

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, 2013	December 31, 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, 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; 4,251,795 shares issued and outstanding at June 30, 2013 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 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 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 Tax Expense (Benefit)	Total	Amount	2012 Tax Expense (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 Tax Expense (Benefit)	Total	Amount	2012 Tax Expense (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 income (loss)	\$ (3,837,179)	\$ (1,331,182)	\$ (2,505,997)	\$ (6,845,986)	\$ 4,020,890	\$ (10,866,876)
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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 Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Warrant	Discount on Preferred Stock	Accumulated Other Comprehensive Income (loss)	Total
Balance, December 31, 2012	\$58,952	\$17,007,180	\$40,705,257	\$(33,173,525)	\$732,479	\$(198,993)	\$(166,549 )	\$24,964,801
Amortization of preferred stock discount	-			(74,295 )	-	74,295		-
Preferred stock dividend	-	-		(368,447 )	-	-	-	(368,447 )
Stock based compensation			483					483
Minimum pension adjustment (net of income taxes of \$2,917)	-	-	-	-	-	-	4,290	4,290
Net income	-	-	-	78,062	-	-	-	78,062
Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	(2,588,349)	(2,588,349 )
Balance, June 30, 2013	\$58,952	\$17,007,180	\$40,705,740	\$(33,538,205)	\$732,479	\$(124,698)	\$(2,750,608)	\$22,090,840
Balance, December 31, 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, 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 Position for less than 12 Months		Securities in a loss Position for more than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2013						
Investment Securities 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 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, secured by first deeds of trust	72,607,945	23.76 %	80,788,425	22.76 %
Secured by 1-4 family residential, 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 (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 Loans
	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 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 Loans
	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 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, secured by first deeds of trust	49,659,724	11,235,261	19,893,440	-	80,788,425
Secured by 1-4 family residential, 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 (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
 Total Loans	 \$221,137,752	 \$61,297,958	 \$71,964,971	 \$509,585	 \$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 Investment > 90 Days and Accruing
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	
Construction and land development:							
Residential	\$ -	\$ -	\$ -	\$ -	\$ 3,834,697	\$ 3,834,697	\$ -
Commercial	629,510	-	-	629,510	32,835,685	33,465,195	-
Total construction and land development	629,510	-	-	629,510	36,670,382	37,299,892	-
Commercial real estate:							
Farmland	-	-	-	-	2,525,434	2,525,434	-
Commercial real estate - owner occupied	371,631	2,010,478	-	2,382,109	72,733,444	75,115,553	-
Commercial real estate - non-owner occupied	1,134,180	225,637	-	1,359,817	44,436,194	45,796,011	-
Multifamily	-	-	-	-	8,851,723	8,851,723	-
Total commercial real estate	1,505,811	2,236,115	-	3,741,926	128,546,795	132,288,721	-
Consumer real estate:							
Home equity lines Secured by 1-4 family residential, secured by first deeds of trust	-	78,334	-	78,334	22,686,109	22,764,443	-
Secured by 1-4 family residential, secured by second deeds of trust	829,190	719,980	-	1,549,170	71,058,775	72,607,945	-
Total consumer 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 Investment	Unpaid Principal Balance	Related 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, secured by first deeds of trust	10,333,851	10,909,071	-
Secured by 1-4 family residential, 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 (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, secured by first deeds of trust	1,467,796	1,467,796	87,343
Secured by 1-4 family residential, 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 (except those secured by real estate)	537,032	537,032	77,577
Consumer and other	-	-	-
	\$17,243,982	\$17,382,982	\$2,475,219
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, secured by first deeds of trust	11,801,647	12,376,867	87,343
Secured by 1-4 family residential, 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 (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 Investment	Unpaid Principal Balance	Related 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, secured by first deeds of trust	10,686,435	10,928,024	-
Secured by 1-4 family residential, secured by second deeds of trust	601,805	861,158	-
Total consumer real estate	13,227,260	13,727,187	-
Commercial and industrial loans (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, secured by first deeds of trust	1,155,027	1,155,027	20,896
Secured by 1-4 family residential, 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 (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, secured by first deeds of trust	11,841,462	12,083,051	20,896
Secured by 1-4 family residential, 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 (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 Ended June 30, 2013		For the Six Months Ended June 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income 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, secured by first deeds of trust	10,627,341	114,279	10,418,614	262,208
Secured by 1-4 family residential, 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 (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, secured by first deeds of trust	1,482,544	7,938	1,482,496	14,014
Secured by 1-4 family residential, 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 (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, secured by first deeds of trust	12,109,885	122,217	11,901,110	276,222
Secured by 1-4 family residential, 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 (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 Ended June 30, 2012		For the Six Months Ended June 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income 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, secured by first deeds of trust	11,593,774	125,304	13,101,708	230,755
Secured by 1-4 family residential, 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 (except those secured by real estate)	1,524,274	13,297	1,792,752	21,909
Consumer and other	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, secured by first deeds of trust	3,555,198	27,332	4,656,755	44,009
Secured by 1-4 family residential, 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 (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, secured by first deeds of trust	15,148,972	152,636	17,758,463	274,764
Secured by 1-4 family residential, 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 (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 Valuation 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 (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 Valuation 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, secured by first deeds of trust	7,205,569	3,648,382	3,557,187	49,610
Secured by 1-4 family residential, 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 (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 Valuation 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, secured by first deeds of trust	7,011,329	3,431,124	3,580,205	15,633
Secured by 1-4 family residential, 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 (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 June 30, 2013		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded 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 (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 Loans	Three Months Ended June 30, 2012	
		Pre- Modification Recorded Balance	Post- Modification Recorded 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 June 30, 2012		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded 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 June 30, 2012	
	Number of Loans	Recorded 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 June 30, 2013			Year Ended December 31, 2012		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded 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 June 30, 2013		Year Ended December 31, 2012	
	Number of Loans	Recorded Balance	Number of Loans	Recorded 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 - 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 residential, secured by first deeds of trust	3	1,212,515	8	3,302,827
Secured by 1-4 family residential, secured by second deeds of trust	-	-	1	338,344
Total consumer real estate	3	1,212,515	9	3,641,171
Commercial and industrial loans (except those secured by real estate)				
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 Balance
	Beginning Balance	Provision for Loan 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 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, secured by first deeds of trust	1,022,995	-	(531,861 )	13,008	504,142
Secured by 1-4 family residential, secured by second deeds of trust	11,622	-	-	2,246	13,868
Commercial and industrial loans (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 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, 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, secured by second deeds of trust	335,352	41,730	(5,970 )	4,440	375,552
Commercial and industrial loans (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 Balance	Allowance for Loan Losses			Ending Balance
		Provision for Loan 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, secured by first deeds of trust	1,358,102	-	(874,994 )	21,034	504,142
Secured by 1-4 family residential, secured by second deeds of trust	223,307	-	(214,720 )	5,281	13,868
Commercial and industrial loans (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
<b>Total</b>	<b>\$10,807,827</b>	<b>\$823,000</b>	<b>\$(2,579,149)</b>	<b>\$558,099</b>	<b>\$9,609,777</b>
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, 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, secured by second deeds of trust	397,504	170,024	(196,609 )	4,633	375,552
Commercial and industrial loans (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
<b>Total</b>	<b>\$16,071,424</b>	<b>\$8,395,000</b>	<b>\$(9,826,725)</b>	<b>\$226,023</b>	<b>\$14,865,722</b>



