

Village Bank & Trust Financial Corp.  
Form 10-Q  
August 12, 2016

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 June 30, 2016**

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)





**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**  
**June 30, 2016 (Unaudited) and December 31, 2015**  
*(in thousands, except share data)*

|   | June 30,<br>2016 | December 31,<br>2015 |
|---|------------------|----------------------|
| Assets  |                  |                      |
| Cash and due from banks                             | \$ 12,638        | \$ 17,076            |
| Federal funds sold                                  | 16,323           | 186                  |
| Total cash and cash equivalents                     | 28,961           | 17,262               |
| Investment securities available for sale            | 21,159           | 37,919               |
| Loans held for sale                                 | 16,164           | 14,373               |
| Loans   |                  |                      |
| Outstandings  | 323,219          | 306,771              |
| Allowance for loan losses                           | (3,523 )         | (3,562 )             |
| Deferred fees and costs, net                        | 602              | 670                  |
| Total loans, net                                    | 320,298          | 303,879              |
| Other real estate owned, net of valuation allowance | 3,941            | 6,249                |
| Assets held for sale                                | 841              | 12,631               |
| Premises and equipment, net                         | 12,590           | 13,671               |
| Bank owned life insurance                           | 7,223            | 7,130                |
| Accrued interest receivable                         | 1,962            | 2,060                |
| Other assets  | 6,402            | 4,767                |
|   | \$ 419,541       | \$ 419,941           |
| Liabilities and Shareholders' Equity                |                  |                      |
| Liabilities   |                  |                      |
| Deposits  |                  |                      |
| Noninterest bearing demand                          | \$ 78,122        | \$ 78,282            |
| Interest bearing                                    | 289,502          | 286,566              |
| Total deposits                                      | 367,624          | 364,848              |
| Federal Home Loan Bank advances                     | 3,200            | 6,000                |
| Long-term debt - trust preferred securities         | 8,764            | 8,764                |
| Other borrowings                                    | 316              | 508                  |
| Accrued interest payable                            | 80               | 1,346                |
| Other liabilities                                   | 7,843            | 8,116                |

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|  |           |            |
|--|-----------|------------|
| Total liabilities  | 387,827   | 389,582    |
| Shareholders' equity   |           |            |
| Preferred stock, \$4 par value, \$1,000 liquidation preference, 1,000,000 shares authorized; 5,715 shares issued and outstanding at June 30, 2016 and December 31, 2015            | 23        | 23         |
| Common stock, \$4 par value - 10,000,000 shares authorized; 1,425,288 shares issued and outstanding at June 30, 2016 1,417,775 shares issued and outstanding and December 31, 2015 | 5,603     | 5,562      |
| Additional paid-in capital   | 58,623    | 58,497     |
| Accumulated deficit  | (33,248 ) | (33,948 )  |
| Common stock warrant   | 732       | 732        |
| Stock in directors rabbi trust   | (1,034 )  | (1,034 )   |
| Directors deferred fees obligation   | 1,034     | 1,034      |
| Accumulated other comprehensive loss   | (19 )     | (507 )     |
| Total shareholders' equity   | 31,714    | 30,359     |
|  | \$419,541 | \$ 419,941 |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Operations**  
**Three and Six Months Ended June 30, 2016 and 2015**  
**(Unaudited)**  
*(in thousands, except per share data)*

|   | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |         |
|---|--------------------------------|----------|------------------------------|---------|
|   | 2016                           | 2015     | 2016                         | 2015    |
| Interest income                                     |                                |          |                              |         |
| Loans   | \$ 3,804                       | \$ 3,692 | \$7,569                      | \$7,316 |
| Investment securities                               | 69                             | 154      | 189                          | 309     |
| Federal funds sold                                  | 14                             | 18       | 28                           | 36      |
| Total interest income                               | 3,887                          | 3,864    | 7,786                        | 7,661   |
| Interest expense                                    |                                |          |                              |         |
| Deposits  | 595                            | 620      | 1,194                        | 1,256   |
| Borrowed funds                                      | 63                             | 103      | 104                          | 225     |
| Total interest expense                              | 658                            | 723      | 1,298                        | 1,481   |
| Net interest income                                 | 3,229                          | 3,141    | 6,488                        | 6,180   |
| Provision for loan losses                           | -                              | -        | -                            | -       |
| Net interest income after provision for loan losses | 3,229                          | 3,141    | 6,488                        | 6,180   |
| Noninterest income                                  |                                |          |                              |         |
| Service charges and fees                            | 649                            | 683      | 1,185                        | 1,275   |
| Gain on sale of loans                               | 1,441                          | 1,728    | 2,587                        | 2,957   |
| Gain on sale of asset held for sale                 | 504                            | -        | 504                          | -       |
| Gain on sale of investment securities               | 38                             | -        | 147                          | 7       |
| Rental income                                       | 262                            | 250      | 582                          | 490     |
| Other   | 92                             | 75       | 177                          | 177     |
| Total noninterest income                            | 2,986                          | 2,736    | 5,182                        | 4,906   |
| Noninterest expense                                 |                                |          |                              |         |
| Salaries and benefits                               | 2,759                          | 2,711    | 5,418                        | 5,379   |
| Commissions   | 381                            | 443      | 630                          | 735     |
| Occupancy   | 415                            | 409      | 864                          | 887     |
| Equipment   | 193                            | 212      | 376                          | 398     |
| Write down of assets held for sale                  | 220                            | 687      | 220                          | 687     |
| Supplies  | 72                             | 65       | 151                          | 134     |
| Professional and outside services                   | 758                            | 649      | 1,476                        | 1,296   |
| Advertising and marketing                           | 78                             | 101      | 163                          | 173     |
| Foreclosed assets, net                              | 70                             | (218 )   | 171                          | (86 )   |
| FDIC insurance premium                              | 135                            | 234      | 197                          | 468     |
| Other operating expense                             | 475                            | 500      | 943                          | 936     |
| Total noninterest expense                           | 5,556                          | 5,793    | 10,609                       | 11,007  |



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|  |         |            |         |          |
|--|---------|------------|---------|----------|
| Income before income tax expense                       | 659     | 84         | 1,061   | 79       |
| Income tax expense                                     | -       | -          | -       | -        |
| Net income   | 659     | 84         | 1,061   | 79       |
| Preferred stock dividends and amortization of discount | (183 )  | (167 )     | (361 )  | (330 )   |
| Preferred stock principal forgiveness                  | -       | -          | -       | 4,404    |
| Preferred stock dividend forgiveness                   | -       | -          | -       | 2,215    |
| Net income (loss) available to common shareholders     | \$ 476  | \$ (83 )   | \$ 700  | \$ 6,368 |
| Earnings (loss) per share, basic                       | \$ 0.34 | \$ (0.06 ) | \$ 0.50 | \$ 7.00  |
| Earnings (loss) per share, diluted                     | \$ 0.34 | \$ (0.06 ) | \$ 0.50 | \$ 6.92  |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Comprehensive Income (Loss)**  
**Three and Six Months Ended June 30, 2016 and 2015**  
**(Unaudited)**  
*(in thousands)*

|  | Three Months<br>Ended<br>June 30,<br>2016 |           | Six Months<br>Ended<br>June 30,<br>2015 |        |
|--|---|-----------|---|--------|
| Net income   | \$ 659                                    | \$ 84     | \$ 1,061                                | \$ 79  |
| Other comprehensive income (loss)  |   |           |   |        |
| Unrealized holding gains (losses) arising during the period                                  | 86  | (551 )    | 880                                     | 106    |
| Tax effect   | 29  | (187 )    | 299                                     | 37     |
| Net change in unrealized holding gains (losses) on securities available for sale, net of tax | 57  | (364 )    | 581                                     | 69     |
| Reclassification adjustment  |   |           |   |        |
| Reclassification adjustment for gains realized in income                                     | (38 )                                     | -         | (147 )                                  | (7 )   |
| Tax effect   | (13 )                                     | -         | (50 )                                   | (2 )   |
| Reclassification for gains included in net income, net of tax                                | (25 )                                     | -         | (97 )                                   | (5 )   |
| Minimum pension adjustment   | 3   | 3         | 6                                       | 6      |
| Tax effect   | 1   | 1         | 2                                       | 2      |
| Minimum pension adjustment, net of tax   | 2   | 2         | 4                                       | 4      |
| Total other comprehensive income (loss)  | 34  | (362 )    | 488                                     | 69     |
| Total comprehensive income (loss)  | \$ 693                                    | \$ (278 ) | \$ 1,549                                | \$ 148 |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Shareholders' Equity**  
**Six Months Ended June 30, 2016 and 2015**  
**(Unaudited)**  
*(in thousands)*

|  | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Warrant | Stock in<br>Directors<br>Rabbi<br>Trust | Directors<br>Deferred<br>Fees<br>Obligation | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total     |
|--|--------------------|-----------------|----------------------------------|------------------------|---------|---|---|---|-----------|
| Balance, December 31, 2015   | \$ 23              | \$ 5,562        | \$ 58,497                        | \$(33,948 )            | \$ 732  | \$(1,034 )                              | \$ 1,034                                    | \$( 507 )   | \$ 30,359 |
| Preferred stock dividend   | -                  | -               | -                                | (361 )                 | -       | -                                       | -   | -   | (361 )    |
| Issuance of common stock   | -                  | 41              | (41 )                            | -                      | -       | -                                       | -   | -   | -         |
| Stock based compensation   | -                  | -               | 167                              | -                      | -       | -                                       | -   | -   | 167       |
| Minimum pension adjustment (net of income taxes of \$2)  | -                  | -               | -                                | -                      | -       | -                                       | -   | 4   | 4         |
| Net income   | -                  | -               | -                                | 1,061                  | -       | -                                       | -   | -   | 1,061     |
| Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification and tax effect | -                  | -               | -                                | -                      | -       | -                                       | -   | 484   | 484       |
| Balance, June 30, 2016   | \$ 23              | \$ 5,603        | \$ 58,623                        | \$(33,248 )            | \$ 732  | \$(1,034 )                              | \$ 1,034                                    | \$( 19 )  | \$ 31,714 |
| Balance, December 31, 2014   | \$ 59              | \$ 1,339        | \$ 58,188                        | \$(40,539 )            | \$ 732  | \$(878 )                                | \$ 878                                      | \$( 721 )   | \$ 19,058 |
| Preferred stock dividend   | -                  | -               | -                                | (330 )                 | -       | -                                       | -   | -   | (330 )    |
| Restricted stock issuance  | -                  | 7               | (85 )                            | -                      | -       | (156 )                                  | 156   | -   | (78 )     |
| Issuance of common stock, net of offering expense of \$1,200   | -                  | 2,875           | 5,842                            | -                      | -       | -                                       | -   | -   | 8,717     |
| Preferred stock exchanged for common stock   | (18 )              | 1,332           | (1,314 )                         | -                      | -       | -                                       | -   | -   | -         |
| Preferred stock principal forgiveness  | (18 )              | -               | (4,386 )                         | 4,404                  | -       | -                                       | -   | -   | -         |
|  | -                  | -               | -                                | 2,215                  | -       | -                                       | -   | -   | 2,215     |

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|  |       |          |           |              |        |             |          |           |           |
|--|-------|----------|-----------|--------------|--------|-------------|----------|-----------|-----------|
| Preferred stock dividend forgiveness   |       |          |           |              |        |             |          |           |           |
| Stock based compensation   | -     | -        | 172       | -            | -      | -           | -        | -         | 172       |
| Minimum pension adjustment (net of income taxes of \$2)  | -     | -        | -         | -            | -      | -           | -        | 4         | 4         |
| Net income   | -     | -        | -         | 79           | -      | -           | -        | -         | 79        |
| Change in unrealized gain (loss) on investment securities available-for-sale, net of reclassification and tax effect | -     | -        | -         | -            | -      | -           | -        | 65        | 65        |
| Balance, June 30, 2015   | \$ 23 | \$ 5,553 | \$ 58,417 | \$ (34,171 ) | \$ 732 | \$ (1,034 ) | \$ 1,034 | \$ (652 ) | \$ 29,902 |

*See accompanying notes to consolidated financial statements.*

**Village Bank and Trust Financial Corp. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
**Six Months Ended June 30, 2016 and 2015**  
*(Unaudited)*  
*(in thousands)*

|  | 2016     | 2015      |
|--|----------|-----------|
| <b>Cash Flows from Operating Activities</b>  |          |           |
| Net income   | \$1,061  | \$79      |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |          |           |
| Depreciation and amortization  | 412      | 445       |
| Deferred income taxes  | 340      | 52        |
| Valuation allowance (recovery) deferred income taxes   | (340 )   | (52 )     |
| Write-down of other real estate owned  | 383      | 158       |
| Valuation allowance other real estate owned  | (294 )   | (293 )    |
| Write-down of assets held for sale   | 220      | 687       |
| Gain on securities sold  | (147 )   | (7 )      |
| Gain on loans sold   | (2,587 ) | (2,957 )  |
| Gain on sale of assets held for sale   | (504 )   | -         |
| Loss on sale and disposal of premises and equipment  | 2        | 12        |
| Gain on sale of other real estate owned  | (55 )    | (451 )    |
| Stock compensation expense   | 167      | 172       |
| Proceeds from sale of mortgage loans   | 87,942   | 101,559   |
| Origination of mortgage loans for sale   | (87,146) | (109,350) |
| Amortization of premiums and accretion of discounts on securities, net                             | 88       | 142       |
| Decrease (increase) in interest receivable   | 98       | (669 )    |
| Increase in bank owned life insurance  | (93 )    | (91 )     |
| Decrease (increase) in other assets  | (997 )   | (822 )    |
| Increase (decrease) in interest payable  | (1,266 ) | 87        |
| Increase (decrease) in other liabilities   | (634 )   | 134       |
| Net cash (used in) provided by operating activities  | (3,350 ) | (11,165 ) |
| <b>Cash Flows from Investing Activities</b>  |          |           |
| Purchases of available for sale securities   | -        | (6,748 )  |
| Proceeds from the sale or calls of available for sale securities                                   | 17,551   | 6,834     |
| Proceeds from the sale of assets held for sale   | 7,338    | -         |
| Net increase in loans  | (12,052) | (15,970 ) |
| Proceeds from sale of other real estate owned  | 2,819    | 4,606     |
| Purchases of premises and equipment  | (391 )   | (561 )    |
| Net cash (used in) provided by investing activities  | 15,265   | (11,839 ) |
| <b>Cash Flows from Financing Activities</b>  |          |           |
| Net proceeds from sale of common stock, net of expenses of \$990                                   | -        | 8,965     |
| Net increase (decrease) in deposits  | 2,776    | (8,449 )  |

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|  |          |           |
|--|----------|-----------|
| Net decrease in Federal Home Loan Bank Advances          | (2,800 ) | (7,000 )  |
| Net increase (decrease) in other borrowings              | (192 )   | 355       |
| Net cash used in financing activities                    | (216 )   | (6,129 )  |
| Net increase (decrease) in cash and cash equivalents     | 11,699   | (29,133 ) |
| Cash and cash equivalents, beginning of period           | 17,262   | 49,103    |
| Cash and cash equivalents, end of period                 | \$28,961 | \$19,970  |
| Supplemental Disclosure of Cash Flow Information         |          |           |
| Cash payments for interest                               | \$2,552  | \$1,395   |
| Supplemental Schedule of Non Cash Activities             |          |           |
| Real estate owned assets acquired in settlement of loans | \$268    | \$279     |
| Assets moved to held for sale                            | \$-      | \$831     |
| Bank financed sale of asset held for sale                | \$4,912  | \$-       |
| Dividends on preferred stock accrued                     | \$361    | \$330     |
| Non-Cash conversion of preferred shares                  | \$-      | \$4,619   |
| Forgiveness of principal and accrued dividends           | \$-      | \$6,619   |

*See accompanying notes to consolidated financial statements.*

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

**Notes to Consolidated Financial Statements**

**Three and Six Months Ended June 30, 2016 and 2015**

**(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 (loss) 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 six month period ended June 30, 2016 is not necessarily indicative of the results to be expected for the full year ending December 31, 2016. 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, 2015 as filed with the Securities and Exchange Commission (“SEC”).

