

Village Bank & Trust Financial Corp.  
Form 10-Q  
November 13, 2012

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

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

For the quarterly period ended September 30, 2012

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

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

Commission file number: 0-50765

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

Virginia  
(State or other jurisdiction of  
incorporation or organization)

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

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

23113  
(Zip code)

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

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

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

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

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

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

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

4,251,795 shares of common stock, \$4.00 par value, outstanding as of November 3, 2012

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## PART I – FINANCIAL INFORMATION

## ITEM 1 – FINANCIAL STATEMENTS

Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Balance Sheets  
September 30, 2012 (Unaudited) and December 31, 2011

	September 30, 2012	December 31, 2011
Assets		
Cash and due from banks	\$26,064,313	\$55,557,541
Federal funds sold	154,012	7,228,475
Total cash and cash equivalents	26,218,325	62,786,016
Investment securities available for sale	33,415,951	30,163,292
Loans held for sale	22,526,733	16,168,405
Loans		
Outstandings	374,350,768	427,870,716
Allowance for loan losses	(12,055,844 )	(16,071,424 )
Deferred fees and costs	776,064	767,775
	363,070,988	412,567,067
Premises and equipment, net	26,071,219	26,826,524
Accrued interest receivable	1,800,872	2,046,524
Bank owned life insurance	6,525,838	6,065,305
Other real estate owned	20,575,964	9,177,167
Restricted equity securities	2,511,786	2,989,286
Other assets	5,582,300	12,914,733
	\$ 508,299,976	\$ 581,704,319
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest bearing demand	\$ 58,469,352	\$ 66,534,956
Interest bearing	376,672,785	418,986,096
	435,142,137	485,521,052
Federal Home Loan Bank advances	28,000,000	37,750,000
Long-term debt - trust preferred securities	8,764,000	8,764,000
Other borrowings	5,351,393	5,778,661
Accrued interest payable	816,390	592,283
Other liabilities	6,128,731	7,050,681
Total liabilities	484,202,651	545,456,677
Stockholders' equity		
Preferred stock, \$4 par value, \$1,000 liquidation preference	58,952	58,952
1,000,000 shares authorized, 14,738 shares issued and outstanding		

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Common stock, \$4 par value - 10,000,000 shares issued and outstanding		
4,251,795 shares issued and outstanding at September 30, 2012		
4,243,378 shares issued and outstanding at December 31, 2011	17,007,180	16,973,512
Additional paid-in capital	40,705,016	40,732,178
Retained earnings (deficit)	(34,026,317 )	(21,895,557 )
Preferred stock warrant	732,479	732,479
Discount on preferred stock	(236,004 )	(346,473 )
Accumulated other comprehensive income (loss)	(143,981 )	(7,449 )
Total stockholders' equity	24,097,325	36,247,642
	\$508,299,976	\$581,704,319

See accompanying notes to consolidated financial statements

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Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Operations  
Three and Nine Months Ended September 30, 2012 and 2011  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest income				
Loans	\$5,488,927	\$6,586,170	\$17,002,398	\$20,394,359
Investment securities	166,684	356,893	532,229	1,010,017
Federal funds sold	11,570	19,464	44,123	58,268
Total interest income	5,667,181	6,962,527	17,578,750	21,462,644
Interest expense				
Deposits	1,187,060	1,693,205	3,791,427	5,638,873
Borrowed funds	263,747	305,307	798,868	885,156
Total interest expense	1,450,807	1,998,512	4,590,295	6,524,029
Net interest income	4,216,374	4,964,015	12,988,455	14,938,615
Provision for loan losses	700,000	9,507,884	9,095,000	11,410,884
Net interest income after provision for loan losses	3,516,374	(4,543,869)	3,893,455	3,527,731
Noninterest income				
Service charges and fees	604,377	495,165	1,652,355	1,366,547
Gain on sale of loans	2,394,138	1,724,730	6,336,030	4,733,648
Gain (loss) on sale of securities	556,805	108,473	820,482	171,617
Rental income	187,839	168,311	557,920	484,540
Other	285,723	100,804	497,927	303,348
Total noninterest income	4,028,882	2,597,483	9,864,714	7,059,700
Noninterest expense				
Salaries and benefits	3,484,073	3,060,285	9,888,166	9,305,684
Occupancy	513,278	540,929	1,579,976	1,552,537
Equipment	231,556	224,334	710,522	668,554
Supplies	125,514	98,621	322,727	324,565
Professional and outside services	708,554	599,893	2,077,845	1,689,339
Advertising and marketing	48,362	84,740	172,408	319,163
Expenses related to foreclosed real estate	1,724,348	387,666	3,520,971	1,211,878
Other operating expenses	915,333	973,426	2,946,054	2,850,734
Total noninterest expense	7,751,018	5,969,894	21,218,669	17,922,454
Net loss before income taxes	(205,762 )	(7,916,280)	(7,460,500 )	(7,335,023 )
Income tax expense (benefit)	161,315	(2,671,535)	4,043,229	(2,429,829 )
Net income (loss)	(367,077 )	(5,244,745)	(11,503,729)	(4,905,194 )

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Preferred stock dividends and amortization of discount	221,142	222,281	627,031	660,508
Net loss available to common shareholders	\$(588,219 )	\$(5,467,026)	\$(12,130,760)	\$(5,565,702 )
Earnings (loss) per share, basic	\$(0.14 )	\$(1.29 )	\$(2.85 )	\$(1.31 )
Earnings (loss) per share, diluted	\$(0.14 )	\$(1.29 )	\$(2.85 )	\$(1.31 )

See accompanying notes to consolidated financial statements



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Village Bank and Trust Financial Corp. and Subsidiary  
 Consolidated Statements of Changes in Comprehensive Income (Loss)  
 Three and Nine Months Ended September 30, 2012 and 2011  
 (Unaudited)

	For the Three Months Ended September 30,					
	Amount	2012		Amount	2011	
Expense (Benefit)		Total	Expense (Benefit)		Total	
Net income (loss)	\$ (205,762)	\$ 161,315	\$ (367,077)	\$ (7,916,280)	\$ (2,671,535)	\$ (5,244,745)
Other comprehensive income (loss)						
Unrealized holding gains (losses) arising during the period	(62,063 )	(21,101 )	(40,962 )	640,049	217,617	422,432
Reclassification adjustment realized in income	(556,805)	(189,314)	(367,491)	(108,473 )	(36,881 )	(71,592 )
Minimum pension adjustment	3,250	1,105	2,145	3,250	1,105	2,145
Total other comprehensive income (loss)	(615,618)	(209,310)	(406,308)	534,826	181,841	352,985
Total comprehensive income (loss)	\$ (821,380)	\$ (47,995 )	\$ (773,385)	\$ (7,381,454)	\$ (2,489,694)	\$ (4,891,760)

	For the Nine Months Ended September 30,					
	2012			2011		
Amount	Tax Expense (Benefit)	Total	Amount	Tax Expense (Benefit)	Total	
Net Income (loss)	\$ (7,460,500)	\$ 4,043,229	\$ (11,503,729)	\$ (7,335,023)	\$ (2,429,829)	\$ (4,905,194)
Other comprehensive income (loss)						
Unrealized holding gains arising during the period	603,865	205,314	398,551	1,744,020	592,967	1,151,053
Reclassification adjustment realized in income	(820,482 )	(278,964 )	(541,518 )	(171,617 )	(58,350 )	(113,267 )

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Minimum pension adjustment	9,750	3,315	6,435	9,750	3,315	6,435
Total other comprehensive income (loss)	(206,867 )	(70,335 )	(136,532 )	1,582,153	537,932	1,044,221
Total comprehensive income (loss)	\$ (7,667,367)	\$ 3,972,894	\$ (11,640,261)	\$ (5,752,870)	\$ (1,891,897)	\$ (3,860,973)

See accompanying notes to consolidated financial statements

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Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Stockholders' Equity  
Nine Months Ended September 30, 2012 and 2011  
(Unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Warrant	Discount on Preferred Stock	Accumulated Other Comprehensive Income (loss)	Total
Balance, December 31, 2011	\$58,952	\$16,973,512	\$40,732,178	\$(21,895,557)	\$732,479	\$(346,473)	\$(7,449)	\$36,247,642
Amortization of preferred stock discount	-	-	-	(110,469)	-	110,469	-	-
Preferred stock dividend	-	-	-	(516,562)	-	-	-	(516,562)
Issuance of common stock	-	33,668	(33,668)	-	-	-	-	-
Stock based compensation	-	-	6,506	-	-	-	-	6,506
Minimum pension adjustment (net of income taxes of \$2,917)	-	-	-	-	-	-	6,435	6,435
Net income (loss)	-	-	-	(11,503,729)	-	-	-	(11,503,729)
Change in unrealized gain on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	(142,967)	(142,967)
Balance, September 30, 2012	\$58,952	\$17,007,180	\$40,705,016	\$(34,026,317)	\$732,479	\$(236,004)	\$(143,981)	\$24,097,325
Balance, December 31, 2010	\$58,952	\$16,953,664	\$40,633,581	\$(9,192,552)	\$732,479	\$(492,456)	\$(373,474)	\$48,320,194
Amortization of preferred stock discount	-	-	-	(109,348)	-	109,348	-	-

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Preferred stock dividend	-	-	(551,160 )	-	-	-	(551,160 )	
Issuance of common stock	-	19,848	(19,848 )	-	-	-	-	
Stock based compensation			88,835				88,835	
Minimum pension adjustment (net of income taxes of \$3,315)	-	-	-	-	-	6,435	6,435	
Net income (loss)	-	-	-	(4,905,194 )	-	-	(4,905,194 )	
Change in unrealized gain on investment securities available-for-sale net of reclassification and tax effect	-	-	-	-	-	1,037,786	1,037,786	
Balance, September 30, 2011	\$58,952	\$16,973,512	\$40,702,568	\$(14,758,254)	\$732,479	\$(383,108)	\$670,747	\$43,996,896

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary  
Consolidated Statements of Cash Flows  
Nine Months Ended September 30, 2012 and 2011  
(Unaudited)

