

OLD POINT FINANCIAL CORP  
Form 10-Q  
August 09, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

or

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

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

Commission File Number: 000-12896

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

VIRGINIA 54-1265373  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

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

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

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

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

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

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.

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Yes  No

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

4,959,009 shares of common stock (\$5.00 par value) outstanding as of July 31, 2013

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OLD POINT FINANCIAL CORPORATION

FORM 10-Q

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

Old Point Financial Corporation and Subsidiaries  
Consolidated Balance Sheets

|  | June 30,<br>2013<br>(unaudited) | December 31,<br>2012 |
|--|---------------------------------|----------------------|
| Assets   |                                 |                      |
| Cash and due from banks  | \$ 14,012,831                   | \$ 15,982,070        |
| Interest-bearing due from banks  | 40,214,328                      | 24,732,329           |
| Federal funds sold   | 943,365                         | 1,602,847            |
| Cash and cash equivalents  | 55,170,524                      | 42,317,246           |
| Securities available-for-sale, at fair value   | 258,583,381                     | 329,455,812          |
| Securities held-to-maturity (fair value approximates \$11,402,809 and \$573,500)                   | 11,412,681                      | 570,000              |
| Restricted securities  | 2,378,100                       | 2,561,900            |
| Loans, net of allowance for loan losses of \$7,295,952 and \$7,324,310                             | 462,211,798                     | 463,808,457          |
| Premises and equipment, net  | 35,508,997                      | 32,528,350           |
| Bank-owned life insurance  | 22,256,631                      | 21,824,197           |
| Foreclosed assets, net of valuation allowance of \$1,723,658 and \$1,870,285                       | 6,559,191                       | 6,573,398            |
| Other assets   | 12,800,048                      | 7,859,344            |
| Total assets   | \$ 866,881,351                  | \$ 907,498,704       |
| Liabilities & Stockholders' Equity   |                                 |                      |
| Deposits:  |                                 |                      |
| Noninterest-bearing deposits   | \$ 177,839,199                  | \$ 176,740,312       |
| Savings deposits   | 270,821,034                     | 268,252,782          |
| Time deposits  | 281,707,695                     | 308,822,642          |
| Total deposits   | 730,367,928                     | 753,815,736          |
| Overnight repurchase agreements  | 25,641,883                      | 35,945,800           |
| Term repurchase agreements   | 410,651                         | 1,279,574            |
| Federal Home Loan Bank advances  | 25,000,000                      | 25,000,000           |
| Accrued expenses and other liabilities   | 2,963,605                       | 2,157,558            |
| Total liabilities  | 784,384,067                     | 818,198,668          |
| Commitments and contingencies  |                                 |                      |
| Stockholders' equity:  |                                 |                      |
| Common stock, \$5 par value, 10,000,000 shares authorized; 4,959,009 shares issued and outstanding | 24,795,045                      | 24,795,045           |
| Additional paid-in capital   | 16,391,845                      | 16,391,845           |
| Retained earnings  | 49,724,841                      | 48,304,609           |
| Accumulated other comprehensive loss, net  | (8,414,447 )                    | (191,463 )           |
| Total stockholders' equity   | 82,497,284                      | 89,300,036           |
| Total liabilities and stockholders' equity   | \$ 866,881,351                  | \$ 907,498,704       |

See Notes to Consolidated Financial Statements.

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Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Income

|  | Three Months Ended |             | Six Months Ended |              |
|--|--------------------|-------------|------------------|--------------|
|  | June 30,           | 2012        | June 30,         | 2012         |
|  | 2013               |             | 2013             |              |
|  | (unaudited)        |             | (unaudited)      |              |
| <b>Interest and Dividend Income:</b>   |                    |             |                  |              |
| Interest and fees on loans   | \$5,891,576        | \$6,749,689 | \$11,899,269     | \$13,818,466 |
| Interest on due from banks   | 18,782             | 10,008      | 32,807           | 26,280       |
| Interest on federal funds sold   | 291                | 460         | 751              | 763          |
| <b>Interest on securities:</b>   |                    |             |                  |              |
| Taxable  | 1,252,486          | 1,379,414   | 2,576,536        | 2,600,900    |
| Tax-exempt   | 287,389            | 148,232     | 551,982          | 242,209      |
| Dividends and interest on all other securities   | 26,023             | 23,815      | 44,118           | 45,192       |
| Total interest and dividend income   | 7,476,547          | 8,311,618   | 15,105,463       | 16,733,810   |
| <b>Interest Expense:</b>   |                    |             |                  |              |
| Interest on savings deposits   | 68,669             | 94,184      | 155,855          | 188,239      |
| Interest on time deposits  | 795,843            | 963,549     | 1,649,735        | 1,938,978    |
| Interest on federal funds purchased, securities sold under agreements to repurchase and other borrowings | 7,875              | 15,627      | 19,441           | 32,023       |
| Interest on Federal Home Loan Bank advances  | 305,229            | 425,046     | 607,104          | 850,092      |
| Total interest expense   | 1,177,616          | 1,498,406   | 2,432,135        | 3,009,332    |
| Net interest income  | 6,298,931          | 6,813,212   | 12,673,328       | 13,724,478   |
| Provision for loan losses  | 300,000            | 1,000,000   | 500,000          | 1,200,000    |
| Net interest income, after provision for loan losses   | 5,998,931          | 5,813,212   | 12,173,328       | 12,524,478   |
| <b>Noninterest Income:</b>   |                    |             |                  |              |
| Income from fiduciary activities   | 865,689            | 793,005     | 1,765,494        | 1,619,651    |
| Service charges on deposit accounts  | 1,036,265          | 1,073,004   | 2,032,865        | 2,103,309    |
| Other service charges, commissions and fees  | 911,619            | 880,032     | 1,770,590        | 1,677,061    |
| Income from bank-owned life insurance  | 216,519            | 225,201     | 431,826          | 448,881      |
| Income from Old Point Mortgage   | 217,799            | 94,311      | 304,324          | 125,298      |
| Gain (loss) on sale of available-for-sale securities, net  | (20,532 )          | 769,474     | (20,532 )        | 1,083,869    |
| Other operating income   | 56,874             | 45,821      | 112,935          | 90,664       |
| Total noninterest income   | 3,284,233          | 3,880,848   | 6,397,502        | 7,148,733    |
| <b>Noninterest Expense:</b>  |                    |             |                  |              |
| Salaries and employee benefits   | 4,805,584          | 5,219,885   | 9,726,510        | 10,180,162   |
| Occupancy and equipment  | 1,078,684          | 1,069,180   | 2,190,883        | 2,162,933    |
| Data processing  | 412,884            | 391,376     | 834,460          | 773,903      |
| FDIC insurance   | 173,914            | 286,314     | 356,975          | 567,152      |
| Customer development   | 205,372            | 202,992     | 411,478          | 406,888      |
| Legal and audit expense  | 123,537            | 224,182     | 234,661          | 408,112      |
| Other outside service fees   | 112,510            | 140,981     | 208,888          | 293,367      |
| Employee professional development  | 181,367            | 187,643     | 312,781          | 329,984      |
| Postage and courier expense  | 120,166            | 118,984     | 243,031          | 243,311      |
| Advertising  | 124,320            | 146,594     | 247,370          | 291,612      |
| Stationery and supplies  | 95,414             | 113,304     | 215,723          | 217,839      |
| Loss on write-down/sale of foreclosed assets   | 77,223             | 380,050     | 203,676          | 636,634      |

