

Village Bank & Trust Financial Corp.  
Form 10-Q  
October 31, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2014**

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)

**OF THE SECURITIES EXCHANGE ACT OF 1934**

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

**Commission file number: 0-50765**

**VILLAGE BANK AND TRUST FINANCIAL CORP.**

(Exact name of registrant as specified in its charter)

**Virginia** **16-1694602**  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

**15521 Midlothian Turnpike, Midlothian, Virginia 23113**  
(Address of principal executive offices) (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

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  (Do not check if smaller reporting company) Smaller Reporting Company

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

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

334,294 shares of common stock, \$4.00 par value, outstanding as of October 21, 2014



**Village Bank and Trust Financial Corp.**

**Form 10-Q**

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## Part I – Financial Information

**ITEM 1 – FINANCIAL STATEMENTS**

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Balance Sheets**  
**September 30, 2014 (Unaudited) and December 31, 2013**  
(dollar amounts in thousands, except per share amounts)

|   | September<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| Assets  |                          |                         |
| Cash and due from banks                             | \$ 13,895                | \$ 15,221               |
| Federal funds sold                                  | 30,937                   | 24,988                  |
| Total cash and cash equivalents                     | 44,832                   | 40,209                  |
| Investment securities available for sale            | 55,515                   | 57,748                  |
| Loans held for sale                                 | 7,298                    | 8,371                   |
| Loans   |                          |                         |
| Outstandings  | 275,123                  | 286,563                 |
| Allowance for loan losses                           | (5,658                   | ) (7,239                |
| Deferred fees and costs                             | 666                      | 683                     |
|   | 270,131                  | 280,007                 |
| Other real estate owned, net of valuation allowance | 14,003                   | 16,742                  |
| Assets held for sale                                | 13,438                   | 13,359                  |
| Premises and equipment, net                         | 13,621                   | 12,409                  |
| Bank owned life insurance                           | 6,902                    | 6,765                   |
| Accrued interest receivable                         | 1,567                    | 1,486                   |
| Other assets  | 5,698                    | 7,077                   |
|   | \$ 433,005               | \$ 444,173              |
| Liabilities and Stockholders' Equity                |                          |                         |
| Liabilities   |                          |                         |
| Deposits  |                          |                         |
| Noninterest bearing demand                          | \$ 65,218                | \$ 57,244               |
| Interest bearing                                    | 315,446                  | 333,384                 |
| Total deposits                                      | 380,664                  | 390,628                 |
| Federal Home Loan Bank advances                     | 14,000                   | 18,000                  |
| Long-term debt - trust preferred securities         | 8,764                    | 8,764                   |
| Other borrowings                                    | 1,835                    | 2,713                   |
| Accrued interest payable                            | 1,120                    | 1,093                   |

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|   |            |            |
|---|------------|------------|
| Other liabilities   | 7,887      | 4,731      |
| Total liabilities   | 414,270    | 425,929    |
| Stockholders' equity  |            |            |
| Preferred stock, \$4 par value, \$1,000 liquidation preference, 1,000,000 shares authorized, 14,738 shares issued and outstanding   | 59         | 59         |
| Common stock, \$4 par value, 10,000,000 shares authorized; 334,294 shares issued and outstanding at September 30, 2014 333,644 shares issued and outstanding at December 31, 2013 | 1,337      | 21,353     |
| Additional paid-in capital  | 58,124     | 38,054     |
| Accumulated deficit   | (39,829 )  | (38,066 )  |
| Common stock warrant  | 732        | 732        |
| Discount on preferred stock   | -          | (50 )      |
| Stock in directors rabbi trust  | (878 )     | (878 )     |
| Directors deferred fees obligation  | 878        | 878        |
| Accumulated other comprehensive loss  | (1,688 )   | (3,838 )   |
| Total stockholders' equity  | 18,735     | 18,244     |
|   | \$ 433,005 | \$ 444,173 |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Operations**  
**Three and Nine Months Ended September 30, 2014 and 2013**  
**(Unaudited)**  
**(dollar amounts in thousands, except per share amounts)**

|   | Three Months Ended<br>September 30, |          | None Months Ended<br>September 30, |           |
|---|-------------------------------------|----------|------------------------------------|-----------|
|   | 2014                                | 2013     | 2014                               | 2013      |
| Interest income                                     |                                     |          |                                    |           |
| Loans   | \$ 3,814                            | \$ 4,459 | \$ 11,579                          | \$ 14,224 |
| Investment securities                               | 304                                 | 324      | 958                                | 751       |
| Federal funds sold                                  | 19                                  | 18       | 64                                 | 71        |
| Total interest income                               | 4,137                               | 4,801    | 12,601                             | 15,046    |
| Interest expense                                    |                                     |          |                                    |           |
| Deposits  | 751                                 | 850      | 2,304                              | 2,843     |
| Borrowed funds                                      | (22 )                               | 167      | 423                                | 610       |
| Total interest expense                              | 729                                 | 1,017    | 2,727                              | 3,453     |
| Net interest income                                 | 3,408                               | 3,784    | 9,874                              | 11,593    |
| Provision for loan losses                           | -                                   | -        | 100                                | 823       |
| Net interest income after provision for loan losses | 3,408                               | 3,784    | 9,774                              | 10,770    |
| Noninterest income                                  |                                     |          |                                    |           |
| Service charges and fees                            | 589                                 | 646      | 1,673                              | 1,791     |
| Gain on sale of loans                               | 1,290                               | 2,126    | 3,453                              | 6,454     |
| Gain on sale of assets                              | -                                   | -        | 3                                  | 598       |
| Gain (loss) on sale of investment securities        | (14 )                               | -        | (14 )                              | 217       |
| Rental income                                       | 226                                 | 214      | 732                                | 657       |
| Other   | 99                                  | 99       | 338                                | 396       |
| Total noninterest income                            | 2,190                               | 3,085    | 6,185                              | 10,113    |
| Noninterest expense                                 |                                     |          |                                    |           |
| Salaries and benefits                               | 2,659                               | 3,054    | 8,108                              | 8,980     |
| Commissions   | 338                                 | 580      | 907                                | 1,612     |
| Occupancy   | 397                                 | 502      | 1,272                              | 1,589     |
| Equipment   | 146                                 | 166      | 529                                | 523       |
| Supplies  | 77                                  | 100      | 243                                | 324       |
| Professional and outside services                   | 615                                 | 500      | 1,896                              | 1,823     |
| Advertising and marketing                           | 81                                  | 50       | 220                                | 192       |
| Expenses related to foreclosed real estate          | 364                                 | 1,301    | 1,051                              | 3,576     |
| Other operating expenses                            | 787                                 | 883      | 2,434                              | 2,453     |
| Total noninterest expense                           | 5,464                               | 7,136    | 16,660                             | 21,072    |
| Income (loss) before income tax expense (benefit)   | 134                                 | (267 )   | (701 )                             | (189 )    |
| Income tax expense (benefit)                        | -                                   | -        | -                                  | -         |



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|  |            |            |             |            |
|--|------------|------------|-------------|------------|
| Net income (loss)                                      | 134        | (267 )     | (701 )      | (189 )     |
| Preferred stock dividends and amortization of discount | 545        | 221        | 1,062       | 664        |
| Net loss available to common shareholders              | \$ (411 )  | \$ (488 )  | \$ (1,763 ) | \$ (853 )  |
| Loss per share, basic and diluted <sup>(1)</sup>       | \$ (1.23 ) | \$ (1.84 ) | \$ (5.28 )  | \$ (3.21 ) |

*See accompanying notes to consolidated financial statements.*

*(1) Earnings per share have been affected for reverse stock split*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Changes in Comprehensive Income (Loss)**  
**Three and Nine Months Ended September 30, 2014 and 2013**  
**(Unaudited)**  
**(dollar amounts in thousands)**

|  | Three Months<br>Ended<br>September 30, |           | Nine Months Ended<br>September 30, |             |
|--|--|-----------|------------------------------------|-------------|
|  | 2014                                   | 2013      | 2014                               | 2013        |
| Net income (loss)  | \$ 134                                 | \$ (267 ) | \$ (701 )                          | \$ (189 )   |
| Other comprehensive income (loss)  |  |           |                                    |             |
| Unrealized holding gains (losses) arising during the period                                  | 84                                     | (597 )    | 3,234                              | (4,302 )    |
| Tax effect   | 28                                     | (203 )    | 1,099                              | (1,463 )    |
| Net change in unrealized holding gains (losses) on securities available for sale, net of tax | 56                                     | (394 )    | 2,135                              | (2,839 )    |
| Reclassification adjustment  |  |           |                                    |             |
| Reclassification adjustment for (gains) losses realized in income (loss)                     | 14                                     | -         | 14                                 | (217 )      |
| Tax effect   | 5                                      | -         | 5                                  | (74 )       |
| Reclassification for (gains) losses included in net income (loss), net of tax                | 9                                      | -         | 9                                  | (143 )      |
| Minimum pension adjustment   | 3                                      | 3         | 9                                  | 9           |
| Tax effect   | 1                                      | 1         | 3                                  | 3           |
| Minimum pension adjustment, net of tax   | 2                                      | 2         | 6                                  | 6           |
| Total other comprehensive income (loss)  | 67                                     | (392 )    | 2,150                              | (2,976 )    |
| Total comprehensive income (loss)  | \$ 201                                 | \$ (659 ) | \$ 1,449                           | \$ (3,165 ) |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Stockholders' Equity**  
**Nine Months Ended September 30, 2014 and 2013**  
**(Unaudited)**  
**(dollar amounts in thousands)**

|  | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Warrant | Discount<br>on<br>Preferred<br>Stock | Stock<br>in<br>Directors<br>Rabbi<br>Trust | Director's<br>Deferred<br>Fees<br>Obligations | Accumulated<br>Other<br>Comprehensive<br>Loss | Total    |
|--|--------------------|-----------------|----------------------------------|------------------------|---------|--------------------------------------|--|---|---|----------|
| Balance, December 31, 2013   | \$ 59              | \$21,353        | \$38,054                         | \$(38,066 )            | \$ 732  | \$(50 )                              | \$(878 )                                   | \$ 878  | \$(3,838 )                                    | \$18,244 |
| Amortization of preferred stock discount   | -                  | -               | -                                | (50 )                  | -       | 50                                   | -  | -   | -   | -        |
| Preferred stock dividend   | -                  | -               | -                                | (1,012 )               | -       | -                                    | -  | -   | -   | (1,012 ) |
| Reverse stock split  | -                  | (20,019)        | 20,019                           | -                      | -       | -                                    | -  | -   | -   | -        |
| Issuance of common stock   | -                  | 3               | (11 )                            | -                      | -       | -                                    | -  | -   | -   | (8 )     |
| Stock based compensation   | -                  | -               | 62                               | -                      | -       | -                                    | -  | -   | -   | 62       |
| Minimum pension adjustment (net of income taxes of \$3)  | -                  | -               | -                                | -                      | -       | -                                    | -  | -   | 6   | 6        |
| Net loss   | -                  | -               | -                                | (701 )                 | -       | -                                    | -  | -   | -   | (701 )   |
| Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification and tax effect | -                  | -               | -                                | -                      | -       | -                                    | -  | -   | 2,144   | 2,144    |
| Balance, September 30, 2014  | \$ 59              | \$1,337         | \$58,124                         | \$(39,829 )            | \$ 732  | \$-                                  | \$(878 )                                   | \$ 878  | \$(1,688 )                                    | \$18,735 |
| Balance, December 31, 2012   | \$ 59              | \$17,007        | \$40,705                         | \$(33,173 )            | \$ 732  | \$(199 )                             | \$-  | \$-   | \$(166 )                                      | \$24,965 |
| Amortization of preferred stock discount   | -                  | -               | -                                | (112 )                 | -       | 112                                  | -  | -   | -   | -        |

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|  |       |           |           |              |        |          |      |      |             |           |
|--|-------|-----------|-----------|--------------|--------|----------|------|------|-------------|-----------|
| Preferred stock dividend   | -     | -         |           | (552 )       | -      | -        | -    | -    | -           | (552 )    |
| Stock based compensation   | -     | -         | 6         |              |        |          |      |      |             | 6         |
| Minimum pension adjustment (net of income taxes of \$3)  | -     | -         | -         | -            | -      | -        | -    | -    | 6           | 6         |
| Net loss   | -     | -         | -         | (189 )       | -      | -        | -    | -    | -           | (189 )    |
| Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification and tax effect | -     | -         | -         | -            | -      | -        | -    | -    | (2,982 )    | (2,982 )  |
| Balance, September 30, 2013  | \$ 59 | \$ 17,007 | \$ 40,711 | \$ (34,026 ) | \$ 732 | \$ (87 ) | \$ - | \$ - | \$ (3,142 ) | \$ 21,254 |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
**Nine Months Ended September 30, 2014 and 2013**  
**(Unaudited)**  
**(dollar amounts in thousands)**

|   | 2014      | 2013      |
|---|-----------|-----------|
| <b>Cash Flows from Operating Activities</b>                                     |           |           |
| Net loss  | \$(701 )  | \$(189 )  |
| Adjustments to reconcile net loss to net cash provided by operating activities: |           |           |
| Depreciation and amortization   | 482       | 981       |
| Deferred income taxes   | (324 )    | (41 )     |
| Valuation allowance deferred income taxes                                       | 324       | -         |
| Provision for loan losses   | 100       | 823       |
| Write-down of other real estate owned   | 751       | 1,282     |
| Valuation allowance other real estate owned                                     | (495 )    | -         |
| (Gain) Loss on securities sold  | 14        | (217 )    |
| Gain on loans sold  | (3,453 )  | (6,454 )  |
| Gain on sale of premises and equipment  | (3 )      | (598 )    |
| (Gain) Loss on sale of other real estate owned                                  | (199 )    | 326       |
| Stock compensation expense  | 62        | 6         |
| Proceeds from sale of mortgage loans  | 128,465   | 235,276   |
| Origination of mortgage loans for sale  | (123,939) | (219,160) |
| Amortization of premiums and accretion of discounts on securities, net          | 304       | 313       |
| Decrease (increase) in interest receivable                                      | (81 )     | 159       |
| Increase in bank owned life insurance   | (137 )    | (144 )    |
| Decrease in other assets  | 205       | 4,356     |
| Increase in interest payable  | 27        | 142       |
| Increase (decrease) in other liabilities  | 2,142     | (1,062 )  |
| Net cash provided by operating activities                                       | 3,544     | 15,799    |
| <b>Cash Flows from Investing Activities</b>                                     |           |           |
| Purchases of available for sale securities                                      | -         | (54,106 ) |
| Proceeds from the sale or calls of available for sale securities                | 5,162     | 15,534    |
| Net decrease in loans   | 4,401     | 44,420    |
| Proceeds from sale of other real estate owned                                   | 8,057     | 4,125     |
| Purchases of premises and equipment   | (1,708 )  | (520 )    |
| Proceeds from sale of premises and equipment                                    | 17        | 1,681     |
| Net cash provided by investing activities                                       | 15,929    | 11,134    |
| <b>Cash Flows from Financing Activities</b>                                     |           |           |
| Issuance of common stock  | (8 )      | -         |
| Net decrease in deposits  | (9,964 )  | (34,727 ) |
| Net decrease in Federal Home Loan Bank Advances                                 | (4,000 )  | (10,000 ) |
| Net decrease in other borrowings  | (878 )    | (1,562 )  |
| Net cash used in financing activities   | (14,850 ) | (46,289 ) |

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|  |          |           |
|--|----------|-----------|
| Net increase (decrease) in cash and cash equivalents     | 4,623    | (19,356 ) |
| Cash and cash equivalents, beginning of period           | 40,209   | 53,131    |
| Cash and cash equivalents, end of period                 | \$44,832 | \$33,775  |
| <b>Supplemental Disclosure of Cash Flow Information</b>  |          |           |
| Cash payments for interest                               | \$2,536  | \$3,117   |
| <b>Supplemental Schedule of Non Cash Activities</b>      |          |           |
| Real estate owned assets acquired in settlement of loans | \$5,375  | \$5,181   |
| Dividends on preferred stock accrued                     | \$1,012  | \$552     |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**

**Notes to Consolidated Financial Statements**

**Three and Nine Months Ended September 30, 2014 and 2013**

**(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 subsidiary. All material intercompany balances and transactions have been eliminated in consolidation.