	Nine Months Ended September 30,	
	2012	2011
<b>Cash Flows from Operating Activities</b>		
Net income (loss)	\$(11,503,729 )	\$(4,905,194 )
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,030,061	1,065,855
Deferred income taxes	(6,584,167 )	(3,710,085 )
Valuation allowance on deferred tax asset	10,513,053	-
Provision for loan losses	9,095,000	11,410,884
Write-down of other real estate owned	1,157,613	546,331
Gain on securities sold	(820,483 )	(172,994 )
Gain on loans sold	(6,336,030 )	(4,733,648 )
Loss on sale of other real estate owned	137,252	239,532
Stock compensation expense	6,506	88,835
Proceeds from sale of mortgage loans	224,700,116	175,498,993
Origination of mortgage loans for sale	(224,722,414)	(164,679,796)
Amortization of premiums and accretion of discounts on securities, net	237,964	106,229
(Increase) decrease in interest receivable	245,652	(13,360 )
Increase in bank owned life insurance	(460,533 )	(147,399 )
Decrease in other assets	3,961,133	(117,566 )
Increase in interest payable	224,107	109,479
Decrease in other liabilities	(1,438,512 )	2,623,546
Net cash provided by (used in) operating activities	(557,411 )	13,209,642
<b>Cash Flows from Investing Activities</b>		
Purchases of available for sale securities	(62,813,678 )	(76,141,951 )
Proceeds from the sale or calls of available for sale securities	57,581,103	803,100
Proceeds from maturities and principal payments of available for sale securities	2,345,817	73,883,951
Net decrease in loans	25,205,931	10,462,525
Proceeds from sale of other real estate owned	2,501,486	5,155,942
Purchases of premises and equipment	(274,756 )	(735,137 )
Net cash provided by investing activities	24,545,903	13,428,430
<b>Cash Flows from Financing Activities</b>		
Net increase (decrease) in deposits	(50,378,915 )	5,159,007
Net increase (decrease) in Federal Home Loan Bank Advances	(9,750,000 )	9,000,000
Net increase (decrease) in other borrowings	(427,268 )	941,972
Net cash provided by (used in) financing activities	(60,556,183 )	15,100,979
Net increase (decrease) in cash and cash equivalents	(36,567,691 )	41,739,051
Cash and cash equivalents, beginning of period	62,786,016	12,012,311

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Cash and cash equivalents, end of period	\$26,218,325	\$53,751,362
Supplemental Schedule of Non Cash Activities		
Real estate owned assets acquired in settlement of loans	\$15,195,148	\$2,714,621
Dividends on preferred stock accrued	\$516,562	\$551,160

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary  
Notes to Condensed Consolidated Financial Statements  
Three and Nine Months Ended September 30, 2012 and 2011 (Unaudited)

Note 1 - Principles of presentation

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

In the opinion of management, the accompanying condensed consolidated financial statements of the Company have been prepared on the accrual basis in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, all adjustments that are, in the opinion of management, necessary for a fair presentation have been included. The results of operations for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year ending December 31, 2012. 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, 2011 as filed with the Securities and Exchange Commission.

Note 2 - Use of estimates

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

Note 3 - Earnings (loss) per common share

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

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	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Numerator				
Net income (loss) - basic and diluted	\$ (367,077 )	\$ (5,244,745 )	\$ (11,503,729 )	\$ (4,905,194 )
Preferred stock dividend and accretion	221,142	222,281	627,031	660,508
Net income (loss) available to common shareholders	\$ (588,219 )	\$ (5,467,026 )	\$ (12,130,760 )	\$ (5,565,702 )
Denominator				
Weighted average shares outstanding - basic	4,250,990	4,243,378	4,250,990	4,242,905
Dilutive effect of common stock options and restricted stock awards	-	-	-	-
Weighted average shares outstanding - diluted	4,250,990	4,243,378	4,250,990	4,242,905
Earnings (loss) per share - basic and diluted				
Earnings (loss) per share - basic	\$ (0.14 )	\$ (1.29 )	\$ (2.85 )	\$ (1.31 )
Effect of dilutive common stock options	-	-	-	-
Earnings (loss) per share - diluted	\$ (0.14 )	\$ (1.29 )	\$ (2.85 )	\$ (1.31 )

Outstanding options and warrants to purchase common stock were considered in the computation of diluted earnings per share for the periods presented. Stock options for 266,530 shares of common stock were not included in computing diluted earnings per share for the three and nine months ended September 30, 2012 because their effects were anti-dilutive. Warrants for 499,029 shares of common stock were not included in computing earnings per share in 2012 and 2011 because their effects were also anti-dilutive.

Note 4 – Investment securities available for sale

At September 30, 2012 and December 31, 2011, all of our securities were classified as available-for-sale. The following table presents the composition of our investment portfolio at the dates indicated (dollars in thousands).



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	Par Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Average Yield	
September 30, 2012							
US Government Agencies							
More than ten years	\$14,500	\$16,985	\$31	\$(62)	\$16,953	2.57	%
Mortgage-backed securities							
More than ten years	2,068	2,177	2	(17)	2,162	0.80	%
Total	2,068	2,177	2	(17)	2,162	0.80	%
Municipals							
One to five years	1,000	1,105	-	(20)	1,085	3.25	%
Five to ten years	1,500	1,748	1	-	1,749	2.33	%
More than ten years	7,280	8,500	8	(38)	8,470	2.86	%
Total	9,780	11,353	9	(58)	11,304	2.81	%
US Treasury Notes							
Five to ten years	3,000	2,973	24	-	2,997	1.73	%
Total investment securities	\$29,348	\$33,487	\$66	\$(137)	\$33,416	2.46	%
December 31, 2011							
US Government Agencies							
More than ten years	\$2,000	\$2,000	\$1	\$-	\$2,001	3.81	%
Mortgage-backed securities							
One to five years	11	11	-	-	11	0.01	%
More than ten years	19,870	20,621	220	(49)	20,792	1.83	%
Total	19,881	20,632	220	(49)	20,803	1.83	%
Other investments							
More than ten years	7,356	7,386	-	(27)	7,359	0.55	%
Total investment securities	\$29,237	\$30,018	\$221	\$(76)	\$30,163	1.65	%

Investment securities available for sale that have an unrealized loss position at September 30, 2012 and December 31, 2011 are detailed below (dollars in thousands).

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	Securities in a loss Position for less than 12 Months		Securities in a loss Position for more than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
September 30, 2012						
Investment Securities available for sale						
US Treasuries	\$9,132	\$(62 )	\$-	\$-	\$9,132	\$(62 )
Municipals	8,319	(58 )	-	-	8,319	(58 )
Mortgage-backed securities	1,979	(17 )	-	-	1,979	(17 )
Total	\$19,430	\$(137 )	\$-	\$-	\$19,430	\$(137 )
December 31, 2011						
Investment Securities available for sale						
US Treasuries	\$7,358	\$(27 )	\$-	\$-	\$7,358	\$(27 )
Mortgage-backed securities	10,221	(47 )	205	(2 )	10,426	(49 )
Total	\$17,579	\$(74 )	\$205	\$(2 )	\$17,784	\$(76 )

Management does not believe that any individual unrealized loss as of September 30, 2012 and December 31, 2011 is other than a temporary impairment. These unrealized losses are primarily attributable to changes in interest rates. As of September 30, 2012, management does not have the intent to sell any of the securities classified as available for sale and management believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

## Note 5 – Loans and allowance for loan losses

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

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	September 30, 2012		December 31, 2011		
	Amount	%	Amount	%	
Construction and land development					
Residential	\$4,938	1	% \$7,906	2	%
Commercial	48,416	13	% 72,621	17	%
Total	53,354	14	% 80,527	19	%
Commercial real estate					
Farmland	2,591	1	% 2,465	1	%
Commercial real estate					
Owner occupied	97,187	25	% 105,592	24	%
Non-owner occupied	55,295	15	% 54,059	13	%
Multifamily	7,569	2	% 6,680	2	%
Total	162,642	43	% 168,796	39	%
Consumer real estate					
Home equity lines	26,712	7	% 30,687	7	%
Secured by 1-4 family residential					
Secured by first deed of trust	82,487	22	% 93,219	22	%
Secured by second deed of trust	9,892	3	% 12,042	3	%
Total	119,091	32	% 135,948	32	%
Commercial and industrial loans (except those secured by real estate)	35,966	10	% 37,734	9	%
Consumer and other	3,298	1	% 4,865	1	%
Total loans	374,351	100	% 427,870	100	%
Deferred fees and costs	776		768		
Allowance for loan losses	(12,056 )		(16,071 )		
	\$363,071		\$412,567		

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

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

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

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	September 30, 2012				Total Loans
	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	
Construction and land development					
Residential	\$4,074,705	\$671,709	\$191,544	\$-	\$4,937,958
Commercial	26,816,617	5,516,377	15,731,836	350,984	48,415,814
Total	30,891,322	6,188,086	15,923,380	350,984	53,353,772
Commercial real estate					
Farmland	1,541,788		1,049,489	-	2,591,277
Commercial real estate					
Owner occupied	69,783,788	8,412,897	18,770,066	220,195	97,186,946
Non-owner occupird	25,558,925	12,118,805	17,616,609	-	55,294,339
Multifamily	4,652,304	1,751,451	1,165,284	-	7,569,039
Total	101,536,805	22,283,153	38,601,448	220,195	162,641,601
Consumer real estate					
Home equity lines	21,960,295	1,889,385	2,805,308	57,000	26,711,988
Secured by 1-4 family residential					
Secured by first deed of trust	54,705,786	10,670,351	17,110,672	-	82,486,809
Secured by second deed of trust	7,866,200	455,326	1,570,968	-	9,892,494
Total	84,532,281	13,015,062	21,486,948	57,000	119,091,291
Commercial and industrial loans (except those secured by real estate)	28,469,590	1,626,538	5,217,585	652,480	35,966,193
Consumer and other	2,936,909	206,052	154,950	-	3,297,911
Total loans	\$248,366,907	\$43,318,891	\$81,384,311	\$1,280,659	\$374,350,768

