined the amount, if any, that the Company will contribute to the plan in the year ending December 31, 2012.

## Note 6. Earnings per Share

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted average number of common shares outstanding during the period, including the effect of dilutive potential common shares attributable to outstanding stock options.

The Company did not include an average of 162 thousand potential common shares attributable to outstanding stock options in the diluted earnings per share calculation for the first nine months of 2012 because they were antidilutive.

## Note 7. Recent Accounting Pronouncements

In April 2011, the FASB issued ASU 2011-03, "Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements." The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation

guidance related to that criterion. The amendments in this ASU were effective for the first interim or annual period beginning on or after December 15, 2011. The guidance was applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

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In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRSs)." This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and IFRSs. The amendments were effective for interim and annual periods beginning after December 15, 2011 with prospective application. The Company has included the required disclosures in its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220): Presentation of Comprehensive Income." The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this ASU require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments were effective for fiscal years and interim periods within those years beginning after December 15, 2011. The amendments do not require transition disclosures. The Company has included the required disclosures in its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company does not expect the adoption of ASU 2011-11 to have a material impact on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, "Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." The amendments in this ASU are being made to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company has included the required disclosures in its consolidated financial statements.

In July 2012, the FASB issued ASU 2012-02, “Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment.” The amendments in this ASU apply to all entities that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. The amendments in this ASU provide an entity with the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset’s fair value when testing an indefinite-lived intangible asset for impairment. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The Company does not expect the adoption of ASU 2012-02 to have a material impact on its consolidated financial statements.

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In October 2012, the FASB issued ASU 2012-06, “Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution.” The amendments in this ASU clarify the applicable guidance for subsequently measuring an indemnification asset recognized as a result of a government-assisted acquisition of a financial institution. In addition, the amendments should resolve current diversity in practice on the subsequent measurement of these types of indemnification assets. The amendments are effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. Early adoption is permitted. The amendments should be applied prospectively to any new indemnification assets acquired after the date of adoption and to indemnification assets existing as of the date of adoption arising from a government-assisted acquisition of a financial institution. The Company does not expect the adoption of ASU 2012-06 to have a material impact on its consolidated financial statements.

Note 8. Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the “Fair Value Measurements and Disclosures” topics of FASB ASU 2010-06 and FASB ASU 2011-04, the fair value of a financial instrument is the price that would be received in the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company’s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimate of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value can be a reasonable point within a range that is most representative of fair value under current market conditions.

In accordance with ASC 820, “Fair Value Measurements and Disclosures,” the Company groups its financial assets and financial liabilities generally measured at fair value into three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on 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 for substantially the full term of the asset or liability.

Level 3 Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar

techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.



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An instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

**ASSETS MEASURED AT FAIR VALUE ON A RECURRING BASIS**

Debt and equity securities with readily determinable fair values are classified as "available-for-sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. Currently, all of the Company's available-for-sale securities are considered to be Level 2 securities.

The following table presents the balances of certain assets measured at fair value on a recurring basis as of the dates indicated:

Description	Balance	Fair Value Measurements at September 30, 2012 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities				
Obligations of U.S. Government agencies	\$ 32,012	\$ 0	\$ 32,012	\$ 0
Obligations of state and political subdivisions	33,555	0	33,555	0
Mortgage-backed securities	245,256	0	245,256	0
Money market investments	1,198	0	1,198	0
Corporate Bonds	399	0	399	0
Total available-for-sale securities	\$ 312,420	\$ 0	\$ 312,420	\$ 0

Fair Value Measurements at December 31, 2011  
Using

Description	Balance	(in thousands)		
		Quoted Prices in Active Markets	Significant Other Observable Inputs	Significant Unobservable Inputs
Available-for-sale securities				
Obligations of U.S. Government agencies	\$ 32,012	\$ 0	\$ 32,012	\$ 0
Obligations of state and political subdivisions	33,555	0	33,555	0
Mortgage-backed securities	245,256	0	245,256	0
Money market investments	1,198	0	1,198	0
Corporate Bonds	399	0	399	0
Total available-for-sale securities	\$ 312,420	\$ 0	\$ 312,420	\$ 0

Description	Balance	for Identical Assets (Level 1)	(Level 2)	(Level 3)
Available-for-sale securities				
U.S. Treasury securities	\$ 250	\$ 0	\$ 250	\$ 0
Obligations of U.S. Government agencies	119,554	0	119,554	0
Obligations of state and political subdivisions	12,261	0	12,261	0
Mortgage-backed securities	103,228	0	103,228	0
Money market investments	1,306	0	1,306	0
Total available-for-sale securities	\$ 236,599	\$ 0	\$ 236,599	\$ 0

#### ASSETS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

Under certain circumstances, adjustments are made to the fair value for assets and liabilities although they are not measured at fair value on an ongoing basis.

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## Impaired loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the 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 outside of the Company 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 real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as part of the provision for loan losses on the Consolidated Statements of Income.

