

OLD POINT FINANCIAL CORP  
Form 10-Q  
November 14, 2017  
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 September 30, 2017

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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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.

5,018,678 shares of common stock (\$5.00 par value) outstanding as of October 31, 2017

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OLD POINT FINANCIAL CORPORATION

FORM 10-Q

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GLOSSARY OF DEFINED TERMS

|                           |   |
|---------------------------|---|
| ALLL                      | Allowance for Loan and Lease Losses   |
| ASC                       | Accounting Standards Codification   |
| ASU                       | Accounting Standards Update   |
| Bank                      | The Old Point National Bank of Phoebus  |
| CET1                      | Common Equity Tier 1  |
| Citizens National Company | Citizens National Bank  |
| CRA                       | Old Point Financial Corporation   |
| ESPP                      | Community Reinvestment Act  |
| EVE                       | Employee Stock Purchase Plan  |
| FASB                      | Economic Value of Equity  |
| FHLB                      | Financial Accounting Standards Board  |
| FOMC                      | Federal Home Loan Bank  |
| Federal Reserve           | Federal Open Market Committee   |
| FRB                       | Board of Governors of the Federal Reserve System  |
| GAAP                      | Federal Reserve Bank  |
| Incentive Stock Plan      | Generally Accepted Accounting Principles  |
| IRS                       | Old Point Financial Corporation 2016 Incentive Stock Plan   |
| OAEM                      | Internal Revenue Service  |
| OCC                       | Other Assets Especially Mentioned   |
| OPM                       | Office of the Comptroller of the Currency   |
| OREO                      | Old Point Mortgage  |
| Pending Acquisition       | Other Real Estate Owned   |
| SEC                       | Acquisition of Citizens National pursuant to a definitive merger agreement by and among the Company, the Bank and Citizens National, dated as of October 27, 2017 |
| TDR                       | Securities and Exchange Commission  |
| Trust                     | Troubled Debt Restructuring   |
| VIE                       | Old Point Trust & Financial Services N.A.   |
|                           | Variable Interest Entities  |

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

Old Point Financial Corporation and Subsidiaries  
Consolidated Balance Sheets

|  | September<br>30, 2017  | December<br>31, 2016 |
|--|--|----------------------|
|  | (dollars in thousands<br>except per share data)<br>(unaudited) * |                      |
| Assets   |  |                      |
| Cash and due from banks  | \$12,496   | \$21,885             |
| Interest-bearing due from banks  | 1,648  | 1,667                |
| Federal funds sold   | 1,291  | 2,302                |
| Cash and cash equivalents  | 15,435   | 25,854               |
| Securities available-for-sale, at fair value   | 164,112  | 199,365              |
| Restricted securities, at cost   | 2,890  | 970                  |
| Loans held for sale, at fair value   | 981  | -                    |
| Loans held for investment, net of allowance for loan losses of \$8,951 and \$8,245   | 692,045  | 595,637              |
| Premises and equipment, net  | 37,750   | 39,324               |
| Bank-owned life insurance  | 25,802   | 25,206               |
| Other real estate owned, net of valuation allowance  | -  | 1,067                |
| Other assets   | 15,482   | 15,543               |
| Total assets   | \$954,497  | \$902,966            |
| Liabilities & Stockholders' Equity   |  |                      |
| Deposits:  |  |                      |
| Noninterest-bearing deposits   | \$223,442  | \$228,641            |
| Savings deposits   | 344,654  | 344,452              |
| Time deposits  | 214,349  | 211,409              |
| Total deposits   | 782,445  | 784,502              |
| Federal funds purchased  | 2,000  | -                    |
| Overnight repurchase agreements  | 21,885   | 18,704               |
| Federal Home Loan Bank advances  | 45,000   | -                    |
| Accrued expenses and other liabilities   | 5,526  | 5,770                |
| Total liabilities  | 856,856  | 808,976              |
| Commitments and contingencies  |  |                      |
| Stockholders' equity:  |  |                      |
| Common stock, \$5 par value, 10,000,000 shares authorized; 5,009,630 and 4,961,258 shares outstanding (includes 2,245 and zero shares of nonvested restricted stock) | 25,037   | 24,806               |
| Additional paid-in capital   | 17,112   | 16,427               |
| Retained earnings  | 58,179   | 56,965               |

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|  |           |           |
|--|-----------|-----------|
| Accumulated other comprehensive loss, net  | (2,687 )  | (4,208 )  |
| Total stockholders' equity                 | 97,641    | 93,990    |
| Total liabilities and stockholders' equity | \$954,497 | \$902,966 |

See Notes to Consolidated Financial Statements.

\* Derived from audited Consolidated Financial Statements

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Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Income

|  | Three Months Ended<br>September 30,                     |         | Nine Months Ended<br>September 30, |          |
|--|---|---------|------------------------------------|----------|
|  | 2017  | 2016    | 2017                               | 2016     |
|  | (unaudited, dollars in thousands except per share data) |         |                                    |          |
| <b>Interest and Dividend Income:</b>   |   |         |                                    |          |
| Interest and fees on loans   | \$7,642   | \$6,646 | \$21,532                           | \$19,619 |
| Interest on due from banks   | 4   | 25      | 12                                 | 30       |
| Interest on federal funds sold   | 1   | 2       | 6                                  | 4        |
| <b>Interest on securities:</b>   |   |         |                                    |          |
| Taxable  | 487   | 357     | 1,474                              | 1,376    |
| Tax-exempt   | 385   | 371     | 1,232                              | 1,131    |
| Dividends and interest on all other securities   | 49  | 35      | 98                                 | 76       |
| Total interest and dividend income   | 8,568   | 7,436   | 24,354                             | 22,236   |
| <b>Interest Expense:</b>   |   |         |                                    |          |
| Interest on savings deposits   | 103   | 56      | 240                                | 165      |
| Interest on time deposits  | 560   | 538     | 1,599                              | 1,572    |
| Interest on federal funds purchased, securities sold under agreements to repurchase and other borrowings | 13  | 6       | 26                                 | 20       |
| Interest on Federal Home Loan Bank advances  | 161   | 33      | 233                                | 177      |
| Total interest expense   | 837   | 633     | 2,098                              | 1,934    |
| Net interest income  | 7,731   | 6,803   | 22,256                             | 20,302   |
| Provision for (recovery of) loan losses  | 1,275   | (100)   | 2,925                              | 1,300    |
| Net interest income, after provision for (recovery of) loan losses                                       | 6,456   | 6,903   | 19,331                             | 19,002   |
| <b>Noninterest Income:</b>   |   |         |                                    |          |
| Income from fiduciary activities   | 903   | 858     | 2,820                              | 2,636    |
| Service charges on deposit accounts  | 1,001   | 1,039   | 2,844                              | 3,035    |
| Other service charges, commissions and fees  | 1,050   | 968     | 3,141                              | 3,019    |
| Income from bank-owned life insurance  | 198   | 215     | 595                                | 647      |
| Income from mortgage banking activities  | 172   | 187     | 462                                | 276      |
| Gain on sale of available-for-sale securities, net   | 2   | 7       | 89                                 | 522      |
| Gain on acquisition of Old Point Mortgage  | -   | -       | 550                                | -        |
| Other operating income   | 35  | 53      | 114                                | 143      |
| Total noninterest income   | 3,361   | 3,327   | 10,615                             | 10,278   |
| <b>Noninterest Expense:</b>  |   |         |                                    |          |
| Salaries and employee benefits   | 5,104   | 5,063   | 15,650                             | 15,107   |
| Occupancy and equipment  | 1,444   | 1,373   | 4,347                              | 4,121    |
| Data processing  | 473   | 419     | 1,328                              | 1,276    |
| FDIC insurance   | 128   | 66      | 322                                | 387      |
| Customer development   | 153   | 146     | 451                                | 450      |
| Legal and audit expenses   | 216   | 372     | 604                                | 869      |
| Other outside service fees   | 292   | 200     | 797                                | 561      |
| Employee professional development  | 196   | 147     | 651                                | 474      |
| Loan expenses  | 302   | 46      | 483                                | 103      |



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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Capital stock tax                                | 141       | 128       | 422       | 390       |
| ATM and other losses                             | 103       | 131       | 435       | 301       |
| Prepayment fee on Federal Home Loan Bank advance | -         | -         | -         | 391       |
| Loss (gain) on other real estate owned           | -         | 45        | (18       | ) 153     |
| Other operating expenses                         | 564       | 553       | 1,620     | 1,682     |
| Total noninterest expense                        | 9,116     | 8,689     | 27,092    | 26,265    |
| Income before income taxes                       | 701       | 1,541     | 2,854     | 3,015     |
| Income tax expense (benefit)                     | (56       | ) 212     | (6        | ) 113     |
| Net income                                       | \$757     | \$1,329   | \$2,860   | \$2,902   |
|  |           |           |           |           |
| Basic earnings per share                         |           |           |           |           |
| Weighted average shares outstanding              | 4,993,805 | 4,959,009 | 4,985,135 | 4,959,009 |
| Net income per share of common stock             | \$0.15    | \$0.27    | \$0.57    | \$0.59    |
|  |           |           |           |           |
| Diluted earnings per share                       |           |           |           |           |
| Weighted average shares outstanding              | 5,003,785 | 4,959,009 | 4,997,231 | 4,959,009 |
| Net income per share of common stock             | \$0.15    | \$0.27    | \$0.57    | \$0.59    |

See Notes to Consolidated Financial Statements.

Old Point Financial Corporation and Subsidiaries  
 Consolidated Statements of Comprehensive Income

|   | Three Months<br>Ended<br>September 30,<br>2017 2016 |         | Nine Months<br>Ended<br>September 30,<br>2017 2016 |         |
|---|---|---------|--|---------|
|   | (unaudited, dollars in thousands)                   |         |  |         |
| Net income  | \$757   | \$1,329 | \$2,860  | \$2,902 |
| Other comprehensive income (loss), net of tax               |   |         |  |         |
| Net unrealized gain (loss) on available-for-sale securities | 57  | (299 )  | 1,521  | 1,877   |
| Comprehensive income  | \$814   | \$1,030 | \$4,381  | \$4,779 |

See Notes to Consolidated Financial Statements.

Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Changes in Stockholders' Equity

|  | Shares of<br>Common<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total     |
|--|------------------------------|-----------------|----------------------------------|----------------------|---|-----------|
| (unaudited, dollars in thousands except per share data)      |                              |                 |                                  |                      |   |           |
| NINE MONTHS ENDED SEPTEMBER 30, 2017                         |                              |                 |                                  |                      |   |           |
| Balance at beginning of period                               | 4,961,258                    | \$ 24,806       | \$ 16,427                        | \$ 56,965            | \$ (4,208 )                                   | \$ 93,990 |
| Net income   | -                            | -               | -                                | 2,860                | -   | 2,860     |
| Other comprehensive income, net of tax                       | -                            | -               | -                                | -                    | 1,521   | 1,521     |
| Exercise of stock options                                    | 48,287                       | 241             | 727                              | -                    | -   | 968       |
| Employee Stock Purchase Plan share issuance                  | 2,523                        | 13              | 58                               | -                    | -   | 71        |
| Repurchase of common stock related to stock option exercises | (4,683 )                     | (23 )           | (109 )                           | -                    | -   | (132 )    |
| Stock-based compensation expense                             | -                            | -               | 9                                | -                    | -   | 9         |
| Cash dividends (\$0.33 per share)                            | -                            | -               | -                                | (1,646 )             | -   | (1,646 )  |
| Balance at end of period                                     | 5,007,385                    | \$ 25,037       | \$ 17,112                        | \$ 58,179            | \$ (2,687 )                                   | \$ 97,641 |
| NINE MONTHS ENDED SEPTEMBER 30, 2016                         |                              |                 |                                  |                      |   |           |
| Balance at beginning of period                               | 4,959,009                    | \$ 24,795       | \$ 16,392                        | \$ 55,151            | \$ (3,162 )                                   | \$ 93,176 |
| Net income   | -                            | -               | -                                | 2,902                | -   | 2,902     |
| Other comprehensive income, net of tax                       | -                            | -               | -                                | -                    | 1,877   | 1,877     |
| Cash dividends (\$0.30 per share)                            | -                            | -               | -                                | (1,488 )             | -   | (1,488 )  |
| Balance at end of period                                     | 4,959,009                    | \$ 24,795       | \$ 16,392                        | \$ 56,565            | \$ (1,285 )                                   | \$ 96,467 |

See Notes to Consolidated Financial Statements.

Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Cash Flows

|   | Nine Months Ended<br>September 30,<br>2017      2016<br>(unaudited, dollars in<br>thousands) |           |
|---|--|-----------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |  |           |
| Net income  | \$2,860  | \$2,902   |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |           |
| Depreciation and amortization   | 2,081  | 2,034     |
| Provision for loan losses   | 2,925  | 1,300     |
| Net gain on sale of available-for-sale securities                                 | (89 )  | (522 )    |
| Net amortization of securities  | 1,727  | 1,595     |
| (Increase) in loans held for sale   | (981 )   | -         |
| Net (gain) loss on disposal of premises and equipment                             | 4  | (3 )      |
| Net (gain) loss on write-down/sale of other real estate owned                     | (18 )  | 153       |
| Income from bank owned life insurance   | (595 )   | (647 )    |
| Stock compensation expense  | 9  | -         |
| Deferred tax benefit  | (171 )   | (256 )    |
| Increase in other assets  | (552 )   | (942 )    |
| Increase (decrease) in other liabilities  | (244 )   | 363       |
| Net cash provided by operating activities   | 6,956  | 5,977     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |  |           |
| Purchases of available-for-sale securities  | (25,220 )  | (104,082) |
| Proceeds from redemption (cash used in purchases) of restricted securities, net   | (1,920 )   | 196       |
| Proceeds from maturities and calls of available-for-sale securities               | 46,625   | 42,330    |
| Proceeds from sales of available-for-sale securities                              | 7,030  | 106,761   |
| Paydowns on available-for-sale securities   | 7,484  | 8,734     |
| (Purchases) paydowns of consumer installment loans, net                           | (7,275 )   | -         |
| Net increase in all other loans (including repayments on student loans)           | (92,058 )  | (26,703 ) |
| Proceeds from sales of other real estate owned                                    | 1,084  | 1,625     |
| Payments for improvements to other real estate owned                              | -  | (52 )     |
| Purchases of premises and equipment   | (510 )   | (710 )    |
| Net cash provided by (used in) investing activities                               | (64,760 )  | 28,099    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |  |           |
| Increase (decrease) in noninterest-bearing deposits                               | (5,199 )   | 10,930    |
| Increase in savings deposits  | 202  | 3,818     |
| Increase in time deposits   | 2,940  | 3,278     |
| Increase (decrease) in federal funds purchased and repurchase agreements, net     | 5,181  | (7,711 )  |
| Increase in Federal Home Loan Bank advances                                       | 120,000  | 55,000    |
| Repayment of Federal Home Loan Bank advances                                      | (75,000 )  | (60,000 ) |
| Proceeds from exercise of stock options and ESPP issuance                         | 1,039  | -         |
| Repurchase and retirement of common stock   | (132 )   | -         |
| Cash dividends paid on common stock   | (1,646 )   | (1,488 )  |
| Net cash provided by financing activities   | 47,385   | 3,827     |

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|  |           |           |
|--|-----------|-----------|
| Net increase (decrease) in cash and cash equivalents | (10,419 ) | 37,903    |
| Cash and cash equivalents at beginning of period     | 25,854    | 36,990    |
| Cash and cash equivalents at end of period           | \$ 15,435 | \$ 74,893 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash payments for:

|            |         |         |
|------------|---------|---------|
| Interest   | \$2,029 | \$1,948 |
| Income tax | \$750   | \$-     |

SUPPLEMENTAL SCHEDULE OF NONCASH TRANSACTIONS

|   |         |         |
|---|---------|---------|
| Unrealized gain on securities available-for-sale                            | \$2,305 | \$2,844 |
| Former bank property transferred from fixed assets to foreclosed properties | \$-     | \$127   |

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 (NASDAQ: OPOF) (the Company) and its subsidiaries have been prepared in accordance with U.S. 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 position at September 30, 2017 and December 31, 2016, the statements of income and comprehensive income for the three and nine months ended September 30, 2017 and 2016, and the statements of changes in stockholders' equity and cash flows for the nine months ended September 30, 2017 and 2016. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2016 annual report on Form 10-K. Certain previously reported amounts have been reclassified to conform to current period presentation, none of which were material in nature.

### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, The Old Point National Bank of Phoebus (the Bank) and Old Point Trust & Financial Services N.A. (Trust). Also included are the accounts of Old Point Mortgage, LLC (OPM) which became a wholly-owned subsidiary of the Bank in the second quarter of 2017. All significant intercompany balances and transactions have been eliminated in consolidation.

### NATURE OF OPERATIONS

Old Point Financial Corporation is a holding company that conducts substantially all of its operations through two subsidiaries, the Bank and Trust. The Bank serves individual and commercial customers, the majority of which are in Hampton Roads, Virginia. As of September 30, 2017, the Bank had 18 branch offices. The Bank offers a full range of deposit and loan products to its retail and commercial customers, including mortgage loan products offered through its subsidiary, OPM. Trust offers a full range of services for individuals and businesses. Products and services include retirement planning, estate planning, financial planning, estate and trust administration, retirement plan administration, tax services and investment management services.

### 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.

On October 27, 2017, the Company and the Bank entered into a definitive Agreement and Plan of Reorganization with Citizens National Bank (OTC Pink: CNBV) (Citizens National) pursuant to which the Company will acquire Citizens National in a stock and cash transaction for total consideration valued at approximately \$7.9 million (the Pending Acquisition), based on a volume-weighted average price of \$31.48 for Old Point common stock for the three trading days ended October 27, 2017. Upon the closing of the Pending Acquisition, Citizens National will merge into the Bank with the Bank as the surviving entity. The Pending Acquisition has been unanimously approved by the boards

of directors of the Company, the Bank and Citizens National. The Pending Acquisition is expected to be completed in first quarter of 2018, subject to the approval of Citizens National shareholders as well as customary regulatory approvals and other closing conditions.

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## RECENT ACCOUNTING PRONOUNCEMENTS

During February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements. As the Company owns the majority of its buildings, management does not anticipate that the ASU will have a material impact.

During June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for Securities and Exchange Commission (SEC) filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements and has formed a committee to oversee the adoption of the new standard. The ALLL model currently in use by the Company already provides it with the ability to archive prior period information and contains loan balance and charge-off information beginning with September 30, 2011. The committee has reviewed the data included in each monthly archive file and has added fields to enhance its data analysis capabilities under the new standard.

During August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments," to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

During January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business." The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a



"set") that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Company does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements. The Company's pending merger with Citizens National Bank will be accounted for under the acquisition accounting guidance.

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During January 2017, the FASB issued ASU No. 2017-04, "Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

During March 2017, the FASB issued ASU No. 2017-07, "Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." The amendments in this ASU require an employer that offers defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715 to report the service cost component of net periodic benefit cost in the same line item(s) as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented in the income statement separately from the service cost component. If the other components of net periodic benefit cost are not presented on a separate line or lines, the line item(s) used in the income statement must be disclosed. In addition, only the service cost component will be eligible for capitalization as part of an asset, when applicable. The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted. The Company does not expect the adoption of ASU 2017-07 to have a material impact on its consolidated financial statements.

During March 2017, the FASB issued ASU No. 2017-08, "Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities." The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company is currently assessing the impact that ASU 2017-08 will have on its consolidated financial statements.

During May 2017, the FASB issued ASU 2017-09, "Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting." The amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The amendments are effective for all entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. The Company is currently assessing the impact that ASU 2017-09 will have on its consolidated financial statements.

During August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted,

including adoption in any interim period. The Company does not expect the adoption of ASU 2017-12 to have a material impact on its consolidated financial statements.

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## Note 2. Securities

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 |
|---|-------------------------------------|------------------------------|-------------------------------|---------------|
| September 30, 2017                              |                                     |                              |                               |               |
| Obligations of U.S. Government agencies         | \$9,574                             | \$ 11                        | \$ (92 )                      | \$9,493       |
| Obligations of state and political subdivisions | 67,815                              | 771                          | (152 )                        | 68,434        |
| Mortgage-backed securities                      | 78,436                              | -                            | (1,120 )                      | 77,316        |
| Money market investments                        | 1,169                               | -                            | -                             | 1,169         |
| Corporate bonds and other securities            | 7,349                               | 166                          | (5 )                          | 7,510         |
| Other marketable equity securities              | 100                                 | 90                           | -                             | 190           |
| Total   | \$164,443                           | \$ 1,038                     | \$ (1,369 )                   | \$164,112     |
| December 31, 2016                               |                                     |                              |                               |               |
| U.S. Treasury securities                        | \$20,000                            | \$ -                         | \$ -                          | \$20,000      |
| Obligations of U.S. Government agencies         | 9,361                               | -                            | (166 )                        | 9,195         |
| Obligations of state and political subdivisions | 78,645                              | 358                          | (1,016 )                      | 77,987        |
| Mortgage-backed securities                      | 85,649                              | 18                           | (1,973 )                      | 83,694        |
| Money market investments                        | 647                                 | -                            | -                             | 647           |
| Corporate bonds and other securities            | 7,598                               | 92                           | (12 )                         | 7,678         |
| Other marketable equity securities              | 100                                 | 64                           | -                             | 164           |
| Total   | \$202,000                           | \$ 532                       | \$ (3,167 )                   | \$199,365     |

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 nine months ended September 30, 2017 or the year ended December 31, 2016.

The following table summarizes realized gains and losses on the sale of investment securities during the periods indicated:

| Three<br>Months | Nine<br>Months |
|-----------------|----------------|
|-----------------|----------------|

|  | Ended     |      | Ended     |       |
|--|-----------|------|-----------|-------|
|  | September |      | September |       |
|  | 30,       | 30,  | 30,       | 30,   |
|  | 2017      | 2016 | 2017      | 2016  |
| Securities Available-for-sale          |           |      |           |       |
| Realized gains on sales of securities  | \$2       | \$24 | \$89      | \$578 |
| Realized losses on sales of securities | -         | (17) | -         | (56)  |
| Net realized gain                      | \$2       | \$7  | \$89      | \$522 |

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The following table shows the number of securities with unrealized losses, and the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired as of September 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of the dates indicated:

September 30, 2017

|   | Less Than<br>Twelve Months    |               | More Than<br>Twelve Months    |               | Total                         |               | Number<br>of<br>Securities |
|---|-------------------------------|---------------|-------------------------------|---------------|-------------------------------|---------------|----------------------------|
|   | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value |                            |
| September 30, 2017                              | (dollars in thousands)        |               |                               |               |                               |               |                            |
| Securities Available-for-Sale                   |                               |               |                               |               |                               |               |                            |
| Obligations of U.S. Government agencies         | \$10                          | \$4,393       | \$82                          | \$3,120       | \$92                          | \$7,513       | 11                         |
| Obligations of state and political subdivisions | 80                            | 5,006         | 72                            | 6,898         | 152                           | 11,904        | 15                         |
| Mortgage-backed securities                      | 257                           | 32,054        | 863                           | 45,262        | 1,120                         | 77,316        | 24                         |
| Corporate bonds                                 | 1                             | 1,299         | 4                             | 295           | 5                             | 1,594         | 10                         |
| Total securities available-for-sale             | \$348                         | \$42,752      | \$1,021                       | \$55,575      | \$1,369                       | \$98,327      | 60                         |

December 31, 2016

|   | Less Than Twelve<br>Months    |               | More Than<br>Twelve<br>Months |               | Total                         |               | Number<br>of<br>Securities |
|---|-------------------------------|---------------|-------------------------------|---------------|-------------------------------|---------------|----------------------------|
|   | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value |                            |
| December 31, 2016                               | (dollars in thousands)        |               |                               |               |                               |               |                            |
| Securities Available-for-Sale                   |                               |               |                               |               |                               |               |                            |
| Obligations of U.S. Government agencies         | \$166                         | \$9,195       | \$-                           | \$-           | \$166                         | \$9,195       | 6                          |
| Obligations of state and political subdivisions | 1,016                         | 38,020        | -                             | -             | 1,016                         | 38,020        | 56                         |
| Mortgage-backed securities                      | 1,973                         | 80,680        | -                             | -             | 1,973                         | 80,680        | 23                         |
| Corporate bonds                                 | 11                            | 1,787         | 1                             | 100           | 12                            | 1,887         | 13                         |
| Total securities available-for-sale             | \$3,166                       | \$129,682     | \$1                           | \$100         | \$3,167                       | \$129,782     | 98                         |

Certain investments within the Company's portfolio had unrealized losses for more than twelve months at September 30, 2017 and December 31, 2016, 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 September 30, 2017 or December 31, 2016.

#### 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:

|   | September<br>30, 2017 | December<br>31, 2016 |
|---|-----------------------|----------------------|
|   | (in thousands)        |                      |
| Mortgage loans on real estate:                          |                       |                      |
| Residential 1-4 family                                  | \$ 100,746            | \$ 94,827            |
| Commercial  | 281,628               | 285,429              |
| Construction  | 23,715                | 23,116               |
| Second mortgages  | 17,557                | 17,128               |
| Equity lines of credit                                  | 54,029                | 51,024               |
| Total mortgage loans on real estate                     | 477,675               | 471,524              |
| Commercial and industrial loans                         | 60,003                | 54,434               |
| Consumer automobile loans                               | 94,041                | 10,407               |
| Other consumer loans                                    | 56,386                | 48,500               |
| Other   | 12,891                | 19,017               |
| Total loans, net of deferred fees (1)                   | 700,996               | 603,882              |
| Less: Allowance for loan losses                         | (8,951 )              | (8,245 )             |
| Loans, net of allowance and deferred fees and costs (1) | \$ 692,045            | \$ 595,637           |

(1) Net deferred loan fees totaled \$874 thousand and \$522 thousand at September 30, 2017 and December 31, 2016, respectively.