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December 31, 2011

	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	Total Loans
Construction and land development:					
Residential					
Commercial	4,943,061		2,963,404	-	\$7,906,465
Total construction and land					
development	44,315,474	-	28,305,063	-	72,620,537
	49,258,535	-	31,268,467	-	80,527,002
Commercial real estate:					
Farmland					
Commercial real estate - owner occupied	2,464,981	-	-	-	2,464,981
Commercial real estate - non-owner					
occupied	46,958,816	16,352,920	42,280,412	-	105,592,148
Multifamily	37,581,904	3,036,887	13,440,358	-	54,059,149
Total commercial real estate	5,511,882	-	1,167,446	-	6,679,328
	92,517,583	19,389,807	56,888,216	-	168,795,606
Consumer real estate:					
Home equity lines					
Secured by 1-4 family residential, secured					
by first deeds of trust	26,403,850	1,373,002	2,910,374	-	30,687,226
Secured by 1-4 family residential, secured					
by second deeds of trust	80,670,887	6,052,128	6,495,783	-	93,218,798
Total consumer real estate	9,960,928	706,484	1,374,651	-	12,042,063
	117,035,665	8,131,614	10,780,808	-	135,948,087
Commercial and industrial loans					
(except those secured by real estate)					
	31,322,834	4,289,037	2,122,645	-	37,734,516
Consumer and other					
	3,508,768	384,387	972,350	-	4,865,505
Total Loans					
	293,643,385	32,194,845	102,032,486	-	427,870,716

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

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September 30, 2012

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Construction and land development							
Residential	\$ -	\$ -	\$ -	\$ -	\$ 4,937,958	\$ 4,937,958	\$ -
Commercial	11,291	449,955	-	461,246	47,954,568	48,415,814	-
Total	11,291	449,955	-	461,246	52,892,526	53,353,772	-
Commercial real estate							
Farmland	-	-	-	-	2,591,277	2,591,277	-
Commercial real estate Owner occupied	-	379,961	-	379,961	96,806,985	97,186,946	-
Non-owner occupied	-	718,354	-	718,354	54,575,985	55,294,339	-
Multifamily	-	-	-	-	7,569,039	7,569,039	-
Total	-	1,098,315	-	1,098,315	161,543,286	162,641,601	-
Consumer real estate							
Home equity lines	188,130	782,639	97,158	1,067,927	25,644,061	26,711,988	97,158
Secured by 1-4 family residential Secured by first deed of trust	2,204,913	707,010	369,792	3,281,715	79,205,094	82,486,809	369,792
Secured by second deed of trust	-	106,287	-	106,287	9,786,207	9,892,494	-
Total	2,393,043	1,595,936	466,950	4,455,929	114,635,362	119,091,291	466,950
Commercial and industrial loans (except those secured by real	68,652	357,954	15,418	442,024	35,524,169	35,966,193	15,418

estate)

Consumer and other	16,998	3,000	-	19,998	3,277,913	3,297,911	-
Total loans	\$ 2,489,984	\$ 3,505,160	\$ 482,368	\$ 6,477,512	\$ 367,873,256	\$ 374,350,768	\$ 482,368

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	December 31, 2011						
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Construction and land development							
Residential	\$ 575,200	\$ 251,799	\$ -	\$ 826,999	\$ 7,079,466	\$ 7,906,465	\$ -
Commercial	1,367,360	408,000	36,770	1,812,130	70,808,407	72,620,537	36,770
Total	1,942,560	659,799	36,770	2,639,129	77,887,873	80,527,002	36,770
Commercial real estate							
Farmland	-	-	-	-	2,464,981	2,464,981	-
Commercial real estate Owner occupied	598,006	36,972	-	634,978	104,957,170	105,592,148	-
Non-owner occupied	55,709	673,561	-	729,270	53,329,879	54,059,149	-
Multifamily	111,571	255,196	-	366,767	6,312,561	6,679,328	-
Total	765,286	965,729	-	1,731,015	167,064,591	168,795,606	-
Consumer real estate:							
Home equity lines	323,349	99,494	299,783	722,626	29,964,600	30,687,226	299,783
Secured by 1-4 family residential							
Secured by first deed of trust	985,116	1,572,973	624,740	3,182,829	90,035,969	93,218,798	624,740
Secured by second deed of trust	12,673	132,928	156,026	301,627	11,740,436	12,042,063	156,026
Total	1,321,138	1,805,395	1,080,549	4,207,082	131,741,005	135,948,087	1,080,549
Commercial and industrial loans (except those secured by	46,392	3,313	54,918	104,623	37,629,893	37,734,516	54,918



real estate)

Consumer and  
other

59,697      3,176      -      62,873      4,802,632      4,865,505      -

Total loans      \$ 4,135,073      \$ 3,437,412      \$ 1,172,237      \$ 8,744,722      \$ 419,125,994      \$ 427,870,716      \$ 1,172,237

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. September 30, 2012 and December 31, 2011 impaired loans are set forth in the following table.

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September 30, 2012

	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded			
Construction and land development			
Residential	\$ 191,544	\$ 471,544	\$-
Commercial	9,219,142	15,132,049	-
Total	9,410,686	15,603,593	-
Commercial real estate			
Farmland			
Commercial real estate - owner occupied	1,049,489	1,049,489	-
Commercial real estate - non-owner occupied	8,484,371	8,514,955	-
Multifamily	12,915,719	13,061,948	-
Total	1,574,878	1,574,878	-
24,024,457	24,201,270	-	
Consumer real estate			
Home equity lines			
Secured by 1-4 family residential, secured by first deeds of trust	1,175,230	1,307,554	-
Secured by 1-4 family residential, secured by second deeds of trust	9,328,458	10,460,195	-
Total	640,995	864,571	-
11,144,683	12,632,320	-	
Commercial and industrial loans (except those secured by real estate)			
Consumer and other	748,040	1,535,397	-
52,019	52,019	-	
\$45,379,885	\$54,024,599	\$-	
With an allowance recorded			
Construction and land development			
Residential	\$-	\$-	\$-
Commercial	5,748,863	7,531,385	344,651
Total	5,748,863	7,531,385	344,651
Commercial real estate			
Farmland			
Commercial real estate - owner occupied	7,101,305	7,616,761	917,527
Commercial real estate - non-owner occupied	4,221,512	4,221,512	513,685
Multifamily	-	-	-
Total	11,322,817	11,838,273	1,431,212
Consumer real estate			
Home equity lines			
Secured by 1-4 family residential, secured by first deeds of trust	399,312	447,596	79,550
Secured by 1-4 family residential, secured by second deeds of trust	1,508,740	1,508,740	59,277
Total	117,002	117,002	105,997
2,025,054	2,073,338	244,824	
Commercial and industrial loans (except those secured by real estate)			
Consumer and other	417,541	927,130	124,646
-	-	-	
\$19,514,275	\$22,370,126	\$2,145,333	
Total			
Construction and land development			
Residential	\$ 191,544	\$ 471,544	\$-
Commercial	14,968,005	22,663,434	344,651

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Total	15,159,549	23,134,978	344,651
Commercial real estate			
Farmland	1,049,489	1,049,489	-
Commercial real estate - owner occupied	15,585,676	16,131,716	917,527
Commercial real estate - non-owner occupied	17,137,231	17,283,460	513,685
Multifamily	1,574,878	1,574,878	-
Total	35,347,274	36,039,543	1,431,212
Consumer real estate			
Home equity lines	1,574,542	1,755,150	79,550
Secured by 1-4 family residential, secured by first deeds of trust	10,837,198	11,968,935	59,277
Secured by 1-4 family residential, secured by second deeds of trust	757,997	981,573	105,997
Total	13,169,737	14,705,658	244,824
Commercial and industrial loans (except those secured by real estate)	1,165,581	2,462,527	124,646
Consumer and other	52,019	52,019	-
	\$64,894,160	\$76,394,725	\$2,145,333

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	December 31, 2011		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded			
Construction and land development			
Residential	\$624,651	\$712,243	\$-
Commercial	9,722,132	11,094,408	-
Total	10,346,783	11,806,651	-
Commercial real estate			
Farmland			
Commercial real estate - owner occupied	6,414,362	6,414,362	-
Commercial real estate - non-owner occupied	7,146,531	7,146,531	-
Multifamily	2,019,675	2,019,675	-
Total	15,580,568	15,580,568	-
Consumer real estate			
Home equity lines			
Secured by 1-4 family residential, secured by first deeds of trust	6,319,837	6,792,837	-
Secured by 1-4 family residential, secured by second deeds of trust	336,257	336,257	-
Total	7,358,432	7,831,432	-
Commercial and industrial loans (except those secured by real estate)	1,194,913	1,494,913	-
Consumer and other	143,241	143,241	-
	\$34,623,937	\$36,856,805	\$-
With an allowance recorded			
Construction and land development			
Residential	\$587,235	\$587,235	\$320,250
Commercial	14,885,541	15,785,541	3,913,820
Total	15,472,776	16,372,776	4,234,070
Commercial real estate			
Farmland			
Commercial real estate - owner occupied	9,508,393	9,652,393	2,031,740
Commercial real estate - non-owner occupied	1,719,690	1,719,690	450,000
Multifamily	-	-	-
Total	11,228,083	11,372,083	2,481,740
Consumer real estate			
Home equity lines			
Secured by 1-4 family residential, secured by first deeds of trust	4,224,325	4,749,325	1,007,155
Secured by 1-4 family residential, secured by second deeds of trust	167,523	167,523	119,524
Total	5,148,740	5,673,740	1,360,285
Commercial and industrial loans (except those secured by real estate)	818,597	818,597	452,773
Consumer and other	267,166	267,166	266,178
	\$32,935,362	\$34,504,362	\$8,795,046
Total			
Construction and land development			
Residential	\$1,211,886	\$1,299,478	\$320,250
Commercial	24,607,673	26,879,949	3,913,820

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Total	25,819,559	28,179,427	4,234,070
Commercial real estate			
Farmland	-	-	-
Commercial real estate - owner occupied	15,922,755	16,066,755	2,031,740
Commercial real estate - non-owner occupied	8,866,221	8,866,221	450,000
Multifamily	2,019,675	2,019,675	-
Total	26,808,651	26,952,651	2,481,740
Consumer real estate			
Home equity lines	1,459,230	1,459,230	233,606
Secured by 1-4 family residential, secured by first deeds of trust	10,544,162	11,542,162	1,007,155
Secured by 1-4 family residential, secured by second deeds of trust	503,780	503,780	119,524
Total	12,507,172	13,505,172	1,360,285
Commercial and industrial loans (except those secured by real estate)	2,013,510	2,313,510	452,773
Consumer and other	410,407	410,407	266,178
	\$67,559,299	\$71,361,167	\$8,795,046

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The following is a summary of average recorded investment in impaired loans with and without a valuation allowance and interest income recognized on those loans for the three and nine months ended September 30, 2012.