On August 6, 2014, the Company filed Articles of Amendment to its Articles of Incorporation with the Virginia State Corporation Commission to effect a reverse stock split of its outstanding common stock which became effective on August 8, 2014. As a result of the reverse split, every sixteen shares of the Company’s issued and outstanding common stock were consolidated into one issued and outstanding share of common stock. The computations of basic and diluted earnings per share have been adjusted retroactively to reflect the reverse stock split.

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 nine month periods ended September 30, 2014 are not necessarily indicative of the results to be expected for the full year ending December 31, 2014. 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, 2013 as filed with the Securities and Exchange Commission.

The Company has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of September 30, 2014 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

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 operations for the period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change include the determination of the allowance for loan losses and its related provision, and the estimate of the fair value of assets held for sale.



## Note 3 - Earnings (loss) per common share

The following table presents the basic and diluted earnings (loss) per common share computation (in thousands, except per share data):

|   | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |             |
|---|-------------------------------------|-------------|------------------------------------|-------------|
|   | 2014                                | 2013        | 2014                               | 2013        |
| Numerator   |                                     |             |                                    |             |
| Net income (loss) - basic and diluted                               | \$ 134                              | \$ (267)    | ) \$ (701)                         | ) \$ (189)  |
| Preferred stock dividend and accretion                              | 545                                 | 221         | 1,062                              | 664         |
| Net loss available to common shareholders                           | \$ (411)                            | ) \$ (488)  | ) \$ (1,763)                       | ) \$ (853)  |
| Denominator   |                                     |             |                                    |             |
| Weighted average shares outstanding - basic                         | 334                                 | 266         | 334                                | 266         |
| Dilutive effect of common stock options and restricted stock awards | -                                   | -           | -                                  | -           |
| Weighted average shares outstanding - diluted                       | 334                                 | 266         | 334                                | 266         |
| Loss per share - basic and diluted                                  | \$ (1.23)                           | ) \$ (1.84) | ) \$ (5.28)                        | ) \$ (3.21) |

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 6,830 were not included in computing diluted earnings per share for the three and nine months ended September 30, 2014 because their effects were anti-dilutive. Restricted stock awards for 14,802 were not included in computing diluted earnings per share for the three and nine months ended September 30, 2014 because their effects were anti-dilutive. Stock options for 16,008 and 16,658 were not included in computing diluted earnings per share for the three and nine months ended September 30, 2013, respectively, because their effects were anti-dilutive. Warrants for 31,190 shares of common stock were not included in computing earnings per share in 2014 and 2013 because their effects were also anti-dilutive.

## Note 4 – Investment securities available for sale

At September 30, 2014 and December 31, 2013, 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):

|                             | Par Value | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value | Average Yield |   |
|-----------------------------|-----------|----------------|------------------------|-------------------------|----------------------|---------------|---|
| September 30, 2014          |           |                |                        |                         |                      |               |   |
| US Treasuries               |           |                |                        |                         |                      |               |   |
| Five to ten years           | \$8,000   | \$ 7,837       | \$ -                   | \$ (255 )               | \$ 7,582             | 2.01          | % |
| US Government Agencies      |           |                |                        |                         |                      |               |   |
| One to Five years           | 8,000     | 8,176          | -                      | (245 )                  | 7,931                | 0.44          | % |
| Five to ten years           | 26,500    | 28,033         | -                      | (1,350 )                | 26,683               | 2.06          | % |
|                             | 34,500    | 36,209         | -                      | (1,595 )                | 34,614               | 1.69          | % |
| Mortgage-backed securities  |           |                |                        |                         |                      |               |   |
| More than ten years         | 542       | 558            | 2                      | (2 )                    | 558                  | 2.43          | % |
| Municipals                  |           |                |                        |                         |                      |               |   |
| Five to ten years           | 6,155     | 6,621          | -                      | (270 )                  | 6,351                | 2.85          | % |
| More than ten years         | 5,280     | 6,728          | -                      | (318 )                  | 6,410                | 3.42          | % |
|                             | 11,435    | 13,349         | -                      | (588 )                  | 12,761               | 3.14          | % |
| Total investment securities | \$54,477  | \$ 57,953      | \$ 2                   | \$ (2,440 )             | \$ 55,515            | 2.07          | % |
| December 31, 2013           |           |                |                        |                         |                      |               |   |
| US Treasuries               |           |                |                        |                         |                      |               |   |
| Five to ten years           | \$8,000   | \$ 7,825       | \$ -                   | \$ (615 )               | \$ 7,210             | 2.13          | % |
| US Government Agencies      |           |                |                        |                         |                      |               |   |
| One to Five years           | 4,000     | 4,194          | -                      | (166 )                  | 4,028                | 0.89          | % |
| Five to ten years           | 31,625    | 33,510         | -                      | (3,187 )                | 30,323               | 1.82          | % |
|                             | 35,625    | 37,704         | -                      | (3,353 )                | 34,351               | 1.71          | % |
| Mortgage-backed securities  |           |                |                        |                         |                      |               |   |
| More than ten years         | 2,782     | 2,792          | 10                     | (50 )                   | 2,752                | 2.43          | % |
| Municipals                  |           |                |                        |                         |                      |               |   |
| Five to ten years           | 6,155     | 6,684          | -                      | (678 )                  | 6,006                | 2.85          | % |
| More than ten years         | 6,780     | 8,428          | -                      | (999 )                  | 7,429                | 3.34          | % |
| Total                       | 12,935    | 15,112         | -                      | (1,677 )                | 13,435               | 3.12          | % |
| Total investment securities | \$59,342  | \$ 63,433      | \$ 10                  | \$ (5,695 )             | \$ 57,748            | 2.13          | % |

Investment securities available for sale that have an unrealized loss position at September 30, 2014 and December 31, 2013 are detailed below (in thousands):

|                            | Securities in a loss<br>position for less than<br>12 Months |                      | Securities in a loss<br>position for more than<br>12 Months |                      | Total         |                      |
|----------------------------|---|----------------------|---|----------------------|---------------|----------------------|
|                            | Fair<br>Value   | Unrealized<br>Losses | Fair<br>Value   | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| September 30, 2014         |   |                      |   |                      |               |                      |
| US Treasuries              | \$ -  | \$ -                 | \$ 7,582  | \$ (255 )            | \$ 7,582      | \$ (255 )            |
| US Government Agencies     | -   | -                    | 34,614  | (1,595 )             | 34,614        | (1,595 )             |
| Municipals                 | -   | -                    | 12,761  | (588 )               | 12,761        | (588 )               |
| Mortgage-backed securities | 432   | (2 )                 | -   | -                    | 432           | (2 )                 |
| Total                      | \$ 432  | \$ (2 )              | \$ 54,957   | \$ (2,438 )          | \$ 55,389     | \$ (2,440 )          |
| December 31, 2013          |   |                      |   |                      |               |                      |
| US Treasuries              | \$ 7,210  | \$ (615 )            | \$ -  | \$ -                 | \$ 7,210      | \$ (615 )            |
| US Government Agencies     | 34,350  | (3,353 )             | -   | -                    | 34,350        | (3,353 )             |
| Municipals                 | 10,864  | (1,471 )             | 2,571   | (206 )               | 13,435        | (1,677 )             |
| Mortgage-backed securities | 1,861   | (50 )                | -   | -                    | 1,861         | (50 )                |
| Total                      | \$ 54,285   | \$ (5,489 )          | \$ 2,571  | \$ (206 )            | \$ 56,856     | \$ (5,695 )          |

Management does not believe that any individual unrealized loss as of September 30, 2014 and December 31, 2013 is other than a temporary impairment. These unrealized losses are primarily attributable to changes in interest rates. As of September 30, 2014, 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. Approximately \$20 million of these securities are pledged against current and potential fundings.

## 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):

|  | September 30, 2014 |         | December 31, 2013 |         |
|--|--------------------|---------|-------------------|---------|
|  | Amount             | %       | Amount            | %       |
| Construction and land development  |                    |         |                   |         |
| Residential  | \$4,592            | 1.67 %  | \$2,931           | 1.02 %  |
| Commercial   | 25,135             | 9.14 %  | 28,179            | 9.84 %  |
|  | 29,727             | 10.81 % | 31,110            | 10.86 % |
| Commercial real estate   |                    |         |                   |         |
| Owner occupied   | 58,275             | 21.18 % | 73,584            | 25.68 % |
| Non-owner occupied   | 39,805             | 14.47 % | 43,868            | 15.31 % |
| Multifamily  | 11,019             | 4.01 %  | 11,560            | 4.03 %  |
| Farmland   | 1,343              | 0.48 %  | 1,463             | 0.51 %  |
|  | 110,442            | 40.14 % | 130,475           | 45.53 % |
| Consumer real estate   |                    |         |                   |         |
| Home equity lines  | 20,275             | 7.37 %  | 21,246            | 7.41 %  |
| Secured by 1-4 family residential,                                       |                    |         |                   |         |
| First deed of trust  | 63,425             | 23.05 % | 66,873            | 23.34 % |
| Second deed of trust   | 8,127              | 2.95 %  | 8,675             | 3.03 %  |
|  | 91,827             | 33.37 % | 96,794            | 33.78 % |
| Commercial and industrial loans<br>(except those secured by real estate) | 22,471             | 8.17 %  | 26,254            | 9.16 %  |
| Consumer and other <sup>(1)</sup>  | 20,656             | 7.51 %  | 1,930             | 0.67 %  |
| Total loans  | 275,123            | 100.0 % | 286,563           | 100.0 % |
| Deferred loan cost, net  | 666                |         | 683               |         |
| Less: allowance for loan losses  | (5,658 )           |         | (7,239 )          |         |
|  | \$ 270,131         |         | \$ 280,007        |         |

<sup>(1)</sup> The Company purchased approximately \$19 million in Student loans in the third quarter of 2014

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

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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;

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; and

- Loans rated 6 or 7 are considered "Classified" loans for regulatory classification purposes.

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The following tables provide information on the risk rating of loans at the dates indicated (in thousands):

|  | Risk Rated<br>1-4 | Risk Rated<br>5 | Risk Rated<br>6 | Risk Rated<br>7 | Total<br>Loans |
|--|-------------------|-----------------|-----------------|-----------------|----------------|
| September 30, 2014   |                   |                 |                 |                 |                |
| Construction and land development  |                   |                 |                 |                 |                |
| Residential  | \$ 4,201          | \$ 132          | \$ 259          | \$ -            | \$4,592        |
| Commercial   | 19,073            | 3,046           | 3,016           | -               | 25,135         |
|  | 23,274            | 3,178           | 3,275           | -               | 29,727         |
| Commercial real estate   |                   |                 |                 |                 |                |
| Owner occupied   | 46,223            | 5,102           | 6,950           | -               | 58,275         |
| Non-owner occupied   | 35,847            | 1,830           | 2,128           | -               | 39,805         |
| Multifamily  | 10,280            | 739             | -               | -               | 11,019         |
| Farmland   | 1,322             | -               | 21              | -               | 1,343          |
|  | 93,672            | 7,671           | 9,099           | -               | 110,442        |
| Consumer real estate   |                   |                 |                 |                 |                |
| Home equity lines  |                   |                 |                 |                 |                |
| Secured by 1-4 family residential  | 18,040            | 466             | 1,769           | -               | 20,275         |
| First deed of trust  | 51,309            | 5,854           | 6,262           | -               | 63,425         |
| Second deed of trust   | 6,606             | 72              | 1,449           | -               | 8,127          |
|  | 75,955            | 6,392           | 9,480           | -               | 91,827         |
| Commercial and industrial loans<br>(except those secured by real estate) |                   |                 |                 |                 |                |
| Commercial and other   | 18,463            | 3,094           | 914             | -               | 22,471         |
| Consumer and other   | 20,536            | 76              | 44              | -               | 20,656         |
| Total loans  | \$ 231,900        | \$ 20,411       | \$ 22,812       | \$ -            | \$275,123      |
| December 31, 2013  |                   |                 |                 |                 |                |
| Construction and land development  |                   |                 |                 |                 |                |
| Residential  | \$ 2,715          | \$ -            | \$ 216          | \$ -            | \$2,931        |
| Commercial   | 18,265            | 2,711           | 7,203           | -               | 28,179         |
|  | 20,980            | 2,711           | 7,419           | -               | 31,110         |
| Commercial real estate   |                   |                 |                 |                 |                |
| Owner occupied   | 51,810            | 13,214          | 8,560           | -               | 73,584         |
| Non-owner occupied   | 31,990            | 3,454           | 8,424           | -               | 43,868         |
| Multifamily  | 10,804            | 756             | -               | -               | 11,560         |
| Farmland   | 1,346             | -               | 117             | -               | 1,463          |
|  | 95,950            | 17,424          | 17,101          | -               | 130,475        |
| Consumer real estate   |                   |                 |                 |                 |                |
| Home equity lines  |                   |                 |                 |                 |                |
| Secured by 1-4 family residential  | 17,610            | 727             | 2,909           | -               | 21,246         |
| First deed of trust  | 49,843            | 6,646           | 10,384          | -               | 66,873         |
| Second deed of trust   | 6,598             | 212             | 1,865           | -               | 8,675          |
|  | 74,051            | 7,585           | 15,158          | -               | 96,794         |
| Commercial and industrial loans<br>(except those secured by real estate) |                   |                 |                 |                 |                |
| Commercial and other   | 22,786            | 1,042           | 2,426           | -               | 26,254         |