The Company has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of June 30, 2016 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, the valuation allowance on the deferred tax asset, and the estimate of the fair value of assets held for sale.



## Note 3 - Earnings 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 June<br>30, |            | Six Months Ended June<br>30, |          |
|---|--------------------------------|------------|------------------------------|----------|
|   | 2016                           | 2015       | 2016                         | 2015     |
| Numerator   |                                |            |                              |          |
| Net income - basic and diluted                                      | \$ 659                         | \$ 84      | \$ 1,061                     | \$ 79    |
| Preferred stock dividend and accretion                              | (183 )                         | (167 )     | (361 )                       | (330 )   |
| Preferred stock principal forgiveness                               | -                              | -          | -                            | 4,404    |
| Preferred stock dividend forgiveness                                | -                              | -          | -                            | 2,215    |
| Net income available to common shareholders                         | \$ 476                         | \$ (83 )   | \$ 700                       | \$ 6,368 |
| Denominator   |                                |            |                              |          |
| Weighted average shares outstanding - basic                         | 1,422                          | 1,388      | 1,420                        | 909      |
| Dilutive effect of common stock options and restricted stock awards | -                              | -          | -                            | 11       |
| Weighted average shares outstanding - diluted                       | 1,422                          | 1,388      | 1,420                        | 920      |
| Earnings(loss) per share - basic                                    | \$ 0.34                        | \$ (0.06 ) | \$ 0.50                      | \$ 7.00  |
| Earnings(loss) per share - diluted                                  | \$ 0.34                        | \$ (0.06 ) | \$ 0.50                      | \$ 6.92  |

Outstanding options and warrants to purchase common stock were considered in the computation of diluted earnings (loss) per share for the periods presented. Stock options for 2,616 were not included in computing diluted earnings per share for the three and six months ended June 30, 2016 and stock options for 4,505 and 6,519 shares were not included in computing diluted earnings per share for the three and six months ended and 2015, respectively, because their effects were anti-dilutive.

## Note 4 – Investment securities available for sale

At June 30, 2016 and December 31, 2015, 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 |   |
|-----------------------------|-----------|----------------|------------------------|-------------------------|----------------------|---------------|---|
| June 30, 2016               |           |                |                        |                         |                      |               |   |
| US Government Agencies      |           |                |                        |                         |                      |               |   |
| One to five years           | \$13,000  | \$13,243       | \$ 62                  | \$ (2 )                 | \$13,303             | 0.99          | % |
| Five to ten years           | 2,000     | 2,075          | 20                     | -                       | 2,095                | 1.63          | % |
| More than ten years         | 3,130     | 3,136          | -                      | (19 )                   | 3,117                | 1.10          | % |
|                             | 18,130    | 18,454         | 82                     | (21 )                   | 18,515               | 1.20          | % |
| Mortgage-backed securities  |           |                |                        |                         |                      |               |   |
| One to five years           | 1,596     | 1,635          | 7                      | (3 )                    | 1,639                | 1.25          | % |
| More than ten years         | 959       | 1,003          | 2                      | -                       | 1,005                | 1.27          | % |
|                             | 2,555     | 2,638          | 9                      | (3 )                    | 2,644                | 1.28          | % |
| Total investment securities | \$20,685  | \$21,092       | \$ 91                  | \$ (24 )                | \$21,159             | 1.21          | % |
| December 31, 2015           |           |                |                        |                         |                      |               |   |
| US Government Agencies      |           |                |                        |                         |                      |               |   |
| One to five years           | \$11,000  | \$11,270       | \$ -                   | \$ (157 )               | \$11,113             | 0.91          | % |
| Five to ten years           | 18,500    | 19,697         | -                      | (403 )                  | 19,294               | 2.32          | % |
| More than ten years         | 3,312     | 3,319          | -                      | (13 )                   | 3,306                | 0.85          | % |
|                             | 32,812    | 34,286         | -                      | (573 )                  | 33,713               | 1.51          | % |
| Mortgage-backed securities  |           |                |                        |                         |                      |               |   |
| One to five years           | 1,794     | 1,841          | -                      | (28 )                   | 1,813                | 1.30          | % |
| More than ten years         | 1,149     | 1,202          | 1                      | (15 )                   | 1,188                | 1.34          | % |
|                             | 2,943     | 3,043          | 1                      | (43 )                   | 3,001                | 1.35          | % |
| Municipals                  |           |                |                        |                         |                      |               |   |
| More than ten years         | 1,130     | 1,255          | -                      | (50 )                   | 1,205                | 3.72          | % |
|                             | 1,130     | 1,255          | -                      | (50 )                   | 1,205                | 3.72          | % |
| Total investment securities | \$36,885  | \$38,584       | \$ 1                   | \$ (666 )               | \$37,919             | 1.57          | % |

Investment securities with book values of approximately \$5,167,000 and \$5,968,000 at June 30, 2016 and December 31, 2015, respectively, were pledged to secure deposit repurchase agreements and FHLB advances.

Gross realized gains and losses pertaining to available for sale securities are detailed as follows for the periods indicated (dollars in thousands):

|                       | Three Months<br>Ended June 30, |      | Six Months<br>Ended June 30, |       |
|-----------------------|--------------------------------|------|------------------------------|-------|
|                       | 2016                           | 2015 | 2016                         | 2015  |
| Gross realized gains  | \$ 38                          | \$ - | \$ 147                       | \$ 13 |
| Gross realized losses | -                              | -    | -                            | (6 )  |
|                       | \$ 38                          | \$ - | \$ 147                       | \$ 7  |

The Company sold approximately \$6 million and \$17 million of investment securities for the three and six months ended June 30, 2016 resulting in a net gain of \$38,000 and \$147,000, respectively. The Company sold approximately \$7 million of investment securities available for sale at a net gain of \$7,000 for the six months ended June 30, 2015, no investment securities were sold during the three months ended June 30, 2015. The sale of these securities, which had fixed interest rates, allowed the Company to decrease its exposure to the anticipated upward movement in interest rates that would result in unrealized losses being recognized in shareholders' equity.

Investment securities available for sale that have an unrealized loss position at June 30, 2016 and December 31, 2015 are detailed below (dollars 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 |
| June 30, 2016              |   |                      |   |                      |               |                      |
| US Government Agencies     | \$ 1,889  | \$ (8 )              | \$ 3,229  | \$ (13 )             | \$ 5,118      | \$ (21 )             |
| Mortgage-backed securities | -   | -                    | 812   | (3 )                 | 812           | (3 )                 |
|                            | \$ 1,889  | \$ (8 )              | \$ 4,041  | \$ (16 )             | \$ 5,930      | \$ (24 )             |
| December 31, 2015          |   |                      |   |                      |               |                      |
| US Government Agencies     | \$ 18,598   | \$ (329 )            | \$ 15,115   | \$ (244 )            | \$ 33,713     | \$ (573 )            |
| Municipals                 | 707   | (14 )                | 497   | (36 )                | 1,204         | (50 )                |
| Mortgage-backed securities | 2,899   | (43 )                | -   | -                    | 2,899         | (43 )                |
|                            | \$ 22,204   | \$ (386 )            | \$ 15,612   | \$ (280 )            | \$ 37,816     | \$ (666 )            |

All of the unrealized losses are attributable to increases in interest rates and not to credit deterioration. Currently, the Company believes that it is probable that the Company will be able to collect all amounts due according to the contractual terms of the investments. Because the decline in market value is attributable to changes in interest rates and not to credit quality, and because it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other than temporarily impaired at June 30, 2016.

## 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):

|   | June 30, 2016 |         | December 31, 2015 |         |
|---|---------------|---------|-------------------|---------|
|   | Amount        | %       | Amount            | %       |
| Construction and land development                                     |               |         |                   |         |
| Residential   | \$5,109       | 1.58 %  | \$5,202           | 1.70 %  |
| Commercial  | 24,873        | 7.70 %  | 25,948            | 8.45 %  |
|   | 29,982        | 9.28 %  | 31,150            | 10.15 % |
| Commercial real estate  |               |         |                   |         |
| Owner occupied  | 78,753        | 24.36 % | 69,256            | 22.58 % |
| Non-owner occupied  | 46,013        | 14.24 % | 38,037            | 12.40 % |
| Multifamily   | 8,993         | 2.78 %  | 8,537             | 2.78 %  |
| Farmland  | 250           | 0.08 %  | 388               | 0.13 %  |
|   | 134,009       | 41.46 % | 116,218           | 37.89 % |
| Consumer real estate  |               |         |                   |         |
| Home equity lines   | 20,694        | 6.40 %  | 20,333            | 6.63 %  |
| Secured by 1-4 family residential,<br>First deed of trust             | 55,289        | 17.11 % | 56,776            | 18.51 % |
| Second deed of trust  | 5,914         | 1.83 %  | 6,485             | 2.11 %  |
|   | 81,897        | 25.34 % | 83,594            | 27.25 % |
| Commercial and industrial loans (except those secured by real estate) | 28,859        | 8.93 %  | 20,086            | 6.55 %  |
| Guaranteed student loans  | 46,781        | 14.47 % | 53,989            | 17.60 % |
| Consumer and other  | 1,691         | 0.52 %  | 1,734             | 0.57 %  |
| Total loans   | 323,219       | 100.0 % | 306,771           | 100.0 % |
| Deferred loan cost, net   | 602           |         | 670               |         |
| Less: allowance for loan losses                                       | (3,523 )      |         | (3,562 )          |         |
|   | \$320,298     |         | \$303,879         |         |

The Bank purchased portfolios of rehabilitated student loans guaranteed by the Department of Education (“DOE”). 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.

Loans pledged as collateral with the Federal Home Loan Bank of Atlanta (“FHLB”) as part of their lending arrangement with the Company totaled \$7,713,000 and \$7,891,000 at June 30, 2016 and December 31, 2015, respectively.

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

Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. These 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.

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

|   | Risk Rated<br>1-4 | Risk<br>Rated<br>5 | Risk<br>Rated<br>6 | Risk<br>Rated<br>7 | Total<br>Loans |
|---|-------------------|--------------------|--------------------|--------------------|----------------|
| June 30, 2016   |                   |                    |                    |                    |                |
| Construction and land development                                     |                   |                    |                    |                    |                |
| Residential   | \$ 5,109          | \$ -               | \$ -               | \$ -               | \$ 5,109       |
| Commercial  | 22,634            | 856                | 1,383              | -                  | 24,873         |
|   | 27,743            | 856                | 1,383              | -                  | 29,982         |
| Commercial real estate  |                   |                    |                    |                    |                |
| Owner occupied  | 73,872            | 2,402              | 2,479              | -                  | 78,753         |
| Non-owner occupied  | 44,801            | 1,121              | 91                 | -                  | 46,013         |
| Multifamily   | 8,798             | 195                | -                  | -                  | 8,993          |
| Farmland  | 250               | -                  | -                  | -                  | 250            |
|   | 127,721           | 3,718              | 2,570              | -                  | 134,009        |
| Consumer real estate  |                   |                    |                    |                    |                |
| Home equity lines   |                   |                    |                    |                    |                |
| Secured by 1-4 family residential                                     | 19,185            | 236                | 1,273              | -                  | 20,694         |
| First deed of trust   | 49,574            | 2,947              | 2,768              | -                  | 55,289         |
| Second deed of trust  | 5,506             | 126                | 282                | -                  | 5,914          |
|   | 74,265            | 3,309              | 4,323              | -                  | 81,897         |
| Commercial and industrial loans (except those secured by real estate) |                   |                    |                    |                    |                |
|   | 27,910            | 436                | 513                | -                  | 28,859         |
| Guaranteed student loans  | 46,781            | -                  | -                  | -                  | 46,781         |
| Consumer and other  | 1,626             | 58                 | 7                  | -                  | 1,691          |
| Total loans   | \$ 306,046        | \$ 8,377           | \$ 8,796           | \$ -               | \$ 323,219     |
| December 31, 2015   |                   |                    |                    |                    |                |
| Construction and land development                                     |                   |                    |                    |                    |                |
| Residential   | \$ 5,202          | \$ -               | \$ -               | \$ -               | \$ 5,202       |
| Commercial  | 24,053            | 572                | 1,323              | -                  | 25,948         |
|   | 29,255            | 572                | 1,323              | -                  | 31,150         |
| Commercial real estate  |                   |                    |                    |                    |                |
| Owner occupied  | 64,261            | 2,850              | 2,145              | -                  | 69,256         |
| Non-owner occupied  | 35,887            | 2,055              | 95                 | -                  | 38,037         |
| Multifamily   | 8,337             | 200                | -                  | -                  | 8,537          |
| Farmland  | 388               | -                  | -                  | -                  | 388            |
|   | 108,873           | 5,105              | 2,240              | -                  | 116,218        |
| Consumer real estate  |                   |                    |                    |                    |                |
| Home equity lines   |                   |                    |                    |                    |                |
|   | 18,539            | 435                | 1,359              | -                  | 20,333         |

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|   |            |          |          |      |            |
|---|------------|----------|----------|------|------------|
| Secured by 1-4 family residential                                     |            |          |          |      |            |
| First deed of trust   | 51,200     | 2,710    | 2,866    | -    | 56,776     |
| Second deed of trust  | 5,751      | 128      | 606      | -    | 6,485      |
|   | 75,490     | 3,273    | 4,831    | -    | 83,594     |
| Commercial and industrial loans (except those secured by real estate) | 18,873     | 373      | 840      | -    | 20,086     |
| Guaranteed student loans  | 53,989     | -        | -        | -    | 53,989     |
| Consumer and other  | 1,649      | 62       | 23       | -    | 1,734      |
| Total loans   | \$ 288,129 | \$ 9,385 | \$ 9,257 | \$ - | \$ 306,771 |



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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 (dollars 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 | Investment<br>><br>90 Days<br>and<br>Accruing |
|---|---------------------------|---------------------------|-------------------------------|----------------------|-----------|----------------|---|
| June 30, 2016   |                           |                           |                               |                      |           |                |   |
| Construction and land development   |                           |                           |                               |                      |           |                |   |
| Residential   | \$ -                      | \$ -                      | \$ -                          | \$ -                 | \$5,109   | \$5,109        | \$ -  |
| Commercial  | 192                       | -                         | -                             | 192                  | 24,681    | 24,873         | -   |
|   | 192                       | -                         | -                             | 192                  | 29,790    | 29,982         | -   |
| Commercial real estate  |                           |                           |                               |                      |           |                |   |
| Owner occupied  | -                         | -                         | -                             | -                    | 78,753    | 78,753         | -   |
| Non-owner occupied  | 107                       | -                         | -                             | 107                  | 45,906    | 46,013         | -   |
| Multifamily   | -                         | -                         | -                             | -                    | 8,993     | 8,993          | -   |
| Farmland  | -                         | -                         | -                             | -                    | 250       | 250            | -   |
|   | 107                       | -                         | -                             | 107                  | 133,902   | 134,009        | -   |
| Consumer real estate  |                           |                           |                               |                      |           |                |   |
| Home equity lines   | 24                        | -                         | -                             | 24                   | 20,670    | 20,694         | -   |
| Secured by 1-4 family residential   |                           |                           |                               |                      |           |                |   |
| First deed of trust   | 96                        | -                         | -                             | 96                   | 55,193    | 55,289         | -   |
| Second deed of trust  | -                         | -                         | -                             | -                    | 5,914     | 5,914          | -   |
|   | 120                       | -                         | -                             | 120                  | 81,777    | 81,897         | -   |
| Commercial and industrial<br>loans (except those secured by real<br>estate) | -                         | -                         | -                             | -                    | 28,859    | 28,859         | -   |
| Guaranteed student loans  | 2,185                     | 1,661                     | 8,412                         | 12,258               | 34,523    | 46,781         | 8,412   |
| Consumer and other  | 8                         | -                         | -                             | 8                    | 1,683     | 1,691          | -   |
| Total loans   | \$ 2,612                  | \$ 1,661                  | \$ 8,412                      | \$ 12,685            | \$310,534 | \$323,219      | \$ 8,412                                      |

|                                   | 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 |
|-----------------------------------|---------------------------|---------------------------|-------------------------------|----------------------|---------|----------------|---|
| December 31, 2015                 |                           |                           |                               |                      |         |                |   |
| Construction and land development |                           |                           |                               |                      |         |                |   |