	For the Three Months Ended September 30, 2012		For the Nine Months Ended September 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance recorded				
Construction and land development				
Residential	\$248,422	\$3,050	\$191,544	\$14,791
Commercial	12,460,662	89,431	10,188,879	270,464
Total construction and land development	12,709,084	92,481	10,380,423	285,255
Commercial real estate				
Farmland	1,049,489	2,000	1,049,489	17,405
Commercial real estate - owner occupied	7,770,119	213,499	8,631,653	439,458
Commercial real estate - non-owner occupied	12,778,883	437,034	13,340,847	677,127
Multifamily	1,361,630	44,333	1,580,204	71,631
Total commercial real estate	22,960,121	696,866	24,602,193	1,205,621
Consumer real estate				
Home equity lines	1,454,661	22,556	1,175,339	55,535
Secured by 1-4 family residential, secured by first deeds of trust	9,222,570	78,162	9,142,698	308,917
Secured by 1-4 family residential, secured by second deeds of trust	674,842	4,677	646,695	22,789
Total consumer real estate	11,352,073	105,395	10,964,732	387,241
Commercial and industrial loans (except those secured by real estate)	876,549	5,416	816,643	27,325
Consumer and other	45,710	1,006	54,754	2,099
	\$47,943,537	\$901,164	\$46,818,745	\$1,907,541

Impaired loans with an allowance recorded

Construction and land development:				
Residential	\$-	\$-	\$-	\$-
Commercial	4,896,911	-	5,929,859	1,373
Total construction and land development	4,896,911	-	5,929,859	1,373
Commercial real estate:				
Farmland	-	-	-	-
Commercial real estate - owner occupied	7,380,990	398	7,362,455	52,668
Commercial real estate - non-owner occupied	4,482,345	-	4,304,172	26,222
Multifamily	-	-	-	-
Total commercial real estate	11,863,335	398	11,666,627	78,890
Consumer real estate:				
Home equity lines	431,298	-	406,192	6,814
Secured by 1-4 family residential, secured by first deeds of trust	3,233,526	-	2,315,032	52,470

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Secured by 1-4 family residential, secured by second deeds of trust	117,246	-	117,388	1,684
Total consumer real estate	3,782,070	-	2,838,612	60,968
Commercial and industrial loans (except those secured by real estate)	1,436,105	-	1,362,576	32,587
Consumer and other	-	-	-	-
	\$21,978,421	\$398	\$21,797,674	\$173,818
				-
<b>Total</b>				
Construction and land development				
Residential	\$248,422	\$3,050	\$191,544	\$14,791
Commercial	17,357,573	89,431	16,118,738	271,837
Total construction and land development	17,605,995	92,481	16,310,282	286,628
Commercial real estate				
Farmland	1,049,489	2,000	1,049,489	17,405
Commercial real estate - owner occupied	15,151,109	213,897	15,994,108	492,126
Commercial real estate - non-owner occupied	17,261,228	437,034	17,645,019	703,349
Multifamily	1,361,630	44,333	1,580,204	71,631
Total commercial real estate	34,823,456	697,264	36,268,820	1,284,511
Consumer real estate				
Home equity lines	1,885,959	22,556	1,581,531	62,349
Secured by 1-4 family residential, secured by first deeds of trust	12,456,096	78,162	11,457,730	361,387
Secured by 1-4 family residential, secured by second deeds of trust	792,088	4,677	764,083	24,473
Total consumer real estate	15,134,143	105,395	13,803,344	448,209
Commercial and industrial loans (except those secured by real estate)	2,312,654	5,416	2,179,219	59,912
Consumer and other	45,710	1,006	54,754	2,099
	\$69,921,958	\$901,562	\$68,616,419	\$2,081,359

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	For the Three Months Ended September 30, 2011		For the Nine Months Ended September 30, 2011	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance recorded				
Construction and land development				
Residential	\$343,992	\$-	\$168,361	\$4,045
Commercial	9,224,062	3,989	8,608,213	23,977
Total construction and land development	9,568,054	3,989	8,776,574	28,022
Commercial real estate				
Farmland	-	-	-	-
Commercial real estate - owner occupied	1,253,390	-	1,651,229	-
Commercial real estate - non-owner occupied	2,289,859	-	1,866,440	49,627
Multifamily	187,721	-	974,736	-
Total commercial real estate	3,730,970	-	4,492,405	49,627
Consumer real estate				
Home equity lines	32,607	765	204,024	13,153
Secured by 1-4 family residential, secured by first deeds of trust	9,045,607	-	8,154,334	56,654
Secured by 1-4 family residential, secured by second deeds of trust	160,812	348	189,526	3,397
Total consumer real estate	9,239,026	1,113	8,547,884	73,204
Commercial and industrial loans (except those secured by real estate)	3,984,776	-	2,764,133	27,667
Consumer and other	351,876	-	196,895	272
	\$26,874,702	\$5,102	\$24,777,891	\$178,792
Impaired loans with an allowance recorded				
Construction and land development:				
Residential	\$184,660	\$-	\$138,495	\$-
Commercial	14,083,611	1,630	13,828,972	4,785
Total construction and land development	14,268,271	1,630	13,967,467	4,785
Commercial real estate:				
Farmland	-	-	-	-
Commercial real estate - owner occupied	1,753,731	-	2,220,067	-
Commercial real estate - non-owner occupied	558,472	-	418,854	-
Multifamily	-	-	-	-
Total commercial real estate	2,312,203	-	2,638,921	-
Consumer real estate:				
Home equity lines	246,129	-	203,270	-
Secured by 1-4 family residential, secured by first deeds of trust	3,233,526	-	2,990,049	2,502
Secured by 1-4 family residential, secured by second deeds of trust	80,999	450	80,999	729
Total consumer real estate	3,560,654	450	3,274,318	3,231



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Commercial and industrial loans (except those secured by real estate)	-	-	-	-
Consumer and other	-	-	-	-
	\$20,141,128	\$2,080	\$19,880,706	\$8,016
				-
<b>Total</b>				
Construction and land development				
Residential	\$528,652	\$-	\$306,856	\$4,045
Commercial	23,307,673	5,619	22,437,185	28,762
Total construction and land development	23,836,325	5,619	22,744,041	32,807
Commercial real estate				
Farmland	-	-	-	-
Commercial real estate - owner occupied	3,007,121	-	3,871,296	-
Commercial real estate - non-owner occupied	2,848,331	-	2,285,294	49,627
Multifamily	187,721	-	974,736	-
Total commercial real estate	6,043,173	-	7,131,326	49,627
Consumer real estate				
Home equity lines	278,736	765	407,294	13,153
Secured by 1-4 family residential, secured by first deeds of trust	12,279,133	-	11,144,383	59,156
Secured by 1-4 family residential, secured by second deeds of trust	241,811	798	270,525	4,126
Total consumer real estate	12,799,680	1,563	11,822,202	76,435
Commercial and industrial loans (except those secured by real estate)	3,984,776	-	2,764,133	27,667
Consumer and other	351,876	-	196,895	272
	\$47,015,830	\$7,182	\$44,658,597	\$186,808

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

	Three Months Ended September 30, 2012			
	Total	Performing	Nonaccrual	Specific Valuation Allowance
Construction and land development				
Commercial	\$39,769	\$-	\$39,769	\$-
Total	39,769	-	39,769	-
Commercial real estate:				
Commercial real estate - owner occupied	-	-	-	-
Commercial real estate - non-owner occupied	4,737,776	4,276,511	461,265	-
Multifamily	634,594	-	-	-
Total	5,372,370	4,276,511	461,265	-
Consumer real estate:				
Secured by 1-4 family residential, secured by first deeds of trust	1,042,595	599,242	443,353	17,949
Total	1,042,595	599,242	443,353	17,949
Commercial and industrial loans (except those secured by real estate)	199,964	-	199,964	-
	\$6,654,698	\$4,875,753	\$1,144,351	\$17,949

	Nine Months Ended September 30, 2012			
	Total	Performing	Nonaccrual	Specific Valuation Allowance
Construction and land development:				
Residential	\$191,544	\$-	\$191,544	\$-
Commercial	9,876,951	5,165,826	4,711,125	278,000
Total construction and land development	10,068,495	5,165,826	4,902,669	278,000
Commercial real estate:				
Commercial real estate - owner occupied	10,385,569	5,886,028	4,499,541	779,111
Commercial real estate - non-owner occupied	13,760,683	7,759,407	6,001,276	719,226
Multifamily	1,210,273	1,210,273	-	-
Total commercial real estate	25,356,525	14,855,708	10,500,817	1,498,337
Consumer real estate:				
Home equity lines	349,192	-	349,192	45,590
Secured by 1-4 family residential, secured by first deeds of trust	5,384,930	2,069,732	3,315,198	17,949
	69,815	-	69,815	68,200

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Secured by 1-4 family residential, secured by second deeds of trust

Total consumer real estate	5,803,937	2,069,732	3,734,205	131,739
Commercial and industrial loans (except those secured by real estate)	456,028	6,180	449,848	80,943
	\$41,684,985	\$22,097,446	\$19,587,539	\$1,989,019

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	Three Months Ended September 30, 2011			
	Total	Performing	Nonaccrual	Specific Valuation Allowance
Construction and land development				
Commercial	\$2,655,029	-	\$2,655,029	823,522
Total	2,655,029	-	2,655,029	823,522
Commercial real estate				
Commercial real estate - owner occupied	-	-	-	-
Commercial real estate - non-owner occupied	-	-	-	-
Multifamily	-	-	-	-
Total	-	-	-	-
Consumer real estate				
Secured by 1-4 family residential, secured by first deeds of trust	3,837,577	3,837,577	-	404,000
Total	3,837,577	3,837,577	-	404,000
Commercial and industrial loans (except those secured by real estate)	360,000	-	360,000	-
	\$6,852,606	\$3,837,577	\$3,015,029	\$1,227,522