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|                    |            |           |           |      |           |
|--------------------|------------|-----------|-----------|------|-----------|
| Consumer and other | 1,739      | 131       | 60        | -    | 1,930     |
| Total loans        | \$ 215,506 | \$ 28,893 | \$ 42,164 | \$ - | \$286,563 |

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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 (in thousands):

|  | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | Greater<br>Than<br>90<br>Days | Total<br>Past<br>Due | Current   | Total<br>Loans | Recorded<br>Investment<br>><br>90 Days<br>and<br>Accruing |
|--|---------------------------|---------------------------|-------------------------------|----------------------|-----------|----------------|---|
| September 30, 2014   |                           |                           |                               |                      |           |                |   |
| Construction and land development  |                           |                           |                               |                      |           |                |   |
| Residential  | \$ -                      | \$ -                      | \$ -                          | \$ -                 | \$4,592   | \$4,592        | \$ -  |
| Commercial   | 37                        | -                         | -                             | 37                   | 25,098    | 25,135         | -   |
|  | 37                        | -                         | -                             | 37                   | 29,690    | 29,727         | -   |
| Commercial real estate   |                           |                           |                               |                      |           |                |   |
| Owner occupied   | 913                       | -                         | -                             | 913                  | 57,362    | 58,275         | -   |
| Non-owner occupied   | -                         | -                         | -                             | -                    | 39,805    | 39,805         | -   |
| Multifamily  | -                         | -                         | -                             | -                    | 11,019    | 11,019         | -   |
| Farmland   | -                         | -                         | -                             | -                    | 1,343     | 1,343          | -   |
|  | 913                       | -                         | -                             | 913                  | 109,529   | 110,442        | -   |
| Consumer real estate   |                           |                           |                               |                      |           |                |   |
| Home equity lines  | 32                        | -                         | -                             | 32                   | 20,243    | 20,275         | -   |
| Secured by 1-4 family residential  |                           |                           |                               |                      |           |                |   |
| First deed of trust  | 102                       | -                         | -                             | 102                  | 63,323    | 63,425         | -   |
| Second deed of trust   | -                         | 56                        | -                             | 56                   | 8,071     | 8,127          | -   |
|  | 134                       | 56                        | -                             | 190                  | 91,637    | 91,827         | -   |
| Commercial and industrial loans<br>(except those secured by real estate) |                           |                           |                               |                      |           |                |   |
| Consumer and other   | 9                         | -                         | -                             | 9                    | 22,462    | 22,471         | -   |
|  | 750                       | 411                       | -                             | 1,161                | 19,495    | 20,656         | -   |
| Total loans  | \$ 1,843                  | \$ 467                    | \$ -                          | \$ 2,310             | \$272,813 | \$275,123      | \$ -  |
| December 31, 2013  |                           |                           |                               |                      |           |                |   |
| Construction and land development  |                           |                           |                               |                      |           |                |   |
| Residential  | \$ -                      | \$ -                      | \$ -                          | \$ -                 | \$2,931   | \$2,931        | \$ -  |
| Commercial   | -                         | 116                       | -                             | 116                  | 28,063    | 28,179         | -   |
|  | -                         | 116                       | -                             | 116                  | 30,994    | 31,110         | -   |
| Commercial real estate   |                           |                           |                               |                      |           |                |   |
| Owner occupied   | 199                       | -                         | -                             | 199                  | 73,385    | 73,584         | -   |
| Non-owner occupied   | -                         | 346                       | -                             | 346                  | 43,522    | 43,868         | -   |
| Multifamily  | 221                       | -                         | -                             | 221                  | 11,339    | 11,560         | -   |
| Farmland   | 194                       | -                         | -                             | 194                  | 1,269     | 1,463          | -   |



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|                                   |          |          |       |          |           |           |       |
|-----------------------------------|----------|----------|-------|----------|-----------|-----------|-------|
|                                   | 614      | 346      | -     | 960      | 129,515   | 130,475   | -     |
| Consumer real estate              |          |          |       |          |           |           |       |
| Home equity lines                 | 98       | 403      | -     | 501      | 20,745    | 21,246    | -     |
| Secured by 1-4 family residential |          |          |       |          |           |           |       |
| First deed of trust               | 555      | 362      | -     | 917      | 65,956    | 66,873    | -     |
| Second deed of trust              | -        | 24       | -     | 24       | 8,651     | 8,675     | -     |
|                                   | 653      | 789      | -     | 1,442    | 95,352    | 96,794    | -     |
| Commercial and industrial loans   |          |          |       |          |           |           |       |
| (except those secured by real     | 25       | 122      | 60    | 207      | 26,047    | 26,254    | 60    |
| estate)                           |          |          |       |          |           |           |       |
| Consumer and other                | 6        | 15       | -     | 21       | 1,909     | 1,930     | -     |
| Total loans                       | \$ 1,298 | \$ 1,388 | \$ 60 | \$ 2,746 | \$283,817 | \$286,563 | \$ 60 |

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 (in thousands):

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|                                       | September 30, 2014 |           |           |
|---------------------------------------|--------------------|-----------|-----------|
|                                       | Unpaid             |           |           |
|                                       | Recorded           | Principal | Related   |
|                                       | Investmen          | Balance   | Allowance |
| With no related allowance recorded    |                    |           |           |
| Construction and land development     |                    |           |           |
| Residential                           | \$259              | \$ 259    | \$ -      |
| Commercial                            | 3,527              | 3,527     | -         |
|                                       | 3,786              | 3,786     | -         |
| Commercial real estate                |                    |           |           |
| Owner occupied                        | 3,133              | 3,133     | -         |
| Non-owner occupied                    | 9,896              | 9,896     | -         |
| Multifamily                           | 2,336              | 2,336     | -         |
| Farmland                              | 21                 | 450       | -         |
|                                       | 15,386             | 15,815    | -         |
| Consumer real estate                  |                    |           |           |
| Home equity lines                     |                    |           |           |
| Secured by 1-4 family residential     |                    |           |           |
| First deed of trust                   | 7,085              | 7,117     | -         |
| Second deed of trust                  | 1,060              | 1,379     | -         |
|                                       | 9,104              | 9,455     | -         |
| Commercial and industrial loans       |                    |           |           |
| (except those secured by real estate) | 745                | 850       | -         |
| Consumer and other                    | 17                 | 17        | -         |
|                                       | 29,038             | 29,923    | -         |
| With an allowance recorded            |                    |           |           |
| Construction and land development     |                    |           |           |
| Commercial                            | 596                | 596       | 26        |
| Commercial real estate                |                    |           |           |
| Owner occupied                        | 4,395              | 4,410     | 323       |
| Non-Owner occupied                    | 215                | 215       | 109       |
|                                       | 4,610              | 4,625     | 432       |
| Consumer real estate                  |                    |           |           |
| Secured by 1-4 family residential     |                    |           |           |
| First deed of trust                   | 1,870              | 1,870     | 341       |
| Second deed of trust                  | 260                | 260       | 44        |
|                                       | 2,130              | 2,130     | 385       |
| Commercial and industrial loans       |                    |           |           |
| (except those secured by real estate) | 100                | 100       | 12        |
|                                       | 7,436              | 7,451     | 855       |
| Total                                 |                    |           |           |
| Construction and land development     |                    |           |           |
| Residential                           | 259                | 259       | -         |
| Commercial                            | 4,123              | 4,123     | 26        |
|                                       | 4,382              | 4,382     | 26        |

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|                                       |          |          |        |
|---------------------------------------|----------|----------|--------|
| Commercial real estate                |          |          |        |
| Owner occupied                        | 7,528    | 7,543    | 323    |
| Non-owner occupied                    | 10,111   | 10,111   | 109    |
| Multifamily                           | 2,336    | 2,336    | -      |
| Farmland                              | 21       | 450      | -      |
|                                       | 19,996   | 20,440   | 432    |
| Consumer real estate                  |          |          |        |
| Home equity lines                     | 959      | 959      | -      |
| Secured by 1-4 family residential,    |          |          |        |
| First deed of trust                   | 8,955    | 8,987    | 341    |
| Second deed of trust                  | 1,320    | 1,639    | 44     |
|                                       | 11,234   | 11,585   | 385    |
| Commercial and industrial loans       |          |          |        |
| (except those secured by real estate) | 845      | 950      | 12     |
| Consumer and other                    | 17       | 17       | -      |
|                                       | \$36,474 | \$37,374 | \$ 855 |

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|  | December 31, 2013 |           |           |
|--|-------------------|-----------|-----------|
|  | Unpaid            |           |           |
|  | Recorded          | Principal | Related   |
|  | Investmen         | Balance   | Allowance |
| With no related allowance recorded                                       |                   |           |           |
| Construction and land development  |                   |           |           |
| Residential  | \$216             | \$ 216    | \$ -      |
| Commercial   | 3,452             | 3,497     | -         |
|  | 3,668             | 3,713     | -         |
| Commercial real estate   |                   |           |           |
| Owner occupied   | 1,919             | 1,969     |           |
| Non-owner occupied   | 11,769            | 11,928    | -         |
| Multifamily  | 2,373             | 2,373     | -         |
| Farmland   | 117               | 450       | -         |
|  | 16,178            | 16,720    | -         |
| Consumer real estate   |                   |           |           |
| Home equity lines  | 1,630             | 1,685     | -         |
| Secured by 1-4 family residential  |                   |           |           |
| First deed of trust  | 8,177             | 8,319     | -         |
| Second deed of trust   | 1,125             | 1,249     | -         |
|  | 10,932            | 11,253    | -         |
| Commercial and industrial loans<br>(except those secured by real estate) |                   |           |           |
| Consumer and other   | 809               | 983       | -         |
|  | 34                | 34        | -         |
|  | 31,621            | 32,703    | -         |
| With an allowance recorded   |                   |           |           |
| Construction and land development  |                   |           |           |
| Commercial   | 1,753             | 1,753     | 220       |
| Commercial real estate   |                   |           |           |
| Owner occupied   | 9,794             | 9,948     | 680       |
| Non-Owner occupied   | 1,297             | 1,297     | 371       |
|  | 11,091            | 11,245    | 1,051     |
| Consumer real estate   |                   |           |           |
| Secured by 1-4 family residential  |                   |           |           |
| First deed of trust  | 2,184             | 2,870     | 484       |
| Second deed of trust   | 132               | 132       | 32        |
|  | 2,316             | 3,002     | 516       |
| Commercial and industrial loans<br>(except those secured by real estate) |                   |           |           |
|  | 151               | 151       | 43        |
|  | 15,311            | 16,151    | 1,830     |
| Total  |                   |           |           |
| Construction and land development  |                   |           |           |
| Residential  | 216               | 216       | -         |
| Commercial   | 5,205             | 5,250     | 220       |
|  | 5,421             | 5,466     | 220       |
| Commercial real estate   |                   |           |           |

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|  |          |          |          |
|--|----------|----------|----------|
| Owner occupied   | 11,713   | 11,917   | 680      |
| Non-owner occupied   | 13,066   | 13,225   | 371      |
| Multifamily  | 2,373    | 2,373    | -        |
| Farmland   | 117      | 450      | -        |
|  | 27,269   | 27,965   | 1,051    |
| Consumer real estate   |          |          |          |
| Home equity lines  | 1,630    | 1,685    | -        |
| Secured by 1-4 family residential,<br>First deed of trust                | 10,361   | 11,189   | 484      |
| Second deed of trust   | 1,257    | 1,381    | 32       |
|  | 13,248   | 14,255   | 516      |
| Commercial and industrial loans<br>(except those secured by real estate) | 960      | 1,134    | 43       |
| Consumer and other   | 34       | 34       | -        |
|  | \$46,932 | \$48,854 | \$ 1,830 |

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 (in thousands):

|  | For the Three Months<br>Ended September 30, 2014 |                                  | For the Nine Months<br>Ended September 30, 2014 |                                  |
|--|--|----------------------------------|---|----------------------------------|
|  | Average<br>Recorded<br>Investment                | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment               | Interest<br>Income<br>Recognized |
| With no related allowance recorded                                       |  |                                  |   |                                  |
| Construction and land development  |  |                                  |   |                                  |
| Residential  | \$ 133   | \$ -                             | \$ 206  | \$ 2                             |
| Commercial   | 3,584  | 52                               | 3,841   | 150                              |
|  | 3,717  | 52                               | 4,047   | 152                              |
| Commercial real estate   |  |                                  |   |                                  |
| Owner occupied   | 2,654  | 70                               | 3,161   | 135                              |
| Non-owner occupied   | 9,557  | 120                              | 9,994   | 335                              |
| Multifamily  | 2,340  | 35                               | 2,353   | 106                              |
| Farmland   | 21   | -                                | 21  | -                                |
|  | 14,572   | 225                              | 15,529  | 576                              |
| Consumer real estate   |  |                                  |   |                                  |
| Home equity lines  | 950  | 3                                | 960   | 19                               |
| Secured by 1-4 family residential  |  |                                  |   |                                  |
| First deed of trust  | 7,259  | 75                               | 7,175   | 268                              |
| Second deed of trust   | 1,147  | 9                                | 1,066   | 42                               |
|  | 9,356  | 87                               | 9,201   | 329                              |
| Commercial and industrial loans<br>(except those secured by real estate) |  |                                  |   |                                  |
| Commercial and other   | 746  | 7                                | 751   | 30                               |
|  | 17   | -                                | 19  | 1                                |
|  | \$ 28,408  | \$ 371                           | \$ 29,547                                       | \$ 1,088                         |
| With an allowance recorded   |  |                                  |   |                                  |
| Construction and land development  |  |                                  |   |                                  |
| Commercial   | 598  | 8                                | 603   | 23                               |
| Commercial real estate   |  |                                  |   |                                  |
| Owner occupied   | 2,801  | 62                               | 4,446   | 154                              |
| Non-Owner occupied   | 1,946  | 9                                | 217   | 9                                |
|  | 4,747  | 71                               | 4,663   | 163                              |
| Consumer real estate   |  |                                  |   |                                  |
| Secured by 1-4 family residential  |  |                                  |   |                                  |
| First deed of trust  | 1,870  | 22                               | 1,944   | 24                               |
| Second deed of trust   | 260  | 5                                | 264   | 8                                |
|  | 2,130  | 27                               | 2,208   | 32                               |
| Commercial and industrial loans<br>(except those secured by real estate) |  |                                  |   |                                  |
|  | 110  | -                                | 115   | -                                |
|  | 7,585  | 106                              | \$ 7,589  | \$ 218                           |