Overdrawn deposit accounts are reclassified as loans and included in the Other category in the table above. Overdrawn deposit accounts totaled \$728 thousand and \$536 thousand at September 30, 2017 and December 31, 2016, 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 identified for charge-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 September 30, 2017

(in thousands)

|                                     | Pass      | OAEM     | Substandard | Doubtful | Total     |
|-------------------------------------|-----------|----------|-------------|----------|-----------|
| Mortgage loans on real estate:      |           |          |             |          |           |
| Residential 1-4 family              | \$98,829  | \$-      | \$ 1,917    | \$ -     | \$100,746 |
| Commercial                          | 256,898   | 11,696   | 13,034      | -        | 281,628   |
| Construction                        | 22,920    | 74       | 721         | -        | 23,715    |
| Second mortgages                    | 16,952    | 446      | 159         | -        | 17,557    |
| Equity lines of credit              | 53,686    | -        | 343         | -        | 54,029    |
| Total mortgage loans on real estate | 449,285   | 12,216   | 16,174      | -        | 477,675   |
| Commercial and industrial loans     | 58,192    | 1,037    | 774         | -        | 60,003    |
| Consumer automobile loans           | 93,984    | -        | 57          | -        | 94,041    |
| Other consumer loans                | 56,336    | -        | 50          | -        | 56,386    |
| Other                               | 12,891    | -        | -           | -        | 12,891    |
| Total                               | \$670,688 | \$13,253 | \$ 17,055   | \$ -     | \$700,996 |

Credit Quality Information

As of December 31, 2016

(in thousands)

|                                     | Pass      | OAEM     | Substandard | Doubtful | Total     |
|-------------------------------------|-----------|----------|-------------|----------|-----------|
| Mortgage loans on real estate:      |           |          |             |          |           |
| Residential 1-4 family              | \$92,458  | \$1,138  | \$ 1,231    | \$ -     | \$94,827  |
| Commercial                          | 260,948   | 10,014   | 14,467      | -        | 285,429   |
| Construction                        | 22,219    | 162      | 735         | -        | 23,116    |
| Second mortgages                    | 16,445    | 475      | 208         | -        | 17,128    |
| Equity lines of credit              | 50,387    | 500      | 137         | -        | 51,024    |
| Total mortgage loans on real estate | 442,457   | 12,289   | 16,778      | -        | 471,524   |
| Commercial and industrial loans     | 49,979    | 2,278    | 2,177       | -        | 54,434    |
| Consumer automobile loans           | 10,407    | -        | -           | -        | 10,407    |
| Other consumer loans                | 48,334    | -        | 166         | -        | 48,500    |
| Other                               | 19,017    | -        | -           | -        | 19,017    |
| Total                               | \$570,194 | \$14,567 | \$ 19,121   | \$ -     | \$603,882 |

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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 September 30, 2017

|                                     | 30 - 59<br>Days<br>Past<br>Due<br>(in thousands) | 60 - 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 <sup>(1)</sup> | 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              | \$869  | \$-                            | \$621                                | \$1,490              | \$99,256                                 | \$100,746      | \$ 52  |
| Commercial                          | 169  | 984                            | 3,530                                | 4,683                | 276,945                                  | 281,628        | 974  |
| Construction                        | 204  | -                              | -                                    | 204                  | 23,511                                   | 23,715         | -  |
| Second mortgages                    | 79   | -                              | -                                    | 79                   | 17,478                                   | 17,557         | -  |
| Equity lines of credit              | 49   | -                              | 53                                   | 102                  | 53,927                                   | 54,029         | -  |
| Total mortgage loans on real estate | 1,370  | 984                            | 4,204                                | 6,558                | 471,117                                  | 477,675        | 1,026  |
| Commercial loans                    | 853  | 154                            | 1,226                                | 2,233                | 57,770                                   | 60,003         | 473  |
| Consumer automobile loans           | 266  | 44                             | 16                                   | 326                  | 93,715                                   | 94,041         | 16   |
| Other consumer loans                | 1,541  | 585                            | 2,466                                | 4,592                | 51,794                                   | 56,386         | 2,466  |
| Other                               | 91   | 8                              | 2                                    | 101                  | 12,790                                   | 12,891         | 2  |
| Total                               | \$4,121  | \$1,775                        | \$7,914                              | \$13,810             | \$687,186                                | \$700,996      | \$ 3,983   |

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

In the table above, the other consumer loans category includes student loans with principal and interest amounts that are 97 - 98% guaranteed by the federal government. The past due principal portion of these guaranteed loans totaled \$4.1 million at September 30, 2017.

## Age Analysis of Past Due Loans as of December 31, 2016

|                                | 30 - 59<br>Days<br>Past<br>Due<br>(in thousands) | 60 - 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 <sup>(1)</sup> | 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         | \$564  | \$-                            | \$496                                | \$1,060              | \$93,767                                 | \$94,827       | \$ 218   |
| Commercial                     | 2,280  | 1,625                          | 227                                  | 4,132                | 281,297                                  | 285,429        | -  |
| Construction                   | 162  | -                              | -                                    | 162                  | 22,954                                   | 23,116         | -  |
| Second mortgages               | -  | 200                            | 188                                  | 388                  | 16,740                                   | 17,128         | 58   |
| Equity lines of credit         | 394  | 9                              | 86                                   | 489                  | 50,535                                   | 51,024         | -  |

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|                                     |         |         |         |          |           |           |          |
|-------------------------------------|---------|---------|---------|----------|-----------|-----------|----------|
| Total mortgage loans on real estate | 3,400   | 1,834   | 997     | 6,231    | 465,293   | 471,524   | 276      |
| Commercial loans                    | 5       | -       | 86      | 91       | 54,343    | 54,434    | -        |
| Consumer automobile loans           | -       | 11      | -       | 11       | 10,396    | 10,407    | -        |
| Other consumer loans                | 1,876   | 702     | 2,684   | 5,262    | 43,238    | 48,500    | 2,603    |
| Other                               | 41      | 12      | 5       | 58       | 18,959    | 19,017    | 5        |
| Total                               | \$5,322 | \$2,559 | \$3,772 | \$11,653 | \$592,229 | \$603,882 | \$ 2,884 |

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

In the table above, the other consumer loans category includes student loans with principal and interest amounts that are 97 - 98% guaranteed by the federal government. The past due principal portion of these guaranteed loans totaled \$4.8 million at December 31, 2016.

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Although the portion of the student loan portfolio that is 90 days or more past due would normally be considered impaired, the Company does not include these loans in its impairment analysis. Because the federal government has provided guarantees of repayment of these student loans in an amount ranging from 97% to 98% of the total principal and interest of the loans, management does not expect significant increases in past due student loans to have a material effect on the Company.

#### NONACCRUAL LOANS

The Company generally places commercial loans (including construction loans and commercial loans secured and not secured by real estate) 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 consumer loans secured by real estate (including residential 1 - 4 family mortgages, second mortgages, and equity lines of credit) are not required to be placed in nonaccrual status. Although consumer loans and consumer loans secured by real estate are not required to be placed in nonaccrual status, the Company may elect to place these loans in nonaccrual status, if necessary to avoid a material overstatement of interest income. Generally, consumer loans secured by real estate are placed in nonaccrual status only when payments are 120 days past due.

Generally, consumer loans not secured by real estate are placed in nonaccrual status only when part of the principal has been charged off. If a charge-off has not occurred sooner for other reasons, a consumer loan not secured by real estate will generally be placed in nonaccrual status when payments are 120 days past due. These loans are charged off or written down to the net realizable value of the collateral when deemed uncollectible, when classified as a "loss," when repayment is unreasonably protracted, when bankruptcy has been initiated, or when the loan is 120 days or more past due unless the credit is well-secured and in the process of collection.

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 basis or cost recovery method, until it qualifies for return to accrual status or is charged off. Generally, loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured, or when the borrower has resumed paying the full amount of the scheduled contractual interest and principal payments for at least six months.

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

| Nonaccrual Loans by Class           | September      |                   |
|-------------------------------------|----------------|-------------------|
|                                     | 30, 2017       | December 31, 2016 |
|                                     | (in thousands) |                   |
| Mortgage loans on real estate       |                |                   |
| Residential 1-4 family              | \$568          | \$ 598            |
| Commercial                          | 8,012          | 6,033             |
| Construction                        | 518            | -                 |
| Second mortgages                    | -              | 129               |
| Equity lines of credit              | 343            | 87                |
| Total mortgage loans on real estate | 9,441          | 6,847             |
| Commercial loans                    | 771            | 231               |
| Other consumer loans                | -              | 81                |
| Total                               | \$10,212       | \$ 7,159          |

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:

|   | Nine Months<br>Ended<br>September<br>30,<br>2017 2016<br>(in<br>thousands) |        |
|---|--|--------|
| Interest income that would have been recorded under original loan terms | \$ 311   | \$ 232 |
| Actual interest income recorded for the period                          | 179  | 182    |
| Reduction in interest income on nonaccrual loans                        | \$ 132   | \$ 50  |

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## 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 is 90 days or more past due and still accruing interest at the report date.

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

The following tables present TDRs during the periods indicated, by class of loan. There were no troubled debt restructurings in the three months ended September 30, 2017.

Troubled Debt Restructurings by Class  
For the Three Months Ended September 30, 2016

|                                     | Recorded<br>Number<br>of<br>Modifications | Investment<br>Prior to<br>Modification<br>(dollars in thousands) | Recorded<br>Investment<br>After<br>Modification | Current<br>Investment<br>on<br>September<br>30, 2016 |
|-------------------------------------|---|--|---|--|
| Mortgage loans on real estate:      |   |  |   |  |
| Residential 1-4 family              | 4   | \$ 1,002   | \$ 1,002  | \$ 1,002   |
| Commercial                          | 1   | 150  | 150   | 150  |
| Second mortgages                    | 1   | 53   | 53  | 53   |
| Equity lines of credit              | 1   | 93   | 93  | 93   |
| Total mortgage loans on real estate | 7   | 1,298  | 1,298   | 1,298  |
| Other consumer loans                | 2   | 8  | 8   | 8  |
| Total                               | 9   | \$ 1,306   | \$ 1,306  | \$ 1,306   |

Troubled Debt Restructurings by Class  
For the Nine Months Ended September 30, 2017

|                                | Recorded<br>Number<br>of<br>Modifications | Investment<br>Prior to<br>Modification<br>(dollars in thousands) | Recorded<br>Investment<br>After<br>Modification | Current<br>Investment<br>on<br>September<br>30, 2017 |
|--------------------------------|---|--|---|--|
| Mortgage loans on real estate: |   |  |   |  |
| Residential 1-4 family         | 1   | \$ 142   | \$ 142  | \$ 141   |
| Commercial                     | 2   | 3,663  | 3,663   | 3,653  |
| Total                          | 3   | \$ 3,805   | \$ 3,805  | \$ 3,794   |

Troubled Debt Restructurings by Class  
For the Nine Months Ended September 30, 2016

| Number<br>of<br>Modifications | Recorded<br>Investment<br>Prior to<br>Modification | Recorded<br>Investment<br>After | Current<br>Investment<br>on |
|-------------------------------|--|---------------------------------|-----------------------------|
|-------------------------------|--|---------------------------------|-----------------------------|

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|                                     |                        | Modification | Modification | September |
|-------------------------------------|------------------------|--------------|--------------|-----------|
|                                     |                        |              |              | 30, 2016  |
|                                     | (dollars in thousands) |              |              |           |
| Mortgage loans on real estate:      |                        |              |              |           |
| Residential 1-4 family              | 4                      | \$ 1,002     | \$ 1,002     | \$ 1      |
| Commercial                          | 1                      | 150          | 150          | 0         |
| Second mortgages                    | 1                      | 53           | 53           | 0         |
| Equity lines of credit              | 1                      | 93           | 93           | 0         |
| Total mortgage loans on real estate | 7                      | 1,298        | 1,298        | 1         |
| Commercial loans                    | 1                      | 152          | 152          | 0         |
| Other consumer loans                | 2                      | 8            | 8            | 0         |
| Commercial loans                    | 10                     | \$ 1,458     | \$ 1,458     | \$ 1      |

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Of the loans restructured in the first nine months of 2017 one was given a below-market rate for debt with similar risk characteristics and two were granted terms that the Company would not otherwise extend to borrowers with similar risk characteristics. Two of the loans restructured in the first nine months ended September 30, 2016 were given below-market rates for debt with similar risk characteristics, and eight of the loans, which were part of a single borrowing relationship, were given terms not otherwise offered to borrowers with similar risk characteristics. At September 30, 2017 and December 31, 2016, the Company had no outstanding commitments to disburse additional funds on any TDR. At December 31, 2016, the Company had \$10 thousand in loans secured by residential 1 - 4 family real estate that were in the process of foreclosure. There were loans totaling \$142 thousand secured by residential 1 - 4 family real estate in the process of foreclosure at September 30, 2017.

In the three and nine months ended September 30, 2017 and 2016, there were no defaulting TDRs where the default occurred within twelve months of restructuring. The Company considers a TDR in default when any of the following occurs: the loan, as restructured, becomes 90 days or more past due; the loan is moved to nonaccrual status following the restructure; the loan is restructured again under terms that would qualify it as a TDR if it were not already so classified; or any portion of the loan is charged off.