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|  |          |          |          |           |            |            |          |
|--|----------|----------|----------|-----------|------------|------------|----------|
| Residential  | \$ -     | \$ -     | \$ -     | \$ -      | \$5,202    | \$5,202    | \$ -     |
| Commercial   | -        | -        | -        | -         | 25,948     | 25,948     | -        |
|  | -        | -        | -        | -         | 31,150     | 31,150     | -        |
| Commercial real estate   |          |          |          |           |            |            |          |
| Owner occupied   | 327      | -        | -        | 327       | 68,929     | 69,256     | -        |
| Non-owner occupied   | -        | 110      | -        | 110       | 37,927     | 38,037     | -        |
| Multifamily  | -        | -        | -        | -         | 8,537      | 8,537      | -        |
| Farmland   | -        | -        | -        | -         | 388        | 388        | -        |
|  | 327      | 110      | -        | 437       | 115,781    | 116,218    | -        |
| Consumer real estate   |          |          |          |           |            |            |          |
| Home equity lines  | -        | -        | -        | -         | 20,333     | 20,333     | -        |
| Secured by 1-4 family residential  |          |          |          |           |            |            |          |
| First deed of trust  | 163      | 292      | -        | 455       | 56,321     | 56,776     | -        |
| Second deed of trust   | 94       | -        | -        | 94        | 6,391      | 6,485      | -        |
|  | 257      | 292      | -        | 549       | 83,045     | 83,594     | -        |
| Commercial and industrial loans<br>(except those secured by real estate) | -        | -        | -        | -         | 20,086     | 20,086     | -        |
| Guaranteed student loans   | 7,816    | 1,252    | 8,590    | 17,658    | 36,331     | 53,989     | 8,590    |
| Consumer and other   | 10       | -        | -        | 10        | 1,724      | 1,734      | -        |
| Total loans  | \$ 8,410 | \$ 1,654 | \$ 8,590 | \$ 18,654 | \$ 288,117 | \$ 306,771 | \$ 8,590 |

Loans greater than 90 days past due are student loans that are guaranteed by the DOE which covers approximately 98% of the principal and interest. Accordingly, these loans will not be placed on nonaccrual status and are included in the 90 Days and Accruing column.

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 (dollars in thousands):

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|   | June 30, 2016 |                  |           |
|---|---------------|------------------|-----------|
|   | Recorded      | Unpaid Principal | Related   |
|   | Investment    | Balance          | Allowance |
| With no related allowance recorded                                    |               |                  |           |
| Construction and land development                                     |               |                  |           |
| Commercial  | \$ 126        | \$ 193           | \$ -      |
| Commercial real estate  |               |                  |           |
| Owner occupied  | 1,422         | 1,431            |           |
| Non-owner occupied  | 2,596         | 2,596            | -         |
|   | 4,018         | 4,027            | -         |
| Consumer real estate  |               |                  |           |
| Home equity lines   | 1,178         | 1,202            | -         |
| Secured by 1-4 family residential                                     |               |                  |           |
| First deed of trust   | 4,403         | 4,434            | -         |
| Second deed of trust  | 633           | 903              | -         |
|   | 6,214         | 6,539            | -         |
| Commercial and industrial loans (except those secured by real estate) | 365           | 595              | -         |
|   | 10,723        | 11,354           | -         |
| With an allowance recorded  |               |                  |           |
| Construction and land development                                     |               |                  |           |
| Commercial  | 1,746         | 1,746            | 25        |
| Commercial real estate  |               |                  |           |
| Owner occupied  | 4,447         | 4,462            | 142       |
| Non-Owner occupied  | 91            | 91               | 1         |
|   | 4,538         | 4,553            | 143       |
| Consumer real estate  |               |                  |           |
| Secured by 1-4 family residential                                     |               |                  |           |
| First deed of trust   | 1,697         | 1,697            | 190       |
| Second deed of trust  | 245           | 245              | 95        |
|   | 1,942         | 1,942            | 285       |
| Commercial and industrial loans (except those secured by real estate) | 143           | 245              | 12        |
|   | 8,369         | 8,486            | 465       |
| Total   |               |                  |           |
| Construction and land development                                     |               |                  |           |
| Commercial  | 1,872         | 1,939            | 25        |
|   | 1,872         | 1,939            | 25        |
| Commercial real estate  |               |                  |           |
| Owner occupied  | 5,869         | 5,893            | 142       |
| Non-owner occupied  | 2,687         | 2,687            | 1         |
|   | 8,556         | 8,580            | 143       |
| Consumer real estate  |               |                  |           |
| Home equity lines   | 1,178         | 1,202            | -         |
| Secured by 1-4 family residential,                                    |               |                  |           |
| First deed of trust   | 6,100         | 6,131            | 190       |

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|   |          |          |        |
|---|----------|----------|--------|
| Second deed of trust  | 878      | 1,148    | 95     |
|   | 8,156    | 8,481    | 285    |
| Commercial and industrial loans (except those secured by real estate) | 508      | 840      | 12     |
|   | \$19,092 | \$19,840 | \$ 465 |

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|   | December 31, 2015 |                  |           |
|---|-------------------|------------------|-----------|
|   | Recorded          | Unpaid Principal | Related   |
|   | Investment        | Balance          | Allowance |
| With no related allowance recorded                                    |                   |                  |           |
| Construction and land development                                     |                   |                  |           |
| Commercial  | \$ 123            | \$ 190           | \$ -      |
| Commercial real estate  |                   |                  |           |
| Owner occupied  | 1,066             | 1,066            | -         |
| Non-owner occupied  | 2,418             | 2,418            | -         |
|   | 3,484             | 3,484            | -         |
| Consumer real estate  |                   |                  |           |
| Home equity lines   | 1,238             | 1,247            | -         |
| Secured by 1-4 family residential                                     |                   |                  |           |
| First deed of trust   | 3,984             | 3,988            | -         |
| Second deed of trust  | 962               | 1,232            | -         |
|   | 6,184             | 6,467            | -         |
| Commercial and industrial loans (except those secured by real estate) | 690               | 920              | -         |
|   | 10,481            | 11,061           | -         |
| With an allowance recorded  |                   |                  |           |
| Construction and land development                                     |                   |                  |           |
| Commercial  | 1,699             | 1,699            | 2         |
| Commercial real estate  |                   |                  |           |
| Owner occupied  | 5,719             | 5,734            | 383       |
| Non-Owner occupied  | 449               | 449              | 26        |
|   | 6,168             | 6,183            | 409       |
| Consumer real estate  |                   |                  |           |
| Secured by 1-4 family residential                                     |                   |                  |           |
| First deed of trust   | 1,775             | 1,775            | 324       |
| Second deed of trust  | 250               | 250              | 98        |
|   | 2,025             | 2,025            | 422       |
| Commercial and industrial loans (except those secured by real estate) | 136               | 238              | 18        |
|   | 10,028            | 10,145           | 851       |
| Total   |                   |                  |           |
| Construction and land development                                     |                   |                  |           |
| Commercial  | 1,822             | 1,889            | 2         |
|   | 1,822             | 1,889            | 2         |
| Commercial real estate  |                   |                  |           |
| Owner occupied  | 6,785             | 6,800            | 383       |
| Non-owner occupied  | 2,867             | 2,867            | 26        |
|   | 9,652             | 9,667            | 409       |
| Consumer real estate  |                   |                  |           |
| Home equity lines   | 1,238             | 1,247            | -         |
| Secured by 1-4 family residential,                                    |                   |                  |           |
| First deed of trust   | 5,759             | 5,763            | 324       |

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|   |          |          |        |
|---|----------|----------|--------|
| Second deed of trust  | 1,212    | 1,482    | 98     |
|   | 8,209    | 8,492    | 422    |
| Commercial and industrial loans (except those secured by real estate) | 826      | 1,158    | 18     |
|   | \$20,509 | \$21,206 | \$ 851 |

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 (dollars in thousands):

|   | For the Three Months<br>Ended June 30, 2016 |                                  | For the Six Months<br>Ended June 30, 2016 |                                  |
|---|---|----------------------------------|---|----------------------------------|
|   | 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   | \$ -  | \$ -                             | \$ -                                      | \$ -                             |
| Commercial  | 443   | 29                               | 271                                       | 40                               |
|   | 443   | 29                               | 271                                       | 40                               |
| Commercial real estate  |   |                                  |   |                                  |
| Owner occupied  | 1,049                                       | 15                               | 932                                       | 29                               |
| Non-owner occupied  | 2,434                                       | 30                               | 2,533                                     | 64                               |
| Multifamily   | -   | -                                | -   | -                                |
| Farmland  | -   | -                                | -   | -                                |
|   | 3,483                                       | 45                               | 3,465                                     | 93                               |
| Consumer real estate  |   |                                  |   |                                  |
| Home equity lines   | 1,287                                       | 1                                | 1,287                                     | 1                                |
| Secured by 1-4 family residential                                     |   |                                  |   |                                  |
| First deed of trust   | 4,339                                       | 45                               | 4,215                                     | 92                               |
| Second deed of trust  | 954   | 11                               | 1,005                                     | 23                               |
|   | 6,580                                       | 57                               | 6,508                                     | 116                              |
| Commercial and industrial loans (except those secured by real estate) |   |                                  |   |                                  |
| Consumer and other  | 453   | 7                                | 625                                       | 14                               |
|   |   | -                                | 7   | -                                |
|   | 10,959                                      | 138                              | 10,876                                    | 263                              |
| With an allowance recorded  |   |                                  |   |                                  |
| Construction and land development                                     |   |                                  |   |                                  |
| Commercial  | 1,428                                       | 6                                | 1,586                                     | 12                               |
| Commercial real estate  |   |                                  |   |                                  |
| Owner occupied  | 5,308                                       | 53                               | 5,454                                     | 110                              |
| Non-Owner occupied  | 272   | 4                                | 183                                       | 9                                |
|   | 5,580                                       | 57                               | 5,637                                     | 119                              |
| Consumer real estate  |   |                                  |   |                                  |
| Home equity line  | -   | -                                | -   | -                                |
| Secured by 1-4 family residential                                     |   |                                  |   |                                  |
| First deed of trust   | 1,681                                       | 3                                | 1,861                                     | 9                                |
| Second deed of trust  | 235   | 2                                | 192                                       | 4                                |
|   | 1,916                                       | 5                                | 2,053                                     | 13                               |
| Commercial and industrial loans (except those secured by real estate) |   |                                  |   |                                  |
|   | 130   | -                                | 134                                       | -                                |

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|   |           |        |           |        |
|---|-----------|--------|-----------|--------|
|   | 9,054     | 68     | 9,410     | 144    |
| Total   |           |        |           |        |
| Construction and land development                                     |           |        |           |        |
| Residential   | -         | -      | -         | -      |
| Commercial  | 1,871     | 35     | 1,856     | 52     |
|   | 1,871     | 35     | 1,856     | 52     |
| Commercial real estate  |           |        |           |        |
| Owner occupied  | 6,357     | 68     | 6,386     | 139    |
| Non-owner occupied  | 2,706     | 34     | 2,716     | 73     |
| Multifamily   | -         | -      | -         | -      |
| Farmland  | -         | -      | -         | -      |
|   | 9,063     | 102    | 9,102     | 212    |
| Consumer real estate  |           |        |           |        |
| Home equity lines   | 1,287     | 1      | 1,287     | 1      |
| Secured by 1-4 family residential,                                    |           |        |           |        |
| First deed of trust   | 6,020     | 48     | 6,077     | 101    |
| Second deed of trust  | 1,189     | 13     | 1,197     | 27     |
|   | 8,496     | 62     | 8,561     | 129    |
| Commercial and industrial loans (except those secured by real estate) | 583       | 7      | 759       | 14     |
| Consumer and other  | -         | -      | 7         | -      |
|   | \$ 20,013 | \$ 206 | \$ 20,285 | \$ 407 |



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 nonaccrual. To restore a nonaccrual loan that has been formally restructured in a TDR to accrual status, we perform a current, well documented credit analysis supporting a return to accrual status based on the borrower’s financial condition and prospects for repayment under the revised terms. Otherwise, the TDR must remain in nonaccrual status. The analysis considers the borrower’s sustained historical repayment performance for a reasonable period to the return-to-accrual date, but may take into account payments made for a reasonable period prior to the restructuring if the payments are consistent with the modified terms. A sustained period of repayment performance generally would be a minimum of six months and would involve payments in the form of cash or cash equivalents.

The following is a summary of performing and nonaccrual TDRs and the related specific valuation allowance by portfolio segment for the periods indicated (dollars in thousands).

|   | Total    | Performing | Nonaccrual | Specific<br>Valuation<br>Allowance |
|---|----------|------------|------------|------------------------------------|
| June 30, 2016   |          |            |            |                                    |
| Construction and land development                                     |          |            |            |                                    |
| Commercial  | \$1,677  | \$ 1,677   | \$ -       | \$ 15                              |
|   | 1,677    | 1,677      | -          | 15                                 |
| Commercial real estate  |          |            |            |                                    |
| Owner occupied  | 5,644    | 5,394      | 250        | 142                                |
| Non-owner occupied  | 2,687    | 2,687      | -          | 1                                  |
|   | 8,331    | 8,081      | 250        | 143                                |
| Consumer real estate  |          |            |            |                                    |
| Secured by 1-4 family residential                                     |          |            |            |                                    |
| First deeds of trust  | 4,290    | 3,346      | 944        | 159                                |
| Second deeds of trust   | 680      | 680        | -          | -                                  |
|   | 4,970    | 4,026      | 944        | 159                                |
| Commercial and industrial loans (except those secured by real estate) | 118      | -          | 118        | 6                                  |
|   | \$15,096 | \$ 13,784  | \$ 1,312   | \$ 323                             |

|   | Total    | Performing | Nonaccrual | Specific Valuation Allowance |
|---|----------|------------|------------|------------------------------|
| December 31, 2015   |          |            |            |                              |
| Construction and land development                                     |          |            |            |                              |
| Commercial  | \$1,699  | \$ 1,699   | \$ -       | \$ 2                         |
|   | 1,699    | 1,699      | -          | 2                            |
| Commercial real estate  |          |            |            |                              |
| Owner occupied  | 5,730    | 5,458      | 272        | 184                          |
| Non-owner occupied  | 2,866    | 2,866      | -          | 26                           |
|   | 8,596    | 8,324      | 272        | 210                          |
| Consumer real estate  |          |            |            |                              |
| Home equity lines   | 87       | -          | 87         | -                            |
| Secured by 1-4 family residential                                     |          |            |            |                              |
| First deeds of trust  | 4,283    | 3,544      | 739        | 236                          |
| Second deeds of trust   | 693      | 693        | -          | 1                            |
|   | 5,063    | 4,237      | 825        | 237                          |
| Commercial and industrial loans (except those secured by real estate) | 127      | -          | 127        | 18                           |
|   | \$15,485 | \$ 14,260  | \$ 1,225   | \$ 467                       |

There were no TDRs identified during the six months ended June 30, 2016 and June 30, 2015.