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|                                       |           |        |           |          |
|---------------------------------------|-----------|--------|-----------|----------|
| Total                                 |           |        |           |          |
| Construction and land development     |           |        |           |          |
| Residential                           | 133       | -      | 206       | 2        |
| Commercial                            | 4,182     | 60     | 4,444     | 173      |
|                                       | 4,315     | 60     | 4,650     | 175      |
| Commercial real estate                |           |        |           |          |
| Owner occupied                        | 5,455     | 132    | 7,607     | 289      |
| Non-owner occupied                    | 11,503    | 129    | 10,211    | 344      |
| Multifamily                           | 2,340     | 35     | 2,353     | 106      |
| Farmland                              | 21        | -      | 21        | -        |
|                                       | 19,319    | 296    | 20,192    | 739      |
| Consumer real estate                  |           |        |           |          |
| Home equity lines                     | 950       | 3      | 960       | 19       |
| Secured by 1-4 family residential,    |           |        |           |          |
| First deed of trust                   | 9,129     | 97     | 9,119     | 292      |
| Second deed of trust                  | 1,407     | 14     | 1,330     | 50       |
|                                       | 11,486    | 114    | 11,409    | 361      |
| Commercial and industrial loans       |           |        |           |          |
| (except those secured by real estate) | 856       | 7      | 866       | 30       |
| Consumer and other                    | 17        | -      | 19        | 1        |
|                                       | \$ 35,993 | \$ 477 | \$ 37,136 | \$ 1,306 |

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|  | For the Three Months<br>Ended September 30, 2013 |                                  | For the Nine Months<br>Ended September 30, 2013 |                                  |
|--|--|----------------------------------|---|----------------------------------|
|  | Average<br>Recorded<br>Investment                | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment               | Interest<br>Income<br>Recognized |
| With no related allowance recorded                                       |  |                                  |   |                                  |
| Construction and land development  |  |                                  |   |                                  |
| Commercial   | \$ 5,749   | 68                               | \$ 6,612  | \$ 218                           |
|  | 5,749  | 68                               | 6,612   | 218                              |
| Commercial real estate   |  |                                  |   |                                  |
| Owner occupied   | 11,033   | 177                              | 10,479  | 419                              |
| Non-owner occupied   | 11,238   | 137                              | 11,315  | 412                              |
| Multifamily  | 2,390  | 36                               | 2,402   | 114                              |
|  | 24,661   | 350                              | 24,196  | 945                              |
| Consumer real estate   |  |                                  |   |                                  |
| Home equity lines  | 1,093  | 7                                | 1,093   | 36                               |
| Secured by 1-4 family residential  |  |                                  |   |                                  |
| First deed of trust  | 14,479   | 128                              | 14,531  | 478                              |
| Second deed of trust   | 974  | 12                               | 978   | 37                               |
|  | 16,546   | 147                              | 16,602  | 551                              |
| Commercial and industrial loans<br>(except those secured by real estate) | 472  | 9                                | 430   | 22                               |
| Consumer and other   | 138  | 2                                | 142   | 7                                |
|  | \$ 47,566  | \$ 576                           | \$ 47,982                                       | \$ 1,743                         |
| With an allowance recorded   |  |                                  |   |                                  |
| Construction and land development  |  |                                  |   |                                  |
| Commercial   | 1,523  | -                                | 1,525   | 6                                |
| Commercial real estate   |  |                                  |   |                                  |
| Non-Owner occupied   | 1,089  | 13                               | 1,089   | 44                               |
| Farmland   | 565  | -                                | 569   | 1                                |
|  | 1,654  | 13                               | 1,658   | 45                               |
| Consumer real estate   |  |                                  |   |                                  |
| Home equity lines  | -  | -                                | -   | -                                |
| Secured by 1-4 family residential  |  |                                  |   |                                  |
| First deed of trust  | 237  | -                                | 269   | -                                |
| Second deed of trust   | 136  | 2                                | 136   | 4                                |
|  | 373  | 2                                | 405   | 4                                |
| Commercial and industrial loans<br>(except those secured by real estate) | 418  | 4                                | 246   | 7                                |
|  | 3,968  | 19                               | 3,834   | 62                               |
| Total  |  |                                  |   |                                  |
| Construction and land development  |  |                                  |   |                                  |
| Commercial   | 7,272  | 68                               | 8,137   | 224                              |
|  | 7,272  | 68                               | 8,137   | 224                              |
| Commercial real estate   |  |                                  |   |                                  |
| Owner occupied   | 11,033   | 177                              | 10,479  | 419                              |



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|                                       |           |        |           |          |
|---------------------------------------|-----------|--------|-----------|----------|
| Non-owner occupied                    | 12,327    | 150    | 12,404    | 456      |
| Multifamily                           | 2,390     | 36     | 2,402     | 114      |
| Farmland                              | 565       | -      | 569       | 1        |
|                                       | 26,315    | 363    | 25,854    | 990      |
| Consumer real estate                  |           |        |           |          |
| Home equity lines                     | 1,093     | 7      | 1,093     | 36       |
| Secured by 1-4 family residential,    |           |        |           |          |
| First deed of trust                   | 14,716    | 128    | 14,800    | 478      |
| Second deed of trust                  | 1,110     | 14     | 1,114     | 41       |
|                                       | 16,919    | 149    | 17,007    | 555      |
| Commercial and industrial loans       |           |        |           |          |
| (except those secured by real estate) | 890       | 13     | 676       | 29       |
| Consumer and other                    | 138       | 2      | 142       | 7        |
|                                       | \$ 51,534 | \$ 595 | \$ 51,816 | \$ 1,805 |

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 (dollars in thousands):

|  | Total    | Performing | Nonaccrual | Specific<br>Valuation<br>Allowance |
|--|----------|------------|------------|------------------------------------|
| September 30, 2014   |          |            |            |                                    |
| Construction and land development  |          |            |            |                                    |
| Residential  | \$7      | \$ -       | \$ 7       | \$ -                               |
| Commercial   | 3,977    | 3,833      | 144        | 26                                 |
|  | 3,984    | 3,833      | 151        | 26                                 |
| Commercial real estate   |          |            |            |                                    |
| Owner occupied   | 6,356    | 6,022      | 334        | 324                                |
| Non-owner occupied   | 9,024    | 9,024      | -          | 108                                |
| Multifamily  | 2,336    | 2,336      | -          | -                                  |
|  | 17,716   | 17,382     | 334        | 432                                |
| Consumer real estate   |          |            |            |                                    |
| Home equity lines  | 160      | -          | 160        | -                                  |
| Secured by 1-4 family residential  | -        |            |            |                                    |
| First deeds of trust   | 7,170    | 4,995      | 2,175      | 341                                |
| Second deeds of trust  | 719      | 614        | 105        | 44                                 |
|  | 8,049    | 5,609      | 2,440      | 385                                |
| Commercial and industrial loans<br>(except those secured by real estate) | 240      | 104        | 136        | 12                                 |
| Consumer and other   | 17       | -          | 17         | -                                  |
|  | \$30,006 | \$ 26,928  | \$ 3,078   | \$ 855                             |
| Number of loans  | 112      | 77         | 35         | 25                                 |

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|  | Total    | Performing | Nonaccrual | Specific Valuation Allowance |
|--|----------|------------|------------|------------------------------|
| December 31, 2013  |          |            |            |                              |
| Construction and land development  |          |            |            |                              |
| Residential  | \$216    | \$ 216     | \$ -       | \$ -                         |
| Commercial   | 4,922    | 3,393      | 1,528      | 211                          |
|  | 5,138    | 3,609      | 1,528      | 211                          |
| Commercial real estate   |          |            |            |                              |
| Owner occupied   | 10,377   | 9,010      | 1,367      | 374                          |
| Non-owner occupied   | 9,973    | 9,568      | 404        | 137                          |
| Multifamily  | 2,373    | 2,373      | -          | -                            |
|  | 22,723   | 20,951     | 1,771      | 511                          |
| Consumer real estate   |          |            |            |                              |
| Home equity lines  | 160      | -          | 160        | -                            |
| Secured by 1-4 family residential  |          |            |            |                              |
| First deeds of trust   | 7,296    | 3,230      | 4,066      | 383                          |
| Second deeds of trust  | 691      | 324        | 367        | -                            |
|  | 8,147    | 3,554      | 4,593      | 383                          |
| Commercial and industrial loans<br>(except those secured by real estate) |          |            |            |                              |
| Consumer and other   | 256      | 121        | 135        | 9                            |
|  | 21       | -          | 21         | -                            |
|  | \$36,285 | \$ 28,235  | \$ 8,048   | \$ 1,114                     |
| Number of loans  | 115      | 62         | 53         | 23                           |

The following table provides information about TDRs identified during the indicated periods (dollars in thousands):

|                                   | Nine Months Ended September 30, 2014 |                                   |                                    | Nine Months Ended September 30, 2013 |                                   |                                    |
|-----------------------------------|--------------------------------------|-----------------------------------|------------------------------------|--------------------------------------|-----------------------------------|------------------------------------|
|                                   | 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 |                                      |                                   |                                    |                                      |                                   |                                    |
| Residential                       | -                                    | \$ -                              | \$ -                               | -                                    | \$ -                              | \$ -                               |
| Commercial                        | 1                                    | 45                                | 45                                 | 6                                    | 2,991                             | 2,991                              |
|                                   | 1                                    | 45                                | 45                                 | 6                                    | 2,991                             | 2,991                              |
| Commercial real estate            |                                      |                                   |                                    |                                      |                                   |                                    |
| Owner occupied                    | 2                                    | 743                               | 743                                | 4                                    | 1,087                             | 1,087                              |
| Non-owner occupied                |                                      | -                                 | -                                  | -                                    | -                                 | -                                  |
|                                   | 2                                    | 743                               | 743                                | 4                                    | 1,087                             | 1,087                              |

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|                                   |    |          |          |    |          |          |
|-----------------------------------|----|----------|----------|----|----------|----------|
| Consumer real estate              |    |          |          |    |          |          |
| Home equity lines                 | -  | -        | -        | -  | -        | -        |
| Secured by 1-4 family residential |    |          |          |    |          |          |
| First deed of trust               | 7  | 729      | 729      | 16 | 2,266    | 2,266    |
| Second deed of trust              | 2  | 105      | 105      | 2  | 162      | 162      |
|                                   | 9  | 834      | 834      | 18 | 2,428    | 2,428    |
| Consumer and other                | -  | -        | -        | 1  | 382      | 382      |
|                                   | 12 | \$ 1,622 | \$ 1,622 | 29 | \$ 6,888 | \$ 6,888 |

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|   | Three Months Ended September 30, 2014 |                                   |                                    | Three Months Ended September 30, 2013 |                                   |                                    |
|---|---------------------------------------|-----------------------------------|------------------------------------|---------------------------------------|-----------------------------------|------------------------------------|
|   | Number of Loans                       | Pre-Modification Recorded Balance | Post-Modification Recorded Balance | Number of Loans                       | Pre-Modification Recorded Balance | Post-Modification Recorded Balance |
| Commercial real estate  |                                       |                                   |                                    |                                       |                                   |                                    |
| Owner occupied  | -                                     | \$ -                              | \$ -                               | 4                                     | \$ 2,256                          | \$ 2,256                           |
|   | -                                     | -                                 | -                                  | 4                                     | 2,256                             | 2,256                              |
| Consumer real estate  |                                       |                                   |                                    |                                       |                                   |                                    |
| Secured by 1-4 family residential                               |                                       |                                   |                                    |                                       |                                   |                                    |
| First deed of trust   | 3                                     | 372                               | 372                                | 5                                     | 715                               | 715                                |
| Second deed of trust  | 2                                     | 105                               | 105                                | 2                                     | 162                               | 162                                |
|   | 5                                     | 477                               | 477                                | 7                                     | 877                               | 877                                |
| Commercial and industrial (except those secured by real estate) |                                       |                                   |                                    |                                       |                                   |                                    |
|   | -                                     | -                                 | -                                  | -                                     | -                                 | -                                  |
|   | 5                                     | \$ 477                            | \$ 477                             | 11                                    | \$ 3,133                          | \$ 3,133                           |

The following table summarizes defaults on TDRs identified for the three and nine months ended September 30, 2014 (dollars in thousands):

|                                   | Three Months Ended September 30, 2014 |                  | Nine Months Ended September 30, 2014 |                  |
|-----------------------------------|---------------------------------------|------------------|--------------------------------------|------------------|
|                                   | Number of Loans                       | Recorded Balance | Number of Loans                      | Recorded Balance |
| Cosntruction and land development |                                       |                  |                                      |                  |
| Commercial                        | -                                     | \$ -             | 1                                    | \$ 45            |
|                                   | -                                     | -                | 1                                    | 45               |
| Commercial real estate            |                                       |                  |                                      |                  |
| Owner occupied                    | -                                     | -                | 1                                    | 334              |
|                                   | -                                     | -                | 1                                    | 334              |
| Consumer real estate:             |                                       |                  |                                      |                  |
| Secured by 1-4 family residential |                                       |                  |                                      |                  |
| First deed of trust               | 1                                     | 186              | 5                                    | 541              |
| Second deed of trust              | 2                                     | 105              | 2                                    | 105              |
|                                   | 3                                     | 291              | 7                                    | 646              |
| Total                             | 3                                     | \$ 291           | 9                                    | \$ 1,025         |