All TDRs are factored into the determination of the allowance for loan losses and 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 when due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming 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 a specific allocation in the allowance 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

|                                     | As of September 30, 2017 |                   |                |                      | For the nine months ended<br>September 30, 2017 |                     |
|-------------------------------------|--------------------------|-------------------|----------------|----------------------|---|---------------------|
|                                     | Unpaid Principal Balance | Without Allowance | With Allowance | Associated Allowance | Average Recorded Investment                     | Interest Recognized |
| Mortgage loans on real estate:      |                          |                   |                |                      |   |                     |
| Residential 1-4 family              | \$2,449                  | \$1,980           | \$ 390         | \$ 75                | \$2,429   | \$ 74               |
| Commercial                          | 12,430                   | 10,758            | 436            | 87                   | 13,447  | 435                 |
| Construction                        | 93                       | -                 | 93             | 18                   | 269   | 4                   |
| Second mortgages                    | 359                      | 201               | 137            | 15                   | 461   | 12                  |
| Equity lines of credit              | 344                      | 53                | 290            | 61                   | 250   | -                   |
| Total mortgage loans on real estate | \$15,675                 | \$12,992          | \$ 1,346       | \$ 256               | \$16,856  | \$ 525              |
| Commercial loans                    | 1,017                    | 163               | 608            | 183                  | 1,513   | 21                  |
| Other consumer loans                | -                        | -                 | -              | -                    | 54  | -                   |
| Total                               | \$16,692                 | \$13,155          | \$ 1,954       | \$ 439               | \$18,423  | \$ 546              |

## Impaired Loans by Class

|                                     | As of December 31, 2016  |                   |                |                      | For the Year Ended<br>December 31, 2016 |                     |
|-------------------------------------|--------------------------|-------------------|----------------|----------------------|---|---------------------|
|                                     | Unpaid Principal Balance | Without Allowance | With Allowance | Associated Allowance | Average Recorded Investment             | Interest Recognized |
| Mortgage loans on real estate:      |                          |                   |                |                      |   |                     |
| Residential 1-4 family              | \$2,496                  | \$1,835           | \$ 622         | \$ 75                | \$2,741                                 | \$ 119              |
| Commercial                          | 16,193                   | 11,095            | 4,274          | 415                  | 11,885                                  | 727                 |
| Construction                        | 619                      | 528               | 96             | 22                   | 496                                     | 43                  |
| Second mortgages                    | 526                      | 309               | 141            | 17                   | 511                                     | 25                  |
| Equity lines of credit              | 87                       | 86                | -              | -                    | 46                                      | 3                   |
| Total mortgage loans on real estate | \$19,921                 | \$13,853          | \$ 5,133       | \$ 529               | \$15,679                                | \$ 917              |
| Commercial loans                    | 1,077                    | -                 | 989            | 271                  | 827                                     | 74                  |
| Other consumer loans                | 81                       | 81                | -              | -                    | 68                                      | 1                   |
| Total                               | \$21,079                 | \$13,934          | \$ 6,122       | \$ 800               | \$16,574                                | \$ 992              |

## 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 (determined by migration analysis) by risk grades are used as a component of the calculation of the allowance for loan losses.

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## ALLOWANCE FOR LOAN LOSSES

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and probable losses inherent in the loan portfolio. The Company segments the loan portfolio into categories as defined by Schedule RC-C of the Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income Form 041 (Call Report). 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.

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.

Each segment of the portfolio is pooled by risk grade or by days past due. Consumer loans not secured by real estate and made to individuals for household, family and other personal expenditures are segmented into pools based on days past due, while all other loans, including loans to consumers that are secured by real estate, are segmented by risk grades. A historical loss percentage is then calculated by migration analysis and applied to each pool. The migration analysis applied to all pools is able to track the risk grading and historical performance of individual loans throughout a number of periods set by management, which provides management with information regarding trends (or migrations) in a particular loan segment. At December 31, 2016 management used four twelve-quarter migration periods; at September 30, 2017 management used eight twelve-quarter migration periods. See "Changes in Allowance Methodology" section later in this note.

Management also provides an allocated component of the allowance for loans that are specifically identified that may be impaired, and are individually analyzed for impairment. An allocated allowance is established when the present value of expected 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.

#### ALLOWANCE FOR LOAN LOSSES BY SEGMENT

The total allowance reflects management's estimate of losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses of \$9.0 million adequate to cover probable loan losses inherent in the loan portfolio at September 30, 2017.

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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)

| For the Nine Months Ended                            | Commercial | Real Estate -<br>Construction | Real Estate -<br>Mortgage<br>(1) | Consumer<br>(2) | Other     | Total      |
|--|------------|-------------------------------|----------------------------------|-----------------|-----------|------------|
| September 30, 2017                                   |            |                               |                                  |                 |           |            |
| Allowance for Loan Losses:                           |            |                               |                                  |                 |           |            |
| Balance at the beginning of period                   | \$ 1,493   | \$ 846                        | \$ 5,267                         | \$ 455          | \$ 184    | \$ 8,245   |
| Charge-offs  | (629 )     | -                             | (1,473 )                         | (228 )          | (136 )    | (2,466 )   |
| Recoveries   | 32         | 104                           | 40                               | 33              | 38        | 247        |
| Provision for loan losses                            | 679        | (332 )                        | 1,573                            | 909             | 96        | 2,925      |
| Ending balance                                       | \$ 1,575   | \$ 618                        | \$ 5,407                         | \$ 1,169        | \$ 182    | \$ 8,951   |
| Ending balance individually evaluated for impairment | \$ 183     | \$ 18                         | \$ 238                           | \$-             | \$-       | \$ 439     |
| Ending balance collectively evaluated for impairment | 1,392      | 600                           | 5,169                            | 1,169           | 182       | 8,512      |
| Ending balance                                       | \$ 1,575   | \$ 618                        | \$ 5,407                         | \$ 1,169        | \$ 182    | \$ 8,951   |
| Loan Balances:                                       |            |                               |                                  |                 |           |            |
| Ending balance individually evaluated for impairment | \$ 771     | \$ 93                         | \$ 14,245                        | \$-             | \$-       | \$ 15,109  |
| Ending balance collectively evaluated for impairment | 59,232     | 23,622                        | 439,715                          | 150,427         | 12,891    | 685,887    |
| Ending balance                                       | \$ 60,003  | \$ 23,715                     | \$ 453,960                       | \$ 150,427      | \$ 12,891 | \$ 700,996 |

| For the Year Ended                                   | Commercial | Real Estate -<br>Construction | Real Estate -<br>Mortgage<br>(1) | Consumer  | Other     | Total      |
|--|------------|-------------------------------|----------------------------------|-----------|-----------|------------|
| December 31, 2016                                    |            |                               |                                  |           |           |            |
| Allowance for Loan Losses:                           |            |                               |                                  |           |           |            |
| Balance at the beginning of period                   | \$ 633     | \$ 985                        | \$ 5,628                         | \$ 279    | \$ 213    | \$ 7,738   |
| Charge-offs  | (915 )     | -                             | (504 )                           | (204 )    | (147 )    | (1,770 )   |
| Recoveries   | 79         | 3                             | 197                              | 28        | 40        | 347        |
| Provision for loan losses                            | 1,696      | (142 )                        | (54 )                            | 352       | 78        | 1,930      |
| Ending balance                                       | \$ 1,493   | \$ 846                        | \$ 5,267                         | \$ 455    | \$ 184    | \$ 8,245   |
| Ending balance individually evaluated for impairment | \$ 271     | \$ 22                         | \$ 507                           | \$-       | \$-       | \$ 800     |
| Ending balance collectively evaluated for impairment | 1,222      | 824                           | 4,760                            | 455       | 184       | 7,445      |
| Ending balance                                       | \$ 1,493   | \$ 846                        | \$ 5,267                         | \$ 455    | \$ 184    | \$ 8,245   |
| Loan Balances:                                       |            |                               |                                  |           |           |            |
| Ending balance individually evaluated for impairment | \$ 989     | \$ 624                        | \$ 18,362                        | \$ 81     | \$-       | \$ 20,056  |
| Ending balance collectively evaluated for impairment | 53,445     | 22,492                        | 430,046                          | 58,826    | 19,017    | 583,826    |
| Ending balance                                       | \$ 54,434  | \$ 23,116                     | \$ 448,408                       | \$ 58,907 | \$ 19,017 | \$ 603,882 |

(1) The real estate-mortgage segment includes residential 1 – 4 family, commercial real estate, second mortgages and equity lines of credit.

(2) The consumer segment includes consumer automobile loans.

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## CHANGES IN ALLOWANCE METHODOLOGY

Historical loss rates calculated by migration analysis are determined by the performance of a loan over a period of time (the migration period). This migration period can be lengthened or shortened based on management's assessment of the most appropriate length of time over which to analyze losses in the loan portfolio. The Company can also calculate multiple migration periods, allowing management to assess the migration of loans based on more than one starting point.

In the third quarter of 2017, management changed its migration approach for calculating the allowance to better match the length of the current credit cycle. The number of migration periods was changed from four to eight. Each migration period remains at twelve quarters, the length of the migration period used by the Company in prior periods. This change had the result of reducing the calculated provision from \$3.4 million to \$2.9 million, a difference of \$447 thousand. The prior quarters' methodology was resulting in distortion between required allocations by segment and the underlying credit metrics for those segments. By increasing the number of migration periods from four to eight, the migration is better able to capture the performance of the portfolio segment over a greater portion of the credit cycle.

The following table represents the effect on the loan loss provision as a result of this change in methodology. It compares the methodology results actually used for the three and nine months ended September 30, 2017 to that used in prior periods.

|                            | Calculated Provision                 |   |            |
|----------------------------|--------------------------------------|---|------------|
|                            | Based on Current Quarter Methodology | Calculated Provision Based on Prior Quarter Methodology | Difference |
|                            | (in thousands)                       |   |            |
| Portfolio Segment:         |                                      |   |            |
| Commercial                 | \$ 679                               | \$ 970  | \$ (291 )  |
| Real estate - construction | (332 )                               | (815 )  | 483        |
| Real estate - mortgage     | 1,573                                | 1,859   | (286 )     |
| Consumer loans             | 909                                  | 1,262   | (353 )     |
| Other                      | 96                                   | 96  | -          |
| Total                      | \$2,925                              | \$ 3,372  | \$ (447 )  |

The allowance for loan losses was 1.28% of total loans at September 30, 2017, compared to 1.37% at December 31, 2016. While the overall coverage of the allowance for loan losses decreased from December 31, 2016 at the same time that both nonaccrual loans and total past dues increased, the increases noted in nonaccrual and past due levels are not considered reflective of general trends in the portfolio. With respect to nonaccruals, the increase is a result of two loan relationships totaling \$4.0 million that were placed on nonaccrual status in the first quarter of 2017 based on declines in the borrowers' performance and changes in the status of the loans' collateral. Both relationships were identified as impaired at December 31, 2016. Management has charged off portions of these relationships and believes that the collateral on these loans will be sufficient to cover remaining balances for which it has no specific allocation. With respect to past dues, approximately \$1 million of the increase is associated with matured loans that have since renewed, and another \$500 thousand is guaranteed by the SBA. Lastly, both impaired loans and classified assets reflect decreased balances from December 31, 2016, respectively.

Note 4. Low-Income Housing Tax Credits



The Company was invested in 4 separate housing equity funds at both September 30, 2017 and December 31, 2016. The general purpose of these funds is to encourage and assist participants in investing in low-income residential rental properties located in the Commonwealth of Virginia; develop and implement strategies to maintain projects as low-income housing; deliver Federal Low Income Housing Credits to investors; allocate tax losses and other possible tax benefits to investors; and preserve and protect project assets.

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The investments in these funds were recorded as other assets on the consolidated balance sheets and were \$3.6 million and \$3.9 million at September 30, 2017 and December 31, 2016, respectively. The expected terms of these investments and the related tax benefits run through 2033. Total projected tax credits to be received for 2017 are \$461 thousand, which is based on the most recent quarterly estimates received from the funds. Additional capital calls expected for the funds totaled \$1.1 million at September 30, 2017 and \$2.5 million at December 31, 2016, respectively, and are recorded in accrued expenses and other liabilities on the corresponding consolidated balance sheet.

|                                    | Three<br>Months<br>Ended<br>September<br>30,<br>2017 |       | Nine<br>Months<br>Ended<br>September<br>30,<br>2016 |       | Affected Line Item on<br>Consolidated Statements of Income |
|------------------------------------|--|-------|---|-------|--|
| Tax credits and other tax benefits |  |       |   |       |  |
| Amortization of operating losses   | \$77   | \$73  | \$255   | \$220 | ATM and other losses                                       |
| Tax benefit of operating losses*   | 26   | 25    | 87  | 75    | Income tax expense   |
| Tax credits                        | 113  | 101   | 346   | 273   | Income tax expense   |
| Total tax benefits                 | \$139  | \$126 | \$433   | \$348 |  |

\* Computed using a 34% taxable rate

## Note 5. Borrowings

### Short-Term Borrowings

The Company classifies all borrowings that will mature within a year from the date on which the Company enters into them as short-term borrowings. Short-term borrowings sources consist of federal funds purchased, overnight repurchase agreements (which are secured transactions with customers that generally mature within one to four days), and advances from the FHLB.

The Company maintains federal funds lines with several correspondent banks to address short-term borrowing needs. At September 30, 2017 and December 31, 2016 the remaining credit available from these lines totaled \$55.0 million. The Company has a collateral dependent line of credit with the FHLB with remaining credit availability of \$239.0 million and \$270.0 as of September 30, 2017 and December 31, 2016, respectively.