The following table summarizes defaults on TDRs identified for the indicated periods (dollars in thousands):

|                                   | June 30, 2016 |          | June 30, 2015 |          |
|-----------------------------------|---------------|----------|---------------|----------|
|                                   | Number of     | Recorded | Number of     | Recorded |
|                                   | Loans         | Balance  | Loans         | Balance  |
| Construction and land development |               |          |               |          |
| Commercial                        | -             | \$ -     | 3             | \$ 91    |
|                                   | -             | -        | 3             | 91       |
| Commercial real estate            |               |          |               |          |
| Owner occupied                    | 1             | 250      | 1             | 158      |
| Non-owner occupied                | 1             | 560      | -             | -        |
|                                   | 2             | 810      | 1             | 158      |
| Consumer real estate              |               |          |               |          |
| Secured by 1-4 family residential |               |          |               |          |
| First deed of trust               | 3             | 500      | 12            | 835      |
| Second deed of trust              | 2             | 88       | 2             | 98       |

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|   |   |          |    |          |
|---|---|----------|----|----------|
|   | 5 | 588      | 14 | 933      |
| Commercial and industrial (except those secured by real estate) | 1 | 118      | 1  | 133      |
|   | 8 | \$ 1,516 | 19 | \$ 1,315 |

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

|  | Beginning<br>Balance | Provision<br>for<br>Loan<br>Losses | Charge-offs | Recoveries | Ending<br>Balance |
|--|----------------------|------------------------------------|-------------|------------|-------------------|
| Three Months Ended June 30, 2016   |                      |                                    |             |            |                   |
| Construction and land development  |                      |                                    |             |            |                   |
| Residential  | \$ 44                | \$ (13 )                           | \$ -        | \$ -       | \$ 31             |
| Commercial   | 353                  | (94 )                              | -           | -          | 259               |
|  | 397                  | (107 )                             | -           | -          | 290               |
| Commercial real estate   |                      |                                    |             |            |                   |
| Owner occupied   | 985                  | (265 )                             | (9 )        | -          | 711               |
| Non-owner occupied   | 402                  | 34                                 | -           | 1          | 437               |
| Multifamily  | 51                   | 3                                  | -           | -          | 54                |
| Farmland   | 4                    | (2 )                               | -           | -          | 2                 |
|  | 1,442                | (230 )                             | (9 )        | 1          | 1,204             |
| Consumer real estate   |                      |                                    |             |            |                   |
| Home equity lines  | 392                  | (81 )                              | (53 )       | 1          | 259               |
| Secured by 1-4 family residential  |                      |                                    |             |            |                   |
| First deed of trust  | 546                  | (63 )                              | -           | 7          | 490               |
| Second deed of trust   | 97                   | 53                                 | (25 )       | 8          | 133               |
|  | 1,035                | (91 )                              | (78 )       | 16         | 882               |
| Commercial and industrial loans (except those secured by<br>real estate) |                      |                                    |             |            |                   |
| Guaranteed student loans   | 206                  | 25                                 | (40 )       | -          | 191               |
| Consumer and other   | -                    | 7                                  | -           | 1          | 8                 |
| Unallocated  | 436                  | 286                                | -           | -          | 722               |
|  | \$ 3,611             | \$ -                               | \$ (127 )   | \$ 39      | \$ 3,523          |

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|   | Beginning<br>Balance | Provision<br>for<br>Loan<br>Losses | Charge-offs | Recoveries | Ending<br>Balance |
|---|----------------------|------------------------------------|-------------|------------|-------------------|
| Three Months Ended June 30, 2015                                      |                      |                                    |             |            |                   |
| Construction and land development                                     |                      |                                    |             |            |                   |
| Residential   | \$ 35                | 57                                 | \$ -        | \$ -       | \$ 92             |
| Commercial  | 88                   | 331                                | (71 )       | 21         | 369               |
|   | 123                  | 388                                | (71 )       | 21         | 461               |
| Commercial real estate  |                      |                                    |             |            |                   |
| Owner occupied  | 1,836                | (23 )                              | (127 )      | -          | 1,686             |
| Non-owner occupied  | 607                  | 30                                 | -           | 2          | 639               |
| Multifamily   | 78                   | 32                                 | -           | -          | 110               |
| Farmland  | 130                  | (3 )                               | -           | -          | 127               |
|   | 2,651                | 36                                 | (127 )      | 2          | 2,562             |
| Consumer real estate  |                      |                                    |             |            |                   |
| Home equity lines   | 469                  | 11                                 | (40 )       | 1          | 441               |
| Secured by 1-4 family residential                                     |                      |                                    |             |            |                   |
| First deed of trust   | 1,703                | (456 )                             | (66 )       | 11         | 1,192             |
| Second deed of trust  | 284                  | 17                                 | (55 )       | 4          | 250               |
|   | 2,456                | (428 )                             | (161 )      | 16         | 1,883             |
| Commercial and industrial loans (except those secured by real estate) |                      |                                    |             |            |                   |
| Guaranteed student loans  | 356                  | (20 )                              | -           | 46         | 382               |
| Consumer and other  | 217                  | 37                                 | (1 )        | -          | 253               |
|   | 41                   | (13 )                              | (3 )        | 1          | 26                |
|   | \$ 5,844             | \$ -                               | \$ (363 )   | \$ 86      | \$ 5,567          |

|                                   | Beginning<br>Balance | Provision<br>for<br>Loan<br>Losses | Charge-offs | Recoveries | Ending<br>Balance |
|-----------------------------------|----------------------|------------------------------------|-------------|------------|-------------------|
| Six Months Ended June 30, 2016    |                      |                                    |             |            |                   |
| Construction and land development |                      |                                    |             |            |                   |
| Residential                       | \$ 30                | \$ -                               | \$ -        | \$ 1       | \$ 31             |
| Commercial                        | 291                  | (32 )                              | -           | -          | 259               |
|                                   | 321                  | (32 )                              | -           | 1          | 290               |
| Commercial real estate            |                      |                                    |             |            |                   |
| Owner occupied                    | 1,167                | (447 )                             | (9 )        | -          | 711               |
| Non-owner occupied                | 460                  | (25 )                              | -           | 2          | 437               |
| Multifamily                       | 51                   | 3                                  | -           | -          | 54                |
| Farmland                          | 17                   | (140 )                             | -           | 125        | 2                 |
|                                   | 1,695                | (609 )                             | (9 )        | 127        | 1,204             |
| Consumer real estate              |                      |                                    |             |            |                   |

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|   |          |        |           |        |          |
|---|----------|--------|-----------|--------|----------|
| Home equity lines   | 448      | (138 ) | (53 )     | 2      | 259      |
| Secured by 1-4 family residential                                     |          |        |           |        |          |
| First deed of trust   | 602      | (99 )  | (27 )     | 14     | 490      |
| Second deed of trust  | 111      | 34     | (25 )     | 13     | 133      |
|   | 1,161    | (203 ) | (105 )    | 29     | 882      |
| Commercial and industrial loans (except those secured by real estate) | 94       | 88     | -         | 44     | 226      |
| Guaranteed student loans  | 230      | 88     | (127 )    | -      | 191      |
| Consumer and other  | 2        | 5      | (1 )      | 2      | 8        |
| Unallocated   | 59       | 663    | -         | -      | 722      |
|   | \$ 3,562 | \$ -   | \$ (242 ) | \$ 203 | \$ 3,523 |

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|   | Beginning<br>Balance | Provision<br>for<br>Loan<br>Losses | Charge-offs | Recoveries | Ending<br>Balance |
|---|----------------------|------------------------------------|-------------|------------|-------------------|
| Six Months Ended June 30, 2015  |                      |                                    |             |            |                   |
| Construction and land development                                     |                      |                                    |             |            |                   |
| Residential   | \$ 34                | \$ 57                              | \$ -        | \$ 1       | \$ 92             |
| Commercial  | 202                  | 330                                | (185 )      | 22         | 369               |
|   | 236                  | 387                                | (185 )      | 23         | 461               |
| Commercial real estate  |                      |                                    |             |            |                   |
| Owner occupied  | 1,837                | (23 )                              | (127 )      | -          | 1,686             |
| Non-owner occupied  | 607                  | 30                                 | -           | 2          | 639               |
| Multifamily   | 77                   | 32                                 | -           | -          | 110               |
| Farmland  | 130                  | (3 )                               | -           | -          | 127               |
|   | 2,651                | 36                                 | (127 )      | 2          | 2,562             |
| Consumer real estate  |                      |                                    |             |            |                   |
| Home equity lines   | 469                  | 11                                 | (40 )       | 1          | 441               |
| Secured by 1-4 family residential                                     |                      |                                    |             |            |                   |
| First deed of trust   | 1,345                | (456 )                             | (66 )       | 369        | 1,192             |
| Second deed of trust  | 275                  | 17                                 | (55 )       | 13         | 250               |
|   | 2,089                | (428 )                             | (161 )      | 383        | 1,883             |
| Commercial and industrial loans (except those secured by real estate) |                      |                                    |             |            |                   |
| Guaranteed student loans  | 506                  | (20 )                              | (162 )      | 58         | 382               |
| Consumer and other  | 217                  | 37                                 | (1 )        | -          | 253               |
|   | 30                   | (12 )                              | (6 )        | 14         | 26                |
|   | \$ 5,729             | \$ -                               | \$ (642 )   | \$ 480     | \$ 5,567          |

|                                   | Beginning<br>Balance | Provision<br>for<br>Loan<br>Losses | Charge-offs | Recoveries | Ending<br>Balance |
|-----------------------------------|----------------------|------------------------------------|-------------|------------|-------------------|
| Year Ended December 31, 2015      |                      |                                    |             |            |                   |
| Construction and land development |                      |                                    |             |            |                   |
| Residential                       | \$ 34                | \$ (6 )                            | \$ -        | \$ 2       | \$ 30             |
| Commercial                        | 202                  | 292                                | (252 )      | 49         | 291               |
|                                   | 236                  | 286                                | (252 )      | 51         | 321               |
| Commercial real estate            |                      |                                    |             |            |                   |
| Owner occupied                    | 1,837                | (576 )                             | (127 )      | 33         | 1,167             |
| Non-owner occupied                | 607                  | (151 )                             | -           | 4          | 460               |
| Multifamily                       | 77                   | (26 )                              | -           | -          | 51                |
| Farmland                          | 130                  | (113 )                             | -           | -          | 17                |
|                                   | 2,651                | (866 )                             | (127 )      | 37         | 1,695             |
| Consumer real estate              |                      |                                    |             |            |                   |

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|   |          |             |           |        |          |
|---|----------|-------------|-----------|--------|----------|
| Home equity lines   | 469      | 36          | (62 )     | 5      | 448      |
| Secured by 1-4 family residential                                     |          |             |           |        |          |
| First deed of trust   | 1,345    | (1,020 )    | (103 )    | 380    | 602      |
| Second deed of trust  | 275      | (159 )      | (55 )     | 50     | 111      |
|   | 2,089    | (1,143 )    | (220 )    | 435    | 1,161    |
| Commercial and industrial loans (except those secured by real estate) | 506      | (350 )      | (162 )    | 100    | 94       |
| Guaranteed student loans  | 217      | 13          | -         | -      | 230      |
| Consumer and other  | 30       | 1           | (55 )     | 26     | 2        |
| Unallocated   | -        | 59          | -         | -      | 59       |
|   | \$ 5,729 | \$ (2,000 ) | \$ (816 ) | \$ 649 | \$ 3,562 |



The allowance for loan losses at each of the periods presented includes an amount that could not be identified to individual types of loans referred to as the unallocated portion of the allowance. 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. We concluded that the unallocated portion of the allowance was within a reasonable range around the estimate of losses.

Discussion of the provision for (recovery of) loan losses related to specific loan types are provided following:

The recovery of loan losses totaling \$609,000 for the commercial real estate portfolio for the first six months of 2016 was attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio declined primarily as a result of declines in the historical loss experience from 0.70% in the first six months of 2015 to 0.15% in the first six months of 2016. In addition, the portfolio was in a net-recovery position of \$118,000 as of June 30, 2016.

The recovery of loan losses totaling \$203,000 for the consumer real estate portfolio for the six months ended 2016 was also attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio declined primarily as a result of declines in the historical loss experience from 0.24% in 2015 to a net recovery of 0.05% in the second quarter of 2016.

The provision for loan losses totaling \$387,000 for the construction and land development portfolio in 2015 was also attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio increased primarily as a result of an increase in the historical loss experience from a net recovery of 0.27% in 2014 to a net charge-off of 0.34% in 2015. In addition, the portfolio was in a net charge-off position of \$162,000 as of June 30, 2015.

The recovery of loan losses totaling \$428,000 for the consumer real estate portfolio in the first quarter of 2015 was also attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio declined primarily as a result of declines in the historical loss experience from 1.36% in 2014 to 0.68% in the second quarter of 2015. In addition, the portfolio was in a net recovery position of \$222,000 as of June 30, 2015.

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

|   | Recorded Investment in Loans |              | Loans        |           |              |              |
|---|------------------------------|--------------|--------------|-----------|--------------|--------------|
|   | Allowance                    |              | Ending       | Ending    | Individually | Collectively |
|   | Balance                      | Individually | Collectively | Balance   | Individually | Collectively |
| Period Ended June 30, 2016  |                              |              |              |           |              |              |
| Construction and land development                                     |                              |              |              |           |              |              |
| Residential   | \$31                         | \$ -         | \$ 31        | \$5,109   | \$ -         | \$ 5,109     |
| Commercial  | 259                          | 25           | 234          | 24,873    | 1,872        | 23,001       |
|   | 290                          | 25           | 265          | 29,982    | 1,872        | 28,110       |
| Commercial real estate  |                              |              |              |           |              |              |
| Owner occupied  | 711                          | 142          | 569          | 78,753    | 5,869        | 72,884       |
| Non-owner occupied  | 437                          | 1            | 436          | 46,013    | 2,687        | 43,326       |
| Multifamily   | 54                           | -            | 54           | 8,993     | -            | 8,993        |
| Farmland  | 2                            | -            | 2            | 250       | -            | 250          |
|   | 1,204                        | 143          | 1,061        | 134,009   | 8,556        | 125,453      |
| Consumer real estate  |                              |              |              |           |              |              |
| Home equity lines   | 259                          | -            | 259          | 20,694    | 1,178        | 19,516       |
| Secured by 1-4 family residential                                     |                              |              |              |           |              |              |
| First deed of trust   | 490                          | 190          | 300          | 55,289    | 6,100        | 49,189       |
| Second deed of trust  | 133                          | 95           | 38           | 5,914     | 878          | 5,036        |
|   | 882                          | 285          | 597          | 81,897    | 8,156        | 73,741       |
| Commercial and industrial loans (except those secured by real estate) |                              |              |              |           |              |              |
| Student loans   | 226                          | 12           | 214          | 28,859    | 508          | 28,351       |
| Consumer and other  | 191                          | -            | 191          | 46,781    | -            | 46,781       |
|   | 730                          | -            | 730          | 1,691     | -            | 1,691        |
|   | \$3,523                      | \$ 465       | \$ 3,058     | \$323,219 | \$ 19,092    | \$ 304,127   |
| Year Ended December 31, 2015  |                              |              |              |           |              |              |
| Construction and land development                                     |                              |              |              |           |              |              |
| Residential   | \$30                         | \$ -         | \$ 30        | \$5,202   | \$ -         | \$ 5,202     |
| Commercial  | 291                          | 2            | 289          | 25,948    | 1,822        | 24,126       |
|   | 321                          | 2            | 319          | 31,150    | 1,822        | 29,328       |
| Commercial real estate  |                              |              |              |           |              |              |
| Owner occupied  | 1,167                        | 383          | 784          | 69,256    | 6,785        | 62,471       |
| Non-owner occupied  | 460                          | 26           | 434          | 38,037    | 2,867        | 35,170       |
| Multifamily   | 51                           | -            | 51           | 8,537     | -            | 8,537        |
| Farmland  | 17                           | -            | 17           | 388       | -            | 388          |
|   | 1,695                        | 409          | 1,286        | 116,218   | 9,652        | 106,566      |
| Consumer real estate  |                              |              |              |           |              |              |
| Home equity lines   | 448                          | -            | 448          | 20,333    | 1,238        | 19,095       |
| Secured by 1-4 family residential                                     |                              |              |              |           |              |              |

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|   |         |        |          |           |           |            |
|---|---------|--------|----------|-----------|-----------|------------|
| First deed of trust   | 602     | 324    | 278      | 56,776    | 5,759     | 51,017     |
| Second deed of trust  | 111     | 98     | 13       | 6,485     | 1,212     | 5,273      |
|   | 1,161   | 422    | 739      | 83,594    | 8,209     | 75,385     |
| Commercial and industrial loans (except those secured by real estate) | 94      | 18     | 76       | 20,086    | 826       | 19,260     |
| Student loans   | 230     | -      | 230      | 53,989    | -         | 53,989     |
| Consumer and other  | 61      | -      | 61       | 1,734     | -         | 1,734      |
|   | \$3,562 | \$ 851 | \$ 2,711 | \$306,771 | \$ 20,509 | \$ 286,262 |

## Note 6 – Deposits

Deposits as of June 30, 2016 and December 31, 2015 were as follows (dollars in thousands):

|                                     | June 30, 2016 |        | December 31, 2015 |         |
|-------------------------------------|---------------|--------|-------------------|---------|
|                                     | Amount        | %      | Amount            | %       |
| Demand accounts                     | \$78,122      | 21.2 % | \$78,282          | 21.4 %  |
| Interest checking accounts          | 42,361        | 11.5 % | 44,256            | 12.1 %  |
| Money market accounts               | 67,831        | 18.5 % | 64,841            | 17.8 %  |
| Savings accounts                    | 19,820        | 5.4 %  | 19,403            | 5.3 %   |
| Time deposits of \$250,000 and over | 15,077        | 4.1 %  | 9,717             | 2.7 %   |
| Other time deposits                 | 144,413       | 39.3 % | 148,349           | 40.7 %  |
| Total                               | \$367,624     | 100.0% | \$364,848         | 100.0 % |

## Note 7 – Trust preferred securities

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, \$5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at June 30, 2016 was 2.80%. The securities were redeemable at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. No amounts have been redeemed at June 30, 2016 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 June 30, 2016 was 2.05%. The securities may be redeemed at par at any time commencing in December 2012 until the securities mature in 2037. No amounts have been redeemed at June 30, 2016 and there are no plans to do so. 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. The company is current on these interest payments.