	Nine Months Ended September 30, 2011			
	Total	Performing	Nonaccrual	Specific Valuation Allowance
Construction and land development				
Residential	\$-	\$-	\$-	\$-
Commercial	5,495,511	600,000	4,895,511	864,868
Total	5,495,511	600,000	4,895,511	864,868
Commercial real estate				
Commercial real estate - owner occupied	-	-	-	-
Commercial real estate - non-owner occupied	775,456	775,456	-	-
Multifamily	-	-	-	-
Total	775,456	775,456	-	-
Consumer real estate				
Home equity lines	-	-	-	-
Secured by 1-4 family residential, secured by first deeds of trust	3,837,577	3,837,577	-	404,000
Secured by 1-4 family residential, secured by second deeds of trust	-	-	-	-
Total	3,837,577	3,837,577	-	404,000
Commercial and industrial loans (except those secured by real estate)	360,000	-	360,000	-
	\$10,468,544	\$5,213,033	\$5,255,511	\$1,268,868



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The following table provides information about TDRs identified during the current period:

	September 30, 2012		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance
Construction and land development			
Residential	-	\$ -	\$ -
Commercial	1	39,769	39,769
Total	1	39,769	39,769
Commercial real estate			
Farmland	-	-	-
Commercial real estate - owner occupied	-	-	-
Commercial real estate - non-owner occupied	7	4,737,776	4,737,776
Multifamily	1	634,594	634,594
Total	8	5,372,370	5,372,370
Consumer real estate			
Home equity lines	-	-	-
Secured by 1-4 family residential, secured by first deeds of trust	4	1,042,595	1,042,595
Secured by 1-4 family residential, secured by second deeds of trust	-	-	-
Total	4	1,042,595	1,042,595
Commercial and industrial loans (except those secured by real estate)	1	199,964	199,964
Consumer and other	-	-	-
	14	\$ 6,654,698	\$ 6,654,698

	September 30, 2012	
	Number of Loans	Recorded Balance
Defaults on TDRs		
Construction and land development		
Residential	-	\$-
Commercial	1	39,769
Total	1	39,769
Commercial real estate		
Farmland	-	-
Commercial real estate - owner occupied	-	-
Commercial real estate - non-owner occupied	1	461,265
Multifamily	1	461,265
Total		
Consumer real estate		
Home equity lines	-	-
Secured by 1-4 family residential, secured by first deeds of trust	-	-
Secured by 1-4 family residential, secured by second deeds of trust	-	-
Total	-	-
Commercial and industrial loans (except those secured by real estate)	1	119,964

Consumer and other	-	-
	3	\$620,998

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	Nine Months Ended September 30, 2012			Year Ended December 31, 2011		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance
Construction and land development:						
Residential	3	\$ 191,544	\$ 191,544		\$ -	\$ -
Commercial	12	3,938,672	3,938,672	11	6,604,400	6,604,400
Total construction and land development	15	4,130,216	4,130,216	11	\$ 6,604,400	6,604,400
Commercial real estate:						
Farmland		-	-			-
Commercial real estate - owner occupied	1	1,388,851	1,388,851	9	9,748,062	9,748,062
Commercial real estate - non-owner occupied	9	9,665,791	9,665,791	5	4,031,868	4,031,868
Multifamily	1	634,594	634,594		-	-
Total commercial real estate	11	11,689,236	11,689,236	14	13,779,930	13,779,930
Consumer real estate:						
Home equity lines	1	349,192	349,192		-	-
Secured by 1-4 family residential, secured by first deeds of trust	39	4,505,468	4,505,468	2	1,422,772	1,422,772
Secured by 1-4 family residential, secured by second deeds of trust	1	69,815	69,815		-	-
Total consumer real estate	41	4,924,475	4,924,475	2	1,422,772	1,422,772
Commercial and industrial loans (except those secured by real estate)	6	456,028	456,028	3	159,073	159,073
Consumer and other	-	-	-	1	128,419	128,419
	73	\$ 21,199,955	\$ 21,199,955	31	\$ 21,966,175	\$ 21,966,175

	Nine Months Ended September 30, 2012		Year Ended December 31, 2011	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Defaults on TDRs				
Construction and land development:				
Residential	3	\$ 191,544	-	\$ -
Commercial	17	4,703,352	8	11,389,291
	20	4,894,896	8	11,389,291



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Total construction and land development				
Commercial real estate:				
Farmland	-	-		
Commercial real estate - owner occupied	3	496,933	2	2,202,688
Commercial real estate - non-owner occupied	1	461,265		-
Multifamily	4	958,198	2	2,202,688
Total commercial real estate				
Consumer real estate:				
Home equity lines	1	349,192		
Secured by 1-4 family residential, secured by first deeds of trust	20	2,459,862	2	1,422,772
Secured by 1-4 family residential, secured by second deeds of trust	1	69,815		-
Total consumer real estate	22	2,878,869	2	1,422,772
Commercial and industrial loans (except those secured by real estate)	5	449,848	2	151,790
Consumer and other	-	-	1	128,419
Total	51	\$ 9,181,811	15	\$ 15,294,960

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	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance
Construction and land development:						
Residential		\$ -	\$ -			\$ -
Commercial	2	2,655,029	2,655,029	7	5,495,511	5,495,511
Total construction and land development	2	2,655,029	2,655,029	7	\$ 5,495,511	5,495,511
Commercial real estate:						-
Farmland		-	-			-
Commercial real estate - owner occupied		-	-	-		-
Commercial real estate - non-owner occupied		-	-	1	775,456	775,456
Multifamily		-	-			-
Total commercial real estate	-	-	-	1	775,456	775,456
Consumer real estate:						
Home equity lines		-	-		-	-
Secured by 1-4 family residential, secured by first deeds of trust	3	3,837,577	3,837,577	3	3,837,577	3,837,577
Secured by 1-4 family residential, secured by second deeds of trust		-	-		-	-
Total consumer real estate	3	3,837,577	3,837,577	3	3,837,577	3,837,577
Commercial and industrial loans (except those secured by real estate)	2	360,000	360,000	2	360,000	360,000
	7	6,852,606	6,852,606	13	10,468,544	10,468,544

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Defaults on TDRs				
Construction and land development:				
Commercial	4	\$ 5,822,810	10	11,475,296
Total construction and land development	4	5,822,810	10	11,475,296
Commercial real estate:				
Commercial real estate - owner occupied	1	2,180,716	1	2,180,716

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Total commercial real estate	1	2,180,716	1	2,180,716
Commercial and industrial loans (except those secured by real estate)	2	360,000	2	360,000
Total	7	\$ 8,363,526	13	\$ 14,016,012

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

	Construction and land development	Construction and land development	Farmland	Commercial Real estate owner occupied	Commercial Real estate non-owner occupied	Multifamily
Nine months ended September 30, 2012						
Beginning balance	\$ 704,728	\$ 6,798,177	\$-	\$1,496,466	\$1,548,899	\$406,635
Provision for loan losses	542,067	3,444,160	-	623,552	(300,898 )	(373,238 )
Charge-offs	(797,286 )	(5,505,724 )	-	(684,670 )	(431,354 )	-
Recoveries	44,783	4,595	-	-	205	-
Ending balance	494,292	4,741,208	-	1,435,348	816,852	33,397
Loans Individually Evaluated for Impairment	1,190,484	32,649,687	1,394,273	70,478,705	42,844,047	5,683,101
Loans collectively Evaluated for Impairment	3,747,474	15,766,127	1,197,004	26,708,241	12,450,292	1,885,938
	\$ 4,937,958	\$ 48,415,814	\$ 2,591,277	\$ 97,186,946	\$ 55,294,339	\$ 7,569,039
	Consumer Home equity lines	Consumer Secured by 1-4 family residential first deeds of trust	Consumer Secured by 1-4 family residential second deeds of trust	Commercial and Industrial (except those secured by real estate)	Consumer and Other	Total
Beginning balance	\$ 860,307	\$ 1,881,470	\$ 397,504	\$ 1,655,713	\$ 321,525	\$ 16,071,424
Provision for loan losses	668,614	2,610,905	468,192	1,230,555	181,091	9,095,000
Charge-offs	(681,405 )	(3,045,937 )	(427,882 )	(1,427,841 )	(403,680 )	(13,405,779 )
Recoveries	8,461	80,804	4,633	146,984	4,734	295,199
Ending balance	855,977	1,527,242	442,447	1,605,411	103,670	12,055,844
Loans Individually Evaluated for Impairment	1,416,634	13,734,018	562,841	16,008,630	-	185,962,420
Loans collectively Evaluated for Impairment	25,295,354	68,752,791	9,329,653	19,957,563	3,297,911	188,388,348
	\$ 26,711,988	\$ 82,486,809	\$ 9,892,494	\$ 35,966,193	\$ 3,297,911	\$ 374,350,768



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	Construction and land development	Construction and land development		Commercial Real estate owner occupied	Commercial Real estate non-owner occupied	Multifamily
	Residential	Commercial	Farmland			
Three months ended September 30, 2012						
Beginning balance	599,554	4,562,330		2,520,907	1,400,093	92,728
Provision for loan losses	(146,645 )	1,907,303	-	(710,375 )	(465,241 )	(59,331 )
Charge-offs	(2,500 )	(1,732,520 )	-	(375,184 )	(118,000 )	-
Recoveries	43,883	4,095	-	-	-	-
Ending balance	494,292	4,741,208	-	1,435,348	816,852	33,397
Loans Individually						
Evaluated for Impairment	1,190,484	32,649,687	1,394,273	70,478,705	42,844,047	5,683,101
Loans collectively						
Evaluated for Impairment	3,747,474	15,766,127	1,197,004	26,708,241	12,450,292	1,885,938
	\$ 4,937,958	\$ 48,415,814	\$ 2,591,277	\$ 97,186,946	\$ 55,294,339	\$ 7,569,039
		Consumer Secured by 1-4 family residential	Consumer Secured by 1-4 family residential second deeds of trust	Commercial and Industrial (except those secured by real estate)	Consumer and Other	Total
Beginning balance	\$ 776,732	\$ 2,038,947	\$ 375,552	\$ 2,345,245	\$ 153,633	\$ 14,865,721
Provision for loan losses	461,686	(55,146 )	298,168	(480,271 )	(50,148 )	700,000
Charge-offs	(389,585 )	(456,559 )	(231,273 )	(272,059 )	(1,374 )	(3,579,054 )
Recoveries	7,144	-	-	12,496	1,559	69,177
Ending balance	855,977	1,527,242	442,447	1,605,411	103,670	12,055,844
Loans Individually						
Evaluated for Impairment	1,416,634	13,734,018	562,841	16,008,630	-	185,962,420
Loans collectively						
Evaluated for Impairment	25,295,354	68,752,791	9,329,653	19,957,563	3,297,911	188,388,348
	\$ 26,711,988	\$ 82,486,809	\$ 9,892,494	\$ 35,966,193	\$ 3,297,911	\$ 374,350,768