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|                            |             |           |             |             |
|----------------------------|-------------|-----------|-------------|-------------|
| Other operating expense    | 537,800     | 465,165   | 1,088,141   | 984,191     |
| Total noninterest expense  | 8,048,775   | 8,946,650 | 16,274,577  | 17,496,088  |
| Income before income taxes | 1,234,389   | 747,410   | 2,296,253   | 2,177,123   |
| Income tax expense         | 219,574     | 109,203   | 380,121     | 460,615     |
| Net income                 | \$1,014,815 | \$638,207 | \$1,916,132 | \$1,716,508 |

Basic Earnings per Share:

|                                      |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|
| Average shares outstanding           | 4,959,009 | 4,959,009 | 4,959,009 | 4,959,009 |
| Net income per share of common stock | \$0.21    | \$0.13    | \$0.39    | \$0.35    |

Diluted Earnings per Share:

|                                      |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|
| Average shares outstanding           | 4,959,009 | 4,959,009 | 4,959,009 | 4,959,009 |
| Net income per share of common stock | \$0.21    | \$0.13    | \$0.39    | \$0.35    |

See Notes to Consolidated Financial Statements.

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## Old Point Financial Corporation

## Consolidated Statements of Comprehensive Income (Loss)

|  | Three Months Ended              |             | Six Months Ended                |             |
|--|---------------------------------|-------------|---------------------------------|-------------|
|  | June 30,<br>2013<br>(unaudited) | 2012        | June 30,<br>2013<br>(unaudited) | 2012        |
| Net income   | \$1,014,815                     | \$638,207   | \$1,916,132                     | \$1,716,508 |
| Other comprehensive income (loss), net   |                                 |             |                                 |             |
| Unrealized gains (losses) on securities, net of reclassification<br>adjustment | (6,496,437)                     | 1,004,031   | (8,222,984)                     | 249,407     |
| Comprehensive income (loss)  | \$(5,481,622)                   | \$1,642,238 | \$(6,306,852)                   | \$1,965,915 |

See Notes to Consolidated Financial Statements.

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Consolidated Statements of Changes in Stockholders' Equity

| (unaudited)                            | Shares of<br>Common<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total        |
|--|------------------------------|-----------------|----------------------------------|----------------------|--|--------------|
| <b>SIX MONTHS ENDED JUNE 30, 2013</b>  |                              |                 |                                  |                      |  |              |
| Balance at beginning of period         | 4,959,009                    | \$24,795,045    | \$16,391,845                     | \$48,304,609         | \$ (191,463 )  | \$89,300,036 |
| Net income                             | 0                            | 0               | 0                                | 1,916,132            | 0  | 1,916,132    |
| Other comprehensive loss, net of tax   | 0                            | 0               | 0                                | 0                    | (8,222,984 )   | (8,222,984 ) |
| Cash dividends (\$0.10 per share)      | 0                            | 0               | 0                                | (495,900 )           | 0  | (495,900 )   |
| Balance at end of period               | 4,959,009                    | \$24,795,045    | \$16,391,845                     | \$49,724,841         | \$ (8,414,447 )  | \$82,497,284 |
| <b>SIX MONTHS ENDED JUNE 30, 2012</b>  |                              |                 |                                  |                      |  |              |
| Balance at beginning of period         | 4,959,009                    | \$24,795,045    | \$16,309,983                     | \$45,109,268         | \$ (349,581 )  | \$85,864,715 |
| Net income                             | 0                            | 0               | 0                                | 1,716,508            | 0  | 1,716,508    |
| Other comprehensive income, net of tax | 0                            | 0               | 0                                | 0                    | 249,407  | 249,407      |
| Stock compensation expense             | 0                            | 0               | 55,330                           | 0                    | 0  | 55,330       |
| Cash dividends (\$0.10 per share)      | 0                            | 0               | 0                                | (495,901 )           | 0  | (495,901 )   |
| Balance at end of period               | 4,959,009                    | \$24,795,045    | \$16,365,313                     | \$46,329,875         | \$ (100,174 )  | \$87,390,059 |

See Notes to Consolidated Financial Statements.

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Consolidated Statements of Cash Flows

|   | Six Months Ended<br>June 30, |               |
|---|------------------------------|---------------|
|   | 2013                         | 2012          |
|   | (unaudited)                  |               |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                              |               |
| Net income  | \$1,916,132                  | \$1,716,508   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |               |
| Depreciation and amortization   | 979,896                      | 938,719       |
| Provision for loan losses   | 500,000                      | 1,200,000     |
| Net (gain) loss on sale of available-for-sale securities                          | 20,532                       | (1,083,869 )  |
| Net amortization of securities  | 1,318,419                    | 572,773       |
| Net loss on disposal of premises and equipment                                    | 16,416                       | 52            |
| Net loss on write-down/sale of foreclosed assets                                  | 203,676                      | 636,634       |
| Income from bank owned life insurance   | (431,826 )                   | (448,881 )    |
| Stock compensation expense  | 0                            | 55,330        |
| Deferred tax (benefit) expense  | (116,994 )                   | 20,688        |
| (Increase) decrease in other assets   | (522,292 )                   | 1,379,570     |
| Increase in other liabilities   | 806,047                      | 534,406       |
| Net cash provided by operating activities   | 4,690,006                    | 5,521,930     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                              |               |
| Purchases of available-for-sale securities  | (11,377,086)                 | (186,286,377) |
| Purchases of held-to-maturity securities  | (10,853,837)                 | 0             |
| Proceeds from sales of restricted securities                                      | 183,800                      | 341,200       |
| Proceeds from maturities and calls of securities                                  | 29,161,524                   | 37,873,835    |
| Decrease in loans made to customers   | 230,300                      | 41,245,918    |
| Proceeds from sales of foreclosed assets  | 1,117,240                    | 2,170,889     |
| Purchases of premises and equipment   | (4,483,255 )                 | (1,028,992 )  |
| Net cash provided by (used in) investing activities                               | 43,279,820                   | (14,678,372 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                              |               |
| Increase in noninterest-bearing deposits  | 1,098,887                    | 9,939,550     |
| Increase in savings deposits  | 2,568,252                    | 11,483,949    |
| Increase (decrease) in time deposits  | (27,114,947)                 | 11,873,082    |
| Decrease in federal funds purchased, repurchase agreements and other borrowings   | (11,172,840)                 | (12,541,091 ) |
| Cash dividends paid on common stock   | (495,900 )                   | (495,901 )    |
| Net cash provided by (used in) financing activities                               | (35,116,548)                 | 20,259,589    |
| Net increase in cash and cash equivalents   | 12,853,278                   | 11,103,147    |
| Cash and cash equivalents at beginning of period                                  | 42,317,246                   | 24,854,656    |
| Cash and cash equivalents at end of period  | \$55,170,524                 | \$35,957,803  |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>                          |                              |               |
| Cash payments for:  |                              |               |
| Interest  | \$2,504,764                  | \$3,021,805   |
| Income tax  | \$450,000                    | \$600,000     |