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	Beginning Balance	Allowance for Loan Losses			Ending Balance
		Provision for Loan 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 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, 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, secured by second deeds of trust	397,504	468,192	(663,135 )	20,746	223,307
Commercial and industrial loans (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, secured by first deeds of trust	12,419,966	60,187,979	72,607,945
Secured by 1-4 family residential, secured by second deeds of trust	545,416	7,789,585	8,335,001
Commercial and industrial loans (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, secured by first deeds of trust	15,526,551	65,261,874	80,788,425
Secured by 1-4 family residential, secured by second deeds of trust	557,600	8,959,645	9,517,245
Commercial and industrial loans (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 Average Exercise Price	Fair Value Per Share	Intrinsic Value		Weighted Average Exercise Price	Fair Value Per Share	Intrinsic 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 (In thousands)	Unobservable Input	Range (Weighted Average)
Impaired Loans -Real Estate Secured	\$ 5,961	Appraisal (1) or Internal Valuation (2)	Appraisal Adjustments Liquidation Expenses (3)	10%-30 %
Impaired Loans - Non-Real Estate Secured	\$ 1,089	Appraisal (1) or Discounted Cash Flow Appraisal (1) or Internal Valuation (2)	Appraisal Adjustments Liquidation Expenses (3)	10%-20 %
Real Estate Owned	\$ 996	Valuation (2)	Appraisal Adjustments 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 (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, 2013		December 31, 2012	
	Level in Fair Value Hierarchy	Carrying Value	Estimated Fair Value	Carrying Value	Estimated 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 available for sale	Level 1	4,217,587	4,217,587	7,918,420	7,918,420
Investment securities available for sale	Level 2	53,849,040	53,849,040	17,235,626	17,235,626
Federal Home Loan 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 owned	Level 2	21,047,658	21,047,658	18,675,164	18,675,164
Other real estate owned	Level 3	995,976	995,976	1,528,527	1,528,527
Bank owned life insurance	Level 3	6,671,315	6,671,315	6,575,018	6,575,018
Accrued interest 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 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 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, 2013	December 31, 2012
Undisbursed credit lines	\$ 35,450,000	\$ 35,780,000
Commitments to extend or originate credit	20,106,000	25,016,000
Standby letter of credit	3,213,000	3,314,000
Total commitments to 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 Ended June 30, 2013	Six Months Ended 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 Interest 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.

Table of ContentsAverage Balance Sheets  
(in thousands)

	Three Months Ended June 30, 2013				Three 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	\$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 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 provision for loan losses		\$3,720				\$4,351		
Interest spread - average yield on interest earning assets, less average rate on 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 (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, secured by first deeds of trust	72,608	23.76	%	80,788	22.76	%
Secured by 1-4 family residential, 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 (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 (In thousands)	
	Six Months Ended 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, secured by first deeds of trust	(875 )	(2,589 )
Secured by 1-4 family residential, secured by second deeds of trust	(215 )	(197 )
Commercial and industrial loans (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, secured by first deeds of trust	21	81
Secured by 1-4 family residential, secured by second deeds of trust	5	5
Commercial and industrial loans (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, 2013	December 31, 2012	June 30, 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 (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 Loans	Foreclosed Properties	Total
Balance December 31, 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 Loans	Foreclosed 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, 2013		December 31, 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, 2013		December 31, 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	
 Tier 2 capital				
Allowance for loan losses	4,326		4,769	
Total Tier 2 capital	4,326		4,769	
 Total risk-based capital	37,610		37,706	
 Risk-weighted assets	\$340,771		\$375,451	
 Average assets	\$484,938		\$505,150	
 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 Months	3 to 6 Months	6 to 12 Months	13 to 36 Months	More than 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>	