The following table presents total short-term borrowings as of the dates indicated:

|                                 | September<br>30,<br>2017 | December<br>31, 2016 |
|---------------------------------|--------------------------|----------------------|
|                                 | (in thousands)           |                      |
| Federal funds purchased         | \$2,000                  | \$ -                 |
| Overnight repurchase agreements | 21,885                   | 18,704               |
| FHLB advances                   | 35,000                   | -                    |
| Total short-term borrowings     | \$58,885                 | \$ 18,704            |

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|   |          |           |      |   |
|---|----------|-----------|------|---|
| Maximum month-end outstanding balance         | \$76,319 | \$ 68,864 |      |   |
| Average outstanding balance during the period | \$49,131 | \$ 39,364 |      |   |
| Average interest rate (year-to-date)          | 0.66     | %         | 0.59 | % |
| Average interest rate at end of period        | 0.86     | %         | 0.10 | % |

Long-Term Borrowings

The Company had one fixed rate hybrid FHLB advance for \$10.0 million classified as a long-term borrowing at September 30, 2017. The advance is scheduled to mature on February 28, 2019. There were no long-term borrowings at December 31, 2016.

Note 6. Share-Based Compensation

The Company has adopted an employee stock purchase plan and offers share-based compensation through its equity compensation plans. Share-based compensation arrangements include stock options, restricted and unrestricted stock awards, restricted stock units, performance-based awards and stock appreciation rights. 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. The Company accounts for forfeitures during the vesting period as they occur.

The Company's 1998 Stock Option Plan, pursuant to which stock options could be granted to key employees and non-employee directors, expired on March 9, 2008. Stock options that were outstanding on March 9, 2008 remained outstanding in accordance with their terms, but no new awards could be granted under the plan after March 9, 2008. Options to purchase 11,068 shares of common stock were outstanding under the Company's 1998 Stock Option Plan at September 30, 2017. 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.

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Stock option activity for the nine months ended September 30, 2017 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, 2017    | 60,605   | \$ 20.05                                 |   |  |
| Granted                                 | -        | -  |   |  |
| Exercised                               | (48,287) | 20.05                                    |   |  |
| Canceled or expired                     | (1,250 ) | 20.05                                    |   |  |
| Options outstanding, September 30, 2017 | 11,068   | \$ 20.05                                 | 0.04  | \$ 137   |
| Options exercisable, September 30, 2017 | 11,068   | \$ 20.05                                 | 0.04  | \$ 137   |

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 fair 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 September 30, 2017. This amount changes based on changes in the fair value of the Company's common stock.

During the nine months ended September 30, 2017, the Company received \$968 thousand from the exercise of stock options. No options were exercised during the nine months ended September 30, 2016.

No options were granted during the nine months ended September 30, 2017 or the nine months ended September 30, 2016. As of September 30, 2017, all outstanding stock options were fully vested and there was no unrecognized stock-based compensation expense.

The Incentive Stock Plan permits the issuance of up to 300,000 shares of common stock for awards to key employees and non-employee directors of the Company and its subsidiaries in the form of stock options, restricted stock, restricted stock units, stock appreciation rights, stock awards and performance units. The Company did not award any equity compensation under the Incentive Stock Plan during 2016.

Restricted stock activity for the nine months ended September 30, 2017 is summarized below:

|                               | Shares | Weighted<br>Average<br>Grant<br>Date Fair<br>Value |
|-------------------------------|--------|--|
| Nonvested, January 1, 2017    | -      | \$ -   |
| Issued                        | 2,245  | 33.60  |
| Vested                        | -      | -  |
| Forfeited                     | -      | -  |
| Nonvested, September 30, 2017 | 2,245  | \$ 33.60   |

The weighted average period over which nonvested awards are expected to be recognized is 2.00 years.

The fair value of restricted stock granted during the nine months ended September 30, 2017 was \$75 thousand.

The remaining unrecognized compensation expense for the shares granted during the nine months ended September 30, 2017 totaled \$67 thousand as of September 30, 2017.

Stock-based compensation expense was \$9 thousand for the three and nine months ended September 30, 2017. There was no stock compensation expense in 2016.

Under the Company's Employee Stock Purchase Plan (ESPP), substantially all employees of the Company and its subsidiaries can authorize a specific payroll deduction from their base compensation for the periodic purchase of the Company's common stock. Shares of stock are issued quarterly at a discount to the market price of the Company's stock on the day of purchase, which can range from 0-15% and was set at 5% for 2016 and for the first nine months of 2017.

Total stock purchases under the ESPP amounted to 999 shares during 2016. 2,523 shares were purchased under the ESPP during the nine months ended September 30, 2017. At September 30, 2017, the Company had 246,478 remaining shares reserved for issuance under this plan.

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## Note 7. 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 September 30, |       |
|--------------------------------|----------------------------------|-------|
|                                | 2017                             | 2016  |
|                                | (in thousands)                   |       |
| Interest cost                  | \$67                             | \$70  |
| Expected return on plan assets | (94)                             | (98)  |
| Amortization of net loss       | 123                              | 140   |
| Net periodic pension plan cost | \$96                             | \$112 |
|                                |                                  |       |
|                                | Nine months ended September 30,  |       |
|                                | 2017                             | 2016  |
|                                | (in thousands)                   |       |
| Interest cost                  | \$201                            | \$210 |
| Expected return on plan assets | (282)                            | (294) |
| Amortization of net loss       | 368                              | 420   |
| Net periodic pension plan cost | \$287                            | \$336 |

On November 23, 2016, the Company's board of directors voted to terminate the pension plan, effective January 31, 2017. The Company anticipates completing the transfer of all liabilities and administrative responsibilities under the plan by the end of the fourth quarter of 2017. Management estimates that the settlement of the plan will result in a nonrecurring pretax termination charge of \$3.0 to \$3.5 million, which will be recorded in the fourth quarter of 2017.

## Note 8. Stockholders' Equity and Earnings per Share

## STOCKHOLDERS' EQUITY – Accumulated Other Comprehensive Loss

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

|                                       | Three Months Ended September 30, 2017 |      | Nine Months Ended September 30, 2016 |       |   |
|---------------------------------------|---------------------------------------|------|--------------------------------------|-------|---|
|                                       | 2017                                  | 2016 | 2017                                 | 2016  | Affected Line Item on Consolidated Statements of Income |
|                                       | (in thousands)                        |      |                                      |       |   |
| Available-for-sale securities         |                                       |      |                                      |       |   |
| Realized gains on sales of securities | \$2                                   | \$7  | \$89                                 | \$522 | Gain on sale of available-for-sale securities, net      |
| Tax effect                            | 1                                     | 2    | 30                                   | 177   | Income tax expense                                      |
|                                       | \$1                                   | \$5  | \$59                                 | \$345 |   |

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

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|                                      | Unrealized<br>Gains<br>(Losses)<br>on<br>Available-for-Sale<br>Securities<br>(in thousands) | Defined<br>Benefit<br>Pension<br>Plans | Accumulated<br>Other<br>Comprehensive<br>Loss |   |
|--------------------------------------|---|--|---|---|
| Nine Months Ended September 30, 2017 |   |  |   |   |
| Balance at beginning of period       | \$ (1,739)  | \$ (2,469)                             | \$ (4,208                                     | ) |
| Net change for the period            | 1,521   | -                                      | 1,521   |   |
| Balance at end of period             | \$ (218 )   | \$ (2,469)                             | \$ (2,687                                     | ) |
| Nine Months Ended September 30, 2016 |   |  |   |   |
| Balance at beginning of period       | \$ (576 )   | \$ (2,586)                             | \$ (3,162                                     | ) |
| Net change for the period            | 1,877   | -                                      | 1,877   |   |
| Balance at end of period             | \$ 1,301  | \$ (2,586)                             | \$ (1,285                                     | ) |

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

|  | Nine Months Ended<br>September 30, 2017 |         |            |
|--|---|---------|------------|
|  | Pretax                                  | Tax     | Net-of-Tax |
|  | (in thousands)                          |         |            |
| Unrealized gains on available-for-sale securities:         |   |         |            |
| Unrealized holding gains arising during the period         | \$2,394                                 | \$814   | \$ 1,580   |
| Reclassification adjustment for gains recognized in income | (89 )                                   | (30 )   | (59 )      |
| Total change in accumulated other comprehensive loss, net  | \$2,305                                 | \$784   | \$ 1,521   |
|  |   |         |            |
|  | Nine Months Ended<br>September 30, 2016 |         |            |
|  | Pretax                                  | Tax     | Net-of-Tax |
|  | (in thousands)                          |         |            |
| Unrealized gains on available-for-sale securities:         |   |         |            |
| Unrealized holding gains arising during the period         | \$3,366                                 | \$1,144 | \$ 2,222   |
| Reclassification adjustment for gains recognized in income | (522 )                                  | (177 )  | (345 )     |
| Total change in accumulated other comprehensive loss, net  | \$2,844                                 | \$967   | \$ 1,877   |

#### 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.

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The following is a reconciliation of the denominators of the basic and diluted EPS computations for the three and nine months ended September 30, 2017 and 2016:

|  | Net<br>Income<br>Available<br>to<br>Common<br>Shareholders<br>(Numerator)<br>(in thousands<br>data) | Weighted<br>Average<br>Common<br>Shares<br>(Denominator) | Per<br>Share<br>Amount |
|--|---|--|------------------------|
| Three Months Ended September 30, 2017                                |   |  |                        |
| Net income, basic  | \$757   | 4,994  | \$ 0.15                |
| Potentially dilutive common shares - stock options                   | -   | 10   | -                      |
| Potentially dilutive common shares - employee stock purchase program | -   | -  | -                      |
| Diluted  | \$757   | 5,004  | \$ 0.15                |
| Three Months Ended September 30, 2016                                |   |  |                        |
| Net income, basic  | \$1,329   | 4,959  | \$ 0.27                |
| Potentially dilutive common shares - stock options                   | -   | -  | -                      |
| Potentially dilutive common shares - employee stock purchase program | -   | -  | -                      |
| Diluted  | \$1,329   | 4,959  | \$ 0.27                |
| Nine Months Ended September 30, 2017                                 |   |  |                        |
| Net income, basic  | \$2,860   | 4,985  | \$ 0.57                |
| Potentially dilutive common shares - stock options                   | -   | 12   | -                      |
| Potentially dilutive common shares - employee stock purchase program | -   | -  | -                      |
| Diluted  | \$2,860   | 4,997  | \$ 0.57                |
| Nine Months Ended September 30, 2016                                 |   |  |                        |
| Net income, basic  | \$2,902   | 4,959  | \$ 0.59                |
| Potentially dilutive common shares - stock options                   | -   | -  | -                      |
| Potentially dilutive common shares - employee stock purchase program | -   | -  | -                      |
| Diluted  | \$2,902   | 4,959  | \$ 0.59                |

The Company had no antidilutive shares in the third quarter or first nine months of 2017. The Company did not include an average of 69 thousand potential common shares attributable to outstanding stock options in the diluted earnings per share calculation for both the three and nine months ended September 30, 2016. Non-vested restricted common shares, which carry all rights and privileges of a common share with respect to the stock, including the right to vote, were included in the basic and diluted per common share calculations.

#### Note 9. 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.

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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 service provider, 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.

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.

- Level 1: Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and 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.
- Level 2: Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
- Level 3: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments 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.



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

|   | Fair Value Measurements at<br>September 30, 2017 Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Significant<br>Identifiable<br>Assets<br>(Level 1) (Level 2) (Level 3) |     |           |  |
|---|---|-----|-----------|--|
|   | Balance<br>(in thousands)   | 1)  | (Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities                   |   |     |           |  |
| Obligations of U.S. Government agencies         | \$9,493   | \$- | \$9,493   | \$ -   |
| Obligations of state and political subdivisions | 68,434  | -   | 68,434    | -  |
| Mortgage-backed securities                      | 77,316  | -   | 77,316    | -  |
| Money market investments                        | 1,169   | -   | 1,169     | -  |
| Corporate bonds                                 | 7,510   | -   | 7,510     | -  |
| Other marketable equity securities              | 190   | -   | 190       | -  |
| Total available-for-sale securities             | \$164,112   | \$- | \$164,112 | \$ -   |

|   | Fair Value Measurements at<br>December 31, 2016 Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Significant<br>Identifiable<br>Assets<br>(Level 1) (Level 2) (Level 3) |     |           |  |
|---|--|-----|-----------|--|
|   | Balance<br>(in thousands)  | 1)  | (Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities                   |  |     |           |  |
| U.S. Treasury securities                        | \$20,000   | \$- | \$20,000  | \$ -   |
| Obligations of U.S. Government agencies         | 9,195  | -   | 9,195     | -  |
| Obligations of state and political subdivisions | 77,987   | -   | 77,987    | -  |
| Mortgage-backed securities                      | 83,694   | -   | 83,694    | -  |
| Money market investments                        | 647  | -   | 647       | -  |
| Corporate bonds                                 | 7,678  | -   | 7,678     | -  |
| Other marketable equity securities              | 164  | -   | 164       | -  |
| Total available-for-sale securities             | \$199,365  | \$- | \$199,365 | \$ -   |

ASSETS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

Under certain circumstances, adjustments are made to the fair value for assets and liabilities although they are not measured at fair value on an ongoing basis.