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	Construction and land development	Construction and land development		Commercial  Real estate owner occupied	Commercial  Real estate non-owner occupied	Multifamily
Three months ended September 30, 2011	Residential	Commercial	Farmland			
Beginning balance	\$ 493,841	\$ 3,142,119	\$-	\$78,445	\$26,174	\$(82,501 )
Provision for loan losses	152,747	3,380,084	-	1,314,523	1,416,169	461,041
Charge-offs	-	(193,251 )	-	-	-	-
Recoveries	8,750	-	-	-	-	-
Ending balance	655,338	6,328,952	-	1,392,968	1,442,343	378,540
Loans Individually Evaluated for Impairment	3,900,611	28,604,482	-	90,752,748	47,537,154	5,762,076
Loans collectively Evaluated for Impairment	6,397,303	47,565,048	2,026,014	12,819,848	6,926,201	983,943
	\$ 10,297,914	\$ 76,169,530	\$ 2,026,014	\$ 103,572,596	\$ 54,463,355	\$ 6,746,019
	Consumer	Consumer Secured by 1-4 family residential	Consumer Secured by 1-4 family residential second deeds of trust	Commercial and Industrial (except those secured by real estate)	Consumer and Other	Total
Beginning balance	\$ 169,497	\$ 1,703,207	\$ 462,249	\$ 927,948	\$ 335,635	\$ 7,256,614
Provision for loan losses	831,159	164,474	76,189	1,655,766	55,732	9,507,884
Charge-offs	(200,397 )	(115,624 )	(167,379 )	(1,042,622 )	(93,414 )	(1,812,687 )
Recoveries	211	-	-	-	1,290	10,251
Ending balance	800,470	1,752,057	371,059	1,541,092	299,243	14,962,062
Loans Individually Evaluated for Impairment	3,976,796	12,172,119	1,066,215	14,828,282	3,976,796	\$ 212,577,279
Loans collectively Evaluated for Impairment	28,973,441	82,417,488	11,428,907	23,133,570	814,921	223,486,684
	\$ 32,950,237	\$ 94,589,607	\$ 12,495,122	\$ 37,961,852	\$ 4,791,717	\$ 436,063,963
	Construction and land development	Construction and land development		Commercial  Real estate owner occupied	Commercial  Real estate non-owner occupied	Multifamily
	Residential	Commercial	Farmland			

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Nine months ended  
September 30, 2011

Beginning balance	\$ 293,841	\$ 2,832,119	\$-	\$78,445	\$20,477	\$-
Provision for loan losses	352,747	3,680,084	-	1,314,523	1,666,169	461,041
Charge-offs	-	(193,251 )	-	-	(244,303 )	(82,501 )
Recoveries	8,750	10,000	-	-	-	-
Ending balance	655,338	6,328,952	-	1,392,968	1,442,343	378,540

Loans Individually

Evaluated for Impairment	3,900,611	28,604,482	-	90,752,748	47,537,154	5,762,076
Loans collectively						
Evaluated for Impairment	6,397,303	47,565,048	2,026,014	12,819,848	6,926,201	983,943
	\$ 10,297,914	\$ 76,169,530	\$ 2,026,014	\$ 103,572,596	\$ 54,463,355	\$ 6,746,019

	Consumer	Consumer	Consumer	Commercial		
	Home	Secured	Secured	and		
	equity	by 1-4	by 1-4	Industrial		
	lines	family	family	(except		
		residential	residential	those		
		first deeds	second	secured by	Consumer	Total
		of trust	deeds of	real estate)	and Other	
			trust			
Beginning balance	\$641,975	\$1,403,207	\$297,401	\$1,315,582	\$428,665	\$7,311,712
Provision for loan losses	1,281,159	464,474	276,189	1,858,766	55,732	\$11,410,884
Charge-offs	(1,124,221 )	(115,624 )	(202,531 )	(1,635,256 )	(186,886 )	(3,784,573 )
Recoveries	1,557	-	-	2,000	1,732	24,039
Ending balance	800,470	1,752,057	371,059	1,541,092	299,243	14,962,062
Loans Individually						
Evaluated for Impairment	3,976,796	12,172,119	1,066,215	14,828,282	3,976,796	\$212,577,279
Loans collectively						
Evaluated for Impairment	28,973,441	82,417,488	11,428,907	23,133,570	814,921	223,486,684
	\$32,950,237	\$94,589,607	\$12,495,122	\$37,961,852	\$4,791,717	\$436,063,963

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	Construction and land development	Construction and land development	Farmland	Commercial  Real estate owner occupied	Commercial  Real estate non-owner occupied	Multifamily
	Residential	Commercial				
Year ended December 31, 2011						
Beginning balance	\$ 293,841	\$ 2,832,119	\$-	\$78,445	\$20,477	\$-
Provision for loan losses	467,187	8,249,320	-	1,568,052	1,871,804	489,136
Charge-offs	(65,500 )	(4,293,262 )	-	(150,031 )	(343,382 )	(82,501 )
Recoveries	9,200	10,000	-	-	-	-
Ending balance	704,728	6,798,177	-	1,496,466	1,548,899	406,635
Loans Individually						
Evaluated for Impairment	1,831,478	30,292,460	-	91,008,321	45,529,918	5,625,490
Loans collectively						
Evaluated for Impairment	6,074,987	42,328,077	2,464,981	14,583,827	8,529,231	1,053,838
	\$ 7,906,465	\$ 72,620,537	\$2,464,981	\$105,592,148	\$54,059,149	\$6,679,328
		Consumer Secured by 1-4 family residential	Consumer Secured by 1-4 family residential second deeds of trust	Commercial and Industrial (except those secured by real estate)	Consumer and Other	Total
Beginning balance	\$641,975	\$1,403,207	\$297,401	\$1,315,582	\$428,665	\$7,311,712
Provision for loan losses	1,447,272	1,571,813	462,634	2,496,729	140,349	18,764,296
Charge-offs	(1,232,153 )	(1,129,509 )	(362,531 )	(2,159,669 )	(249,526 )	(10,068,063 )
Recoveries	3,213	35,959	-	3,070	2,037	63,479
Ending balance	860,307	1,881,470	397,504	1,655,713	321,525	16,071,424
Loans Individually						
Evaluated for Impairment	4,314,190	13,105,245	1,692,944	14,343,224	3,501,524	211,244,794
Loans collectively						
Evaluated for Impairment	26,373,036	80,113,553	10,349,119	23,391,292	1,363,981	216,625,922
	\$30,687,226	\$93,218,798	\$12,042,063	\$37,734,516	\$4,865,505	\$427,870,716

Note 6 – Deposits

Deposits as of September 30, 2012 and December 31, 2011 were as follows:

	September 30, 2012		December 31, 2011	
	Amount	%	Amount	%
Noninterest bearing demand	\$58,469,352	13 %	\$66,534,956	14 %



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Interest checking accounts	42,795,169	10	%	40,237,146	8	%
Money market accounts	63,309,886	15	%	75,487,907	16	%
Savings accounts	18,073,601	4	%	15,166,012	3	%
Time deposits of \$100,000 and over	115,499,674	27	%	129,436,270	27	%
Other time deposits	136,994,455	31	%	158,658,761	32	%
Total	\$435,142,137	100	%	\$485,521,052	100	%

Note 7 – Trust preferred securities

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, \$5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at September 30, 2012 was 2.54%. The securities were redeemable at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. No amounts have been redeemed at September 30, 2012 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.

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

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

The obligations of the Company with respect to the issuance of the Trust Preferred Capital Notes constitute a full and unconditional guarantee by the Company of the Trust's obligations with respect to the Trust Preferred Capital Notes. Subject to certain exceptions and limitations, the Company may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related Trust Preferred Capital Notes and require a deferral of common dividends. In consideration of our agreements with our regulators, which require regulatory approval to make interest payments on these securities, the Company has deferred an aggregate of \$558,600 in interest payments on the junior subordinated debt securities as of September 30, 2012. The Company has been deferring interest payments since June 2011. Although we elected to defer payment of the interest due, the amount has been accrued and is included in interest expense.

## Note 8 – Stock incentive plan

The Company has a stock incentive plan which authorizes the issuance of up to 455,000 shares of common stock to assist the Company in recruiting and retaining key personnel.

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

	Nine Months Ended September 30,							
	2012				2011			
	Options	Weighted Average Exercise Price	Fair Value Per Share	Intrinsic Value	Options	Weighted Average Exercise Price	Fair Value Per Share	Intrinsic Value
Options outstanding, beginning of period	264,980	\$ 9.48	\$ 4.70		310,205	\$ 9.48	\$ 4.73	
Granted	5,000	1.00	1.08		-	-	-	
Forfeited	(3,450 )	4.98	3.12		-	-	-	
Exercised	-	-	-		-	-	-	
Options outstanding, end of period	266,530	\$ 9.54	\$ 4.66	\$ -	310,205	\$ 9.48	\$ 4.73	\$ -

Options exercisable, end of period	261,530	291,350
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During the first quarter of 2009, we granted to certain officers 26,592 restricted shares of common stock with a weighted average fair market value of \$4.60 at the date of grant. These restricted stock awards

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had three-year graded vesting. Prior to vesting, these shares are subject to forfeiture to us without consideration upon termination of employment under certain circumstances. The remaining balance of restricted stock has been issued as of September 30, 2012. The total number of shares underlying non-vested restricted stock and performance share awards was 6,271 at September 30, 2011.

The fair value of the stock is calculated under the same methodology as stock options and the expense is recognized over the vesting period. Unamortized stock-based compensation related to nonvested share based compensation arrangements granted under the Incentive Plan as of September 30, 2012 and 2011 was \$2,734 and \$35,960 respectively. The time based unamortized compensation of \$2,734 is expected to be recognized over a weighted average period of 2.83 years.

Stock-based compensation expense was \$6,506 and \$88,835 for the nine months ended September 30, 2012 and 2011, respectively.