**SUPPLEMENTAL SCHEDULE OF NONCASH TRANSACTIONS**

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|   |                |           |
|---|----------------|-----------|
| Unrealized gain (loss) on securities available-for-sale                   | \$(12,459,065) | \$377,890 |
| Loans transferred to foreclosed assets                                    | \$866,359      | \$564,480 |
| Former branch site transferred from fixed assets to foreclosed properties | \$506,296      | \$0       |

See Notes to Consolidated Financial Statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. General

The accompanying unaudited consolidated financial statements of Old Point Financial Corporation (the Company) and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2013 and December 31, 2012, the results of operations and statements of comprehensive income for the three and six months ended June 30, 2013 and 2012, and the statements of changes in stockholders' equity and statements of cash flows for the six months ended June 30, 2013 and 2012. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2012 annual report on Form 10-K. Certain previously reported amounts have been reclassified to conform to current period presentation.

AVAILABLE INFORMATION

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

SUBSEQUENT EVENTS

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

The Company is expanding the building of a current branch office. The Company signed a contract with a general contractor on April 19, 2012. The contract entitles the contractor to \$2.1 million for Phase I of the construction, which includes site work and construction of the building shell. The Company signed an amendment to the contract with the general contractor on October 16, 2012 for the remainder of the construction. The revised contract entitles the contractor to \$12.2 million for the construction of the building. As of the writing of this quarterly report on Form 10-Q, \$6.5 million had been disbursed to the contractor. The Company anticipates that the total project will likely cost between \$13.0 million and \$15.0 million and be completed in the next nine months.

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

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## Note 2. Securities

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

|   | Amortized<br>Cost<br>(in thousands) | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------------------------|------------------------------|-------------------------------|---------------|
| June 30, 2013                                   |                                     |                              |                               |               |
| Obligations of U.S. Government agencies         | \$570                               | \$ 3                         | \$ (3)                        | ) \$570       |
| Obligations of state and political subdivisions | 10,843                              | 9                            | (19)                          | ) 10,833      |
| Total   | \$11,413                            | \$ 12                        | \$ (22)                       | ) \$11,403    |
| December 31, 2012                               |                                     |                              |                               |               |
| Obligations of U.S. Government agencies         | \$570                               | \$ 4                         | \$ 0                          | \$574         |

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

|   | Amortized<br>Cost<br>(in thousands) | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------------------------|------------------------------|-------------------------------|---------------|
| June 30, 2013                                   |                                     |                              |                               |               |
| Obligations of U.S. Government agencies         | \$25,372                            | \$ 551                       | \$ (118)                      | ) \$25,805    |
| Obligations of state and political subdivisions | 50,997                              | 160                          | (2,393)                       | ) 48,764      |
| Mortgage-backed securities                      | 189,456                             | 0                            | (7,613)                       | ) 181,843     |
| Money market investments                        | 801                                 | 0                            | 0                             | 801           |
| Corporate bonds                                 | 1,399                               | 0                            | (29)                          | ) 1,370       |
| Total   | \$268,025                           | \$ 711                       | \$ (10,153)                   | ) \$258,583   |
| December 31, 2012                               |                                     |                              |                               |               |
| Obligations of U.S. Government agencies         | \$35,787                            | \$ 1,314                     | \$ (13)                       | ) \$37,088    |
| Obligations of state and political subdivisions | 43,276                              | 712                          | (214)                         | ) 43,774      |
| Mortgage-backed securities                      | 246,132                             | 1,966                        | (743)                         | ) 247,355     |
| Money market investments                        | 541                                 | 0                            | 0                             | 541           |
| Corporate bonds and other securities            | 700                                 | 0                            | (2)                           | ) 698         |
| Total   | \$326,436                           | \$ 3,992                     | \$ (972)                      | ) \$329,456   |

**OTHER-THAN-TEMPORARILY IMPAIRED SECURITIES**

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

The present value of expected future cash flows is determined using the best-estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or

floating rate security. The methodology and assumptions for establishing the best-estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds, and structural support, including subordination and guarantees.

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

The Company has not recorded impairment charges through income on securities for the three or six months ended June 30, 2013 or the year ended December 31, 2012.

TEMPORARILY IMPAIRED SECURITIES

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

|   | June 30, 2013                                   |               | More Than                     |               | Total                         |               | Number<br>of<br>Securities |
|---|---|---------------|-------------------------------|---------------|-------------------------------|---------------|----------------------------|
|   | Less Than Twelve                                |               | Twelve                        |               | Total                         |               |                            |
|   | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value |                            |
| <u>Securities Available-for-Sale</u>            |   |               |                               |               |                               |               |                            |
| Debt securities:                                |   |               |                               |               |                               |               |                            |
| Obligations of U.S. Government agencies         | \$ 118  | \$4,890       | \$ 0                          | \$ 0          | \$ 118                        | \$4,890       | 1                          |
| Obligations of state and political subdivisions | 2,393   | 37,905        | 0                             | 0             | 2,393                         | 37,905        | 69                         |
| Mortgage-backed securities                      | 7,613   | 181,843       | 0                             | 0             | 7,613                         | 181,843       | 19                         |
| Corporate bonds                                 | 29  | 1,370         | 0                             | 0             | 29                            | 1,370         | 11                         |
| Total securities available-for-sale             | \$10,153  | \$226,008     | \$ 0                          | \$ 0          | \$10,153                      | \$226,008     | 100                        |
| <u>Securities Held-to-Maturity</u>              |   |               |                               |               |                               |               |                            |
| Obligations of U.S. Government agencies         | \$3   | \$97          | \$ 0                          | \$ 0          | \$3                           | \$97          | 1                          |
| Obligations of state and political subdivisions | 19  | 857           | 0                             | 0             | 19                            | 857           | 1                          |
| Total securities held-to-maturity               | \$22  | \$954         | \$ 0                          | \$ 0          | \$22                          | \$954         | 2                          |