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 when due from the borrower in accordance with the contractual terms of the loan. The measurement of fair value and loss associated with impaired loans can be based on the observable market price of the loan, the fair value of the collateral securing the loan, or the present value of the loan's expected future cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable, with the vast majority of the collateral in real estate.

The value of real estate collateral is determined utilizing an income, market, or cost valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company. In the case of loans with lower balances, the Company may obtain a real estate evaluation instead of an appraisal. Evaluations utilize many of the same techniques as appraisals, and are typically performed by independent appraisers. Once received, appraisals and evaluations are reviewed by trained staff independent of the lending function to verify consistency and reasonability. Appraisals and evaluations are based on significant unobservable inputs, including but not limited to: adjustments made to comparable properties, judgments about the condition of the subject property, the availability and suitability of comparable properties, capitalization rates, projected income of the subject or comparable properties, vacancy rates, projected depreciation rates, and the state of the local and regional economy. The Company may also elect to make additional reductions in the collateral value based on management's best judgment, which represents another source of unobservable inputs. Because of the subjective nature of collateral valuation, impaired loans are considered Level 3.

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Impaired loans may be secured by collateral other than real estate. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). If a loan is not collateral-dependent, its impairment may be measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate. Because the loan is discounted at its effective rate of interest, rather than at a market rate, the loan is not considered to be held at fair value and is not included in the tables below. Collateral-dependent impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as part of the provision for loan losses on the Consolidated Statements of Income.

#### Other Real Estate Owned (OREO)

Loans are transferred to OREO when the collateral securing them is foreclosed on. The measurement of gain or loss associated with OREOs is based on the fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property. If there is a contract for the sale of a property, and management reasonably believes the transaction will be consummated in accordance with the terms of the contract, fair value is based on the sale price in that contract (Level 1). If management has recent information about the sale of identical properties, such as when selling multiple condominium units on the same property, the remaining units would be valued based on the observed market data (Level 2). Lacking either a contract or such recent data, management would obtain an appraisal or evaluation of the value of the collateral as discussed above under Impaired Loans (Level 3). After the asset has been booked, a new appraisal or evaluation is obtained when management has reason to believe the fair value of the property may have changed and no later than two years after the last appraisal or evaluation was received. Any fair value adjustments to OREOs below the original book value are recorded in the period incurred and expensed against current earnings.

#### Loans Held For Sale

Loans held for sale are carried at fair value. These loans currently consist of residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). Gains and losses on the sale of loans are recorded within the mortgage segment and are reported on a separate line item on the Company's Consolidated Statements of Income.

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The following table presents the assets carried on the consolidated balance sheets for which a nonrecurring change in fair value has been recorded. Assets are shown by class of loan and by level in the fair value hierarchy, as of the dates indicated. Certain impaired loans are valued by the present value of the loan's expected future cash flows, discounted at the loan's effective interest rate rather than at a market rate. These loans are not carried on the consolidated balance sheets at fair value and, as such, are not included in the table below.

|                                     | Carrying Value at September<br>30, 2017 Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Significant<br>Identifiable<br>Assets |  |  |        |
|-------------------------------------|---|--|--|--------|
|                                     | Fair Value<br>(Level 1)   | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |        |
|                                     | (in thousands)  |  |  |        |
| Impaired loans                      |   |  |  |        |
| Mortgage loans on real estate:      |   |  |  |        |
| Residential 1-4 family              | \$316   | \$-  | \$-  | \$ 316 |
| Commercial                          | 349   | -  | -  | 349    |
| Construction                        | 74  | -  | -  | 74     |
| Equity lines of credit              | 229   | -  | -  | 229    |
| Total mortgage loans on real estate | \$968   | \$-  | \$-  | \$ 968 |
| Loans                               |   |  |  |        |
| Loans held for sale                 | \$981   | \$-  | \$ 981   | \$ 0   |

|                                     | Carrying Value at December 31,<br>2016 Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Significant<br>Identifiable<br>Assets |  |  |          |
|-------------------------------------|--|--|--|----------|
|                                     | Fair Value<br>(Level 1)  | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |          |
|                                     | (in thousands)   |  |  |          |
| Impaired loans                      |  |  |  |          |
| Mortgage loans on real estate:      |  |  |  |          |
| Residential 1-4 family              | \$400  | \$-  | \$-  | \$ 400   |
| Commercial                          | 1,483  | -  | -  | 1,483    |
| Construction                        | 74   | -  | -  | 74       |
| Total mortgage loans on real estate | \$1,957  | \$-  | \$-  | \$ 1,957 |



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|                  |         |     |     |          |
|------------------|---------|-----|-----|----------|
| Commercial loans | 718     | -   | -   | 718      |
| Total            | \$2,675 | \$- | \$- | \$ 2,675 |

|                         |       |     |     |        |
|-------------------------|-------|-----|-----|--------|
| Other real estate owned |       |     |     |        |
| Construction            | \$940 | \$- | \$- | \$ 940 |

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The following table displays quantitative information about Level 3 Fair Value Measurements as of the dates indicated:

Quantitative Information About Level 3 Fair Value Measurements

|                                    | Fair Value<br>at<br>September<br>30, 2017<br>(dollars in<br>thousands) | Valuation Techniques | Unobservable Input   | Range (Weighted<br>Average) |
|------------------------------------|--|----------------------|----------------------|-----------------------------|
| Impaired loans                     |  |                      |                      |                             |
| Residential 1-4 family real estate | \$ 316   | Market comparables   | Selling costs        | 0.00% - 7.25% (3.36 %)      |
|                                    |  |                      | Liquidation discount | 0.00% - 4.00% (3.12 %)      |
| Commercial real estate             | \$ 349   | Market comparables   | Selling costs        | 7.25 %                      |
|                                    |  |                      | Liquidation discount | 4.00 %                      |
| Construction                       | \$ 74  | Market comparables   | Selling costs        | 7.25 %                      |
|                                    |  |                      | Liquidation discount | 4.00 %                      |
| Equity lines of credit             | \$ 229   | Market comparables   | Selling costs        | 6.07 %                      |
|                                    |  |                      | Liquidation discount | 4.00 %                      |

Quantitative Information About Level 3 Fair Value Measurements

|                                    | Fair Value<br>at<br>December<br>31, 2016<br>(dollars in<br>thousands) | Valuation Techniques | Unobservable Input   | Range (Weighted<br>Average) |
|------------------------------------|---|----------------------|----------------------|-----------------------------|
| Impaired loans                     |   |                      |                      |                             |
| Residential 1-4 family real estate | \$ 400  | Market comparables   | Selling costs        | 7.25 %                      |
|                                    |   |                      | Liquidation discount | 4.00 %                      |
| Commercial real estate             | \$ 1,483  | Market comparables   | Selling costs        | 7.25 %                      |
|                                    |   |                      | Liquidation discount | 4.00 %                      |
| Construction                       | \$ 74   | Market comparables   | Selling costs        | 7.25 %                      |
|                                    |   |                      | Liquidation discount | 4.00 %                      |
| Commercial loans                   | \$ 718  | Market comparables   | Selling costs        | 0.00 %                      |
|                                    |   |                      | Liquidation discount | 0.00% - 38.58% (32.40 %)    |
| Other real estate owned            |   |                      |                      |                             |
| Construction                       | \$ 940  | Market comparables   | Selling costs        | 7.25 %                      |
|                                    |   |                      | Liquidation discount | 0.00 %                      |

ASC 825, "Financial Instruments," requires disclosure about fair value of financial instruments for interim periods and excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company's assets.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

#### CASH AND CASH EQUIVALENTS

The carrying amounts of cash and short-term instruments, including interest-bearing due from banks, approximate fair values.

#### RESTRICTED SECURITIES

The restricted security category is comprised of FHLB and FRB stock. These stocks are classified as restricted securities because their ownership is restricted to certain types of entities and they lack a market. When the FHLB or FRB repurchases stock, they repurchase at the stock's book value. Therefore, the carrying amounts of restricted securities approximate fair value.

#### LOANS RECEIVABLE

The fair value of a loan is based on its interest rate in relation to its risk profile, in comparison to what an investor could earn on a different investment with a similar risk profile. Variations in risk tolerance between lenders, and thus in risk pricing, can result in the same loan being priced differently at different institutions. A bank's experience with the type of lending (such as commercial real estate) can also impact its assessment of the riskiness of a loan. A comprehensive picture of competitors' rates in relation to borrower risk profiles is not available. Instead, the Company uses a model which estimates market value based on the loan's interest rate (regardless of its risk level) and rates for debt of similar maturities where market data is available. Since the rate and risk profile are the primary factors in determining the fair value of a loan, both of which are unobservable in the market, the Company classifies loans as Level 3 in the fair value hierarchy. Fair values for non-performing loans are estimated as described above.

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#### BANK-OWNED LIFE INSURANCE

Bank-owned life insurance represents insurance policies on certain current and former officers of the Company. The cash value of the policies is estimated using information provided by the insurance carrier. The insurance carrier uses actuarial data to estimate the value of each policy, based on the age and health of the insured relative to other individuals about whom the carrier has information. Health information can be broken down into quantitative, observable inputs, such as smoking habits, blood pressure, and weight, which, along with the insured's age, can be compared to observable data the insurance carrier has available. The carrier can then estimate the cash value of each policy. Since the cash value represents the amount of cash the Company would receive when the policies are paid, the cash value closely approximates the fair value of the policies. Accordingly, bank-owned life insurance is classified as Level 2.

#### DEPOSITS

The fair value of demand deposits, savings and certain money market deposits is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. Information about the rates paid by other institutions for deposits of similar terms is readily available, and rates are mainly influenced by the term of the deposit itself. As a result, fair value calculations are based on observable inputs, and are classified as Level 2.

#### OVERNIGHT REPURCHASE AGREEMENTS

The carrying amounts of federal funds purchased, overnight repurchase agreements, and other short-term borrowings maturing within 90 days approximate their fair values. Since the contractual terms of these borrowings provide all information necessary to calculate the amounts that will be due at maturity, these liabilities are classified as Level 2.

#### FEDERAL HOME LOAN BANK ADVANCES

The fair values of the Company's long-term borrowings are estimated based on the current cost to repay the debt in full, discounted to current values and including any prepayment penalties that may apply. As the contractual terms of the borrowing provide all the necessary inputs for this calculation, long-term borrowings are classified as Level 2.

#### ACCRUED INTEREST

The calculation of accrued interest is based on readily observable information, such as the rate and term of the underlying asset or liability. Since these amounts are expected to be realized quickly (generally within 30 to 90 days), the carrying value approximates fair value and is classified as Level 2.

#### COMMITMENTS TO EXTEND CREDIT AND IRREVOCABLE LETTERS OF CREDIT

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit-worthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2017 and December 31, 2016, the fair value of fees charged for loan commitments and irrevocable letters of credit was immaterial.

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The estimated fair values, and related carrying or notional amounts, of the Company's financial instruments as of the dates indicated are as follows:

|  | Carrying Value | Fair Value Measurements at September 30, 2017 Using Quoted Prices in Active Markets for Significant |                                   |   |
|--|----------------|---|-----------------------------------|---|
|  |                | Identical Assets (Level 1)  | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Assets</b>                            |                |   |                                   |   |
| Cash and cash equivalents                | \$ 15,435      | \$ 15,435   | \$ -                              | \$ -                                      |
| Securities available-for-sale            | 164,112        | -   | 164,112                           | -   |
| Restricted securities                    | 2,890          | -   | 2,890                             | -   |
| Loans held for sale                      | 981            | -   | 981                               | -   |
| Loans, net of allowances for loan losses | 692,045        | -   | -                                 | 691,615                                   |
| Bank-owned life insurance                | 25,802         | -   | 25,802                            | -   |
| Accrued interest receivable              | 2,987          | -   | 2,987                             | -   |
| <b>Liabilities</b>                       |                |   |                                   |   |
| Deposits                                 | \$ 782,445     | \$ -  | \$ 782,315                        | \$ -                                      |
| Federal funds purchased                  | 2,000          | -   | 2,000                             | -   |
| Overnight repurchase agreements          | 21,885         | -   | 21,885                            | -   |
| Federal Home Loan Bank advances          | 45,000         | -   | 44,959                            | -   |
| Accrued interest payable                 | 297            | -   | 297                               | -   |
| <br>                                     |                |   |                                   |   |
|  | Carrying Value | Fair Value Measurements at December 31, 2016 Using Quoted Prices in Active Markets for Significant  |                                   |   |
|  |                | Identical Assets (Level 1)  | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Assets</b>                            |                |   |                                   |   |
| Cash and cash equivalents                | \$ 25,854      | \$ 25,854   | \$ -                              | \$ -                                      |
| Securities available-for-sale            | 199,365        | -   | 199,365                           | -   |
| Restricted securities                    | 970            | -   | 970                               | -   |
| Loans, net of allowances for loan losses | 595,637        | -   | -                                 | 594,190                                   |

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|                                 |           |     |            |      |
|---------------------------------|-----------|-----|------------|------|
| Bank-owned life insurance       | 25,206    | -   | 25,206     | -    |
| Accrued interest receivable     | 3,189     | -   | 3,189      | -    |
| Liabilities                     |           |     |            |      |
| Deposits                        | \$784,502 | \$- | \$ 783,450 | \$ - |
| Overnight repurchase agreements | 18,704    | -   | 18,704     | -    |
| Accrued interest payable        | 228       | -   | 228        | -    |

Note 10. Segment Reporting

The Company operates in a decentralized fashion in three principal business segments: The Old Point National Bank of Phoebus (the Bank), Old Point Trust & Financial Services, N. A. (Trust), and the Company as a separate segment (for purposes of this Note, the Parent). Revenues from the Bank's operations consist primarily of interest earned on loans and investment securities and service charges on deposit accounts. Trust's operating revenues consist principally of income from fiduciary activities. The Parent's revenues are mainly fees and dividends received from the Bank and Trust companies. The Company has no other segments.

The Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each segment appeals to different markets and, accordingly, requires different technologies and marketing strategies.

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Information about reportable segments, and reconciliation of such information to the consolidated financial statements as of and for the three and nine months ended September 30, 2017 and 2016 follows:

|                                       | Three Months Ended September 30, 2017 |         |          |              |              |
|---------------------------------------|---------------------------------------|---------|----------|--------------|--------------|
|                                       | Bank                                  | Trust   | Parent   | Eliminations | Consolidated |
|                                       | (in thousands)                        |         |          |              |              |
| Revenues                              |                                       |         |          |              |              |
| Interest and dividend income          | \$8,550                               | \$18    | \$898    | \$ (898)     | ) \$ 8,568   |
| Income from fiduciary activities      | -                                     | 903     | -        | -            | 903          |
| Other income                          | 2,275                                 | 198     | 50       | (65)         | ) 2,458      |
| Total operating income                | 10,825                                | 1,119   | 948      | (963)        | ) 11,929     |
| Expenses                              |                                       |         |          |              |              |
| Interest expense                      | 837                                   | -       | -        | -            | 837          |
| Provision for loan losses             | 1,275                                 | -       | -        | -            | 1,275        |
| Salaries and employee benefits        | 4,343                                 | 657     | 104      | -            | 5,104        |
| Other expenses                        | 3,664                                 | 253     | 160      | (65)         | ) 4,012      |
| Total operating expenses              | 10,119                                | 910     | 264      | (65)         | ) 11,228     |
| Income before taxes                   | 706                                   | 209     | 684      | (898)        | ) 701        |
| Income tax expense (benefit)          | (55)                                  | ) 72    | (73)     | ) -          | (56)         |
| Net income                            | \$761                                 | \$137   | \$757    | \$ (898)     | ) \$ 757     |
| Capital expenditures                  | \$60                                  | \$6     | \$-      | \$ -         | \$ 66        |
| Total assets                          | \$948,377                             | \$6,141 | \$97,645 | \$ (97,666)  | ) \$ 954,497 |
| Three Months Ended September 30, 2016 |                                       |         |          |              |              |
|                                       | Bank                                  | Trust   | Parent   | Eliminations | Consolidated |
|                                       | (in thousands)                        |         |          |              |              |
| Revenues                              |                                       |         |          |              |              |
| Interest and dividend income          | \$7,420                               | \$16    | \$1,572  | \$ (1,572)   | ) \$ 7,436   |
| Income from fiduciary activities      | -                                     | 858     | -        | -            | 858          |
| Other income                          | 2,277                                 | 207     | 50       | (65)         | ) 2,469      |
| Total operating income                | 9,697                                 | 1,081   | 1,622    | (1,637)      | ) 10,763     |
| Expenses                              |                                       |         |          |              |              |
| Interest expense                      | 633                                   | -       | -        | -            | 633          |
| Recovery of loan losses               | (100)                                 | ) -     | -        | -            | (100)        |
| Salaries and employee benefits        | 4,296                                 | 665     | 102      | -            | 5,063        |
| Other expenses                        | 3,114                                 | 262     | 315      | (65)         | ) 3,626      |
| Total operating expenses              | 7,943                                 | 927     | 417      | (65)         | ) 9,222      |
| Income before taxes                   | 1,754                                 | 154     | 1,205    | (1,572)      | ) 1,541      |
| Income tax expense (benefit)          | 284                                   | 53      | (125)    | ) -          | 212          |
| Net income                            | \$1,470                               | \$101   | \$1,330  | \$ (1,572)   | ) \$ 1,329   |

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|                      |           |         |          |              |            |
|----------------------|-----------|---------|----------|--------------|------------|
| Capital expenditures | \$234     | \$-     | \$-      | \$ -         | \$ 234     |
| Total assets         | \$900,160 | \$5,814 | \$96,467 | \$ (96,685 ) | \$ 905,756 |

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|   | Nine Months Ended September 30, 2017 |         |          |              |              |
|---|--------------------------------------|---------|----------|--------------|--------------|
|   | Bank                                 | Trust   | Parent   | Eliminations | Consolidated |
|   | (in thousands)                       |         |          |              |              |
| <b>Revenues</b>                             |                                      |         |          |              |              |
| Interest and dividend income                | \$24,300                             | \$52    | \$3,251  | \$ (3,249 )  | \$ 24,354    |
| Income from fiduciary activities            | -                                    | 2,820   | -        | -            | 2,820        |
| Other income                                | 7,133                                | 708     | 150      | (196 )       | 7,795        |
| Total operating income                      | 31,433                               | 3,580   | 3,401    | (3,445 )     | 34,969       |
| <b>Expenses</b>                             |                                      |         |          |              |              |
| Interest expense                            | 2,097                                | -       | -        | 1            | 2,098        |
| Provision for loan losses                   | 2,925                                | -       | -        | -            | 2,925        |
| Salaries and employee benefits              | 13,252                               | 2,068   | 330      | -            | 15,650       |
| Other expenses                              | 10,460                               | 766     | 412      | (196 )       | 11,442       |
| Total operating expenses                    | 28,734                               | 2,834   | 742      | (195 )       | 32,115       |
| Income before taxes                         | 2,699                                | 746     | 2,659    | (3,250 )     | 2,854        |
| Income tax expense (benefit)                | (60 )                                | 255     | (201 )   | -            | (6 )         |
| Net income                                  | \$2,759                              | \$491   | \$2,860  | \$ (3,250 )  | \$ 2,860     |
| Capital expenditures                        | \$504                                | \$6     | \$-      | \$ -         | \$ 510       |
| Total assets                                | \$948,377                            | \$6,141 | \$97,645 | \$ (97,666 ) | \$ 954,497   |
| <b>Nine Months Ended September 30, 2016</b> |                                      |         |          |              |              |
|   | Bank                                 | Trust   | Parent   | Eliminations | Consolidated |
|   | (in thousands)                       |         |          |              |              |
| <b>Revenues</b>                             |                                      |         |          |              |              |
| Interest and dividend income                | \$22,191                             | \$45    | \$3,443  | \$ (3,443 )  | \$ 22,236    |
| Income from fiduciary activities            | -                                    | 2,636   | -        | -            | 2,636        |
| Other income                                | 6,954                                | 734     | 150      | (196 )       | 7,642        |
| Total operating income                      | 29,145                               | 3,415   | 3,593    | (3,639 )     | 32,514       |
| <b>Expenses</b>                             |                                      |         |          |              |              |
| Interest expense                            | 1,934                                | -       | -        | -            | 1,934        |
| Provision for loan losses                   | 1,300                                | -       | -        | -            | 1,300        |
| Salaries and employee benefits              | 12,782                               | 2,022   | 303      | -            | 15,107       |
| Other expenses                              | 9,913                                | 774     | 667      | (196 )       | 11,158       |
| Total operating expenses                    | 25,929                               | 2,796   | 970      | (196 )       | 29,499       |
| Income before taxes                         | 3,216                                | 619     | 2,623    | (3,443 )     | 3,015        |
| Income tax expense (benefit)                | 181                                  | 211     | (279 )   | -            | 113          |
| Net income                                  | \$3,035                              | \$408   | \$2,902  | \$ (3,443 )  | \$ 2,902     |
| Capital expenditures                        | \$706                                | \$4     | \$-      | \$ -         | \$ 710       |

Total assets \$900,160 \$5,814 \$96,467 \$ (96,685 ) \$ 905,756

The accounting policies of the segments are the same as those described in the summary of significant accounting policies reported in the Company's 2016 annual report on Form 10-K. The Company evaluates performance based on profit or loss from operations before income taxes, not including nonrecurring gains or losses.

Both the Parent and the Trust companies maintain deposit accounts with the Bank, on terms substantially similar to those available to other customers. These transactions are eliminated to reach consolidated totals.

#### Note 11. Commitments and Contingencies

There have been no material changes in the Company's commitments and contingencies from those disclosed in the Company's 2016 annual report on Form 10-K.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Management's discussion and analysis is presented to aid the reader in understanding and evaluating the financial condition and results of operations of Old Point Financial Corporation and its subsidiaries (collectively, the Company). This discussion and analysis should be read with the consolidated financial statements, the notes to the financial statements, and the other financial data included in this report, as well as the Company's Annual Report on Form 10-K and management's discussion and analysis for the year ended December 31, 2016. Highlighted in the discussion are material changes from prior reporting periods and any identifiable trends affecting the Company. Results of operations for the three and nine months ended September 30, 2017 and 2016 are not necessarily indicative of results that may be attained for any other period. Amounts are rounded for presentation purposes while some of the percentages presented are computed based on unrounded amounts.

Caution About Forward-Looking Statements

In addition to historical information, certain statements in this report which use language such as "believes," "expects," "plans," "may," "will," "should," "projects," "contemplates," "anticipates," "forecasts," "intends" and similar expressions, may identify forward-looking statements. For this purpose, any statement that is not a statement of historical fact may be deemed to be a forward-looking statement. These forward-looking statements are based on the beliefs of the Company's management, as well as estimates and assumptions made by, and information currently available to, management. These statements are inherently uncertain, and there can be no assurance that the underlying estimates or assumptions will prove to be accurate. Actual results could differ materially from historical results or those anticipated by such statements. Forward-looking statements in this report include, without limitation: statements regarding the Pending Acquisition of Citizens National; future financial performance and profitability; performance of the investment and loan portfolios, including performance of the consumer auto loan portfolio and the purchased student loan portfolio and expected trends in the quality of the loan portfolio; the effects of diversifying the loan portfolio; strategic business and growth initiatives; management's efforts to reposition the balance sheet; deposit growth; levels and sources of liquidity; the securities portfolio; use of proceeds from the sale of securities; future levels of charge-offs or net recoveries; the impact of increases in NPAs on future earnings; write-downs and expected sales of other real estate owned; income taxes; expected timing of and expense in connection with the anticipated termination of the pension plan; monetary policy actions of the Federal Open Market Committee; and changes in interest rates.

Factors that could have a material adverse effect on the operations and future prospects of the Company include, but are not limited to: the possibility that any of the anticipated benefits of the Pending Acquisition of Citizens National will not be realized or will not be realized within the expected time period; Citizens National may not be integrated into the Company successfully or such integration may be more difficult, time-consuming, or costly than expected; expected revenue synergies and cost savings from the Pending Acquisition may not be fully realized or realized within the expected timeframe; revenues following the Pending Acquisition may be lower than expected; customer and employee relationships and business operations may be disrupted by the Pending Acquisition; or obtaining required regulatory approvals and the approval of Citizens National shareholders or completing the Pending Acquisition may be more difficult, time-consuming, or costly than expected. Other factors that could have a material adverse effect on the operations and future prospects of the Company include, but are not limited to, changes in: interest rates and yields; general economic and business conditions, including unemployment levels; demand for loan products; the performance of the Company's dealer lending program; the legislative/regulatory climate; monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Federal Reserve Board and any changes associated with the new administration; the quality or composition of the loan or securities portfolios; changes in the volume and mix of interest-earning assets and interest-bearing liabilities; the effects of management's investment strategy and strategy to manage the net interest margin; the U.S. government's guarantee of repayment of student loans purchased by the Company; the level of net charge-offs on loans; deposit flows; competition; demand for financial services in the Company's market area; implementation of new technologies; the Company's ability to develop and

maintain secure and reliable electronic systems; any interruption or breach of security in the Company's information systems or those of the Company's third party vendors or other service providers; reliance on third parties for key services; the use of inaccurate assumptions in management's modeling systems; the real estate market; accounting principles, policies and guidelines; and other factors detailed in the Company's publicly filed documents, including its Annual Report on Form 10-K for the year ended December 31, 2016. These risks and uncertainties should be considered in evaluating the forward-looking statements contained herein, and readers are cautioned not to place undue reliance on such statements, which speak only as of date of the report.

These risks and uncertainties, in addition to the risks and uncertainties identified in the Company's 2016 annual report on Form 10-K, should be considered in evaluating the forward-looking statements contained herein, and readers are cautioned not to place undue reliance on such statements. Any forward-looking statement speaks only as of the date on which it is made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which it is made. In addition, past results of operations are not necessarily indicative of future results.

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#### 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 with or furnishes to the SEC 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).