## Note 8 – Stock incentive plan

The Village Bank and Trust Financial Corp. Incentive Plan, which was adopted on February 28, 2006, authorized the issuance of up to 48,750 shares of common stock (after the reverse stock split) (the “2006 Plan”). On May 26, 2015, the Company’s shareholders approved the adoption of the Village Bank and Trust Financial Corp. 2015 Stock Incentive Plan (the “2015 Plan”) authorizing the issuance of up to 60,000 shares of common stock. The 2015 Plan was adopted to replace the 2006 Plan and any new awards will be made pursuant to the 2015 Plan. The prior awards made under the 2006 Plan were unchanged by the adoption of the 2015 Plan and continue to be governed by the terms of the 2006 Plan.

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

|  | Six Months Ended June 30,<br>2016 |  |                               | 2015               |         |  |                               |                    |
|--|-----------------------------------|--|-------------------------------|--------------------|---------|--|-------------------------------|--------------------|
|  | Options                           | Weighted<br>Average<br>Exercise<br>Price | Fair<br>Value<br>Per<br>Share | Intrinsic<br>Value | Options | Weighted<br>Average<br>Exercise<br>Price | Fair<br>Value<br>Per<br>Share | Intrinsic<br>Value |
| Options outstanding, beginning of period | 2,929                             | \$ 24.47                                 | \$12.71                       | \$ -               | 6,830   | \$ 92.34                                 | \$52.74                       | \$ -               |
| Granted                                  | -                                 | -  | -                             | -                  | -       | -  | -                             | -                  |
| Forfeited                                | -                                 | -  | -                             | -                  | (2,012) | 171.03                                   | 94.35                         | -                  |
| Exercised                                | -                                 | -  | -                             | -                  | -       | -  | -                             | -                  |
| Options outstanding, end of period       | 2,929                             | \$ 24.47                                 | \$12.71                       | \$ -               | 4,818   | \$ 59.48                                 | \$35.36                       | \$ -               |
| Options exercisable, end of period       | 1,730                             |  |                               |                    | 3,306   |  |                               |                    |

During the third quarter of 2015, we granted certain officers 40,675 restricted shares of common stock with a weighted average fair market value of \$19.72 at the date of grant. These restricted stock awards have three-year grading vesting. Prior to vesting, these shares are subject to forfeiture to us without consideration upon termination of employment under certain circumstances. The total number of shares underlying non-vested restricted stock was 50,253 and 14,096 at June 30, 2016 and 2015, respectively.

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 stock incentive plan as of June 30, 2016 and 2015, was \$856,794 and \$363,030,

respectively. The time based unamortized compensation of \$364,375 is expected to be recognized over a weighted average period of 1.76 years.

Stock-based compensation expense was approximately \$167,000 and \$172,000 for the six months ended June 30, 2016 and 2015, 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 held for sale: Assets held for sale were transferred from premises and equipment at cost less accumulated depreciation at the date of transfer. The Company periodically evaluates the value of assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. 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 assets held for sale 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 asset held for sale 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 (dollars in thousands):

|                                  | Fair Value Measurement<br>at June 30, 2016 Using                           |  |  |       |
|----------------------------------|--|--|--|-------|
|                                  | 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) |       |
| Carrying Value                   |  |  |  |       |
| Financial Assets - Recurring     |  |  |  |       |
| US Government Agencies           | \$18,515   | \$ 3,118                                   | \$ 15,397  | \$ -  |
| Mortgage-backed securities       | 2,644  | -  | 2,644  | -     |
| Financial Assets - Non-Recurring |  |  |  |       |
| Impaired loans                   | 19,092   | -  | 17,752   | 1,340 |
| Assets held for sale             | 841  | -  | 841  | -     |
| Real estate owned                | 3,941  | -  | 3,941  | -     |

|                                  | Fair Value Measurement<br>at December 31, 2015 Using                       |  |  |       |
|----------------------------------|--|--|--|-------|
|                                  | 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) |       |
| Carrying Value                   |  |  |  |       |
| Financial Assets - Recurring     |  |  |  |       |
| US Government Agencies           | \$33,713   | \$ 3,307                                   | \$ 30,406  | \$ -  |
| Mortgage-backed securities       | 3,001  | -  | 3,001  | -     |
| Municipals                       | 1,205  | -  | 1,205  | -     |
| Financial Assets - Non-Recurring |  |  |  |       |
| Impaired loans                   | 20,509   | -  | 18,862   | 1,647 |
| Assets held for sale             | 12,631   | -  | 12,631   | -     |
| Real estate owned                | 6,249  | -  | 6,190  | 59    |

The following tables present qualitative information about Level 3 fair value measurements for financial instruments measured at fair value at June 30, 2016 and December 31, 2015 (dollars in thousands):

| June 30, 2016                            |   |   | Range<br>(Weighted<br>Average)                          |              |
|--|---|---|---|--------------|
| Fair Value                               | Valuation<br>Estimate<br>(In thousands) | Unobservable<br>Input                   |   |              |
| Impaired loans - real estate secured     | \$751                                   | Appraisal (1) or Internal Valuation (2) | Selling costs   | 6%-10% (7)%  |
|  |   |   | Discount for lack of marketability and age of appraisal | 6%-30% (10)% |
| Impaired loans - non-real estate secured | \$589                                   | Appraisal (1) or Discounted Cash Flow   | Selling costs   | 10%          |
|  |   |   | Discount for lack of marketability or practical life    | 0%-50% (20)% |
| Assets held for sale                     | \$841                                   | Appraisal (1) or Internal Valuation (2) | Selling costs   | 6%-10% (7)%  |
|  |   |   | Discount for lack of marketability and age of appraisal | 6%-30% (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

| December 31, 2015                        |                                    |   |   | Range              |
|--|------------------------------------|---|---|--------------------|
|  | Fair Value Estimate (In thousands) | Valuation Techniques                    | Unobservable Input                                      | (Weighted Average) |
| Impaired loans - real estate secured     | \$1,042                            | Appraisal (1) or Internal Valuation (2) | Selling costs   | 6%-10% (7)%        |
|  |                                    |   | Discount for lack of marketability and age of appraisal | 6%-30% (10) )%     |
| Impaired loans - non-real estate secured | \$605                              | Appraisal (1) or Discounted Cash Flow   | Selling costs   | 10 )%              |
|  |                                    |   | Discount for lack of marketability or practical life    | 0%-50% (20) )%     |
| Real estate owned                        | \$59                               | Appraisal (1) or Internal Valuation (2) | Selling costs   | 6%-10% (7)%        |
|  |                                    |   | Discount for lack of marketability and age of appraisal | 6%-30% (15) )%     |
| Assets held for sale                     | \$12,631                           | Appraisal (1) or Internal Valuation (2) | Selling costs   | 6%-10% (7)%        |
|  |                                    |   | Discount for lack of marketability and age of appraisal | 6%-30% (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 quarterly 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.

*Assets held for sale* – The carrying value of assets held for sale is based on fair value less selling costs. Fair values for assets held for sale are estimated based on appraised values of the asset or management’s estimation of the value of the assets.

*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.

|  |   | June 30,<br>2016  |                         | December 31,<br>2015 |                         |
|--|---|-------------------|-------------------------|----------------------|-------------------------|
|  | Level in Fair<br>Value<br>Hierarchy<br>(In thousands) | Carrying<br>Value | Estimated<br>Fair Value | Carrying<br>Value    | Estimated<br>Fair Value |
| Financial assets                         |   |                   |                         |                      |                         |
| Cash                                     | Level 1   | \$12,638          | \$12,638                | \$17,076             | \$17,076                |
| Cash equivalents                         | Level 2   | 16,323            | 16,323                  | 186                  | 186                     |
| Investment securities available for sale | Level 1   | 3,118             | 3,118                   | 3,307                | 3,307                   |
| Investment securities available for sale | Level 2   | 18,041            | 18,041                  | 34,612               | 34,612                  |
| Federal Home Loan Bank stock             | Level 2   | 546               | 546                     | 685                  | 685                     |
| Loans held for sale                      | Level 2   | 16,164            | 16,164                  | 14,373               | 14,373                  |
| Loans                                    | Level 2   | 304,127           | 292,133                 | 286,262              | 274,230                 |
| Impaired loans                           | Level 2   | 17,752            | 17,752                  | 18,862               | 18,862                  |
| Impaired loans                           | Level 3   | 1,340             | 1,340                   | 1,647                | 1,647                   |
| Assets held for sale                     | Level 2   | 841               | 841                     | 12,631               | 12,631                  |

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|                             |         |         |         |         |         |
|-----------------------------|---------|---------|---------|---------|---------|
| Other real estate owned     | Level 2 | 3,941   | 3,941   | 6,190   | 6,190   |
| Other real estate owned     | Level 3 | -       | -       | 59      | 59      |
| Bank owned life insurance   | Level 3 | 7,223   | 7,223   | 7,130   | 7,130   |
| Accrued interest receivable | Level 2 | 1,962   | 1,962   | 2,060   | 2,060   |
| Financial liabilities       |         |         |         |         |         |
| Deposits                    | Level 2 | 367,624 | 368,077 | 364,848 | 365,294 |
| FHLB borrowings             | Level 2 | 3,200   | 3,210   | 6,000   | 6,004   |
| Trust preferred securities  | Level 2 | 8,764   | 8,796   | 8,764   | 8,984   |
| Other borrowings            | Level 2 | 316     | 316     | 508     | 508     |
| Accrued interest payable    | Level 2 | 80      | 80      | 1,346   | 1,346   |



Note 10 – Segment Reporting

In previous reports, the Company had concluded that it had one operating and reportable segment, “Community Banking”. This conclusion was based on the fact that the Company’s activities are interrelated, and each activity is dependent and assessed based on how each of the activities supports the others. The Company has re-assessed its segment reporting and decided to report two segments: traditional commercial banking and mortgage banking as management has changed the information it reviews to make decisions. Revenues from commercial banking operations consist primarily of interest earned on loans and securities and fees from deposit services. Mortgage banking operating revenues consist principally of interest earned on mortgage loans held for sale, gains on sales of loans in the secondary mortgage market, and loan origination fee income.

The commercial banking segment provides the mortgage banking segment with the short-term funds needed to originate mortgage loans through a warehouse line of credit and charges the mortgage banking segment interest based on the commercial banking segment’s cost of funds. Additionally, the mortgage banking segment leases premises from the commercial banking segment. These transactions are eliminated in the consolidation process.

The following table presents segment information as of and for the three and six months ended June 30, 2016 and 2015 (in thousands):

|                                   | Commercial<br>Banking | Mortgage<br>Banking | Eliminations | Consolidated<br>Totals |
|-----------------------------------|-----------------------|---------------------|--------------|------------------------|
| Three Months Ended June 30, 2016  |                       |                     |              |                        |
| Revenues                          |                       |                     |              |                        |
| Interest income                   | \$ 3,801              | \$ 116              | \$ (30       | ) \$ 3,887             |
| Gain on sale of loans             | -                     | 1,441               |              | 1,441                  |
| Other revenues                    | 1,381                 | 209                 | (45          | ) 1,545                |
| Total revenues                    | 5,182                 | 1,766               | (75          | ) 6,873                |
| Expenses                          |                       |                     |              |                        |
| Interest expense                  | 658                   | 30                  | (30          | ) 658                  |
| Salaries and benefits             | 1,877                 | 882                 |              | 2,759                  |
| Commissions                       | -                     | 381                 |              | 381                    |
| Other expenses                    | 2,206                 | 255                 | (45          | ) 2,416                |
| Total operating expenses          | 4,741                 | 1,548               | (75          | ) 6,214                |
| Income before income taxes        | \$ 441                | \$ 218              | \$ -         | \$ 659                 |
| Total assets                      | \$ 421,572            | \$ 9,096            | \$ (11,127   | ) \$ 419,541           |
| Three Months Ended June 30, 2015  |                       |                     |              |                        |
| Revenues                          |                       |                     |              |                        |
| Interest income                   | \$ 3,768              | \$ 129              | \$ (33       | ) \$ 3,864             |
| Gain on sale of loans             | -                     | 1,728               |              | 1,728                  |
| Other revenues                    | 846                   | 210                 | (48          | ) 1,008                |
| Total revenues                    | 4,614                 | 2,067               | (81          | ) 6,600                |
| Expenses                          |                       |                     |              |                        |
| Interest expense                  | 723                   | 33                  | (33          | ) 723                  |
| Salaries and benefits             | 1,837                 | 874                 |              | 2,711                  |
| Commissions                       | -                     | 443                 |              | 443                    |
| Other expenses                    | 2,393                 | 294                 | (48          | ) 2,639                |
| Total operating expenses          | 4,953                 | 1,644               | (81          | ) 6,516                |
| Income (loss) before income taxes | \$ (339               | ) \$ 423            | \$ -         | \$ 84                  |
| Total assets                      | \$ 430,169            | \$ 8,850            | \$ (10,953   | ) \$ 428,066           |



|                                | Commercial<br>Banking | Mortgage<br>Banking | Eliminations | Consolidated<br>Totals |
|--------------------------------|-----------------------|---------------------|--------------|------------------------|
| Six Months Ended June 30, 2016 |                       |                     |              |                        |
| Revenues                       |                       |                     |              |                        |
| Interest income                | \$ 7,630              | \$ 198              | \$ (42       | ) \$ 7,786             |
| Gain on sale of loans          | -                     | 2,587               |              | 2,587                  |
| Other revenues                 | 2,389                 | 304                 | (98          | ) 2,595                |
| Total revenues                 | 10,019                | 3,089               | (140         | ) 12,968               |
| Expenses                       |                       |                     |              |                        |
| Interest expense               | 1,298                 | 42                  | (42          | ) 1,298                |
| Salaries and benefits          | 3,763                 | 1,655               |              | 5,418                  |
| Commissions                    | -                     | 630                 |              | 630                    |
| Other expenses                 | 4,147                 | 512                 | (98          | ) 4,561                |
| Total operating expenses       | 9,208                 | 2,839               | (140         | ) 11,907               |
| Income before income taxes     | \$ 811                | \$ 250              | \$ -         | \$ 1,061               |
| Total assets                   | \$ 421,572            | \$ 9,096            | \$ (11,127   | ) \$ 419,541           |

|                                   | Commercial<br>Banking | Mortgage<br>Banking | Eliminations | Consolidated<br>Totals |
|-----------------------------------|-----------------------|---------------------|--------------|------------------------|
| Six Months Ended June 30, 2015    |                       |                     |              |                        |
| Revenues                          |                       |                     |              |                        |
| Interest income                   | \$ 7,509              | \$ 200              | \$ (48       | ) \$ 7,661             |
| Gain on sale of loans             | -                     | 2,957               |              | 2,957                  |
| Other revenues                    | 1,656                 | 423                 | (130         | ) 1,949                |
| Total revenues                    | 9,165                 | 3,580               | (178         | ) 12,567               |
| Expenses                          |                       |                     |              |                        |
| Interest expense                  | 1,481                 | 48                  | (48          | ) 1,481                |
| Salaries and benefits             | 3,754                 | 1,625               |              | 5,379                  |
| Commissions                       | -                     | 735                 |              | 735                    |
| Other expenses                    | 4,496                 | 527                 | (130         | ) 4,893                |
| Total operating expenses          | 9,731                 | 2,935               | (178         | ) 12,488               |
| Income (loss) before income taxes | \$ (566               | ) \$ 645            | \$ -         | \$ 79                  |
| Total assets                      | \$ 430,169            | \$ 8,850            | \$ (10,953   | ) \$ 428,066           |

Note 11 – Shareholders’ equity and regulatory matters

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 \$70.88 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 Warrant was determined to be \$10,742,000 with 95% of the aggregate attributable to the preferred stock and 5% attributable to the 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 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 was 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 accrued cumulative dividends at a rate of 5% until May 1, 2014 and now accrues at a 9% rate. The preferred stock is generally non-voting, other than on certain matters that could adversely affect the preferred stock.