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|   | December 31, 2012   |  |      |      | Total<br>Gross<br>Unrealized<br>Losses Value | Number<br>of<br>Securities |    |
|---|---|--|------|------|--|----------------------------|----|
|   | Less Than<br>Twelve Months<br>Gross<br>Unrealized<br>Losses Value<br>(in thousands) | More Than<br>Twelve<br>Months<br>Gross<br>Unrealized<br>Losses Value |      |      |  |                            |    |
| <u>Securities Available-for-Sale</u>            |   |  |      |      |  |                            |    |
| Debt securities:                                |   |  |      |      |  |                            |    |
| Obligations of U. S. Government agencies        | \$ 13   | \$ 5,103   | \$ 0 | \$ 0 | \$ 13  | \$ 5,103                   | 1  |
| Obligations of state and political subdivisions | 214   | 9,535  | 0    | 0    | 214  | 9,535                      | 24 |
| Mortgage-backed securities                      | 743   | 104,066  | 0    | 0    | 743  | 104,066                    | 9  |
| Corporate bonds and other securities            | 2   | 700  | 0    | 0    | 2  | 700                        | 2  |
| Total securities available-for-sale             | \$ 972  | \$ 119,404   | \$ 0 | \$ 0 | \$ 972                                       | \$ 119,404                 | 36 |

Certain investments within the Company's portfolio had unrealized losses at June 30, 2013 and December 31, 2012, as shown in the tables above. The unrealized losses were caused by increases in market interest rates. Because the Company does not intend to sell the investments and management believes it is unlikely that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider the investments to be other-than-temporarily impaired at June 30, 2013 or December 31, 2012.

Restricted Securities

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

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

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

|                                     | June 30,<br>2013<br>(in thousands) | December<br>31,<br>2012 |
|-------------------------------------|------------------------------------|-------------------------|
| Mortgage loans on real estate:      |                                    |                         |
| Residential 1-4 family              | \$ 80,553                          | \$ 77,267               |
| Commercial                          | 273,498                            | 274,613                 |
| Construction                        | 13,493                             | 12,005                  |
| Second mortgages                    | 12,242                             | 14,315                  |
| Equity lines of credit              | 31,201                             | 32,327                  |
| Total mortgage loans on real estate | 410,987                            | 410,527                 |
| Commercial loans                    | 28,687                             | 25,341                  |
| Consumer loans                      | 10,985                             | 13,146                  |
| Other                               | 18,849                             | 22,119                  |
| Total loans                         | 469,508                            | 471,133                 |
| Less: Allowance for loan losses     | (7,296 )                           | (7,324 )                |

Loans, net of allowance and deferred fees \$462,212 \$463,809

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Overdrawn deposit accounts are reclassified as loans and included in the Other category in the table above. Overdrawn deposit accounts totaled \$587 thousand and \$1.6 million at June 30, 2013 and December 31, 2012, respectively.

**CREDIT QUALITY INFORMATION**

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

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

·Pass: Loans are of acceptable risk.

·Other Assets Especially Mentioned (OAEM): Loans have potential weaknesses that deserve management's close attention.

·Substandard: Loans reflect significant deficiencies due to several adverse trends of a financial, economic or managerial nature.

·Doubtful: Loans have all the weaknesses inherent in a substandard loan with added characteristics that make collection or liquidation in full based on currently existing facts, conditions and values highly questionable or improbable.

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

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

## Credit Quality Information

As of June 30, 2013

(in thousands)

|                                     | Pass      | OAEM     | Substandard | Total     |
|-------------------------------------|-----------|----------|-------------|-----------|
| Mortgage loans on real estate:      |           |          |             |           |
| Residential 1-4 family              | \$73,496  | \$1,746  | \$ 5,311    | \$80,553  |
| Commercial                          | 256,142   | 7,708    | 9,648       | 273,498   |
| Construction                        | 10,374    | 239      | 2,880       | 13,493    |
| Second mortgages                    | 11,895    | 238      | 109         | 12,242    |
| Equity lines of credit              | 30,598    | 0        | 603         | 31,201    |
| Total mortgage loans on real estate | 382,505   | 9,931    | 18,551      | 410,987   |
| Commercial loans                    | 27,533    | 112      | 1,042       | 28,687    |
| Consumer loans                      | 10,956    | 0        | 29          | 10,985    |
| Other                               | 18,849    | 0        | 0           | 18,849    |
| Total                               | \$439,843 | \$10,043 | \$ 19,622   | \$469,508 |

## Credit Quality Information

As of December 31, 2012

(in thousands)

|                                     | Pass     | OAEM    | Substandard | Total    |
|-------------------------------------|----------|---------|-------------|----------|
| Mortgage loans on real estate:      |          |         |             |          |
| Residential 1-4 family              | \$70,961 | \$1,711 | \$ 4,595    | \$77,267 |
| Commercial                          | 258,195  | 6,781   | 9,637       | 274,613  |
| Construction                        | 8,651    | 254     | 3,100       | 12,005   |
| Second mortgages                    | 13,488   | 242     | 585         | 14,315   |
| Equity lines of credit              | 31,704   | 239     | 384         | 32,327   |
| Total mortgage loans on real estate | 382,999  | 9,227   | 18,301      | 410,527  |

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|                  |           |         |           |           |
|------------------|-----------|---------|-----------|-----------|
| Commercial loans | 23,997    | 209     | 1,135     | 25,341    |
| Consumer loans   | 13,042    | 0       | 104       | 13,146    |
| Other            | 22,119    | 0       | 0         | 22,119    |
| Total            | \$442,157 | \$9,436 | \$ 19,540 | \$471,133 |

As of June 30, 2013 and December 31, 2012 the Company did not have any loans internally classified as Loss or Doubtful.