## Foreclosed assets

Loans are transferred to foreclosed assets when the collateral securing them is foreclosed on. The measurement of loss associated with foreclosed assets is based on the fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property. If there is a contract for the sale of a property, and management reasonably believes the transaction will be consummated in accordance with the terms of the contract, fair value is based on the sale price in that contract (Level 1). Lacking such a contract, 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 outside of the Company 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 real estate property is over two years old, then the fair value is considered Level 3. Any fair value adjustments to foreclosed assets are recorded in the period incurred and expensed against current earnings.

The following table presents the assets carried on the consolidated balance sheets by caption and by level in the fair value hierarchy for which a nonrecurring change in fair value has been recorded as of the dates indicated:

Description	Carrying Value at September 30, 2012 Using (in thousands)			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired loans	\$ 6,633	\$ 0	\$ 3,604	\$ 3,029
Foreclosed assets	\$ 6,842	\$ 0	\$ 6,842	\$ 0

Description	Carrying Value at December 31, 2011 Using (in thousands)	
	Fair Value	Significant

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	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Assets:			
Impaired loans	\$ 2,802	\$ 0	\$ 230
Foreclosed assets	\$ 9,390	\$ 0	\$ 0

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The changes in Level 3 assets measured at estimated fair value on a nonrecurring basis during the nine months ended September 30, 2012 were as follows:

Nine months ended September 30, 2012  
(in thousands)

Balance as of December 31, 2011	\$ 230
Net (charge-offs) recoveries	(97 )
Additions	2,942
Sales	0
Net payments and upgrades	(46 )
Ending balance	\$ 3,029

The following table displays quantitative information about Level 3 Fair Value Measurements as of the date indicated (dollars in thousands):

Quantitative Information About Level 3 Fair Value Measurements at September 30, 2012

	Fair Value	Valuation Techniques	Unobservable Input	Range (Average)
Assets				
Impaired Loans \$	3,029	Market comparables Discounted cash flows	Selling costs Yield	6% - 10%(6%) 7.75%

ASC 825, "Financial Instruments," requires disclosure about fair value of financial instruments for interim periods and excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

#### CASH AND CASH EQUIVALENTS

The carrying amounts of cash and short-term instruments, including interest-bearing due from banks, approximate fair values.

#### INVESTMENT SECURITIES

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Securities are classified as Level 2 if quoted market prices are not available. Fair value is estimated using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes and credit spreads. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified in Level 3.

#### RESTRICTED SECURITIES

The restricted security category is comprised of FHLB and FRB stock. These stocks are classified as restricted securities because their ownership is restricted to certain types of entities and they lack a market. Therefore, the carrying amounts of restricted securities approximate fair value.

#### LOANS RECEIVABLE

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans (e.g., commercial real estate and investment property mortgage loans,

commercial and industrial loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for non-performing loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

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**BANK-OWNED LIFE INSURANCE**

Bank-owned life insurance represents insurance policies on certain officers of the Company. The cash value of the policies is estimated using information provided by the insurance carrier. These policies are carried at their cash value, which approximates the fair value.

**DEPOSIT LIABILITIES**

The fair value of demand deposits, savings and certain money market deposits is the amount payable on demand at the reporting date. The fair value of certificates of deposits is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

**SHORT-TERM BORROWINGS**

The carrying amounts of federal funds purchased, overnight repurchase agreements, and other short-term borrowings maturing within 90 days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

**LONG-TERM BORROWINGS**

The fair values of the Company's long-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

**ACCRUED INTEREST**

The carrying amounts of accrued interest approximate fair value.

**COMMITMENTS TO EXTEND CREDIT AND IRREVOCABLE LETTERS OF CREDIT**

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit-worthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2012 and December 31, 2011, the fair value of fees charged for loan commitments and irrevocable letters of credit was immaterial.

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The estimated fair values, and related carrying or notional amounts, of the Company's financial instruments as of the dates indicated are as follows:

Fair Value Measurements at September 30, 2012  
Using  
(in thousands)

	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Cash and cash equivalents	\$ 49,576	\$ 49,576	\$ 0	\$ 0
Securities available-for-sale	312,420	0	312,420	0
Securities held-to-maturity	615	0	620	0
Restricted securities	2,562	0	2,562	0
Loans, net of allowances for loan losses	456,243	0	455,823	3,029
Bank owned life insurance	21,627	0	21,627	0
Accrued interest receivable	2,397	0	2,397	0
<b>Liabilities</b>				
Deposits	\$ 731,674	\$ 0	\$ 733,554	\$ 0
Overnight repurchase agreements	37,265	0	37,265	0
Term repurchase agreements	1,278	0	1,279	0
Federal Home Loan Bank advances	25,000	0	28,957	0
Accrued interest payable	473	0	473	0

Fair Value Measurements at December 31, 2011 Using  
(in thousands)

Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other
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