The Warrant was 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.

In accordance with the Company’s prior Written Agreement with the Federal Reserve Bank of Richmond (the “Reserve Bank”), the Company has been deferring quarterly cash dividends on the preferred stock since May 2011. The total arrearage on such preferred stock as of June 30, 2016 was \$2,437,935. This amount has been accrued for and is included in other liabilities in the consolidated balance sheet. With the termination of the Written Agreement as of July 28, 2016, the Company is not required to defer the quarterly cash dividends on the preferred stock, however the Company is evaluating various options with respect to the preferred stock.

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

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 affect 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.

On March 27, 2015, the Company completed a rights offering to shareholders (the “Rights Offering”) and concurrent standby offering to Kenneth R. Lehman (the “Standby Offering”), in which the Company issued an aggregate of 1,051,866 shares of common stock (the total number of shares offered) at \$13.87 per share for aggregate gross proceeds of \$14,589,381 (including the value of the Company’s preferred stock exchanged by Mr. Lehman for shares of common stock of \$4,618,813). In connection with the Rights Offering, 283,293 shares were issued to shareholders upon exercise of their basic subscription rights and 191,773 shares were issued to shareholders upon exercise of their oversubscription privileges (approximately 36.9% of the total number of shares requested pursuant to oversubscription privileges). In connection with the Standby Offering, Mr. Lehman purchased an aggregate of 576,800 shares of the Company’s common stock, 333,007 of which were issued in exchange for 9,023 shares of the Company’s preferred stock and 243,793 of which were purchased for cash. Also, as part of the Standby Offering, Mr. Lehman forgave \$2,215,009 in accrued and unpaid dividends on the preferred 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.

Under the final capital rules that became effective on January 1, 2015, there was a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets, which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. We have included the 0.625% increase for 2016 in our minimum capital adequacy ratios in the table below. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. Management believes that, as of June 30, 2016, the Company would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

The Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board’s Small Bank Holding Company Policy Statement issued February 2015, and is no longer obligated to report consolidated regulatory capital. The Bank continues to be subject to various capital requirements administered by banking agencies. The capital amounts and ratios at June 30, 2016 and December 31, 2015 for the Bank are presented in the table below (dollars in thousands):

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|  | Actual   |        | For Capital Adequacy Purposes |       | Minimum Capital Adequacy with Capital buffer |        | To be Well Capitalized |        |
|--|----------|--------|-------------------------------|-------|--|--------|------------------------|--------|
|  | Amount   | Ratio  | Amount                        | Ratio | Amount                                       | Ratio  | Amount                 | Ratio  |
| June 30, 2016  |          |        |                               |       |  |        |                        |        |
| Total capital (to risk-weighted assets) Village Bank           | \$44,088 | 14.68% | \$24,022                      | 8.00% | \$25,898                                     | 8.625% | \$30,027               | 10.00% |
| Tier 1 capital (to risk-weighted assets) Village Bank          | \$40,565 | 13.51% | \$12,011                      | 4.00% | \$19,893                                     | 6.625% | \$18,016               | 6.00%  |
| Leverage ratio (Tier 1 capital to average assets) Village Bank | \$40,565 | 6.68%  | \$16,762                      | 4.00% | N/A  | N/A    | \$20,952               | 5.00%  |
| Common equity tier 1 (to risk-weighted assets) VillageBank     | \$40,565 | 13.51% | \$13,512                      | 4.50% | \$15,389                                     | 5.125% | \$19,517               | 6.50%  |
| December 31, 2015  |          |        |                               |       |  |        |                        |        |
| Total capital (to risk-weighted assets) Village Bank           | \$42,695 | 14.02% | \$24,369                      | 8.00% | N/A  | N/A    | \$30,461               | 10.00% |
| Tier 1 capital (to risk-weighted assets) Village Bank          | \$39,133 | 12.85% | \$12,184                      | 4.00% | N/A  | N/A    | \$18,277               | 6.00%  |
| Leverage ratio (Tier 1 capital to average assets) Village Bank | \$39,133 | 9.33%  | \$16,776                      | 4.00% | N/A  | N/A    | \$20,970               | 5.00%  |
| Common equity tier 1 (to risk-weighted assets) VillageBank     | \$39,133 | 12.85% | \$13,707                      | 4.50% | N/A  | N/A    | \$15,231               | 6.50%  |

Note 12 – 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):

|   | June 30,<br>2016 | December 31,<br>2015 |
|---|------------------|----------------------|
| Undisbursed credit lines                  | \$52,812         | \$ 46,656            |
| Commitments to extend or originate credit | 31,932           | 9,132                |
| Standby letters of credit                 | 3,627            | 1,484                |
| Total commitments to extend credit        | \$88,371         | \$ 57,272            |

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.

Approximately 15% of the Company's loan portfolio consists of student loans that are guaranteed by the DOE and covers approximately 98% of the principal and interest in the event of default. The Company utilizes a third party vendor with significant experience and expertise to service these loans. In the unlikely event that the third party servicer does not service the loans in accordance with the DOE requirements and could not reimburse the Company for losses sustained as a result of servicing errors, the Company could sustain additional losses beyond what has been factored in the allowance for loan losses.

*Prior Agreements with Regulators* – In February 2012, the Bank entered into a Stipulation and Consent to the Issuance of a Consent Order with the Federal Deposit Insurance Corporation (the “FDIC”) and the Virginia Bureau of Financial Institutions (the “Supervisory Authorities”), and the Supervisory Authorities issued the related Consent Order effective February 3, 2012 (the “Consent Order”). In June 2012, the Company entered into a similar written agreement (the “Written Agreement”) with the Reserve Bank. As a result of the steps the Company and the Bank took to, among other things, improve asset quality, increase capital, augment management and board oversight, and increase earnings, the Consent Order was terminated effective December 14, 2015. In place of the Consent Order, the Bank’s Board of Directors made certain written assurances to the Supervisory Authorities in the form of a Memorandum of Understanding (“MOU”) that became effective November 17, 2015. Due to further improvements by the Company and the Bank in asset quality and earnings, and the correction of a prior Regulation W violation, the MOU was terminated effective May 12, 2016, and the Written Agreement was terminated effective July 28, 2016. With the terminations of the MOU and the Written Agreement, neither the Company nor the Bank is under any formal or informal agreements with its regulators.

Note 13 – 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. While the Company has been experiencing a consistent pattern of quantitative and subjective positive evidence to support the ability to realize the tax benefits of the net deferred tax asset, management believes it is appropriate to maintain a valuation allowance at June 30, 2016 of \$11,657,000. The net operating losses available to offset future taxable income amounted to \$23,663,000 at June 30, 2016 and begin expiring in 2028, \$1,257,000 of such amount is subject to a limitation by Section 382 of the Internal Revenue Code of 1986, as amended, to \$908,000 per year.

Note 14 – Recent accounting pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The amendments in this ASU modify the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The ASU requires that entities apply a specific method to recognize revenue reflecting the consideration expected from customers in exchange for the transfer of goods and services. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. Entities are also required to disclose significant judgments and changes in judgments for determining the satisfaction of performance obligations. Most revenue associated with financial instruments, including interest and loan origination fees, is outside the scope of the guidance. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2016, with early adoption prohibited. In April 2015, the FASB proposed to delay the effective date of this standard for one year. The Company is evaluating the effect ASU 2014-09 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU 2014-12, Compensation-Stock Compensation. The guidance in this ASU requires that a performance target that affects vesting and that could be achieved after the requisite service is treated as a performance condition. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite period, the remaining unrecognized cost should be recognized prospectively over the remaining service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period. The guidance in this ASU is effective for annual and interim periods beginning after December 15, 2015. This ASU did not have a significant impact on our financial condition or results of operations.

In January 2016, the FASB issued ASU No. 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities.” This ASU requires an entity to: (i) measure equity investments at fair value through net income, with certain exceptions; (ii) present in Other Comprehensive Income the changes in instrument-specific credit risk for financial liabilities measured using the fair value option; (iii) present financial assets and financial liabilities by measurement category and form of financial asset; (iv) calculate the fair value of financial instruments for disclosure purposes based on an exit price and; (v) assess a valuation allowance on deferred tax assets related to unrealized losses of AFS debt securities in combination with other deferred tax assets. The ASU provides an election to subsequently measure certain nonmarketable equity investments at cost less any impairment and adjusted for certain observable price changes. The ASU also requires a qualitative impairment assessment of such equity investments and amends certain fair value disclosure requirements. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is only permitted for the provision related to instrument-specific credit risk. The Company is currently assessing the impact of ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, “Leases”. This ASU requires lessees to recognize assets and liabilities arising from most operating leases on the statement of financial position. The Company is currently evaluating the impact of ASU 2016-02, which is effective for the Company on January 1, 2019.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” This ASU amends guidance on reporting credit losses for assets held at amortized cost basis and available-for-sale debt securities by eliminating the probable initial recognition threshold (incurred loss methodology) and requiring entities to reflect its current estimate of all expected credit losses. The amendments in the ASU are effective beginning after December 15, 2019 and for interim periods within that year. Early adoption is permitted beginning after December 15, 2018. Entities will apply the amendments in this ASU through a cumulative-effect adjustment to retained earnings in the first period effective. The Company is currently evaluating the potential impact of ASU 2016-13 on its financial statements.



## 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:

- changes in assumptions underlying the establishment of allowances for loan losses, and other estimates;
- 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;
- the effects of future economic, business and market conditions;
- the inability of the Company and the Bank to comply with the requirements of agreements with its regulators;
- our inability to maintain our regulatory capital position;
- the Company's computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance, or other disruptions despite security measures implemented by the Company;
- 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;
- changes in operations 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 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;
- governmental monetary and fiscal policies;
- changes in accounting policies, rules and practices;

- reliance on our management team, including our ability to attract and retain key personnel;



competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;

- demand, development and acceptance of new products and services;
- problems with technology utilized by us;
- changing trends in customer profiles and behavior; and
- other factors described from time to time in our reports filed with the SEC.

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.

## **Results of operations**

The following presents management's discussion and analysis of the financial condition of the Company at June 30, 2016 and December 31, 2015 and the results of operations for the Company for the three and six months ended June 30, 2016 and 2015. 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 June 30, 2016, the Company had net income of \$659,000 and net income available to common shareholders of \$476,000, or \$0.34 per fully diluted share, compared to net income of \$84,000 and net loss available to common shareholders of \$(83,000), or \$(.06) per fully diluted share, for the same period in 2015. For the six months ended June 30, 2016, the Company had net income of \$1,061,000 and net income available to common shareholders of \$700,000, or \$0.50 per fully diluted share, compared to net income of \$79,000 and net income available to common shareholders of \$6,368,000, or \$6.92 per fully diluted share.

There were significant changes in income and expense items when comparing the 2016 and 2015 results. The more significant changes are reflected in the following table (in thousands):

|  | Q2 2016<br>Compared to<br>Q2 2015 | Six Months 2016<br>Compared to<br>Six Months 2015 |
|--|-----------------------------------|---|
| Increase (decrease) in                     |                                   |   |
| Net interest income                        | \$ 88                             | \$ 308  |
| Gains on loan sales                        | (287 )                            | (370 )  |
| Gain on sale of assets                     | 504                               | 504   |
| Gain on sale of investments                | 38                                | 140   |
| Rental income                              | 12                                | 92  |
| (Increase) decrease in                     |                                   |   |
| Professional and outside services          | (109 )                            | (180 )  |
| Writedown of assets held for sale          | 467                               | 467   |
| Expenses related to foreclosed real estate | (288 )                            | (257 )  |
| FDIC premium                               | 99                                | 271   |
|  | \$ 524                            | \$ 975  |

### *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 shareholders' equity. Net interest spread is the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities. The net yield on interest-earning assets ("net interest margin") is calculated by dividing tax equivalent net interest income by average interest-earning assets. Generally, the net interest margin will exceed the net interest spread because a portion of interest earning assets are funded by various noninterest-bearing sources, principally noninterest-bearing deposits and shareholders' equity.

Net interest income of \$3,229,000 for the second quarter of 2016 represents an increase of \$88,000, or 3%, compared to the second quarter of 2015. Net interest income was increased due to an increase in average loans outstanding of \$25,892,000 increasing interest income on loans by \$112,000, as well as a decline in average interest-bearing liabilities of \$14,845,000 decreasing interest expense by \$65,000. These increases in net interest income were offset by a decline in interest income on investment securities of \$85,000 as a result of sales of securities in 2016.

Net interest income of \$6,488,000 for the first six months of 2016 represents an increase of \$308,000, or 5%, compared to the same period in 2015. Net interest income was increased due to an increase in average loans outstanding of \$24,349,000, increasing interest income on loans by \$253,000, as well as a decline in average interest-bearing liabilities of \$18,615,000, decreasing interest expense by \$183,000. These increases in net interest income were offset by a decline in interest income on investment securities of \$120,000 as a result of sales of securities in 2016.

Average interest-bearing assets for the second quarter of 2016 declined by \$9,304,000, or 3%, compared to the same period in 2015. Although average interest-bearing assets declined slightly, the mix improved to higher yielding loans from lower yielding securities and federal funds sold. This improvement in the interest-bearing asset mix resulted in a higher yield of 4.30% in 2016 compared to 4.15% in 2015.

Average interest-bearing liabilities for the second quarter of 2016 declined by \$18,615,000, or 6%, compared to the same period in 2015. This decline was a result of declines in average deposits of \$9,856,000 and average borrowings of \$8,759,000. Until the first quarter of 2016, loan demand was not strong so we utilized liquidity to allow higher cost certificates of deposit and borrowings to run off. As a result, the average cost of interest-bearing liabilities decreased to 0.86% for the six months ended June 30, 2016 from 0.93% for the six months ended June 30, 2015. See our discussion of interest rate sensitivity below for more information.

The Company's net interest margin is not a measurement under accounting principles generally accepted in the United States of America, 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      | Interest<br>Margin |
|--------------------|--------------------|
| June 30, 2015      | 3.34 %             |
| September 30, 2015 | 3.45 %             |
| December 31, 2015  | 3.46 %             |
| March 31, 2016     | 3.63 %             |
| June 30, 2016      | 3.56 %             |

The decline in our net interest margin of 7 basis points for the three months ended June 30, 2016 compared to March 31, 2016 was attributable to a decrease in yield on interest-bearing assets of 5 basis points and an increase in our cost of funds of 2 basis points. The decrease in yield on interest-bearing assets is a result of the recognition of approximately \$50,000 in accrued interest income during the first three months of 2016 from moving one loan from nonaccrual to accrual status, which increased the net interest margin by 6 basis points for the period ended March 31, 2016.