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## AGE ANALYSIS OF PAST DUE LOANS BY CLASS

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

## Age Analysis of Past Due Loans as of June 30, 2013

|                                     | 30 -<br>59<br>Days<br>Past<br>Due<br>(in thousands) | 60 -<br>89<br>Days<br>Past<br>Due | 90 or<br>More<br>Days<br>Past<br>Due | Total<br>Past<br>Due | Total<br>Current<br>Loans (1) | Total<br>Loans | Recorded<br>Investment<br>> 90 Days<br>Past Due<br>and<br>Accruing |
|-------------------------------------|---|-----------------------------------|--------------------------------------|----------------------|-------------------------------|----------------|--|
| Mortgage loans on real estate:      |   |                                   |                                      |                      |                               |                |  |
| Residential 1-4 family              | \$ 1,752  | \$ 38                             | \$ 3,306                             | \$ 5,096             | \$ 75,457                     | \$ 80,553      | \$ 258   |
| Commercial                          | 0   | 200                               | 716                                  | 916                  | 272,582                       | 273,498        | 0  |
| Construction                        | 404   | 0                                 | 2,880                                | 3,284                | 10,209                        | 13,493         | 0  |
| Second mortgages                    | 46  | 35                                | 20                                   | 101                  | 12,141                        | 12,242         | 20   |
| Equity lines of credit              | 175   | 75                                | 0                                    | 250                  | 30,951                        | 31,201         | 0  |
| Total mortgage loans on real estate | 2,377   | 348                               | 6,922                                | 9,647                | 401,340                       | 410,987        | 278  |
| Commercial loans                    | 54  | 49                                | 0                                    | 103                  | 28,584                        | 28,687         | 0  |
| Consumer loans                      | 80  | 40                                | 13                                   | 133                  | 10,852                        | 10,985         | 13   |
| Other                               | 65  | 9                                 | 5                                    | 79                   | 18,770                        | 18,849         | 5  |
| Total                               | \$ 2,576  | \$ 446                            | \$ 6,940                             | \$ 9,962             | \$ 459,546                    | \$ 469,508     | \$ 296   |

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

## Age Analysis of Past Due Loans as of December 31, 2012

|                                     | 30 - 59<br>Days<br>Past<br>Due | 60 -<br>89<br>Days<br>Past<br>Due | 90 or<br>More<br>Days<br>Past<br>Due | Total<br>Past<br>Due | Total<br>Current<br>Loans (1) | Total<br>Loans | Recorded<br>Investment<br>> 90 Days<br>Past Due<br>and<br>Accruing |
|-------------------------------------|--------------------------------|-----------------------------------|--------------------------------------|----------------------|-------------------------------|----------------|--|
| (in thousands)                      |                                |                                   |                                      |                      |                               |                |  |
| Mortgage loans on real estate:      |                                |                                   |                                      |                      |                               |                |  |
| Residential 1-4 family              | \$ 1,115                       | \$ 0                              | \$ 3,783                             | \$ 4,898             | \$ 72,369                     | \$ 77,267      | \$ 348   |
| Commercial                          | 207                            | 0                                 | 724                                  | 931                  | 273,682                       | 274,613        | 0  |
| Construction                        | 140                            | 0                                 | 2,925                                | 3,065                | 8,940                         | 12,005         | 0  |
| Second mortgages                    | 113                            | 0                                 | 544                                  | 657                  | 13,658                        | 14,315         | 60   |
| Equity lines of credit              | 90                             | 0                                 | 287                                  | 377                  | 31,950                        | 32,327         | 0  |
| Total mortgage loans on real estate | 1,665                          | 0                                 | 8,263                                | 9,928                | 400,599                       | 410,527        | 408  |
| Commercial loans                    | 275                            | 13                                | 122                                  | 410                  | 24,931                        | 25,341         | 25   |
| Consumer loans                      | 85                             | 22                                | 11                                   | 118                  | 13,028                        | 13,146         | 11   |
| Other                               | 54                             | 7                                 | 3                                    | 64                   | 22,055                        | 22,119         | 3  |
| Total                               | \$ 2,079                       | \$ 42                             | \$ 8,399                             | \$ 10,520            | \$ 460,613                    | \$ 471,133     | \$ 447   |

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

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## NONACCRUAL LOANS

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

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

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

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

## Nonaccrual Loans by Class

|                                     | June<br>30,<br>2013 | December<br>31, 2012 |
|-------------------------------------|---------------------|----------------------|
|                                     | (in thousands)      |                      |
| Mortgage loans on real estate:      |                     |                      |
| Residential 1-4 family              | \$3,363             | \$ 3,663             |
| Commercial                          | 2,965               | 3,037                |
| Construction                        | 2,880               | 3,065                |
| Second mortgages                    | 35                  | 484                  |
| Equity lines of credit              | 0                   | 286                  |
| Total mortgage loans on real estate | 9,243               | 10,535               |
| Commercial loans                    | 0                   | 97                   |
| Consumer loans                      | 0                   | 0                    |
| Total                               | \$9,243             | \$ 10,632            |

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

|   | Six Months<br>Ended June<br>30,<br>2013 2012<br>(in<br>thousands) |       |
|---|---|-------|
| Interest income that would have been recorded under original loan terms | \$275   | \$275 |

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|  |       |       |
|--|-------|-------|
| Actual interest income recorded for the period   | 51    | 32    |
| Reduction in interest income on nonaccrual loans | \$224 | \$243 |

**TROUBLED DEBT RESTRUCTURINGS**

The Company's loan portfolio includes certain loans that have been modified in a troubled debt restructuring (TDR), where economic concessions have been granted to borrowers who are experiencing financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reduction in the interest rate below current market rates for borrowers with similar risk profiles, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection. The Company defines a TDR as nonperforming if the TDR is in nonaccrual status or 90 days or more past due and still accruing interest at the report date.

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

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

Troubled Debt Restructurings by Class  
For the Six Months Ended June 30, 2013  
(dollars in thousands)

|                                | Number of<br>Modifications | Recorded<br>Investment<br>Prior to<br>Modification | Recorded<br>Investment<br>After<br>Modification | Current<br>Investment<br>on<br>June 30,<br>2013 |
|--------------------------------|----------------------------|--|---|---|
| Mortgage loans on real estate: |                            |  |   |   |
| Residential 1-4 family         | 3                          | \$ 676   | \$ 676  | \$ 673  |
| Commercial                     | 1                          | 207  | 207   | 203   |
| Total                          | 4                          | \$ 883   | \$ 883  | \$ 876  |

Troubled Debt Restructurings by Class  
For the Six Months Ended June 30, 2012  
(dollars in thousands)

|                                | Number of<br>Modifications | Recorded<br>Investment<br>Prior to<br>Modification | Recorded<br>Investment<br>After<br>Modification | Current<br>Investment<br>on<br>June 30,<br>2012 |
|--------------------------------|----------------------------|--|---|---|
| Mortgage loans on real estate: |                            |  |   |   |
| Commercial                     | 2                          | \$ 3,019   | \$ 2,461  | \$ 2,373  |
| Second mortgages               | 1                          | 111  | 145   | 140   |
| Total                          | 3                          | \$ 3,130   | \$ 2,606  | \$ 2,513  |

The four loans restructured in the first six months of 2013 were all given below-market rates for debt with similar risk characteristics. The restructurings during the first six months of 2012 were given principal reductions, with the principal forgiveness on all loans in the table totaling \$525 thousand. One loan restructured during the first six months of 2012 was also given a below-market rate for debt with similar risk characteristics.