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Activity in the allowance for loan losses is as follows for the periods indicated (dollars in thousands):

|  | Beginning<br>Balance | Provision for<br>Loan Losses | Charge-offs | Recoveries | Ending<br>Balance |
|--|----------------------|------------------------------|-------------|------------|-------------------|
| Three Months Ended September 30, 2014                                    |                      |                              |             |            |                   |
| Construction and land development  |                      |                              |             |            |                   |
| Residential  | \$ 141               | \$ -                         | \$ -        | \$ -       | \$ 141            |
| Commercial   | 770                  | -                            | -           | 27         | 797               |
|  | 911                  | -                            | -           | 27         | 938               |
| Commercial real estate   |                      |                              |             |            |                   |
| Owner occupied   | 1,245                | -                            | -           | -          | 1,245             |
| Non-owner occupied   | (15 )                | -                            | -           | 1          | (14 )             |
| Multifamily  | 17                   | -                            | -           | -          | 17                |
| Farmland   | 409                  | -                            | -           | -          | 409               |
|  | 1,656                | -                            | -           | 1          | 1,657             |
| Consumer real estate   |                      |                              |             |            |                   |
| Home equity lines  | 225                  | -                            | (52 )       | 12         | 185               |
| Secured by 1-4 family residential  |                      |                              |             |            |                   |
| First deed of trust  | 1,744                | -                            | (39 )       | 9          | 1,714             |
| Second deed of trust   | 440                  | -                            | -           | 5          | 445               |
|  | 2,409                | -                            | (91 )       | 26         | 2,344             |
| Commercial and industrial loans<br>(except those secured by real estate) |                      |                              |             |            |                   |
| Consumer and other   | 678                  | -                            | -           | 13         | 691               |
|  | 27                   | -                            | (3 )        | 4          | 28                |
|  | \$ 5,681             | \$ -                         | \$ (94 )    | \$ 71      | \$ 5,658          |

|                                       | Beginning<br>Balance | Provision for<br>Loan Losses | Charge-offs | Recoveries | Ending<br>Balance |
|---------------------------------------|----------------------|------------------------------|-------------|------------|-------------------|
| Three Months Ended September 30, 2013 |                      |                              |             |            |                   |
| Construction and land development     |                      |                              |             |            |                   |
| Residential                           | \$ 596               | \$ -                         | \$ -        | \$ -       | \$ 596            |
| Commercial                            | 4,777                | -                            | (175 )      | 35         | 4,637             |
|                                       | 5,373                | -                            | (175 )      | 35         | 5,233             |
| Commercial real estate                |                      |                              |             |            |                   |
| Owner occupied                        | 1,126                | -                            | (128 )      | -          | 998               |
| Non-owner occupied                    | 307                  | -                            | -           | -          | 307               |
| Multifamily                           | 23                   | -                            | -           | -          | 23                |
| Farmland                              | 808                  | -                            | (448 )      | -          | 360               |
|                                       | 2,264                | -                            | (576 )      | -          | 1,688             |
| Consumer real estate                  |                      |                              |             |            |                   |
| Home equity lines                     | 415                  | -                            | (22 )       | 9          | 402               |
| Secured by 1-4 family residential     |                      |                              |             |            |                   |

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|  |          |      |             |       |          |
|--|----------|------|-------------|-------|----------|
| First deed of trust  | 504      | -    | (127 )      | 1     | 378      |
| Second deed of trust   | 14       | -    | -           | -     | 14       |
|  | 933      | -    | (149 )      | 10    | 794      |
| Commercial and industrial loans<br>(except those secured by real estate) | 947      | -    | (115 )      | 24    | 856      |
| Consumer and other   | 93       | -    | (39 )       | 3     | 57       |
|  | \$ 9,610 | \$ - | \$ (1,054 ) | \$ 72 | \$ 8,628 |



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|  | Beginning<br>Balance | Provision for<br>Loan Losses | Charge-offs | Recoveries | Ending<br>Balance |
|--|----------------------|------------------------------|-------------|------------|-------------------|
| Nine Months Ended September 30, 2014                                     |                      |                              |             |            |                   |
| Construction and land development  |                      |                              |             |            |                   |
| Residential  | \$ 135               | \$ 5                         | \$ -        | \$ 1       | \$ 141            |
| Commercial   | 1,274                | (421 )                       | (100 )      | 44         | 797               |
|  | 1,409                | (416 )                       | (100 )      | 45         | 938               |
| Commercial real estate   |                      |                              |             |            |                   |
| Owner occupied   | 1,200                | 653                          | (608 )      | -          | 1,245             |
| Non-owner occupied   | 670                  | (470 )                       | (238 )      | 24         | (14 )             |
| Multifamily  | 19                   | (2 )                         | -           | -          | 17                |
| Farmland   | 337                  | 168                          | (96 )       | -          | 409               |
|  | 2,226                | 349                          | (942 )      | 24         | 1,657             |
| Consumer real estate   |                      |                              |             |            |                   |
| Home equity lines  | 424                  | 223                          | (476 )      | 14         | 185               |
| Secured by 1-4 family residential  |                      |                              |             |            |                   |
| First deed of trust  | 1,992                | (65 )                        | (277 )      | 64         | 1,714             |
| Second deed of trust   | 394                  | 12                           | (76 )       | 115        | 445               |
|  | 2,810                | 170                          | (829 )      | 193        | 2,344             |
| Commercial and industrial loans<br>(except those secured by real estate) |                      |                              |             |            |                   |
| Consumer and other   | 724                  | 45                           | (168 )      | 90         | 691               |
|  | 70                   | (48 )                        | (8 )        | 14         | 28                |
|  | \$ 7,239             | \$ 100                       | \$ (2,047 ) | \$ 366     | \$ 5,658          |

|                                      | Beginning<br>Balance | Provision for<br>Loan Losses | Charge-offs | Recoveries | Ending<br>Balance |
|--------------------------------------|----------------------|------------------------------|-------------|------------|-------------------|
| Nine Months Ended September 30, 2013 |                      |                              |             |            |                   |
| Construction and land development    |                      |                              |             |            |                   |
| Residential                          | \$ 495               | \$ -                         | \$ -        | \$ 101     | \$ 596            |
| Commercial                           | 4,611                | 15                           | (270 )      | 281        | 4,637             |
|                                      | 5,106                | 15                           | (270 )      | 382        | 5,233             |
| Commercial real estate               |                      |                              |             |            |                   |
| Owner occupied                       | 1,359                | -                            | (404 )      | 43         | 998               |
| Non-owner occupied                   | 817                  | -                            | (510 )      | -          | 307               |
| Multifamily                          | 23                   | -                            | -           | -          | 23                |
| Farmland                             | -                    | 808                          | (448 )      | -          | 360               |
|                                      | 2,199                | 808                          | (1,362 )    | 43         | 1,688             |
| Consumer real estate                 |                      |                              |             |            |                   |
| Home equity lines                    | 658                  | -                            | (266 )      | 10         | 402               |
| Secured by 1-4 family residential    |                      |                              |             |            |                   |
| First deed of trust                  | 1,358                | -                            | (1,002 )    | 22         | 378               |
| Second deed of trust                 | 224                  | -                            | (215 )      | 5          | 14                |
|                                      | 2,240                | -                            | (1,483 )    | 37         | 794               |
| Commercial and industrial loans      |                      |                              |             |            |                   |

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|                                       |           |        |           |   |        |          |
|---------------------------------------|-----------|--------|-----------|---|--------|----------|
| (except those secured by real estate) | 1,162     | -      | (466      | ) | 160    | 856      |
| Consumer and other                    | 101       | -      | (52       | ) | 8      | 57       |
|                                       | \$ 10,808 | \$ 823 | \$ (3,633 | ) | \$ 630 | \$ 8,628 |

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|  | Beginning<br>Balance | Provision for<br>Loan Losses | Charge-offs | Recoveries | Ending<br>Balance |
|--|----------------------|------------------------------|-------------|------------|-------------------|
| Year Ended December 31, 2013   |                      |                              |             |            |                   |
| Construction and land development  |                      |                              |             |            |                   |
| Residential  | \$ 495               | \$ (462                      | ) \$ -      | \$ 102     | \$ 135            |
| Commercial   | 4,611                | (3,482                       | ) (279      | ) 424      | 1,274             |
|  | 5,106                | (3,944                       | ) (279      | ) 526      | 1,409             |
| Commercial real estate   |                      |                              |             |            |                   |
| Owner occupied   | 1,359                | 252                          | (454        | ) 43       | 1,200             |
| Non-owner occupied   | 817                  | 452                          | (619        | ) 20       | 670               |
| Multifamily  | 23                   | (4                           | ) -         | -          | 19                |
| Farmland   | -                    | 1,233                        | (896        | ) -        | 337               |
|  | 2,199                | 1,933                        | (1,969      | ) 63       | 2,226             |
| Consumer real estate   |                      |                              |             |            |                   |
| Home equity lines  | 658                  | 23                           | (266        | ) 9        | 424               |
| Secured by 1-4 family residential  |                      |                              |             |            |                   |
| First deed of trust  | 1,358                | 2,493                        | (1,953      | ) 94       | 1,992             |
| Second deed of trust   | 224                  | 498                          | (367        | ) 39       | 394               |
|  | 2,240                | 3,014                        | (2,586      | ) 142      | 2,810             |
| Commercial and industrial loans<br>(except those secured by real estate) |                      |                              |             |            |                   |
| Consumer and other   | 1,162                | 145                          | (760        | ) 177      | 724               |
|  | 101                  | 25                           | (65         | ) 9        | 70                |
|  | \$ 10,808            | \$ 1,173                     | \$ (5,659   | ) \$ 917   | \$ 7,239          |

Loans were evaluated for impairment as follows for the periods indicated (dollars in thousands):

|  | Loans Evaluated for Impairment |              |            |
|--|--------------------------------|--------------|------------|
|  | Individually                   | Collectively | Total      |
| Nine Months Ended September 30, 2014                                     |                                |              |            |
| Construction and land development  |                                |              |            |
| Residential  | \$ 546                         | \$ 4,046     | \$4,592    |
| Commercial   | 14,264                         | 10,871       | 25,135     |
| Commercial real estate   |                                |              |            |
| Owner occupied   | 38,797                         | 19,478       | 58,275     |
| Non-owner occupied   | 30,929                         | 8,876        | 39,805     |
| Multifamily  | 8,305                          | 2,714        | 11,019     |
| Farmland   | 768                            | 575          | 1,343      |
| Consumer real estate   |                                |              |            |
| Home equity lines  | 2,063                          | 18,212       | 20,275     |
| Secured by 1-4 family residential  |                                |              |            |
| First deed of trust  | 7,075                          | 56,350       | 63,425     |
| Second deed of trust   | 514                            | 7,613        | 8,127      |
| Commercial and industrial loans<br>(except those secured by real estate) |                                |              |            |
| Commercial and other   | 8,751                          | 13,720       | 22,471     |
| Consumer and other   | -                              | 20,656       | 20,656     |
|  | \$ 112,012                     | \$ 163,111   | \$ 275,123 |
| Year Ended December 31, 2013   |                                |              |            |
| Construction and land development  |                                |              |            |
| Residential  | \$ 576                         | \$ 2,355     | \$ 2,931   |
| Commercial   | 15,592                         | 12,587       | 28,179     |
| Commercial real estate   |                                |              |            |
| Owner occupied   | 53,126                         | 20,458       | 73,584     |
| Non-owner occupied   | 34,367                         | 9,501        | 43,868     |
| Multifamily  | 9,363                          | 2,197        | 11,560     |
| Farmland   | 778                            | 685          | 1,463      |
| Consumer real estate   |                                |              |            |
| Home equity lines  | 1,382                          | 19,864       | 21,246     |
| Secured by 1-4 family residential  |                                |              |            |
| First deed of trust  | 8,969                          | 57,904       | 66,873     |
| Second deed of trust   | 533                            | 8,142        | 8,675      |
| Commercial and industrial loans  |                                |              |            |

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|                                       |            |            |            |
|---------------------------------------|------------|------------|------------|
| (except those secured by real estate) | 10,845     | 15,409     | 26,254     |
| Consumer and other                    | -          | 1,930      | 1,930      |
|                                       | \$ 135,531 | \$ 151,032 | \$ 286,563 |

## Note 6 – Deposits

Deposits as of September 30, 2014 and December 31, 2013 were as follows (dollars in thousands):

|                                     | September 30, 2014 |                | December 31, 2013 |                |
|-------------------------------------|--------------------|----------------|-------------------|----------------|
|                                     | Amount             | %              | Amount            | %              |
| Demand accounts                     | \$ 65,218          | 17.1 %         | \$ 57,244         | 14.7 %         |
| Interest checking accounts          | 42,196             | 11.1 %         | 43,691            | 11.2 %         |
| Money market accounts               | 66,361             | 17.4 %         | 63,357            | 16.2 %         |
| Savings accounts                    | 20,032             | 5.3 %          | 20,229            | 5.2 %          |
| Time deposits of \$100,000 and over | 83,694             | 22.0 %         | 94,245            | 24.1 %         |
| Other time deposits                 | 103,163            | 27.1 %         | 111,862           | 28.6 %         |
| <b>Total</b>                        | <b>\$ 380,664</b>  | <b>100.0 %</b> | <b>\$ 390,628</b> | <b>100.0 %</b> |

## 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 September 30, 2014 was 2.38%. 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 September 30, 2014 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 LIBOR-indexed floating rate of interest (three-month LIBOR plus 1.4%) which adjusts, and is also payable, quarterly. The interest rate at September 30, 2014 was 1.63%. 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 these securities, the Company has deferred an aggregate of \$1,009,712 in interest payments on the junior subordinated debt securities as of September 30, 2014. 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 48,750 shares of common stock (after the reverse stock split) 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:

|  | Nine Months Ended September 30,<br>2014 |  |                            |                    | 2013    |  |                            |                    |
|--|---|--|----------------------------|--------------------|---------|--|----------------------------|--------------------|
|  | Options                                 | Weighted<br>Average<br>Exercise<br>Price | Fair<br>Value<br>Per Share | Intrinsic<br>Value | Options | Weighted<br>Average<br>Exercise<br>Price | Fair<br>Value<br>Per Share | Intrinsic<br>Value |
| Options outstanding, beginning of period | 6,210                                   | \$ 99.03                                 | \$ 59.21                   |                    | 15,977  | \$ 151.68                                | \$ 75.20                   |                    |
| Granted                                  | 884                                     | 25.28                                    | 15.52                      |                    | 2,638   | 25.28                                    | 9.76                       |                    |
| Forfeited                                | (264 )                                  | 25.28                                    | 80.33                      |                    | (188 )  | 123.20                                   | 79.84                      |                    |
| Exercised                                | -                                       | -  | -                          |                    | -       | -  | -                          |                    |
| Options outstanding, end of period       | 6,830                                   | \$ 92.34                                 | \$ 52.74                   | \$ -               | 18,427  | \$ 150.40                                | \$ 64.96                   | \$ -               |
| Options exercisable, end of period       | 5,318                                   |  |                            |                    | 16,008  |  |                            |                    |

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 September 30, 2014 and 2013 was \$355,274 and \$115,764, respectively. The time based unamortized compensation of \$355,274 is expected to be recognized over a weighted average period of 2.74 years.

Stock-based compensation expense was \$62,304 and \$5,963 for the nine months ended September 30, 2014 and 2013, 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 transactions 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.

Financial Accounting Standards Board (“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 hierarchy 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 Operations.



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.