The 2 basis point decline in our cost of funds resulted because we utilized liquidity to allow higher cost certificates of deposit and borrowings to run off. Noninterest bearing demand deposits represented 21.2% of our total deposits at June 30, 2016 compared to 20.1% at June 30, 2015.

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



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|   | Three Months Ended June 30,<br>2016 |                                |                             |   | Three Months Ended June 30,<br>2015 |                                |                             |   |
|---|-------------------------------------|--------------------------------|-----------------------------|---|-------------------------------------|--------------------------------|-----------------------------|---|
|   | Average<br>Balance                  | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate |   | Average<br>Balance                  | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate |   |
| Loans net of deferred fees  | \$ 317,877                          | \$ 3,688                       | 4.67                        | % | \$ 291,985                          | \$ 3,563                       | 4.89                        | % |
| Loans held for sale   | 12,559                              | 116                            | 3.71                        | % | 13,223                              | 129                            | 3.91                        | % |
| Investment securities   | 21,969                              | 69                             | 1.26                        | % | 38,843                              | 154                            | 1.59                        | % |
| Federal funds and other   | 11,998                              | 14                             | 0.47                        | % | 32,868                              | 18                             | 0.22                        | % |
| Total interest earning assets   | 364,403                             | 3,887                          | 4.29                        | % | 376,919                             | 3,864                          | 4.11                        | % |
| Allowance for loan losses and deferred fees   | (3,566 )                            |                                |                             |   | (5,778 )                            |                                |                             |   |
| Cash and due from banks   | 17,758                              |                                |                             |   | 8,591                               |                                |                             |   |
| Premises and equipment, net   | 13,651                              |                                |                             |   | 14,857                              |                                |                             |   |
| Other assets  | 29,241                              |                                |                             |   | 38,359                              |                                |                             |   |
| Total assets  | \$ 421,487                          |                                |                             |   | \$ 432,948                          |                                |                             |   |
| Interest bearing deposits   |                                     |                                |                             |   |                                     |                                |                             |   |
| Interest checking   | \$ 42,947                           | \$ 19                          | 0.18                        | % | \$ 44,344                           | \$ 20                          | 0.18                        | % |
| Money market  | 67,931                              | 62                             | 0.37                        | % | 68,147                              | 63                             | 0.37                        | % |
| Savings   | 19,790                              | 9                              | 0.18                        | % | 20,678                              | 9                              | 0.17                        | % |
| Certificates  | 159,665                             | 505                            | 1.27                        | % | 164,645                             | 528                            | 1.29                        | % |
| Total   | 290,333                             | 595                            | 0.82                        | % | 297,814                             | 620                            | 0.84                        | % |
| Borrowings  | 13,072                              | 63                             | 1.94                        | % | 20,436                              | 103                            | 2.02                        | % |
| Total interest bearing liabilities  | 303,405                             | 658                            | 0.87                        | % | 318,250                             | 723                            | 0.91                        | % |
| Noninterest bearing deposits  | 78,700                              |                                |                             |   | 75,669                              |                                |                             |   |
| Other liabilities   | 7,766                               |                                |                             |   | 8,333                               |                                |                             |   |
| Total liabilities   | 389,871                             |                                |                             |   | 402,252                             |                                |                             |   |
| Equity capital  | 31,616                              |                                |                             |   | 30,696                              |                                |                             |   |
| Total liabilities and capital   | \$ 421,487                          |                                |                             |   | \$ 432,948                          |                                |                             |   |
| Net interest income before provision for loan losses  |                                     | \$ 3,229                       |                             |   | \$ 3,141                            |                                |                             |   |
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities |                                     |                                | 3.42                        | % |                                     |                                | 3.20                        | % |
| Annualized net interest margin (net interest income expressed as percentage of average earning assets)        |                                     |                                | 3.56                        | % |                                     |                                | 3.34                        | % |

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|   | Six Months Ended June 30,<br>2016 |                                |                             | Six Months Ended June 30, 2015 |                                |                             |  |
|---|-----------------------------------|--------------------------------|-----------------------------|--------------------------------|--------------------------------|-----------------------------|--|
|   | Average<br>Balance                | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate | Average<br>Balance             | Interest<br>Income/<br>Expense | Annualized<br>Yield<br>Rate |  |
| Loans net of deferred fees  | \$ 314,478                        | \$ 7,371                       | 4.70 %                      | \$ 290,129                     | \$ 7,116                       | 4.95 %                      |  |
| Loans held for sale   | 10,269                            | 198                            | 3.87 %                      | 11,022                         | 200                            | 3.66 %                      |  |
| Investment securities   | 26,772                            | 189                            | 1.42 %                      | 37,469                         | 309                            | 1.66 %                      |  |
| Federal funds and other   | 11,266                            | 28                             | 0.50 %                      | 33,469                         | 36                             | 0.22 %                      |  |
| Total interest earning assets   | 362,785                           | 7,786                          | 4.30 %                      | 372,089                        | 7,661                          | 4.15 %                      |  |
| Allowance for loan losses and deferred fees   | (3,605 )                          |                                |                             | (5,809 )                       |                                |                             |  |
| Cash and due from banks   | 17,650                            |                                |                             | 9,642                          |                                |                             |  |
| Premises and equipment, net   | 13,655                            |                                |                             | 14,710                         |                                |                             |  |
| Other assets  | 30,577                            |                                |                             | 39,051                         |                                |                             |  |
| Total assets  | \$ 421,062                        |                                |                             | \$ 429,683                     |                                |                             |  |
| Interest bearing deposits   |                                   |                                |                             |                                |                                |                             |  |
| Interest checking   | \$ 43,420                         | \$ 39                          | 0.18 %                      | \$ 44,132                      | \$ 40                          | 0.18 %                      |  |
| Money market  | 66,946                            | 122                            | 0.37 %                      | 67,478                         | 125                            | 0.37 %                      |  |
| Savings   | 19,711                            | 18                             | 0.18 %                      | 20,550                         | 18                             | 0.18 %                      |  |
| Certificates  | 159,142                           | 1,015                          | 1.28 %                      | 166,915                        | 1,073                          | 1.30 %                      |  |
| Total   | 289,219                           | 1,194                          | 0.83 %                      | 299,075                        | 1,256                          | 0.85 %                      |  |
| Borrowings  | 14,019                            | 104                            | 1.49 %                      | 22,778                         | 225                            | 1.99 %                      |  |
| Total interest bearing liabilities  | 303,238                           | 1,298                          | 0.86 %                      | 321,853                        | 1,481                          | 0.93 %                      |  |
| Noninterest bearing deposits  | 78,109                            |                                |                             | 73,004                         |                                |                             |  |
| Other liabilities   | 8,374                             |                                |                             | 9,390                          |                                |                             |  |
| Total liabilities   | 389,721                           |                                |                             | 404,247                        |                                |                             |  |
| Equity capital  | 31,341                            |                                |                             | 25,436                         |                                |                             |  |
| Total liabilities and capital   | \$ 421,062                        |                                |                             | \$ 429,683                     |                                |                             |  |
| Net interest income before provision for loan losses  |                                   | \$ 6,488                       |                             |                                | \$ 6,180                       |                             |  |
| Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities |                                   |                                | 3.46 %                      |                                |                                | 3.23 %                      |  |
| Annualized net interest margin (net interest income expressed as percentage of average earning assets)        |                                   |                                | 3.59 %                      |                                |                                | 3.35 %                      |  |

*Provision for (recovery of) loan losses*



The amount of the loan loss provision (recovery) is determined by an evaluation of the level of loans outstanding, the level of non-performing loans, historical loan loss experience, delinquency trends, underlying collateral values, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions.

The level of the allowance reflects changes in the size of the portfolio or in any of its components as well as management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Company did not record a provision for loan losses for the three and six months ended June 30, 2016 and 2015.

The provision for (recovery of) loan losses by category is presented following (in thousands):

|                                   | Six Months Ended June 30, |             | 2015       |             |
|-----------------------------------|---------------------------|-------------|------------|-------------|
|                                   | 2016                      |             | 2015       |             |
|                                   | Average                   |             | Average    |             |
|                                   | Provision                 | Loans       | Provision  | Loans       |
|                                   | (Recovery)                | Outstanding | (Recovery) | Outstanding |
| Construction and land development | \$(32 )                   | \$ 30,566   | \$387      | \$ 30,491   |
| Commercial real estate            | (609)                     | 125,113     | 36         | 110,452     |
| Consumer real estate              | (203)                     | 82,745      | (428)      | 88,428      |
| Commercial and industrial         | 88                        | 24,472      | (20 )      | 22,141      |
| Guaranteed student loans          | 88                        | 50,382      | 37         | 40,806      |
| Consumer                          | 5                         | 1,712       | (12 )      | 1,569       |
| Unallocated                       | 663                       | -           | -          | -           |
|                                   | \$-                       | \$ 314,990  | \$-        | \$ 293,887  |

The allowance for loan losses at each of the periods presented includes an amount that could not be identified to individual types of loans referred to as the unallocated portion of the allowance. 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. We concluded that the unallocated portion of the allowance was acceptable given the continued higher level of classified assets and was within a reasonable range around the estimate of losses. At June 30, 2016 the allowance for loan losses included an unallocated amount of approximately \$722,000 compared to \$59,000 at December 31, 2015.

Discussion of the provision for (recovery of) loan losses related to specific loan types are provided following:

The recovery of loan losses totaling \$609,000 for the commercial real estate portfolio for the first six months of 2016 was attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio declined primarily as a result of declines in the historical loss experience from 0.70% in the first six months of 2015 to 0.15% in the first six months of 2016. In addition, the portfolio was in a net-recovery position of \$118,000 as of June 30, 2016.

The recovery of loan losses totaling \$203,000 for the consumer real estate portfolio for the six months ended 2016 was also attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio declined primarily as a result of declines in the historical loss experience from 0.24% in 2015 to a net recovery of 0.05% in the second quarter of 2016.



The provision for loan losses totaling \$387,000 for the construction and land development portfolio in 2015 was also attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio increased primarily as a result of an increase in the historical loss experience from a net recovery of 0.27% in 2014 to a net charge-off of 0.34% in the second quarter of 2015. In addition, the portfolio was in a net charge-off position of \$162,000 as of June 30, 2015.

The recovery of loan losses totaling \$428,000 for the consumer real estate portfolio in the first quarter of 2015 was also attributable to changes in our assessment of the general component of the allowance for loan losses as it related to this portfolio. The general component allocated to this portfolio declined primarily as a result of declines in the historical loss experience from 1.36% in 2014 to 0.68% in the second quarter of 2015. In addition, the portfolio was in a net recovery position of \$222,000 as of June 30, 2015.

### **Noninterest income**

Noninterest income increased from \$2,736,000 for the three months ended June 30, 2015 to \$2,986,000 for the three months ended June 30, 2016, an increase of \$250,000 or 9%. Noninterest income also increased from \$4,906,000 for the first six months of 2015 to \$5,182,000 for the first six months of 2016, an increase of \$276,000 or 6%. These increases in noninterest income were primarily the result of a gain on the sale of assets held for sale of \$504,000 in the second quarter of 2016, offset by lower gains on sale of loans of \$287,000 and \$370,000 for the three and six month periods, respectively. Additionally, gains from sales of securities increased by \$38,000 and \$140,000 for the three and six month periods, respectively. The securities sold had longer maturities with fixed interest rates and were sold to reduce interest rate risk in the event rates increase.

### ***Noninterest expense***

Noninterest expense for the three months ended June 30, 2016 was \$5,556,000 compared to \$5,793,000 for the three months ended June 30, 2015, a decrease of \$237,000 or 4%. The most significant decreases occurred in the write-down of assets held for sale of \$467,000 and the FDIC insurance premium which declined by \$99,000. The decrease in the FDIC insurance premium was due to the improvement in the Bank's risk rating with the FDIC based on the removal of the Consent Order in December 2015. These decreases were offset by increases in expenses related to foreclosed real estate of \$288,000 and professional and outside services of \$109,000. The increase in expenses related to foreclosed real estate was due to gains on sales of foreclosed properties in 2015 that reduced the amount of expense. The increase in professional and outside services was due to an increase in data processing expenses from new products and services.

Noninterest expense for the six months ended June 30, 2016 was \$10,609,000 compared to \$11,007,000 for the six months ended June 30, 2015, a decrease of \$398,000 or 4%. The more significant decreases occurred in the

write-down of assets held for sale of \$467,000 and in the FDIC insurance premium which declined by \$271,000. These decreases were offset by increases in expenses related to foreclosed real estate of \$257,000 and professional and outside services of \$180,000. The increase in expenses related to foreclosed real estate was due to gains on sales of foreclosed properties in 2015 that reduced the amount of expense. The increase in professional and outside services was due to an increase in data processing expenses from new products and services.

### ***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. At December 31, 2015, management continues to believe that the objective negative evidence represented by the Company’s prior losses outweighed the more subjective positive evidence and, as a result, maintains a valuation allowance at December 31, 2015 of \$11,997,000. At June 30, 2016, management continues to believe that the objective negative evidence represented by the Company’s prior losses outweighed the more subjective positive evidence and, as a result, maintains a valuation allowance at June 30, 2016 of \$11,657,000. The net operating losses available to offset future taxable income amounted to \$23,633,000 at June 30, 2016 and begin expiring in 2028; \$1,257,000 of such amount is subject to a limitation by Section 382 of the Internal Revenue Code of 1986, as amended, to \$908,000 per year.

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Company recorded franchise tax expense of approximately \$19,000 and \$38,000 for the three and six months ended June 30, 2016. Due to the Company’s adjusted capital level we were not subject to franchise tax expense for the three and six months ended June 30, 2015.

### **Balance Sheet Analysis**

Our total assets decreased to \$419,541,000 at June 30, 2016 from \$419,941,000 at December 31, 2015, a decrease of \$400,000, or 0.09%. The decrease in the balance sheet was minimal, however there were several variances of note during the six months ended June 30, 2016. Assets held for sale decreased by \$11,790,000 due to the sale of our previous headquarters building at the Watkins Centre, investment securities decreased by \$16,760,000 due to the sale of securities, and other real estate owned decreased by \$2,308,000 due to sale of several properties. These decreases were offset by an increase in loans outstanding of \$16,448,000 and cash and cash equivalents of \$11,699,000.