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As of June 30, 2013 and June 30, 2012, there were no TDRs for which there was a payment default where the default occurred within twelve months of restructuring. A TDR is considered in default when it is 90 days or more past due or has been charged off.

The TDRs in the tables above are factored into the determination of the allowance for loan losses as of the periods indicated. These loans are included in the impaired loan analysis, as discussed below.

**IMPAIRED LOANS**

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

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

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The following table includes the recorded investment and unpaid principal balances (a portion of which may have been charged off) for impaired loans with the associated allowance amount, if applicable, as of the dates presented. Also presented are the average recorded investments in the impaired loans and the related amount of interest recognized for the periods presented. The average balances are calculated based on daily average balances.

Impaired Loans by Class  
(in thousands)

|                                     | As of June 30, 2013      |                                       |                                    |                      | For the six months ended<br>June 30, 2013 |                     |
|-------------------------------------|--------------------------|---------------------------------------|------------------------------------|----------------------|---|---------------------|
|                                     | Unpaid Principal Balance | Recorded Investment Without Allowance | Recorded Investment With Allowance | Associated Allowance | Average Recorded Investment               | Interest Recognized |
| Mortgage loans on real estate:      |                          |                                       |                                    |                      |   |                     |
| Residential 1-4 family              | \$4,546                  | \$872                                 | \$ 3,415                           | \$ 237               | \$4,738                                   | \$ 16               |
| Commercial                          | 13,702                   | 3,683                                 | 7,082                              | 1,261                | 10,910                                    | 269                 |
| Construction                        | 3,639                    | 0                                     | 2,880                              | 360                  | 2,891                                     | 0                   |
| Second mortgages                    | 183                      | 43                                    | 136                                | 47                   | 745                                       | 4                   |
| Equity lines of credit              | 50                       | 50                                    | 0                                  | 0                    | 193                                       | 1                   |
| Total mortgage loans on real estate | \$22,120                 | \$4,648                               | \$ 13,513                          | \$ 1,905             | \$19,477                                  | \$ 290              |
| Commercial loans                    | 0                        | 0                                     | 0                                  | 0                    | 12  | 0                   |
| Consumer loans                      | 16                       | 16                                    | 0                                  | 0                    | 18  | 1                   |
| Total                               | \$22,136                 | \$4,664                               | \$ 13,513                          | \$ 1,905             | \$19,507                                  | \$ 291              |

Impaired Loans by Class  
(in thousands)

|                                     | As of December 31, 2012  |                                       |                                    |                      | For the year ended<br>December 31, 2012 |                     |
|-------------------------------------|--------------------------|---------------------------------------|------------------------------------|----------------------|---|---------------------|
|                                     | Unpaid Principal Balance | Recorded Investment Without Allowance | Recorded Investment With Allowance | Associated Allowance | Average Recorded Investment             | Interest Recognized |
| Mortgage loans on real estate:      |                          |                                       |                                    |                      |   |                     |
| Residential 1-4 family              | \$4,100                  | \$681                                 | \$ 3,235                           | \$ 226               | \$2,354                                 | \$ 136              |
| Commercial                          | 12,459                   | 3,741                                 | 5,817                              | 180                  | 10,151                                  | 242                 |
| Construction                        | 3,782                    | 3,064                                 | 0                                  | 0                    | 3,320                                   | (9 )                |
| Second mortgages                    | 695                      | 583                                   | 47                                 | 5                    | 542                                     | 12                  |
| Equity lines of credit              | 370                      | 286                                   | 0                                  | 0                    | 391                                     | (2 )                |
| Total mortgage loans on real estate | \$21,406                 | \$8,355                               | \$ 9,099                           | \$ 411               | \$16,758                                | \$ 379              |
| Commercial loans                    | 117                      | 0                                     | 97                                 | 33                   | 104                                     | (14 )               |
| Consumer loans                      | 17                       | 17                                    | 0                                  | 0                    | 26                                      | 1                   |
| Total                               | \$21,540                 | \$8,372                               | \$ 9,196                           | \$ 444               | \$16,888                                | \$ 366              |

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

Loan officers are responsible for continual portfolio analysis and prompt identification and reporting of problem loans, which includes assigning a risk grade to each applicable loan at its origination and revising such grade as the situation dictates. Loan officers maintain frequent contact with borrowers, which should enable the loan officer to identify potential problems before other personnel. In addition, meetings with loan officers and upper management are

held to discuss problem loans and review risk grades. Nonetheless, in order to avoid over-reliance upon loan officers for problem loan identification, the Company's loan review system provides for review of loans and risk grades by individuals who are independent of the loan approval process. Risk grades and historical loss rates by risk grades are used as a component of the calculation of the allowance for loan losses.

#### ALLOWANCE FOR LOAN LOSSES

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

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Each portfolio segment has risk characteristics as follows:

**Commercial:** Commercial loans carry risks associated with the successful operation of a business or project, in addition to other risks associated with the ownership of a business. The repayment of these loans may be dependent upon the profitability and cash flows of the business. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time and cannot be appraised with as much precision.

**Real estate-construction:** Construction loans carry risks that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may at any point in time be less than the principal amount of the loan. Construction loans also bear the risk that the general contractor, who may or may not be the loan customer, may be unable to finish the construction project as planned because of financial pressure unrelated to the project.

**Real estate-mortgage:** Residential mortgage loans and equity lines of credit carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral. Commercial real estate loans carry risks associated with the successful operation of a business if owner occupied. If non-owner occupied, the repayment of these loans may be dependent upon the profitability and cash flow from rent receipts.

**Consumer loans:** Consumer loans carry risks associated with the continued credit-worthiness of the borrowers and the value of the collateral. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy.

**Other loans:** Other loans are loans to mortgage companies, loans for purchasing or carrying securities, and loans to insurance, investment and finance companies. These loans carry risks associated with the successful operation of a business. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time, depend on interest rates or fluctuate in active trading markets.

To determine the balance of the allowance account for each segment of the loan portfolio, management pools each segment by risk grade individually and applies a historical loss percentage. At June 30, 2013 and December 31, 2012, the historical loss percentage was based on losses sustained in each segment of the portfolio over the previous eight quarters.