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

|                                  | Fair Value Measurement<br>at September 30, 2014 Using<br>(In thousands) |  |  |  |
|----------------------------------|---|--|--|--|
|                                  | Carrying<br>Value   | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial Assets - Recurring     |   |  |  |  |
| US Treasuries                    | \$7,582   | \$ -   | 7,582                                      | \$ -   |
| US Government Agencies           | 34,614  | -  | 34,614                                     | -  |
| Mortgage-backed securities       | 558   | -  | 558  | -  |
| Municipals                       | 12,761  | -  | 12,761                                     | -  |
| Residential loans held for sale  | 7,298   | -  | 7,298                                      | -  |
|                                  |   |  | -  |  |
| Financial Assets - Non-Recurring |   |  |  |  |
| Impaired loans                   | 36,474  | -  | 33,836                                     | 2,638  |
| Real estate owned                | 14,003  | -  | 13,356                                     | 647  |

| Fair Value Measurement<br>at December 31, 2013 Using<br>(In thousands) |  |      |  |  |  |
|--|--|------|--|--|--|
| Carrying<br>Value  | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) |      |  | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|  |  |      |  |  |  |
| Financial Assets - Recurring   |  |      |  |  |  |
| US Treasuries  | \$7,210  | \$ - |  | 7,210                                      | \$ -   |
| US Government Agencies   | 34,351   | -    |  | 34,351                                     | -  |
| Mortgage-backed securities   | 2,752  | -    |  | 2,752                                      | -  |
| Municipals   | 13,435   | -    |  | 13,435                                     | -  |
| Residential loans held for sale  | 8,371  | -    |  | 8,371                                      | -  |
| Financial Assets - Non-Recurring                                       |  |      |  |  |  |
| Impaired loans   | 46,932   | -    |  | 42,679                                     | 4,253  |
| Real estate owned  | 16,742   | -    |  | 15,405                                     | 1,337  |

The following table presents qualitative information about level 3 fair value measurements for financial instruments measured at fair value at September 30, 2014:

|   | Fair Value<br>Estimate<br>(In thousands) | Valuation<br>Techniques                    | Unobservable<br>Input   | Range<br>(Weighted<br>Average)    |
|---|--|--|---|-----------------------------------|
| Impaired loans - real<br>estate secured     | \$ 1,790                                 | Appraisal (1) or Internal<br>Valuation (2) | Selling costs<br><br>Discount for lack of marketability<br>and age of appraisal | 6%-10%<br>(7%)<br>6%-30%<br>(10%) |
| Impaired loans - non-real<br>estate secured | \$ 848                                   | Appraisal (1) or Discounted<br>Cash Flow   | Selling costs<br><br>Discount for lack of marketability or<br>practical life    | 10%<br>0%-50%<br>(20%)            |
| Real estate owned                           | \$ 647                                   | Appraisal (1) or Internal<br>Valuation (2) | Selling costs<br><br>Discount for lack of marketability<br>and age of appraisal | 6%-10%<br>(7%)<br>6%-30%<br>(15%) |

(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

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.

*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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|  | Level in Fair Value Hierarchy<br>(In thousands) | September 30, 2014 |                      | December 31, 2013 |                      |
|--|---|--------------------|----------------------|-------------------|----------------------|
|  |   | Carrying Value     | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| <b>Financial assets</b>                  |   |                    |                      |                   |                      |
| Cash                                     | Level 1   | \$ 13,895          | \$ 13,895            | \$ 15,221         | \$ 15,221            |
| Cash equivalents                         | Level 2   | 30,937             | 30,937               | 24,988            | 24,988               |
| Investment securities available for sale | Level 2   | 55,515             | 55,515               | 57,748            | 57,748               |
| Federal Home Loan Bank stock             | Level 2   | 1,073              | 1,073                | 1,417             | 1,417                |
| Loans                                    | Level 2   | 238,649            | 238,676              | 233,075           | 236,582              |
| Impaired loans                           | Level 2   | 33,836             | 33,836               | 42,679            | 42,679               |
| Impaired loans                           | Level 3   | 2,638              | 2,638                | 4,253             | 4,253                |
| Other real estate owned                  | Level 2   | 13,356             | 13,356               | 15,405            | 15,405               |
| Other real estate owned                  | Level 3   | 647                | 647                  | 1,337             | 1,337                |
| Accrued interest receivable              | Level 2   | 1,567              | 1,567                | 1,486             | 1,486                |
| <b>Financial liabilities</b>             |   |                    |                      |                   |                      |
| Deposits                                 | Level 2   | 380,664            | 381,571              | 390,628           | 391,814              |
| FHLB borrowings                          | Level 2   | 14,000             | 14,015               | 18,000            | 18,212               |
| Trust preferred securities               | Level 2   | 8,764              | 7,274                | 8,764             | 7,274                |
| Other borrowings                         | Level 2   | 1,835              | 1,836                | 2,713             | 3,289                |
| Accrued interest payable                 | Level 2   | 1,120              | 1,120                | 1,093             | 1,093                |

Note 10 – Capital Resources

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, 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 31,190 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, and was determined to be \$10,208,000. 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, and was determined to be \$534,000. The aggregate fair value for both the preferred stock and common stock warrants was determined to be \$10,742,000 with 95% of the aggregate attributable to the preferred stock and 5% attributable to the common stock warrant. Therefore, the \$14,738,000 issuance was allocated with \$14,006,000 being assigned to the preferred stock and \$732,000 being allocated to the common stock warrant. The difference between the \$14,738,000 face value of the preferred stock and the amount allocated of \$14,006,000 to the preferred stock 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 paid cumulative dividends at a rate of 5% until May 1, 2014, at which time the rate increased to 9%. 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 “Reserve Bank”), 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 September 30, 2014 was \$3,243,600. This amount has been accrued for and is included in other liabilities in the consolidated balance sheet.

In November 2013, the Company participated in a successful auction of the Company's preferred stock securities by the Treasury that resulted in the purchase of the securities by private and institutional investors.

On December 4, 2013, the Company issued 1,086,500 new shares of common stock through a private placement to directors and executive officers. The sale raised \$1,684,075 in new capital for the Company. The \$1.55 sale price for the common shares was equal to the stock's book value at September 30, 2013, which represented a 30% premium over the closing price of the stock on December 3, 2013.

On August 6, 2014, the Company filed Articles of Amendment to its Articles of Incorporation with the Virginia State Corporation Commission to effect a reverse stock split of its outstanding common stock which became effective on August 8, 2014. As a result of the reverse split, every sixteen shares of the Company's issued and outstanding common stock were consolidated into one issued and outstanding share of common stock.

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.

#### 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 (dollars in thousands):

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|   | September 30,<br>2014 | December 31,<br>2013 |
|---|-----------------------|----------------------|
| Undisbursed credit lines                  | \$ 34,398             | \$ 37,474            |
| Commitments to extend or originate credit | 15,253                | 10,581               |
| Standby letters of credit                 | 1,571                 | 2,192                |
| Total commitments to extend credit        | \$ 51,222             | \$ 50,247            |

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.

Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

*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.

*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 (the "FDIC") and the Virginia Bureau of Financial Institutions (collectively, 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.

**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 was required to prepare and submit the following written plans or reports to the Supervisory Authorities:

- 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; and
- Assessment of the Bank's information technology function.

Under the Order, the Bank's board of directors 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 was also required to 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 continue 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. 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.

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; or
- purchase or redeem any shares of its stock.

Since entering into the Order and the Written Agreement, the Company has taken numerous steps to comply with their terms. As of September 30, 2014, we believe we have complied with all requirements of the Order and the Written Agreement with the exception of the capital requirements in the Order and correction of noncompliance with Section 23A of Regulation W of the Federal Reserve Act in the Written Agreement.

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 September 30, 2014, 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 the entire net deferred tax asset that is dependent on future earnings of the Company of approximately \$12,214,000.

Note 13 – Recent accounting pronouncements

In January 2014, the FASB issued Accounting Standards Update (“ASU”) 2014-01, “Investments – Equity Method and Joint Ventures: Accounting for Investments in Qualified Affordable Housing Projects”. This ASU applies to all reporting entities that invest in qualified affordable housing projects through limited liability entities that are flow through entities for tax purposes. The amendments in the ASU eliminate the effective yield election and permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Those not electing the proportional amortization method would account for the investment using the equity method or cost method. The amendments in this ASU are effective for public business entities for annual periods beginning after December 15, 2014. The adoption of this guidance should not have a material effect on the Company’s financial condition or results of operations.

In January 2014, the FASB issued ASU 2014-04, “Receivables – Troubled Debt Restructurings by Creditors”. ASU 2014-04 clarifies when a creditor should be considered to have received physical possession of residential real estate property during a foreclosure. ASU 2014-04 establishes a loan receivable should be derecognized and the real estate property recognized upon the creditor obtaining legal title to the residential real estate property upon completion of foreclosure or the borrower conveying all interest in the residential real estate property to the creditor to satisfy the loan. The provisions of ASU 2014-04 are effective for annual periods beginning after December 15, 2014. The adoption of this guidance should not have a material effect on the Company’s financial condition or results of operations.

## 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 Company and the Bank to comply with the requirements of agreements with and orders from 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 Securities and Exchange Commission (“SEC”).

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. In 2013 and continuing through the third quarter of 2014, the provision for loan losses declined substantially from previous years as we resolved nonperforming loans and real estate values have recovered somewhat.

## **Results of operations**

The following presents management’s discussion and analysis of the financial condition of the Company at September 30, 2014 and December 31, 2013 and the results of operations for the Company for the three and nine months ended September 30, 2014 and 2013. This discussion should be read in conjunction with the Company’s consolidated financial statements and the notes thereto appearing elsewhere in this Quarterly report.

## ***Summary***

For the three months ended September 30, 2014, the Company had net income of \$134,000 and net loss available to common shareholders of \$411,000 or \$1.23 per fully diluted share, compared to net loss of \$267,000 and net loss available to common shareholders of \$488,000, or \$1.84 per fully diluted share, for the same period in 2013. For the nine months ended September 30, 2014, the Company had a net loss totaling \$701,000 and a net loss available to common shareholders of \$1,763,000, or \$5.28 per fully diluted share, compared to net loss totaling \$189,000 and a net loss available to common shareholders of \$853,000, or \$3.21 per share on a fully diluted share, for the same period in 2013. The computation of basic and diluted earnings per share has been adjusted retroactively for all periods presented to reflect the reverse stock split in August 2014. As indicated in the following table, there were significant decreases in income and expense items when comparing the 2014 results to the 2013 results (in thousands):



(in thousands):

|  | Affect on Income                      |                                      |
|--|---------------------------------------|--------------------------------------|
|  | Three Months Ended September 30, 2014 | Nine Months Ended September 30, 2014 |
| Decreases in                               |                                       |                                      |
| Net interest income                        | \$ (376 )                             | \$ (1,719 )                          |
| Provision for loan losses                  | -                                     | 723                                  |
| Gains on loan sales                        | (836 )                                | (3,001 )                             |
| Gains on asset sales                       | -                                     | (595 )                               |
| Gains on sale of investments               | -                                     | (231 )                               |
| Salaries and benefits                      | 637                                   | 1,577                                |
| Expenses related to foreclosed real estate | 937                                   | 2,525                                |
|  | \$ 362                                | \$ (721 )                            |

The decline in net interest income reflects the decline in average loans outstanding, which averaged \$275,157,000 for the first nine months of 2014 compared to \$321,721,000 for the same period in 2013. In 2013, the loan portfolio declined primarily due to charge-offs of nonperforming loans as well as an unfavorable lending market; however, the decline in our loan portfolio for 2014 was primarily due to scheduled payments as well as some large payoffs that were not anticipated as other banks provided more favorable terms. The decreases in the provision for loan losses and the expenses related to foreclosed property are attributable to stabilization of the loan portfolio and an improving real estate market. The gains on loan sales as well as the decline in salaries and benefits (commissions paid to loan officers) are a result of a decline in mortgage production by our mortgage company. Our mortgage company's profit decreased by \$399,000 in the third quarter of 2014 compared to 2013 due to the mortgage company closing \$42,918,000 in mortgage loans in the third quarter of 2014 compared to \$76,947,000 in the third quarter of 2013.

Our cost of deposits declined from 0.97% for the third quarter of 2013 to 0.93% for the third quarter of 2014. This decline in cost of deposits is a result of the repricing of higher cost certificates of deposit during the low interest rate environment that has existed for the last three years as well as an effort to change our deposit mix so that we are not so dependent on higher cost deposits.

### ***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 stockholders' equity.

Net interest income of \$3,408,000 for the third quarter of 2014 represents a decrease of \$376,000, or 10%, compared to the same period in 2013. This decline is primarily due to a decrease in average loans outstanding of \$30,221,000.

Net interest income of \$9,874,000 for the first nine months of 2014 represents a decrease of \$1,719,000, or 15%, compared to the same period in 2013. This decline is primarily due to a decrease in average loans outstanding of \$45,564,000.

Average interest-bearing liabilities for the three and nine month periods decreased by \$35,487,000, or 9%, and \$43,363,000, or 11%, respectively. These declines were primarily a result of declines in deposits of \$27,648,000 for the three month period and \$33,688,000 for the nine month period. The average cost of interest-bearing liabilities decreased to 1.03% for the nine months ended September 30, 2014 from 1.16% for the nine months ended September 30, 2013. The principal reason for the decrease in liability costs was the maintenance of short-term interest rates at a low level by the Board of Governors of the Federal Reserve System. 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.

In the third quarter we determined that amounts previously accrued as interest expense representing compounding on unpaid preferred stock dividends should have been recorded as additional dividends. This had no effect on our capital (as interest expense and dividends increase retained deficit) but did result in higher interest expense. Because the amount involved was not significant, we adjusted interest expense by \$144,000 in the third quarter of 2014, which represented the amount of interest expense that should have been recorded as dividends through June 30, 2014. This had the effect of increasing our third quarter income by \$144,000, however did not have any effect on the income to common shareholders.

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:

| Quarter Ended      | Net<br>Interest<br>Margin |
|--------------------|---------------------------|
| September 30, 2013 | 3.69 %                    |
| December 31, 2013  | 3.66 %                    |
| March 31, 2014     | 3.60 %                    |
| June 30, 2014      | 3.41 %                    |
| September 30, 2014 | 3.46 %                    |

Although loans have declined significantly over the last twelve months, our net interest margin has only declined slightly over that same time period. This indicates that the decline in our net interest income is primarily a result of declining outstanding loan balances rather than margin compression.

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, stockholders' 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.