*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 76% 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 and industrial loan portfolio represents approximately 9% 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 15% 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):

|   | June 30, 2016 |         | December 31, 2015 |         |
|---|---------------|---------|-------------------|---------|
|   | Amount        | %       | Amount            | %       |
| Construction and land development                                     |               |         |                   |         |
| Residential   | \$5,109       | 1.58 %  | \$5,202           | 1.70 %  |
| Commercial  | 24,873        | 7.70 %  | 25,948            | 8.45 %  |
|   | 29,982        | 9.28 %  | 31,150            | 10.15 % |
| Commercial real estate  |               |         |                   |         |
| Owner occupied  | 78,753        | 24.36 % | 69,256            | 22.58 % |
| Non-owner occupied  | 46,013        | 14.24 % | 38,037            | 12.40 % |
| Multifamily   | 8,993         | 2.78 %  | 8,537             | 2.78 %  |
| Farmland  | 250           | 0.08 %  | 388               | 0.13 %  |
|   | 134,009       | 41.46 % | 116,218           | 37.89 % |
| Consumer real estate  |               |         |                   |         |
| Home equity lines   | 20,694        | 6.40 %  | 20,333            | 6.63 %  |
| Secured by 1-4 family residential,                                    |               |         |                   |         |
| First deed of trust   | 55,289        | 17.11 % | 56,776            | 18.51 % |
| Second deed of trust  | 5,914         | 1.83 %  | 6,485             | 2.11 %  |
|   | 81,897        | 25.34 % | 83,594            | 27.25 % |
| Commercial and industrial loans (except those secured by real estate) | 28,859        | 8.93 %  | 20,086            | 6.55 %  |
| Guaranteed student loans  | 46,781        | 14.47 % | 53,989            | 17.60 % |
| Consumer and other  | 1,691         | 0.52 %  | 1,734             | 0.57 %  |
| Total loans   | 323,219       | 100.0 % | 306,771           | 100.0 % |
| Deferred loan cost, net   | 602           |         | 670               |         |
| Less: allowance for loan losses                                       | (3,523 )      |         | (3,562 )          |         |
|   | \$320,298     |         | \$303,879         |         |

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



Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. These 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 June 30, 2016 was \$3,523,000, compared to \$3,562,000 at December 31, 2015. The ratio of the allowance for loan losses to gross portfolio loans (net of unearned income and excluding mortgage loans held for sale) at June 30, 2016 and December 31, 2015 was 1.09% and 1.16%, respectively. The decrease in the allowance for loan losses for the first six months of 2016 was primarily a result of charge offs recognized during the quarter. We believe the amount of the allowance for loan losses at June 30, 2016 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):

|   | Six Months Ended<br>June 30, |           |
|---|------------------------------|-----------|
|   | 2016                         | 2015      |
| Beginning balance   | \$3,562                      | \$5,729   |
| Provision for loan losses                                       | -                            | -         |
| Charge-offs   |                              |           |
| Construction and land development                               |                              |           |
| Commercial  | -                            | (185 )    |
| Commercial real estate  |                              |           |
| Owner occupied  | (9 )                         | (127 )    |
| Non-owner occupied  | -                            | -         |
| Farmland  | -                            | -         |
| Consumer real estate  |                              |           |
| Home equity lines   | (53 )                        | (40 )     |
| Secured by 1-4 family residential                               |                              |           |
| First deed of trust   | (27 )                        | (66 )     |
| Second deed of trust  | (25 )                        | (55 )     |
| Commercial and industrial (except those secured by real estate) | -                            | (162 )    |
| Guaranteed student loans  | (127 )                       | -         |
| Consumer and other  | (1 )                         | (7 )      |
|   | (242 )                       | (642 )    |
| Recoveries  |                              |           |
| Construction and land development                               |                              |           |
| Residential   | 1                            | 1         |
| Commercial  | -                            | 22        |
| Commercial real estate  |                              |           |
| Non-owner occupied  | 2                            | 2         |
| Farmland  | 125                          | -         |
| Consumer real estate  |                              |           |
| Home equity lines   | 2                            | 1         |
| Secured by 1-4 family residential                               |                              |           |
| First deed of trust   | 14                           | 369       |
| Second deed of trust  | 13                           | 13        |
| Commercial and industrial (except those secured by real estate) | 44                           | 58        |
| Consumer and other  | 2                            | 14        |
|   | 203                          | 480       |
| Net charge-offs   | (39 )                        | (162 )    |
| Ending balance  | \$3,523                      | \$5,567   |
| Loans outstanding at end of period <sup>(1)</sup>               | \$323,821                    | \$302,689 |

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|   |           |   |           |   |
|---|-----------|---|-----------|---|
| Ratio of allowance for loan losses as a percent of loans outstanding at end of period | 1.09      | % | 1.84      | % |
| Average loans outstanding for the period <sup>(1)</sup>                               | \$314,478 |   | \$290,129 |   |
| Ratio of net charge-offs to average loans outstanding for the period                  | 0.01      | % | 0.06      | % |

(1) Loans are net of unearned income.

**Asset quality**

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

|   | June 30,<br>2016 | December 31,<br>2015 | June 30,<br>2015 |
|---|------------------|----------------------|------------------|
| Nonaccrual loans  | \$2,841          | \$ 3,718             | \$5,770          |
| Foreclosed properties                                       | 3,941            | 6,249                | 8,605            |
| Total nonperforming assets                                  | \$6,782          | \$ 9,967             | \$14,375         |
| Restructured loans (not included in nonaccrual loans above) | \$13,784         | \$ 14,260            | \$15,848         |
| Loans past due 90 days and still accruing <sup>(1)</sup>    | \$8,412          | \$ 8,590             | \$9,632          |
| Nonperforming loans to loans <sup>(2)</sup>                 | 0.9 %            | 1.2 %                | 1.9 %            |
| Nonperforming assets to total assets <sup>(3)</sup>         | 1.6 %            | 2.4 %                | 3.4 %            |
| Allowance for loan losses to nonaccrual loans               | 124.0 %          | 95.8 %               | 96.5 %           |

(1) All loans 90 days past due and still accruing are rehabilitated student loans which have a 98% guarantee by the DOE

(2) Loans are net of unearned income and deferred cost.

(3) Nonperforming assets excludes performing troubled debt restructurings.

The following table presents an analysis of the changes in nonperforming assets for the six months ended June 30, 2016 (dollars in thousands):

|                           | Nonaccrual<br>Loans | Foreclosed<br>Properties | Total   |
|---------------------------|---------------------|--------------------------|---------|
| Balance December 31, 2015 | \$ 3,718            | \$ 6,249                 | \$9,967 |
| Additions                 | 1,427               | 277                      | 1,704   |

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|                              |          |          |         |
|------------------------------|----------|----------|---------|
| Loans placed back on accrual | (1,841 ) | -        | (1,841) |
| Transfers to OREO            | (268 )   | 268      | -       |
| Repayments                   | (105 )   | -        | (105 )  |
| Charge-offs                  | (90 )    | (89 )    | (179 )  |
| Sales                        | -        | (2,764 ) | (2,764) |
|                              | -        | -        | -       |
| Balance June 30, 2016        | \$ 2,841 | \$ 3,941 | \$6,782 |

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 on 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 \$2,841,000 at June 30, 2016 that were considered impaired, twelve (12) loans totaling \$1,166,000 had specific allowances for loan losses totaling \$174,000. This compares to \$3,718,000 in nonaccrual loans at December 31, 2015 of which twelve (12) loans totaling \$2,112,000 had specific allowances for loan losses of \$370,000.

Cumulative interest income that would have been recorded had nonaccrual loans been performing would have been approximately \$115,000 and \$182,000 for the six months ended June 30, 2016 and 2015, respectively.

### *Deposits*

Deposits as of June 30, 2016 and December 31, 2015 were as follows (dollars in thousands):

|                                     | June 30, 2016 |         | December 31, 2015 |         |
|-------------------------------------|---------------|---------|-------------------|---------|
|                                     | Amount        | %       | Amount            | %       |
| Demand accounts                     | \$78,122      | 21.2 %  | \$78,282          | 21.4 %  |
| Interest checking accounts          | 42,361        | 11.5 %  | 44,256            | 12.1 %  |
| Money market accounts               | 67,831        | 18.5 %  | 64,841            | 17.8 %  |
| Savings accounts                    | 19,820        | 5.4 %   | 19,403            | 5.3 %   |
| Time deposits of \$100,000 and over | 78,890        | 21.5 %  | 72,745            | 19.9 %  |
| Other time deposits                 | 80,600        | 21.9 %  | 85,321            | 23.4 %  |
| Total                               | \$367,624     | 100.0 % | \$364,848         | 100.0 % |

Total deposits increased by \$2,776,000, or 0.8%, from \$364,848,000 at December 31, 2015 to \$367,624,000 at June 30, 2016, as compared to a decrease of \$8,449,000, or 2.2%, during the first six months of 2015. Checking and savings accounts increased by \$1,095,000, money market accounts increased by \$2,990,000 and time deposits

decreased by \$1,424,000. The cost of our interest-bearing deposits declined to 0.83% for the first six months of 2016 compared to 0.85% for the first six months of 2015.

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 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 \$3,200,000 and \$6,000,000 at June 30, 2016 and December 31, 2015, respectively. The FHLB advances are secured by the pledge of investment securities and loans.

### *Capital resources*

On May 1, 2009, as part of the Capital Purchase Program established by the U.S. Department of the Treasury under the Emergency Economic Stabilization Act of 2008, the Company entered into a Letter Agreement and Securities Purchase Agreement—Standard Terms 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 and (ii) a 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 Warrant was determined to be \$10,742,000 with 95% of the aggregate attributable to the preferred stock and 5% attributable to the 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 was 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.

In accordance with the Company's written agreement with the Reserve Bank, the Company has been deferring quarterly cash dividends on the preferred stock since May 2011. The total arrearage on such preferred stock as of June 30, 2016 was \$2,437,935. This amount has been accrued for and is included in other liabilities in the consolidated balance sheet. With the termination of the Written Agreement as of July 28, 2016, the Company is not required to defer the quarterly cash dividends on the preferred stock, however the Company is evaluating various options with respect to the preferred stock.

In November 2013, the Company participated in a successful auction of the Company's preferred stock 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 \$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 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.

On March 27, 2015, the Company completed a rights offering to shareholders and concurrent standby offering to Kenneth R. Lehman, in which the Company issued an aggregate of 1,051,866 shares of common stock (the total number of shares offered) at \$13.87 per share for aggregate gross proceeds of \$14,589,381 (including the value of the Company's preferred stock exchanged by Mr. Lehman for shares of common stock of \$4,618,813). In connection with the Rights Offering, 283,293 shares were issued to shareholders upon exercise of their basic subscription rights and 191,773 shares were issued to shareholders upon exercise of their oversubscription privileges (approximately 36.9% of the total number of shares requested pursuant to oversubscription privileges). In connection with the Standby Offering, Mr. Lehman purchased an aggregate of 576,800 shares of the Company's common stock, 333,007 of which were issued in exchange for 9,023 shares of the Company's preferred stock and 243,793 of which were purchased for cash. Also, as part of the Standby Offering, Mr. Lehman forgave \$2,215,009 in accrued and unpaid dividends on the preferred stock.

The Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board's Small Bank Holding Company Policy Statement issued in February 2015, and is no longer obligated to report consolidated regulatory capital. The Bank continues to be subject to various capital requirements administered by banking agencies.

Under the final capital rules that became effective on January 1, 2015, there was a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets, which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. We have included the 0.625% increase for 2016 in our minimum capital adequacy ratios in the table below. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. Management believes that, as of June 30, 2016, the Company would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

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

|   | June 30,<br>2016 | December 31,<br>2015 |       |   |
|---|------------------|----------------------|-------|---|
| Tier 1 capital  |                  |                      |       |   |
| Total bank equity capital                                   | \$40,577         | \$ 38,665            |       |   |
| Net unrealized (gain) loss on available-for-sale securities | (45 )            | 439                  |       |   |
| Defined benefit postretirement plan                         | 64               | 69                   |       |   |
| Disallowed intangible assets                                | (31 )            | (40 )                |       |   |
| Total Tier 1 capital  | 40,565           | 39,133               |       |   |
| Tier 2 capital  |                  |                      |       |   |
| Allowance for loan losses                                   | 3,523            | 3,562                |       |   |
| Total Tier 2 capital  | 3,523            | 3,562                |       |   |
| Total risk-based capital                                    | 44,088           | 42,695               |       |   |
| Risk-weighted assets  | \$300,269        | \$ 304,611           |       |   |
| Average assets  | \$419,045        | \$ 419,398           |       |   |
| Capital ratios  |                  |                      |       |   |
| Leverage ratio (Tier 1 capital to average assets)           | 9.68             | %                    | 9.33  | % |
| Common equity tier 1 capital ratio (CET 1)                  | 13.51            | %                    | 12.85 | % |
| Tier 1 capital to risk-weighted assets                      | 13.51            | %                    | 12.85 | % |
| Total capital to risk-weighted assets                       | 14.68            | %                    | 14.02 | % |
| Equity to total assets                                      | 9.72             | %                    | 9.25  | % |

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The Bank met the ratio criteria to be categorized as a “well capitalized” institution as of December 31, 2015, 2014 and 2013. However, due to the minimum capital ratios required by the prior Consent Order, the Bank was considered adequately capitalized in 2014 and 2013. The MOU required the Bank to maintain a leverage ratio of at least 8% and a total capital to risk-weighted assets ratio of at least 12%. Primarily as a result of the Company’s Rights Offering and Standby Offering completed on March 27, 2015, the Bank’s leverage ratio increased to 9.33% and the total capital to risk-weighted assets ratio was 14.02%, exceeding the ratios required by the MOU. 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 June 30, 2016, our liquid assets, consisting of cash, cash equivalents and investment securities available for sale totaled \$50,120,000, or 12% 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 \$5,000,000 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 \$10 million for which there were no borrowings against the lines at June 30, 2016.

At June 30, 2016, we had commitments to originate \$88,371,000 of loans. Fixed commitments to incur capital expenditures were approximately \$290,000 at June 30 2016. Certificates of deposit scheduled to mature in the 12-month period ending June 30, 2017 totaled \$71,695,000. 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.

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.

During the fourth quarter of 2015, we adopted a software solution for the analysis of the allowance for loan losses. While our methodology of evaluating the adequacy of the allowance for loan losses generally did not change, the software is more robust in that it:

- allows us to take a more measureable approach to our evaluation of qualitative factors such as economic conditions that may affect loss experience; and
- is widely used by community banks which provides peer data that can be used as a benchmark for comparison to our analysis.

In addition to the adoption of the software solution for our analysis, we reviewed the last twenty years of historical loss data for peer banks in Virginia to assist us in our evaluation of environmental factors and other conditions that could affect the loan portfolio and the overall adequacy of the allowance for loan losses.

***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 TDRs 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 June 30, 2016 and December 31, 2015, the objective negative evidence represented by the Company's prior losses outweighed the more subjective positive evidence and, as a result, maintains a valuation allowance of \$11,657,000 and \$11,997,000 respectively, representing all of the net deferred tax asset that is dependent on future earnings of the Company at the indicated date.

**Amendment to Village Bank Supplemental Executive Retirement Plan**

On July 9, 2016, the Bank amended its supplemental executive retirement plan to provide that the participants' benefits will vest upon a change of control of the Bank. The plan previously provided that a participant's benefits would vest upon a change of control only if the participant experienced a qualifying termination of employment within 12 months after the change of control.



### **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 of America, 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 June 30, 2016. Based on that evaluation, management concluded that the Company's disclosure controls and procedures were effective as of June 30, 2016 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. Except as previously reported, 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 was previously prohibited by its Written Agreement with the Reserve Bank from making dividend or interest payments on the preferred stock or trust preferred capital notes without prior regulatory approval. The Written Agreement was terminated by the Reserve Bank as of July 28, 2016. The Company is current on its interest payments on the trust preferred capital notes. With the termination of the Written Agreement, the Company is not required to defer the quarterly cash dividends on the preferred stock, however the Company is evaluating various options with respect to the preferred stock. At June 30, 2016, the aggregate amount of all of the Company's total accrued but deferred dividend payments on the preferred stock was \$2,437,935.

**ITEM 4 – MINE SAFETY DISCLOSURES**

None.

**ITEM 5 – OTHER INFORMATION**

Not applicable.

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**ITEM 6 – EXHIBITS**

10.1 Village Bank Supplemental Executive Retirement Plan, as amended and restated effective July 9, 2016.

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 June 30, 2016 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Comprehensive Income (Loss), (iv) Consolidated Statements of Shareholders' 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.

Date: August 12, 2016 By: /s/ William G. Foster, Jr.  
William G. Foster, Jr.  
President and Chief Executive  
Officer

Date: August 12, 2016 By: /s/ C. Harril Whitehurst, Jr.  
C. Harril Whitehurst, Jr.  
Executive Vice President and  
Chief Financial Officer

**EXHIBIT INDEX**

| Exhibit Number | Document   |
|----------------|--|
| 10.1           | Village Bank Supplemental Executive Retirement Plan, as amended and restated effective July 9, 2016.   |
| 31.1           | Certification of Chief Executive Officer   |
| 31.2           | Certification of Chief Financial Officer   |
| 32.1           | Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350  |
| 101            | The following materials from the Village Bank and Trust Financial Corp. Quarterly Report on Form 10-Q for the quarter ended June 30, 2016 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Comprehensive Income (Loss), (iv) Consolidated Statements of Shareholders' Equity, (v) Consolidated Statements of Cash Flows, and (vi) Notes to Consolidated Financial Statements. |