Note 9 – Fair Value

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

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

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

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

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

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

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

transactions are executed in the marketplace (Levels 1 and 2).

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

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

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

	Carrying Value	Fair Value Measurement at September 30, 2012 Using (In thousands)		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets - Recurring				
US Government Agencies	\$16,954	\$4,978	\$11,976	\$ -
MBS	2,161	-	2,161	-
Municipals	11,304	1,736	9,568	-
US Treasury	2,997			
Residential loans held for sale	22,527	-	22,527	-
			-	
Financial Assets - Non-Recurring				
Impaired loans	64,894	-	55,007	9,887
Real estate owned	20,576	-	18,132	2,444

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	Carrying Value	Fair Value Measurement at December 31, 2011 Using (in thousands)		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets - Recurring				
US Government Agencies	\$2,001	\$-	\$2,001	\$ -
MBS	20,803	2,849	17,954	-
Small Business Administration	7,359	7,359	-	-
Residential loans held for sale	16,168	-	16,168	-
Financial Assets - Non-Recurring				
Impaired loans	64,655	-	51,868	12,787
Real estate owned	9,177	-	874	8,303

The following table presents qualitative information about level 3 fair value measurements for financial instruments measured at fair value at September 30, 2012:

	Fair Value Estimate	Valuation Techniques (In thousands)	Unobservable Input	Range (Weighted Average)
Impaired Loans - Real Estate Secured	\$ 7,768	Appraisal (1) or Internal Valuation (2)	Appraisal Adjustments Liquidation Expenses (3)	10%-30 %
Impaired Loans - Non-Real Estate Secured	\$ 2,119	Appraisal (1) or Discounted Cash Flow	Appraisal Adjustments Liquidation Expenses (3)	10%-20 %
Real Estate Owned	\$ 2,444	Appraisal (1) or Internal Valuation (2)	Appraisal Adjustments Liquidation Expenses (3)	7%-30 %

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

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

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

The following table presents the changes in the Level 3 fair value category for the nine months ended September 30, 2012.





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	Impaired Loans	Real Estate Owned (In thousands)	Total Assets
Balance at December 31, 2011	\$12,787	\$8,030	\$20,817
Total realized and unrealized gains (losses)			
Included in earnings	-	(137 )	(137 )
Included in other comprehensive income	-	-	-
Net transfers in and/or out of Level 3	(2,900 )	(5,449 )	(8,349 )
Balance at September 30, 2012	\$9,887	\$2,444	\$12,331
	Impaired Loans	Real Estate Owned (In thousands)	Total Assets
Balance at June 30, 2012	\$14,700	\$6,465	\$21,165
Total realized and unrealized gains (losses)			
Included in earnings	-	(94 )	(94 )
Included in other comprehensive income	-	-	-
Net transfers in and/or out of Level 3	(4,813 )	(3,927 )	(8,740 )
Balance at September 30, 2012	\$9,887	\$2,444	\$12,331

In general, fair value of securities is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon market prices determined by an outside, independent entity that primarily uses as inputs, observable market-based parameters. Fair value of loans held for sale is based upon internally developed models that primarily use as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly and or quarter valuation process.

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

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

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

remaining maturities.

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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.

The following table presents the estimated fair value of our financial instruments at the indicated dates:

	Level in Fair Value Hierarchy	September 30, 2012		December 31, 2011	
		Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial assets</b>					
Cash	Level 1	\$ 26,064,313	\$ 26,064,313	\$ 55,557,541	\$ 55,557,541
Cash equivalents	Level 2	154,012	154,012	7,228,475	7,228,475
Investment securities available for sale	Level 1	6,713,476	6,713,476	10,207,805	10,207,805
Investment securities available for sale	Level 2	26,702,475	26,702,475	19,955,487	19,955,487
Federal Home Loan Bank stock	Level 2	2,166,900	2,166,900	2,647,000	2,647,000
Loans held for sale	Level 2	22,526,733	22,526,733	16,168,405	16,168,405
Loans	Level 2	298,176,828	290,131,297	353,186,646	353,349,981
Impaired loans	Level 2	55,007,435	55,007,435	51,867,625	51,867,625
Impaired loans	Level 3	9,886,725	9,886,725	12,787,473	12,787,473
Other real estate owned	Level 2	18,132,086	18,132,086	874,246	874,246
Other real estate owned	Level 3	2,443,878	2,443,878	8,302,921	8,302,921
Bank owned life insurance	Level 3	6,525,838	6,525,838	6,065,305	6,065,305
Accrued interest receivable	Level 2	1,800,872	1,800,872	2,046,524	2,046,524
<b>Financial liabilities</b>					
Deposits	Level 2	435,142,137	436,603,601	485,521,052	487,915,609
FHLB borrowings	Level 2	28,000,000	28,484,102	37,750,000	37,963,672
Trust preferred securities	Level 2	8,764,000	8,764,000	8,764,000	8,764,000
Other borrowings	Level 2	5,351,393	5,351,393	5,778,661	5,778,661
Accrued interest payable	Level 2	816,390	816,390	592,283	592,283

## Note 10 – Capital Purchase Program

On May 1, 2009, as part of the Capital Purchase Program established by the U.S. Department of the Treasury (the “Treasury”) under the Emergency Economic Stabilization Act of 2008 (“EESA”), the Company entered into a Letter

Agreement and Securities Purchase Agreement—Standard Terms (collectively, the “Purchase Agreement”) with the Treasury, pursuant to which the Company sold (i) 14,738 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$4.00 per share, having a liquidation preference of \$1,000 per share (the “Preferred Stock”) and (ii) a warrant (the “Warrant”) to purchase 499,029 shares of the Company’s common stock at an initial exercise price of \$4.43 per share, subject to certain anti-dilution and other adjustments, for an aggregate purchase price of \$14,738,000 in cash. The fair value of the preferred stock was estimated using discounted cash flow methodology at an assumed market equivalent rate of 13%, with 20 quarterly payments over a five year period. The fair value of the warrant was estimated using the Black-Scholes option pricing model, with assumptions of 25% volatility, a risk-free rate of 2.03%, a yield of

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6.162% and an estimated life of 5 years. The value attributed to the warrant is being accreted as a discount on the preferred stock using the effective interest rate method over five years.

The Preferred Stock qualifies as Tier 1 capital and pays cumulative dividends at a rate of 5% per annum until May 1, 2014, and thereafter at a rate of 9% per annum. The Preferred Stock is generally non-voting, other than on certain matters that could adversely affect the Preferred Stock.

In consideration of our agreements with our regulators, which require regulatory approval to make dividend payments on our preferred stock, the Company notified the U.S. Treasury in May 2011 that the Company was going to defer the payment of the quarterly cash dividend of \$184,225 due on May 16, 2011, and subsequent quarterly payments, on the Preferred Stock. The total arrearage on such preferred stock as of September 30, 2012 was \$1,166,758. In June 2012 as a result of the unpaid dividends, Treasury requested that an observer appointed by Treasury be allowed to attend the Company's meetings of its board of directors.

The 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. See further discussion of capital requirements under Capital Resources in Management's Discussion and Analysis of Financial Condition and Results of Operations following.

#### Note 11 – Commitments and contingencies

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

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

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

	September 30, 2012	December 31, 2011
Undisbursed credit lines	\$ 34,947,000	\$ 40,661,000
Commitments to extend or originate credit	35,834,000	18,214,000
Standby letter of credit	2,774,000	3,719,000
	\$ 73,555,000	\$ 62,594,000

Total commitments to  
extend credit

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

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

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

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

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

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





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

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

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

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

- Plan to improve liquidity, contingency funding, interest rate risk, and asset liability management
- Plan to reduce assets of \$250,000 or greater classified "doubtful" and "substandard"
- Revised lending and collection policy to provide effective guidance and control over the Bank's lending and credit administration functions
- Effective internal loan review and grading system
- Policy for managing the Bank's other real estate
- Business/strategic plan covering the overall operation of the Bank
- Plan and comprehensive budget for all categories of income and expense for the year 2012
- Policy and procedures for managing interest rate risk
- Assessment of the Bank's information technology function

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

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



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

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

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

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

Since entering into the Order and the Written Agreement, the Company has taken the following steps, among other things, to comply with their terms:

- The board of directors has established two committees that meet at least monthly. The Regulatory Oversight Committee to monitor and coordinate compliance with the Order and the Written Agreement and any other related regulatory matters that may arise, and the Asset Quality Committee to oversee management's progress in reducing the Bank's classified assets.
- The board of directors retained a bank consultant that developed a written analysis and assessment of the Bank's management and staffing needs for the purpose of providing qualified management for the Bank. Based on the results of this written analysis and assessment, the Bank formulated a written management plan that incorporates the findings of the management report, a plan of action in response to each recommendation contained in the management report, and a timeframe for completing each action which was submitted to the Supervisory Authorities.
- We have established a Problem Assets Group headed by a newly hired member of senior management with extensive experience with problem loan workouts which has developed a plan to reduce our nonperforming assets. This group has also established a plan to manage foreclosed real estate.
- We have revised our lending and collection policy to provide effective guidance and control over the Bank's lending and credit administration functions. This policy was also revised to provide for an effective internal loan review and grading system.
- We have prepared a comprehensive budget and strategic plan covering the overall operation of the Bank which has been submitted to the Supervisory Authorities.
- Prepared and submitted a plan to correct any violations of section 23A of the Federal Reserve Act and Regulation W to the Reserve Bank.

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



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Note 12 – Income Taxes

The net deferred tax asset is included in other assets on the balance sheet. Accounting Standards Codification Topic 740, Income Taxes, requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. Management considers both positive and negative evidence and analyzes changes in near-term market conditions as well as other factors which may impact future operating results. In making such judgments, significant weight is given to evidence that can be objectively verified. The deferred tax assets are analyzed quarterly for changes affecting realization. Management determined that as of September 30, 2012, the objective negative evidence represented by the Company’s recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance for all of the net deferred tax asset of approximately \$10,513,000.

Note 13 – Recent accounting pronouncements

In May 2011, the FASB issued ASU No. 2011-04, “Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.” The Company adopted ASU 2011-04, which generally aligns the principles of fair value measurements with International Financial Reporting Standards (IFRSs), in its consolidated financial statements in the first quarter 2012. The provisions of ASU 2011-04 clarify the application of existing fair value measurement requirements, and expand the disclosure requirements for fair value measurements. The increased provisions of ASU 2011-04 did not have a material effect on the Company’s financial condition and results of operations.