### Average Balance Sheet

(in thousands)

|  | Three Months Ended September 30, 2014 |                         |                       |   | Three Months Ended September 30, 2013 |                         |                       |   |
|--|---------------------------------------|-------------------------|-----------------------|---|---------------------------------------|-------------------------|-----------------------|---|
|  | Average Balance                       | Interest Income/Expense | Annualized Yield Rate | % | Average Balance                       | Interest Income/Expense | Annualized Yield Rate | % |
| Loans net of deferred fees                           | \$ 273,645                            | \$ 3,695                | 5.36                  | % | \$ 303,866                            | \$ 4,293                | 5.61                  | % |
| Loans held for sale                                  | 11,186                                | 119                     | 4.22                  | % | 14,798                                | 166                     | 4.45                  | % |
| Investment securities                                | 56,645                                | 304                     | 2.13                  | % | 58,054                                | 324                     | 2.21                  | % |
| Federal funds and other                              | 32,923                                | 19                      | 0.23                  | % | 30,097                                | 18                      | 0.24                  | % |
| Total interest earning assets                        | 374,399                               | 4,137                   | 4.38                  | % | 406,815                               | 4,801                   | 4.68                  | % |
| Allowance for loan losses and deferred fees          | (5,714 )                              |                         |                       |   | (9,381 )                              |                         |                       |   |
| Cash and due from banks                              | 12,086                                |                         |                       |   | 11,649                                |                         |                       |   |
| Premises and equipment, net                          | 13,147                                |                         |                       |   | 23,743                                |                         |                       |   |
| Other assets   | 48,216                                |                         |                       |   | 36,499                                |                         |                       |   |
| Total assets   | \$ 442,134                            |                         |                       |   | \$ 469,325                            |                         |                       |   |
| Interest bearing deposits                            |                                       |                         |                       |   |                                       |                         |                       |   |
| Interest checking                                    | \$ 42,423                             | \$ 20                   | 0.19                  | % | \$ 42,261                             | \$ 20                   | 0.19                  | % |
| Money market   | 67,257                                | 64                      | 0.38                  | % | 64,776                                | 33                      | 0.20                  | % |
| Savings  | 20,016                                | 9                       | 0.18                  | % | 20,995                                | 10                      | 0.19                  | % |
| Certificates   | 190,890                               | 658                     | 1.37                  | % | 220,202                               | 787                     | 1.42                  | % |
| Total  | 320,586                               | 751                     | 0.93                  | % | 348,234                               | 850                     | 0.97                  | % |
| Borrowings <sup>(1)</sup>                            | 25,770                                | 122                     | 1.88                  | % | 33,609                                | 167                     | 1.97                  | % |
| Total interest bearing liabilities                   | 346,356                               | 873                     | 1.00                  | % | 381,843                               | 1,017                   | 1.06                  | % |
| Noninterest bearing deposits                         | 63,784                                |                         |                       |   | 58,614                                |                         |                       |   |
| Other liabilities                                    | 12,596                                |                         |                       |   | 6,739                                 |                         |                       |   |
| Total liabilities                                    | 422,736                               |                         |                       |   | 447,196                               |                         |                       |   |
| Equity capital                                       | 19,398                                |                         |                       |   | 22,129                                |                         |                       |   |
| Total liabilities and capital                        | \$ 442,134                            |                         |                       |   | \$ 469,325                            |                         |                       |   |
| Net interest income before provision for loan losses |                                       | \$ 3,264                |                       |   |                                       | \$ 3,784                |                       |   |

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|   |        |        |
|---|--------|--------|
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities | 3.38 % | 3.62 % |
| Annualized net interest margin (net interest income expressed as percentage of average earning assets)        | 3.46 % | 3.69 % |

**Average Balance Sheet****(in thousands)**

|   | Nine Months Ended September 30, 2014 |                         |                       | Nine Months Ended September 30, 2013 |                         |                       |
|---|--------------------------------------|-------------------------|-----------------------|--------------------------------------|-------------------------|-----------------------|
|   | Average Balance                      | Interest Income/Expense | Annualized Yield Rate | Average Balance                      | Interest Income/Expense | Annualized Yield Rate |
| Loans net of deferred fees  | \$ 275,157                           | \$ 11,301               | 5.49 %                | \$ 321,721                           | \$ 13,746               | 5.71 %                |
| Loans held for sale   | 8,680                                | 278                     | 4.28 %                | 15,963                               | 478                     | 4.00 %                |
| Investment securities   | 58,004                               | 958                     | 2.21 %                | 44,203                               | 751                     | 2.27 %                |
| Federal funds and other   | 36,636                               | 64                      | 0.23 %                | 41,683                               | 71                      | 0.23 %                |
| Total interest earning assets   | 378,477                              | 12,601                  | 4.45 %                | 423,570                              | 15,046                  | 4.75 %                |
| Allowance for loan losses and deferred fees   | (6,415 )                             |                         |                       | (9,925 )                             |                         |                       |
| Cash and due from banks   | 12,490                               |                         |                       | 12,324                               |                         |                       |
| Premises and equipment, net   | 12,926                               |                         |                       | 24,370                               |                         |                       |
| Other assets  | 46,824                               |                         |                       | 37,074                               |                         |                       |
| Total assets  | \$ 444,302                           |                         |                       | \$ 487,413                           |                         |                       |
| Interest bearing deposits   |                                      |                         |                       |                                      |                         |                       |
| Interest checking   | \$ 42,456                            | \$ 58                   | 0.18 %                | \$ 42,654                            | \$ 81                   | 0.25 %                |
| Money market  | 66,620                               | 187                     | 0.38 %                | 65,453                               | 143                     | 0.29 %                |
| Savings   | 20,557                               | 28                      | 0.18 %                | 20,734                               | 50                      | 0.32 %                |
| Certificates  | 197,736                              | 2,031                   | 1.37 %                | 232,216                              | 2,568                   | 1.48 %                |
| Total   | 327,369                              | 2,304                   | 0.94 %                | 361,057                              | 2,842                   | 1.05 %                |
| Borrowings <sup>(1)</sup>   | 27,811                               | 567                     | 2.73 %                | 37,486                               | 611                     | 2.18 %                |
| Total interest bearing liabilities  | 355,180                              | 2,871                   | 1.08 %                | 398,543                              | 3,453                   | 1.16 %                |
| Noninterest bearing deposits  | 60,577                               |                         |                       | 57,484                               |                         |                       |
| Other liabilities   | 9,487                                |                         |                       | 7,289                                |                         |                       |
| Total liabilities   | 425,244                              |                         |                       | 463,316                              |                         |                       |
| Equity capital  | 19,058                               |                         |                       | 24,097                               |                         |                       |
| Total liabilities and capital   | \$ 444,302                           |                         |                       | \$ 487,413                           |                         |                       |
| Net interest income before provision for loan losses  |                                      | \$ 9,730                |                       |                                      | \$ 11,593               |                       |
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities |                                      |                         | 3.37 %                |                                      |                         | 3.59 %                |
| Annualized net interest margin (net interest income expressed as percentage of average earning assets)        |                                      |                         | 3.44 %                |                                      |                         | 3.66 %                |

*(1) Interest expense on borrowings for the three and nine month periods ended September 30, 2014 has been adjusted for the reclassification of \$144,000 from interest expense to dividends related to preferred stock reflected as a reduction of interest expense in those periods.*



### ***Provision for loan losses***

The Company did not record a provision for loan losses for the three months ended September 30, 2014 and 2013. The provision for loan losses for the nine months ended September 30, 2014 was \$100,000 compared to \$823,000 for the nine months ended September 30, 2013. The decline in the provision for loan losses for the nine month period of 2014 was primarily driven by a \$24,934,000 decline in net loans outstanding from September 30, 2013 to September 30, 2014 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 as well as a decline in classified assets, 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 decreased from \$3,085,000 for the three months ended September 30, 2013 to \$2,190,000 for the three months ended September 30, 2014, a decrease of \$895,000, or 29%. This decrease in noninterest income was primarily the result of lower gains on sales from decreased loan production by our mortgage banking subsidiary of \$836,000. Noninterest income also decreased from \$10,113,000 for the first nine months of 2013 to \$6,185,000 for the first nine months of 2014, a decrease of \$3,928,000, or 39%. The decrease in noninterest income is primarily a result of lower gains on sale of loans of \$3,001,000, a lower gain on the sale of investments of \$231,000 and the gain on the sale of the Robious branch of \$598,000 in the first quarter of 2013.

### ***Noninterest expense***

Noninterest expense for the three months ended September 30, 2014 was \$5,464,000 compared to \$7,136,000 for the three months ended September 30, 2013, a decrease of \$1,672,000 or 23%. The more significant decreases occurred in salaries and benefits of \$637,000 and expenses related to foreclosed real estate of \$937,000. Noninterest expense for the nine months ended September 30, 2014 was \$16,660,000 compared to \$21,072,000 for the nine months ended September 30, 2013, a decrease of \$4,412,000 or 21%. The more significant decreases occurred in salaries and benefits of \$1,577,000 and expenses related to foreclosed assets of \$2,525,000. The decrease in salaries and benefits for the three and nine month periods is attributable to the decrease in salaries and commissions paid to mortgage loan officers from the decreased loan production by our mortgage banking subsidiary as well as reductions in Bank staff. The decrease in expenses related to foreclosed real estate for the three and nine month periods is a result of our higher write downs and the disposition of significant collateral in 2013 as well as an improving real estate market.

### ***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.

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, 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 on its net deferred tax asset that is dependent on future earnings of the Company of approximately \$11,940,000. At September 30, 2014, management continues to believe that the objective negative evidence represented by the Company’s continued losses in the third quarter outweighed the more subjective positive evidence and, as a result, recognized an addition to the valuation allowance on its net deferred tax asset of approximately \$274,000 resulting in a total valuation allowance at September 30, 2014 of \$12,214,000. The net operating losses available to offset future taxable income amounted to \$21,712,000 at September 30, 2014 and expire at the end of 2031.

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. Due to the Company’s adjusted capital level we were not subject to franchise tax expense for the nine months ended September 30, 2014 and 2013.

### **Balance Sheet Analysis**

Our total assets decreased to \$433,005,000 at September 30, 2014 from \$444,173,000 at December 31, 2013, a decrease of \$11,168,000, or 2.5%. The decrease in loans was the primary driver of this decline. Net portfolio loans decreased by \$9,876,000 during the first nine months of 2014 primarily a result of large loan payoffs. Investment securities also contributed to the decrease in assets with a decrease of \$2,233,000.

### ***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 84% 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 8% 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 8% of the total.

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

|  | September 30, 2014 |         | December 31, 2013 |         |
|--|--------------------|---------|-------------------|---------|
|  | Amount             | %       | Amount            | %       |
| Construction and land development  |                    |         |                   |         |
| Residential  | \$4,592            | 1.67 %  | \$2,931           | 1.02 %  |
| Commercial   | 25,135             | 9.15 %  | 28,179            | 9.84 %  |
|  | 29,727             | 10.80 % | 31,110            | 10.86 % |
| Commercial real estate   |                    |         |                   |         |
| Owner occupied   | 58,275             | 21.17 % | 73,584            | 25.68 % |
| Non-owner occupied   | 39,805             | 14.47 % | 43,868            | 15.31 % |
| Multifamily  | 11,019             | 4.01 %  | 11,560            | 4.03 %  |
| Farmland   | 1,343              | 0.49 %  | 1,463             | 0.51 %  |
|  | 110,442            | 40.13 % | 130,475           | 45.53 % |
| Consumer real estate   |                    |         |                   |         |
| Home equity lines  | 20,275             | 7.37 %  | 21,246            | 7.41 %  |
| Secured by 1-4 family residential  |                    |         |                   |         |
| First deed of trust  | 63,425             | 23.05 % | 66,873            | 23.34 % |
| Second deed of trust   | 8,127              | 2.95 %  | 8,675             | 3.03 %  |
|  | 91,827             | 33.39 % | 96,794            | 33.78 % |
| Commercial and industrial loans<br>(except those secured by real estate) | 22,471             | 8.17 %  | 26,254            | 9.16 %  |
| Consumer and other   | 20,656             | 7.51 %  | 1,930             | 0.67 %  |
| Total loans  | 275,123            | 100.0 % | 286,563           | 100.0 % |
| Deferred loan cost, net  | 666                |         | 683               |         |
| Less: allowance for loan losses  | (5,658 )           |         | (7,239 )          |         |
|  | \$ 270,131         |         | \$ 280,007        |         |

The decline in our total loan portfolio for the first nine months of 2014 was primarily due to scheduled payments as well as some large payoffs during the period. Although total loans have decreased, our consumer loans have increased by \$18,726,000. The Bank purchased a portfolio of rehabilitated student loans guaranteed by the Department of Education (“DOE”) totaling approximately \$19 million on July 29, 2014. The guarantee covers approximately 98% of principal and accrued interest. The loans are serviced by a third-party servicer that specializes in handling the special needs of the DOE student loan programs. The Bank used excess liquidity to purchase the loans.

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

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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.

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.

The allowance for loan losses at September 30, 2014 was \$5,658,000, compared to \$7,239,000 at December 31, 2013. The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) at September 30, 2014 and December 31, 2013 was 2.06% and 2.52%, respectively. The decrease in the allowance for loan losses for the first nine months of 2014 was primarily a result of 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 September 30, 2014 is adequate to absorb the losses that can reasonably be anticipated from the loan portfolio at that date.

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

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|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2014                               | 2013      |
| Beginning balance   | \$7,239                            | \$10,808  |
| Provision for loan losses   | 100                                | 823       |
| Charge-offs   |                                    |           |
| Construction and land development   |                                    |           |
| Commercial  | (100 )                             | (270 )    |
| Commercial real estate  |                                    |           |
| Owner occupied  | (608 )                             | (404 )    |
| Non-owner occupied  | (238 )                             | (510 )    |
| Farmland  | (96 )                              | (448 )    |
| Consumer real estate  |                                    |           |
| Home equity lines   | (476 )                             | (266 )    |
| Secured by 1-4 family residential   |                                    |           |
| First deed of trust   | (277 )                             | (1,002 )  |
| Second deed of trust  | (76 )                              | (215 )    |
| Commercial and industrial<br>(except those secured by real estate)                    | (168 )                             | (466 )    |
| Consumer and other  | (8 )                               | (52 )     |
|   | (2,047 )                           | (3,633 )  |
| Recoveries  |                                    |           |
| Construction and land development   |                                    |           |
| Residential   | 1                                  | 101       |
| Commercial  | 44                                 | 281       |
| Commercial real estate  |                                    |           |
| Owner occupied  | -                                  | 43        |
| Non-owner occupied  | 24                                 | -         |
| Consumer real estate  |                                    |           |
| Home equity lines   | 14                                 | 10        |
| Secured by 1-4 family residential   |                                    |           |
| First deed of trust   | 64                                 | 22        |
| Second deed of trust  | 115                                | 5         |
| Commercial and industrial<br>(except those secured by real estate)                    | 90                                 | 160       |
| Consumer and other  | 14                                 | 8         |
|   | 366                                | 630       |
| Net charge-offs   | (1,681 )                           | (3,003 )  |
| Ending balance  | \$5,658                            | \$8,628   |
| Loans outstanding at end of period <sup>(1)</sup>                                     | \$275,123                          | \$303,693 |
| Ratio of allowance for loan losses as a percent of loans outstanding at end of period | 2.06 %                             | 2.84 %    |
| Average loans outstanding for the period <sup>(1)</sup>                               | \$275,157                          | \$321,721 |
| Ratio of net charge-offs to average loans outstanding for the period                  | 0.61 %                             | 0.93 %    |

*(1)* Loans are net of unearned income.