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

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

## THE COMPANY'S ESTIMATION PROCESS

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

## ALLOWANCE FOR LOAN LOSSES BY SEGMENT

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses of \$7.3 million adequate to cover loan losses inherent in the loan portfolio at June 30, 2013.

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

## ALLOWANCE FOR LOAN LOSSES AND RECORDED INVESTMENT IN LOANS

(in thousands)

|  | Commercial | Real Estate<br>Construction | Real<br>Estate -<br>Mortgage | Consumer  | Other    | Total     |
|--|------------|-----------------------------|------------------------------|-----------|----------|-----------|
| For the Six Months Ended June 30, 2013               |            |                             |                              |           |          |           |
| Allowance for Loan Losses:                           |            |                             |                              |           |          |           |
| Balance at the beginning of period                   | \$677      | \$ 187                      | \$6,179                      | \$ 204    | \$77     | \$7,324   |
| Charge-offs  | (106 )     | (100 )                      | (413 )                       | (66 )     | (79 )    | (764 )    |
| Recoveries   | 43         | 3                           | 121                          | 34        | 35       | 236       |
| Provision for loan losses                            | (339 )     | 429                         | 421                          | (22 )     | 11       | 500       |
| Ending balance                                       | \$275      | \$ 519                      | \$6,308                      | \$ 150    | \$44     | \$7,296   |
| Ending balance individually evaluated for impairment | \$0        | \$ 360                      | \$1,545                      | \$0       | \$0      | \$1,905   |
| Ending balance collectively evaluated for impairment | 275        | 159                         | 4,763                        | 150       | 44       | 5,391     |
| Ending balance                                       | \$275      | \$ 519                      | \$6,308                      | \$ 150    | \$44     | \$7,296   |
| Loan Balances:                                       |            |                             |                              |           |          |           |
| Ending balance individually evaluated for impairment | \$0        | \$ 2,880                    | \$15,281                     | \$ 16     | \$0      | \$18,177  |
| Ending balance collectively evaluated for impairment | 28,687     | 10,613                      | 382,213                      | 10,969    | 18,849   | 451,331   |
| Ending balance                                       | \$28,687   | \$ 13,493                   | \$397,494                    | \$ 10,985 | \$18,849 | \$469,508 |

|  | Commercial | Real Estate<br>Construction | Real<br>Estate -<br>Mortgage | Consumer  | Other    | Total     |
|--|------------|-----------------------------|------------------------------|-----------|----------|-----------|
| For the Year Ended                                   |            |                             |                              |           |          |           |
| December 31, 2012                                    |            |                             |                              |           |          |           |
| Allowance for Loan Losses:                           |            |                             |                              |           |          |           |
| Balance at the beginning of period                   | \$ 1,011   | \$ 323                      | \$6,735                      | \$ 300    | \$129    | \$8,498   |
| Charge-offs  | (138 )     | (831 )                      | (2,554 )                     | (259 )    | (187 )   | (3,969 )  |
| Recoveries   | 67         | 30                          | 162                          | 70        | 66       | 395       |
| Provision for loan losses                            | (263 )     | 665                         | 1,836                        | 93        | 69       | 2,400     |
| Ending balance                                       | \$ 677     | \$ 187                      | \$6,179                      | \$ 204    | \$77     | \$7,324   |
| Ending balance individually evaluated for impairment | \$ 33      | \$ 0                        | \$411                        | \$0       | \$0      | \$444     |
| Ending balance collectively evaluated for impairment | 644        | 187                         | 5,768                        | 204       | 77       | 6,880     |
| Ending balance                                       | \$ 677     | \$ 187                      | \$6,179                      | \$ 204    | \$77     | \$7,324   |
| Loan Balances:                                       |            |                             |                              |           |          |           |
| Ending balance individually evaluated for impairment | \$ 97      | \$ 3,064                    | \$14,390                     | \$ 17     | \$0      | \$17,568  |
| Ending balance collectively evaluated for impairment | 25,244     | 8,941                       | 384,132                      | 13,129    | 22,119   | 453,565   |
| Ending balance                                       | \$ 25,341  | \$ 12,005                   | \$398,522                    | \$ 13,146 | \$22,119 | \$471,133 |

## CHANGES IN ACCOUNTING METHODOLOGY

There were no changes in the Company's accounting methodology for the allowance for loan losses in the first six months of 2013.

Note 4. Share-Based Compensation

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

Historically, the Company has only granted share-based compensation in the form of stock options. There were no options granted in the first six months of 2013.

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On March 9, 2008, the Company's 1998 Stock Option Plan expired. Options to purchase 154,460 shares of common stock were outstanding under the Company's 1998 Stock Option Plan at June 30, 2013. The exercise price of each option equals the market price of the Company's common stock on the date of the grant and each option's maximum term is ten years.

Stock option activity for the six months ended June 30, 2013 is summarized below:

|                                      | Shares   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|--------------------------------------|----------|--|---|--|
| Options outstanding, January 1, 2013 | 156,960  | \$ 21.63                                 |   |  |
| Granted                              | 0        | 0  |   |  |
| Exercised                            | 0        | 0  |   |  |
| Canceled or expired                  | (2,500 ) | 21.94                                    |   |  |
| Options outstanding, June 30, 2013   | 154,460  | \$ 21.63                                 | 2.96  | \$ 0   |
| Options exercisable, June 30, 2013   | 154,460  | \$ 21.63                                 | 2.96  | \$ 0   |

The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on June 30, 2013. This amount changes based on changes in the market value of the Company's common stock. As of June 30, 2013, the outstanding options had no intrinsic value because the exercise prices of all outstanding options were above the market value of a share of the Company's common stock.

No options were exercised during the six months ended June 30, 2013.

As of June 30, 2013, all outstanding stock options were fully vested and there was no unrecognized stock-based compensation expense.

**Note 5. Pension Plan**

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

|                                |                  |           |
|--------------------------------|------------------|-----------|
| Three months ended June 30,    | 2013             | 2012      |
|                                | Pension Benefits |           |
| Interest cost                  | \$62,983         | \$71,750  |
| Expected return on plan assets | (88,399 )        | (97,500 ) |
| Amortization of net loss       | 74,524           | 56,250    |
| Net periodic pension plan cost | \$49,108         | \$30,500  |
| Six months ended June 30,      | 2013             | 2012      |
|                                | Pension Benefits |           |
| Interest cost                  | \$125,966        | \$143,500 |
| Expected return on plan assets | (176,798)        | (195,000) |
| Amortization of net loss       | 149,048          | 112,500   |
| Net periodic pension plan cost | \$98,216         | \$61,000  |

At June 30, 2013, management had not yet determined the amount, if any, that the Company will contribute to the plan in the year ending December 31, 2013.