In June 2011, The FASB issued ASU No. 2011-05, Presentation of Comprehensive Income, Topic 220. This ASU eliminates the option of presenting the components of other comprehensive income (OCI) as part of the statement of changes in stockholders’ equity. The ASU instead permits an entity to present the total of comprehensive income, the components of net income, and the components of OCI either in a single continuous statement of comprehensive income or in two separate but consecutive statements. With either format, the entity is required to present each component of net income along with total net income, each component of OCI along with the total for OCI, and a total amount for comprehensive income. Also, the ASU requires entities to present, for either format, reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. This ASU is to be applied retrospectively. The Company adopted ASU-2011-05 in the first quarter of 2012. The provisions of ASU 2011-05 did not have a material effect on the Company’s financial condition and results of operations.

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

Caution about forward-looking statements

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

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

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

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

### General

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

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

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

Given current economic uncertainty as well as stress on our capital ratios resulting from operating losses, the Company has adopted a balance sheet reduction plan that focuses on the reduction of nonperforming assets and higher risk-weighted assets that will help increase capital ratios in three ways. First, the lower overall asset size affords the Company's capital reserves to support a smaller balance sheet. Second, the reduced risk profile of the Company's ensuing loan portfolio requires less capital support during times of economic stress. Third, a reduced infrastructure reduces general and administrative expenses, which in turn reduces the need for additional capital.

In light of the asset growth restriction in the Consent Order and the Company's current weakened financial position, the Company does not anticipate undertaking growth via acquisition or de novo branching during the foreseeable future.

The Company's short-term objective is to continue decreasing its balance sheet by loan and deposit attrition.

### Results of operations

The following represents management's discussion and analysis of the financial condition of the Company at September 30, 2012 and December 31, 2011 and the results of operations for the Company for the three and nine months ended September 30, 2012 and 2011. This discussion should be read in conjunction with the Company's condensed consolidated financial statements and the notes thereto appearing elsewhere in this Quarterly Report.





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## Statement of Operations Analysis

## Summary

For the three months ended September 30, 2012, the Company had a net loss of \$(367,000) and net loss available to common shareholders of \$(588,000), or \$(0.14) per fully diluted share, compared to a net loss of \$(5,245,000) and a net loss available to common shareholders of \$(5,467,000), or \$(1.29) per fully diluted share, for the same period in 2011. For the nine months ended September 30, 2012, the Company had a net loss totaling \$(11,504,000) and a net loss available to common shareholders of \$(12,131,000), or \$(2.85) per fully diluted share, compared to a net loss of \$(4,905,000) and a net loss available to common shareholders of \$(5,566,000), or \$(1.31) per share on a fully diluted share, for the same period in 2011.

The components of the changes in net income before payment of dividends are presented following:

	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Decrease in net interest income	\$ (748,000 )	\$ (1,950,000)
Decrease in provision for loan losses	8,808,000	2,316,000
Increase in noninterest income	1,431,000	2,805,000
Increase in noninterest expense	(1,781,000)	(3,296,000)
Increase in tax expense	(2,832,000)	(6,474,000)
	\$ 4,878,000	\$ (6,599,000)

Our profitability continues to be negatively affected by the continued stress on our borrowers and real estate values from the recessionary economy. As a result, asset quality continues to be a concern and management is devoting substantial resources to problem asset resolution. While the provision for loan losses decreased in 2012 from 2011 levels, it remains significant at \$9,095,000 for the nine months ended September 30, 2012. Additionally, expenses related to foreclosed property, which are included in noninterest expense, increased significantly from \$1,211,878 in 2011 to \$3,520,971 in 2012. The provision for loan losses is discussed further under Asset quality and Provision for loan losses.

The decline in our net interest income is attributable to our plan to reduce our balance sheet and nonaccrual loans. Changes in our net interest income are more fully discussed under Net interest income.

Our mortgage company's pretax profit increased in the first nine months of 2012 compared to the same period of 2011 by \$1,074,000 due to the mortgage company closing \$224,722,000 in mortgage loans for the first three quarters of 2012 compared to \$164,680,000 for the same period in 2011.

## Net interest income

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

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will exceed the net interest spread because a portion of interest earning assets are funded by various noninterest-bearing sources, principally noninterest-bearing deposits and shareholders' equity.

Net interest income for the third quarter of \$4,216,000 represents a decrease of \$(748,000), or 15%, compared to the third quarter of 2011, and a decrease of \$(135,000), or 3%, compared to the second quarter of 2012. Comparing the first nine months of 2012 to the same period in 2011, there was a decline in net interest income of \$(1,950,000), or 13%. The continued decline in our net interest income is a result of our asset reduction plan and loans placed on nonaccrual status.

Compared to the third quarter of 2011, average interest-earning assets for the third quarter of 2012 decreased by \$89,937,000, or 17%. This decrease in average interest-earning assets was due to decreases in average portfolio loans of \$55,131,000, average investment securities of \$24,135,000 and average federal funds sold of \$16,778,000, offset by an increase in average loans held for sale of \$6,107,000. Comparing average interest-earning assets for the nine months ended September 30, 2012 to the same period in 2011, there was a decline of \$64,676,000, or 12%. This decrease in average interest-earning assets was due to decreases in average portfolio loans of \$39,497,000, average investment securities of \$21,155,000 and average federal funds sold of \$9,723,000, offset by an increase in average loans held for sale of \$5,698,000. The primary reasons for the decline in our portfolio loans that are interest-earning were our strategic plan to reduce our balance sheet, loan charge-offs, and loans placed on nonaccrual status. The declines in investment securities and federal funds sold were part of our asset reduction plan. In addition to the decline in interest-earning assets, the average yield on interest-earning assets decreased to 4.97% for the third quarter of 2012 from 5.09% for the third quarter of 2011, and to 4.92% for the nine months of 2012 from 5.29% for the same period in 2011. These declines resulted in a decline in interest income from the third quarter of 2011 to the third quarter of 2012 of \$1,296,000, or 19%, and \$3,885,000, or 18%, for the comparative nine month periods.

Average interest-bearing liabilities for the third quarter of 2012 decreased by \$75,921,000, or 15%, compared to the third quarter of 2011, and by \$64,532,000, or 13%, for the comparative nine month periods. The decrease in interest-bearing liabilities was due primarily to declines in average deposits of \$64,894,000 and 59,791,000, respectively. The decrease in deposits was consistent with our balance sheet reduction plan as we repriced maturing time deposits at rates below market for noncore depositors. The average cost of interest-bearing liabilities for the three months ended September 30, 2012 decreased to 1.36% from 1.59% for the same period in 2011, and to 1.40% from 1.73% the comparative nine month periods. The principal reason for the decrease in liability costs was the maintenance of short-term interest rates by the Federal Reserve. The continuing low interest rates have allowed us to reduce our cost of funds as certificates of deposit and borrowings mature. See our discussion of interest rate sensitivity below for more information.

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

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Quarter Ended	Net Interest Margin
September 30, 2011	3.63%
December 31, 2011	3.38%
March 31, 2012	3.53%
June 30, 2012	3.65%
September 30, 2012	3.70%

The net interest margin declined during the fourth quarter of 2011 primarily as a result of increasing nonaccrual loans. Additionally our margin was compressed as our deposits generally do not reprice as quickly as our loans. The improvement in net interest margin during 2012 is a result of utilizing lower interest-earning assets, primarily federal funds sold, to fund a decrease in average interest-bearing liabilities of \$57,123,000, from \$480,888,000 for the fourth quarter of 2011 to \$423,765,000 for the third quarter of 2012. As a result, higher yielding average loans represented 89% of total average interest-bearing assets for the third quarter of 2012 as compared to 80% for the fourth quarter of 2011. However, given the continued depressed economy and the potential impact on interest income from new nonaccrual loans, no assurance can be provided that increases in the net interest margin will continue to occur.

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

Table of ContentsAverage Balance Sheets  
(in thousands)

	Three Months Ended September 30, 2012				Three Months Ended September 30, 2011			
	Average Balance	Interest Income/ Expense	Annualized Yield Rate		Average Balance	Interest Income/ Expense	Annualized Yield Rate	
Loans net of deferred fees	\$386,330	\$5,344	5.49	%	\$441,461	\$6,469	5.81	%
Loans held for sale	16,375	145	3.51	%	10,268	117	4.52	%
Investment securities	30,740	167	2.16	%	54,875	357	2.58	%
Federal funds and other	18,847	11	0.23	%	35,625	20	0.22	%
Total interest earning assets	452,292	5,667	4.97	%	542,229	6,963	5.09	%
Allowance for loan losses and deferred fees	(14,094 )				(7,423 )			
Cash and due from banks	13,540				13,589			
Premises and equipment, net	26,183				27,245			
Other assets	36,769				31,304			
Total assets	\$514,690				\$606,944			
Interest bearing deposits								
Interest checking	\$43,779	\$36	0.33	%	\$38,226	\$52	0.54	%
Money market	64,693	59	0.36	%	85,361	116	0.54	%
Savings	18,652	22	0.47	%	13,199	22	0.66	%
Certificates	254,045	1,070	1.67	%	309,277	1,504	1.93	%
Total	381,169	1,187	1.24	%	446,063	1,694	1.51	%
Borrowings	42,595	264	2.46	%	53,622	305	2.26	%
Total interest bearing liabilities	423,764	1,451	1.36	%	499,685	1,999	1.59	%
Noninterest bearing deposits	56,983				53,139			
Other liabilities	6,087				4,210			
Total liabilities	486,834				557,034			
Equity capital	27,856				49,910			
Total liabilities and capital	\$514,690				\$606,944			
Net interest income before provision for loan losses		\$4,216				\$4,964		
Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities			3.61	%			3.51	%
Annualized net interest margin (net								

interest income expressed as  
percentage of average earning  
assets)

3.70 %

3.63 %

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Average Balance Sheets  
(in thousands)

Nine Months Ended September 30, 2012			Nine Months Ended September 30, 2011		
Average	Interest	Annualized	Average	Interest	Annualized
Balance	Income/ Expense	Yield Rate	Balance	Income/ Expense	Yield Rate