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**Asset quality**

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

|  | September<br>30,<br>2014 | December<br>31,<br>2013 | September<br>30,<br>2013 |  |   |
|--|--------------------------|-------------------------|--------------------------|--|---|
| Nonaccrual loans   | \$ 9,547                 | \$ 18,647               | \$ 22,490                |  |   |
| Foreclosed properties  | 14,003                   | 16,742                  | 19,652                   |  |   |
| Total nonperforming assets   | \$ 23,550                | \$ 35,389               | \$ 42,142                |  |   |
| Restructured loans still accruing  | \$ 26,923                | \$ 28,236               | \$ 28,474                |  |   |
| Loans past due 90 days and still accruing (not included in nonaccrual loans above) | \$ -                     | \$ 60                   | \$ -                     |  |   |
| Nonperforming assets to loans <sup>(1)</sup>                                       | 8.6                      | % 12.3                  | % 13.9                   |  | % |
| Nonperforming assets to total assets   | 5.4                      | % 8.0                   | % 9.2                    |  | % |
| Allowance for loan losses to nonaccrual loans                                      | 59.3                     | % 38.8                  | % 38.4                   |  | % |

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

The following table presents an analysis of the changes in nonperforming assets for the nine months ended September 30, 2014 (in thousands):

|                              | Nonaccrual<br>Loans | Foreclosed<br>Properties | Total     |
|------------------------------|---------------------|--------------------------|-----------|
| Balance December 31, 2013    | \$ 18,647           | \$ 16,742                | \$ 35,389 |
| Additions                    | 5,840               | 780                      | 6,620     |
| Loans placed back on accrual | (6,877 )            | -                        | (6,877 )  |
| Transfers to OREO            | (5,090 )            | 5,090                    | -         |
| Repayments                   | (1,140 )            | -                        | (1,140 )  |
| Charge-offs                  | (1,833 )            | (751 )                   | (2,584 )  |
| Sales                        | -                   | (7,858 )                 | (7,858 )  |

Balance September 30, 2014    \$ 9,547        \$ 14,003        \$23,550

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 \$9,547,000 at September 30, 2014 that were considered impaired, 13 loans totaling \$1,572,000 had specific allowances for loan losses totaling \$460,000. This compares to \$18,647,000 in nonaccrual loans at December 31, 2013 of which 18 loans totaling \$4,647,000 had specific allowances for loan losses of \$1,189,000.

Cumulative interest income that would have been recorded had nonaccrual loans been performing would have been approximately \$333,000 and \$1,980,000 for the nine months ended September 30, 2014 and 2013, respectively.

### *Deposits*

Deposits as of September 30, 2014 and December 31, 2013 were as follows (dollars in thousands):

|                                     | September 30, 2014 |         | December 31, 2013 |         |
|-------------------------------------|--------------------|---------|-------------------|---------|
|                                     | Amount             | %       | Amount            | %       |
| Demand accounts                     | \$ 65,218          | 17.1 %  | \$ 57,244         | 14.7 %  |
| Interest checking accounts          | 42,196             | 11.1 %  | 43,691            | 11.2 %  |
| Money market accounts               | 66,361             | 17.4 %  | 63,357            | 16.2 %  |
| Savings accounts                    | 20,032             | 5.3 %   | 20,229            | 5.2 %   |
| Time deposits of \$100,000 and over | 83,694             | 22.0 %  | 94,245            | 24.1 %  |
| Other time deposits                 | 103,163            | 27.1 %  | 111,862           | 28.6 %  |
| Total                               | \$ 380,664         | 100.0 % | \$ 390,628        | 100.0 % |

Total deposits decreased by \$9,964,000, or 2.6% from \$390,628,000 at December 31, 2013 to \$380,664,000 at September 30, 2014, as compared to a decrease of \$34,727,000, or 8.0%, during the first nine months of 2013. Checking and savings accounts increased by \$6,282,000, money market accounts increased by \$3,004,000 and time deposits decreased by \$19,250,000. The decline in time deposits was a result of repricing maturing time deposits at rates below market for noncore depositors. The cost of our interest-bearing deposits declined to 0.94% for the first nine months of 2014 compared to 1.05% for the first nine months of 2013.

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.

*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 \$14,000,000 and \$18,000,000 at September 30, 2014 and December 31, 2013, respectively. The FHLB advances are secured by the pledge of residential mortgage loans, investment securities and our FHLB stock.

### *Capital resources*

Stockholders’ equity at September 30, 2014 was \$18,735,000, compared to \$18,244,000 at December 31, 2013. The \$491,000 increase in equity during the first nine months of 2014 was primarily due to the reduction in accumulated other comprehensive loss of \$2,150,000, offset by the net loss available to common shareholders of \$1,763,000.

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”). Under the TARP Program, the Company issued to the Treasury \$14,738,000 of preferred stock and warrants to purchase 31,190 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 Program carried a 5% dividend until May 1, 2014, and now carries a 9% dividend. In November 2013, the Company participated in a successful auction of the preferred stock by the Treasury that resulted in the purchase of the preferred stock by private and institutional investors. The Treasury continues to own the warrants.

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 Supervisory Authorities 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 September 30, 2014, the aggregate amount of all of the Company’s total accrued but deferred dividend payments on the preferred stock was \$3,243,600.

On December 4, 2013, the Company issued 67,907 new shares of common stock through a private placement to directors and executive officers. The sale raised \$1,684,075 in new capital for the Company. The \$24.80 sale price for



the common shares was equal to the stock's book value at September 30, 2013, which represented a 30% premium over the closing price of the stock on December 3, 2013.

On August 6, 2014, the Company filed Articles of Amendment to its Articles of Incorporation with the Virginia State Corporation Commission to effect a reverse stock split of its outstanding common stock. The Articles of Amendment which became effective on August 8, 2014. As a result of the reverse split, every sixteen shares of the Company's issued and outstanding common stock were consolidated into one issued and outstanding share of common stock.

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

|  | September 30,<br>2014 | December 31,<br>2013 |       |   |
|--|-----------------------|----------------------|-------|---|
| Tier 1 capital                                       |                       |                      |       |   |
| Total equity capital                                 | \$ 18,735             | \$ 18,244            |       |   |
| Net unrealized loss on available-for-sale securities | 1,609                 | 3,752                |       |   |
| Defined benefit postretirement plan                  | 79                    | 86                   |       |   |
| Qualifying trust preferred securities                | 1,675                 | 2,240                |       |   |
| Disallowed intangible assets                         | (222)                 | (295)                | )     | ) |
| Total Tier 1 capital                                 | 21,876                | 24,027               |       |   |
| Tier 2 capital                                       |                       |                      |       |   |
| Qualifying trust preferred securities                | 7,089                 | 6,524                |       |   |
| Allowance for loan losses                            | 3,685                 | 4,101                |       |   |
| Total Tier 2 capital                                 | 10,774                | 10,625               |       |   |
| Total risk-based capital                             | 32,650                | 34,652               |       |   |
| Risk-weighted assets                                 | \$ 292,859            | \$ 324,965           |       |   |
| Average assets                                       | \$ 435,426            | \$ 451,734           |       |   |
| Capital ratios                                       |                       |                      |       |   |
| Leverage ratio (Tier 1 capital to average assets)    | 5.02                  | %                    | 5.32  | % |
| Tier 1 capital to risk-weighted assets               | 7.47                  | %                    | 7.39  | % |
| Total capital to risk-weighted assets                | 11.15                 | %                    | 10.66 | % |
| Equity to total assets                               | 4.33                  | %                    | 4.11  | % |

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

|  | September 30,<br>2014 |   | December 31,<br>2013 |   |
|--|-----------------------|---|----------------------|---|
| Tier 1 capital                                       |                       |   |                      |   |
| Total bank equity capital                            | \$ 29,357             |   | \$ 27,574            |   |
| Net unrealized loss on available-for-sale securities | 1,609                 |   | 3,752                |   |
| Defined benefit postretirement plan                  | 79                    |   | 86                   |   |
| Disallowed intangible assets                         | (222                  | ) | (295                 | ) |
| Total Tier 1 capital                                 | 30,823                |   | 31,117               |   |
| Tier 2 capital                                       |                       |   |                      |   |
| Allowance for loan losses                            | 3,652                 |   | 4,075                |   |
| Total Tier 2 capital                                 | 3,652                 |   | 4,075                |   |
| Total risk-based capital                             |                       |   |                      |   |
|  | 34,475                |   | 35,192               |   |
| Risk-weighted assets                                 |                       |   |                      |   |
|  | \$ 290,151            |   | \$ 322,853           |   |
| Average assets                                       |                       |   |                      |   |
|  | \$ 433,337            |   | \$ 449,606           |   |
| Capital ratios                                       |                       |   |                      |   |
| Leverage ratio (Tier 1 capital to average assets)    | 7.11                  | % | 6.92                 | % |
| Tier 1 capital to risk-weighted assets               | 10.62                 | % | 9.64                 | % |
| Total capital to risk-weighted assets                | 11.88                 | % | 10.90                | % |
| Equity to total assets                               | 6.83                  | % | 6.19                 | % |

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 September 30, 2014 and December 31, 2013. 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 September 30, 2014, the Bank’s leverage ratio was 7.11% and the total capital to risk weighted assets ratio was 11.88%. As required by the Consent Order, the Bank has provided a capital plan to the Supervisory Authorities 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.

At September 30, 2014, our liquid assets, consisting of cash, cash equivalents and investment securities available for sale totaled \$100,347,000, or 23% 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 \$20,030,000 of these securities are pledged against current and potential fundings.

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 \$17 million for which there were no borrowings against the lines at September 30, 2014.

At September 30, 2014, we had commitments to originate \$51,222,000 of loans. Fixed commitments to incur capital expenditures were approximately \$600,000 at September 30, 2014. Certificates of deposit scheduled to mature in the 12-month period ending September 30, 2015 totaled \$77,109,000. 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.

## **Critical accounting policies**

### ***General***

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

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

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

### ***Allowance for loan losses***

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

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

impairment.

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

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

### ***Troubled debt restructurings***

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

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

### ***Real estate acquired in settlement of loans***

Real estate acquired in settlement of loans represent properties acquired through foreclosure or physical possession. Write-downs to fair value less cost to sell of foreclosed assets at the time of transfer are charged to allowance for loan losses. Subsequent to foreclosure, the Company periodically evaluates the value of foreclosed assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. Subsequent declines in



value are charged to operations. Fair value is based on an assessment of information available at the end of a reporting period and depends upon a number of factors, including historical experience, economic conditions, and issues specific to individual properties. The evaluation of these factors involves subjective estimates and judgments that may change.

### ***Income taxes***

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established. Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if management projects lower levels of future taxable income. Management determined that as of December 31, 2013 and September 30, 2014, the objective negative evidence represented by the Company's recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance of \$11,940,000 and \$12,214,000 respectively, representing all of the net deferred tax asset that is dependent on future earnings of the Company at the indicated date.

### **New accounting standards**

In January 2014, the FASB issued ASU 2014-01, "Investments – Equity Method and Joint Ventures: Accounting for Investments in Qualified Affordable Housing Projects". This ASU applies to all reporting entities that invest in qualified affordable housing projects through limited liability entities that are flow through entities for tax purposes. The amendments in the ASU eliminate the effective yield election and permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Those not electing the proportional amortization method would account for the investment using the equity method or cost method. The amendments in this ASU are effective for public business entities for annual periods beginning after December 15, 2014. The adoption of this guidance should not have a material effect on the Company's financial condition or results of operations.

In January 2014, the FASB issued ASU 2014-04, "Receivables – Troubled Debt Restructurings by Creditors". ASU 2014-04 clarifies when a creditor should be considered to have received physical possession of residential real estate property during a foreclosure. ASU 2014-04 establishes a loan receivable should be derecognized and the real estate property recognized upon the creditor obtaining legal title to the residential real estate property upon completion of foreclosure or the borrower conveying all interest in the residential real estate property to the creditor to satisfy the loan. The provisions of ASU 2014-04 are effective for annual periods beginning after December 15, 2014. The adoption of this guidance should not have a material effect on the Company's financial condition or results of operations.



### **Impact of inflation and changing prices**

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

### **ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Not Applicable.

### **ITEM 4 – CONTROLS AND PROCEDURES**

The Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) as of September 30, 2014. Based on that evaluation, management concluded that the Company's disclosure controls and procedures were effective as of September 30, 2014 in ensuring that all material information required to be disclosed in reports that it files or submits under the Exchange Act is recorded, processed summarized and reported with the time periods specified in SEC rules and regulations and that such information is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

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

**PART II – OTHER INFORMATION**

**ITEM 1 – LEGAL PROCEEDINGS**

In the course of its operations, the Company may become a party to legal proceedings. There are no material pending legal proceedings to which the Company is party or of which the property of the Company is subject.

**ITEM 1A – RISK FACTORS**

Not applicable.

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

Not applicable.

**ITEM 3 – DEFAULTS UPON SENIOR SECURITIES**

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 Supervisory Authorities 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 September 30, 2014, the aggregate amount of all of the Company's total accrued but deferred dividend payments on the preferred stock was \$3,243,600.

**ITEM 4 – MINE SAFETY DISCLOSURES**

None.

**ITEM 5 – OTHER INFORMATION**

Not applicable.

**ITEM 6 – EXHIBITS**

3.1 Articles of Incorporation of Village Bank and Trust Financial Corp. as amended.

31.1 Certification of Chief Executive Officer

31.2 Certification of Chief Financial Officer

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

The following materials from the Village Bank and Trust Financial Corp. Quarterly Report on Form 10-Q for the quarter ended September 30, 2014 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Changes in Comprehensive Income (Loss), (iv) Consolidated Statements of Stockholders' Equity, (v) Consolidated Statements of Cash Flows, and (vi) Notes to Condensed Consolidated Financial Statements.

SIGNATURES

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

VILLAGE BANK AND  
TRUST FINANCIAL CORP.  
(Registrant)

Date: October 31, 2014 By: /s/ William G. Foster, Jr.  
William G. Foster, Jr.  
President and  
Chief Executive Officer

Date: October 31, 2014 By: /s/ C. Harril Whitehurst, Jr.  
C. Harril Whitehurst, Jr.  
Executive Vice President and  
Chief Financial Officer



**EXHIBIT INDEX**

Exhibit  
Number Document

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