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## Note 6. Stockholders' Equity and Earnings per Share

## STOCKHOLDERS' EQUITY – OTHER COMPREHENSIVE LOSS

The following table presents information on amounts reclassified out of accumulated other comprehensive loss, by category, during the periods indicated:

|  | Three<br>Months<br>Ended<br>June 30,<br>2013 |       | Six Months<br>Ended<br>June 30,<br>2012 |         | Affected Line Item on<br>Consolidated Statement of Income |
|--|--|-------|---|---------|---|
| Available-for-sale securities                  | (in thousands)                               |       |   |         |   |
| Realized gains (losses) on sales of securities | \$(21)                                       | \$769 | \$(21)                                  | \$1,084 | Gain (loss) on sale of available-for-sale securities, net |
| Tax effect                                     | (7 )   | 262   | (7 )                                    | 369     | Income tax expense  |
|  | \$(14)                                       | \$507 | \$(14)                                  | \$715   | Net of tax  |

The following table presents the changes in accumulated other comprehensive loss, by category, net of tax, for the periods indicated:

|                                | Unrealized<br>Gains (Losses)<br>on Securities<br>(in thousands) |   |             |
|--------------------------------|---|---|-------------|
|                                | Defined<br>Benefit<br>Pension<br>Plans                          | Accumulated<br>Other<br>Comprehensive<br>Loss |             |
| SIX MONTHS ENDED JUNE 30, 2013 |   |   |             |
| Balance at beginning of period | \$1,993   | \$(2,184)                                     | \$ (191 )   |
| Net change for the period      | (8,223)   | 0   | (8,223 )    |
| Balance at end of period       | \$(6,230)   | \$(2,184)                                     | \$ (8,414 ) |

|                                   | Unrealized<br>Gains (Losses)<br>on Securities<br>(in thousands) |   |           |
|-----------------------------------|---|---|-----------|
|                                   | Defined<br>Benefit<br>Pension<br>Plans                          | Accumulated<br>Other<br>Comprehensive<br>Loss |           |
| SIX MONTHS ENDED JUNE 30,<br>2012 |   |   |           |
| Balance at beginning of period    | \$1,526   | \$(1,875)                                     | \$ (349 ) |
| Net change for the period         | 249   | 0   | 249       |
| Balance at end of period          | \$1,775   | \$(1,875)                                     | \$ (100 ) |

The following table presents the change in each component of other comprehensive income on a pre-tax and after-tax basis for the periods indicated.

Six Months Ended June 30, 2013

Tax

Pretax Expense Net-of-Tax  
(Benefit)

(in thousands)

|  |             |             |             |
|--|-------------|-------------|-------------|
| Unrealized losses on securities                                  |             |             |             |
| Unrealized holding losses arising during the period              | \$ (12,480) | \$ (4,243 ) | \$ (8,237 ) |
| Less reclassification adjustment for losses recognized in income | (21 )       | (7 )        | (14 )       |
| Net unrealized losses on securities                              | (12,459)    | (4,236 )    | (8,223 )    |
| <br>   |             |             |             |
| Total decrease in other comprehensive loss                       | \$ (12,459) | \$ (4,236 ) | \$ (8,223 ) |

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|   | Six Months Ended June 30,<br>2012 |                             |            |
|---|-----------------------------------|-----------------------------|------------|
|   | Pretax                            | Tax<br>Expense<br>(Benefit) | Net-of-Tax |
|   | (in thousands)                    |                             |            |
| Unrealized gains on securities                                  |                                   |                             |            |
| Unrealized holding gains arising during the period              | \$ 1,461                          | \$ 497                      | \$ 964     |
| Less reclassification adjustment for gains recognized in income | 1,084                             | 369                         | 715        |
| Net unrealized gains on securities                              | 377                               | 128                         | 249        |
| <br>  |                                   |                             |            |
| Total increase in other comprehensive loss                      | \$ 377                            | \$ 128                      | \$ 249     |

**EARNINGS PER COMMON SHARE**

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

The Company did not include an average of 156 thousand potential common shares attributable to outstanding stock options in the diluted earnings per share calculation for the first six months of 2013 because they were antidilutive.

**Note 7. Recent Accounting Pronouncements**

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Public companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in its consolidated financial statements.

**Note 8. Fair Value Measurements**

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

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

The fair value can be a reasonable point within a range that is most representative of fair value under current market conditions.

In estimating the fair value of assets and liabilities, the Company relies mainly on two models. The first model, used by the Company's bond accounting company, determines the fair value of securities. Securities are priced based on an evaluation of observable market data, including benchmark yield curves, reported trades, broker/dealer quotes, and issuer spreads. Pricing is also impacted by credit information about the issuer, perceived market movements, and current news events impacting the individual sectors. For assets other than securities and for all liabilities, fair value is determined using the Company's asset/liability modeling software. The software uses current yields, anticipated yield changes, and estimated duration of assets and liabilities to calculate fair value.

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

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

Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset Level or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or 2 – liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Valuation is based on unobservable inputs that are supported by little or no market activity and that are Level significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments 3 – whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

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

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

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

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

| Description | Balance | Fair Value Measurements at June 30, 2013 Using (in thousands) |
|-------------|---------|---|
|             |         | Quoted Prices in Active Markets for Identical Assets          |
|             |         | Significant Other Inputs (Level 2)                            |
|             |         | Significant Unobservable Inputs (Level 3)                     |

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|   |           | (Level<br>1) |           |    |   |
|---|-----------|--------------|-----------|----|---|
| Available-for-sale securities                   |           |              |           |    |   |
| Obligations of U.S. Government agencies         | \$25,805  | \$0          | \$25,805  | \$ | 0 |
| Obligations of state and political subdivisions | 48,764    | 0            | 48,764    |    | 0 |
| Mortgage-backed securities                      | 181,843   | 0            | 181,843   |    | 0 |
| Money market investments                        | 801       | 0            | 801       |    | 0 |
| Corporate bonds                                 | 1,370     | 0            | 1,370     |    | 0 |
| Total available-for-sale securities             | \$258,583 | \$0          | \$258,583 | \$ | 0 |

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| Description                                     | Balance | Fair Value Measurements at<br>December 31, 2012 Using<br>(in thousands)                   |   |  |
|---|---------|---|---|--|
|   |         | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities                   |         |   |   |  |
| Obligations of U.S. Government agencies         | 37,088  | 0   | 37,088  | 0  |
| Obligations of state and political subdivisions | 43,774  | 0   | 43,774  |  |