#### About Old Point Financial Corporation

The Company is the parent company of The Old Point National Bank of Phoebus (the Bank) and Old Point Trust & Financial Services, N. A. (Trust). The Bank is a locally managed community bank serving the Hampton Roads localities of Chesapeake, Hampton, Isle of Wight County, Newport News, Norfolk, Virginia Beach, Williamsburg/James City County and York County. The Bank currently has 18 branch offices and is the parent company of Old Point Mortgage, LLC (OPM), which provides mortgage origination services. Trust is a wealth management services provider.

On October 30, 2017, the Company announced that it had entered into a definitive merger agreement with Citizens National (OTC Pink: CNBV) pursuant to which the Company will acquire Citizens National in a stock and cash transaction for total consideration valued at approximately \$7.9 million, based on a volume-weighted average price of \$31.48 for Old Point common stock for the three trading days ended October 27, 2017. Upon the closing of the Pending Acquisition, Citizens National will merge into the Bank. The Pending Acquisition has been unanimously approved by the Boards of Directors of both institutions. The Pending Acquisition is expected to be completed in first quarter 2018, subject to the approval of Citizens National shareholders as well as customary regulatory approvals and other closing conditions.

#### Critical Accounting Policies and Estimates

As of September 30, 2017, there have been no significant changes with regard to the critical accounting policies and estimates disclosed in the Company's 2016 annual report on Form 10-K. The accounting policy that required management's most difficult, subjective or complex judgments continues to be the Company's allowance for loan losses. The Company's policies for calculating the allowance for loan losses are discussed in this Item 2 and in Note 3 of the Notes to the Consolidated Financial Statements included in this quarterly report on Form 10-Q, and are discussed in further detail in the Company's 2016 annual report on Form 10-K.

#### Executive Overview

In the third quarter of 2017, net income was \$757 thousand and decreased \$572 thousand when compared to the third quarter of 2016. This decrease in quarterly net income was the net effect of higher interest income, particularly on the loan portfolio; higher interest expense due to an increase in borrowings; an increased provision for loan losses as a result of increases in loans and nonperforming assets; higher noninterest income; and higher noninterest expense, driven primarily by increases in loan expenses.

Net income for the first nine months of 2017 was \$2.9 million, or \$0.57 per diluted share, compared to net income of \$2.9 million, or \$0.59 per diluted share, for the first nine months of 2016. The decrease in year-to-date net income was driven primarily by the same factors that impacted quarterly net income. Noninterest income was also positively impacted by the Old Point Mortgage acquisition in the second quarter of 2017, while noninterest expense was affected by increases in salaries and employee benefits, in addition to higher loan expenses as in the quarterly period.

Highlights of the quarter are as follows:

- The Company entered into a definitive merger agreement to acquire Citizens National in the Pending Acquisition, which is expected to close in the first quarter of 2018, subject to customary closing conditions, including regulatory and Citizens National shareholder approval.
- Total loans held for investment grew \$97.1 million or 16.08% from December 31, 2016. Average loans held for investment increased \$102.7 million or 17.38% from the same quarter in the prior year.
- Deposits decreased \$2.1 million or 0.26% from December 31, 2016. Average deposits increased \$24.6 million, or 3.28%, from the same quarter in the prior year.
- The net interest margin improved to 3.68%, from 3.66% for the third quarter of 2016.
- Return on average assets was 0.32% in the third quarter of 2017, compared to 0.59% in the third quarter of 2016.
- Non-performing assets (NPAs) were \$14.2 million at September 30, 2017, up from \$11.1 million at December 31, 2016. Non-accrual loans were \$10.2 million at September 30, 2017, up from \$7.2 million at December 31, 2016.

### Net Interest Income

The principal source of earnings for the Company is net interest income. Net interest income is the difference between interest and fees generated by earning assets and interest expense paid to fund them. Changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as their respective yields and rates, have a significant impact on the level of net interest income. The net interest margin is calculated by dividing tax-equivalent net interest income by average earning assets.

For the nine months ended September 30, 2017, net interest income was \$22.3 million, an increase of \$2.0 million or 9.62% compared to the prior year period, primarily due to increased interest and fees on loans associated with loan growth. For the third quarter of 2017, net interest income was \$7.7 million, an increase of \$928 thousand or 13.64% from the third quarter of 2016. The increases in net interest income were driven by higher earning asset balances.

Net interest income, on a fully tax-equivalent basis, was \$23.0 million for the nine months ended September 30, 2017, compared to \$21.0 million for the nine months ended September 30, 2016, an increase of 9.55%. For the third quarter of 2017, tax-equivalent net interest income was \$8.0 million, an increase of 13.29% from the third quarter of 2016.

### Year-to-Date Review

Unless otherwise noted, all comparisons in this section are between the nine months ended September 30, 2017 and the nine months ended September 30, 2016.

Average loans held for investment increased \$76.0 million, with this increase in average balances offsetting a 14-basis-point decline in loan yields to increase interest income on loans by \$1.9 million. Average investment securities increased \$3.1 million while the tax-equivalent yield on the portfolio increased 15 basis points; on a combined basis, the higher balances and higher yields on securities added \$252 thousand to tax-equivalent interest income. During the second half of 2016 and the first half of 2017, management closely monitored the investment portfolio and was able to strategically buy and sell securities to improve the yield on the portfolio.

Average earning assets increased \$73.3 million, offsetting a marginal decline in the average yield of 1 basis point. In addition to the growth in average earning assets, interest income also increased due to a change in the mix of earning assets as average loans grew faster than average investment securities. Average total nonearning assets decreased \$18.6 million over the same time period, with the Company utilizing its excess liquidity to fund a portion of the growth in average total assets. With a higher percent of the Company's average assets in loans--the highest yielding category on the Company's balance sheet--tax-equivalent interest income increased \$2.2 million.

The growth in the average balance sheet was funded primarily through increases in deposits, with average deposits growing \$42.7 million. Low-cost deposits in particular grew \$46.2 million, with higher-cost time deposits decreasing \$3.5 million. While the cost of time deposits increased 3 basis points, the shift in the deposit mix toward less costly sources of funding limited the impact on the cost of total time and savings deposits to an overall increase of only 1 basis point. This change in the deposit mix also helped reduce the effect of deposit growth on interest expense, with interest expense on deposits increasing \$102 thousand, or 5.87% as compared to the 9.46% increase in tax-equivalent interest income. Management expects that the Company's solid base of low-cost deposits will continue to beneficially impact the net interest margin in 2017.

Growth in the average balance sheet was also supported by additional FHLB advances, with average FHLB advances increasing \$13.5 million. The growth in balances was mitigated by a decline in the average rate on these advances, primarily due to the payoff of an FHLB advance in February 2016. As can be seen in the following table, this paid off advance bore a rate significantly higher than other available funding sources in the current rate environment. The total cost of interest-bearing liabilities increased 1 basis point to 0.47%.

The decline in the yield on average earning assets combined with the increase in the cost of total interest-bearing liabilities would typically result in a decrease in the net interest margin. However, the Company's earning assets grew 9.61% while interest-bearing liabilities grew 6.70%. As discussed above, the Company used excess liquidity previously held in cash and due from banks to fund a portion of its balance sheet growth, which offset both the decline in the yield on earning assets and the increase in the cost of interest-bearing liabilities, leaving the net interest margin unchanged at 3.67%.

Management expects that the Company's loan yields will continue to decline, due to intense competition for quality loans and rate reductions on loans currently held in the portfolio. Management also expects that the reduction in loan yields will likely continue throughout 2017, depending on monetary policy actions taken by the Federal Open Market Committee (FOMC). The FOMC raised the target range for the federal funds rate in March 2017 and June 2017, and management currently expects one additional increase in the remainder of the year. If the FOMC does continue to raise its target range, then management expects that the decline in loan yields will eventually slow as new loans are booked at current market rates. To partially offset the anticipated decline, management has placed an increased focus on managing the Company's mix of liabilities in order to increase low cost funds and reduce high cost funds where possible.

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Third Quarter Review

Unless otherwise noted, all comparisons in this section are between the third quarter of 2017 and the third quarter of 2016.

Comparisons between the third quarters of 2017 and 2016 are substantially the same as those for the nine months ended September 30, 2017 and 2016, although the effects of the Company's initiatives surrounding loan growth tended to be more pronounced in the quarterly comparison. Average loans held for investment grew \$102.7 million or 17.38%, offsetting a 10-basis-point decline in loan yields for a net increase in tax-equivalent interest income of \$983 thousand. The effects of the strategic investment purchases and sales in the second half of 2016 and the first half of 2017 are also evident in the quarterly comparison, with average total investment securities increasing \$13.4 million while the yield increased 17 basis points. Average nonearning assets declined \$44.3 million or 31.28% as loan growth absorbed excess liquidity previously held in noninterest-bearing accounts. As a result of the increase in securities yields and the shift in the Company's balance sheet to higher-yielding loans, the tax-equivalent yield on earning assets increased 7 basis points to 4.06% and tax-equivalent interest income increased \$1.1 million or 14.86%.

In addition to available liquidity, the increase in loans was funded by growth in low-cost deposits (\$29.1 million) and by FHLB advances (\$28.0 million). As market rates have increased, the rate on FHLB advances has also increased, with the cost increasing from 0.58% in the third quarter of 2016 to 1.27% in the third quarter of 2017. Although the Company's overall cost on time deposits is lower than the cost of FHLB advances, much of the balance in time deposits is from accounts opened in lower rate environments. The current market rates on time deposits in the Company's market area remain generally higher than the rates on short-term FHLB advances.

The following table shows an analysis of average earning assets, interest-bearing liabilities and rates and yields for the periods indicated. Nonaccrual loans are included in loans outstanding.

## AVERAGE BALANCE SHEETS, NET INTEREST INCOME\* AND RATES\*

|   | For the quarter ended September 30, |                          |               |                 |                          |               |
|---|-------------------------------------|--------------------------|---------------|-----------------|--------------------------|---------------|
|   | 2017                                |                          |               | 2016            |                          |               |
|   | Average Balance                     | Interest Income/ Expense | Yield/ Rate** | Average Balance | Interest Income/ Expense | Yield/ Rate** |
|   | (dollars in thousands)              |                          |               |                 |                          |               |
| <b>ASSETS</b>                               |                                     |                          |               |                 |                          |               |
| Loans held for investment*                  | \$693,693                           | \$ 7,661                 | 4.42 %        | \$590,964       | \$ 6,678                 | 4.52 %        |
| Loans held for sale                         | 1,090                               | 12                       | 4.40 %        | 0               | 0                        | 0.00 %        |
| Investment securities:                      |                                     |                          |               |                 |                          |               |
| Taxable                                     | 101,612                             | 487                      | 1.92 %        | 88,462          | 357                      | 1.61 %        |
| Tax-exempt*                                 | 64,662                              | 584                      | 3.61 %        | 64,389          | 563                      | 3.50 %        |
| Total investment securities                 | 166,274                             | 1,071                    | 2.58 %        | 152,851         | 920                      | 2.41 %        |
| Interest-bearing due from banks             | 1,093                               | 4                        | 1.46 %        | 19,671          | 25                       | 0.51 %        |
| Federal funds sold                          | 457                                 | 1                        | 0.88 %        | 1,596           | 2                        | 0.50 %        |
| Other investments                           | 3,132                               | 49                       | 6.26 %        | 1,935           | 35                       | 7.24 %        |
| Total earning assets                        | 865,739                             | \$ 8,798                 | 4.06 %        | 767,017         | \$ 7,660                 | 3.99 %        |
| Allowance for loan losses                   | (9,128 )                            |                          |               | (8,048 )        |                          |               |
| Other non-earning assets                    | 97,420                              |                          |               | 141,759         |                          |               |
| Total assets                                | \$954,031                           |                          |               | \$900,728       |                          |               |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                                     |                          |               |                 |                          |               |
| Time and savings deposits:                  |                                     |                          |               |                 |                          |               |
| Interest-bearing transaction accounts       | \$27,705                            | \$ 2                     | 0.03 %        | \$27,404        | \$ 2                     | 0.03 %        |
| Money market deposit accounts               | 231,785                             | 90                       | 0.16 %        | 213,597         | 44                       | 0.08 %        |

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|   |           |         |        |           |         |        |
|---|-----------|---------|--------|-----------|---------|--------|
| Savings accounts  | 84,220    | 11      | 0.05 % | 78,997    | 10      | 0.05 % |
| Time deposits   | 207,491   | 560     | 1.08 % | 212,057   | 538     | 1.01 % |
| Total time and savings deposits                                     | 551,201   | 663     | 0.48 % | 532,055   | 594     | 0.45 % |
| Federal funds purchased, repurchase agreements and other borrowings | 27,046    | 13      | 0.19 % | 26,506    | 6       | 0.09 % |
| Federal Home Loan Bank advances                                     | 50,707    | 161     | 1.27 % | 22,717    | 33      | 0.58 % |
| Total interest-bearing liabilities                                  | 628,954   | 837     | 0.53 % | 581,278   | 633     | 0.44 % |
| Demand deposits   | 222,429   |         |        | 217,020   |         |        |
| Other liabilities   | 5,006     |         |        | 6,294     |         |        |
| Stockholders' equity  | 97,642    |         |        | 96,136    |         |        |
| Total liabilities and stockholders' equity                          | \$954,031 |         |        | \$900,728 |         |        |
| Net interest margin   |           | \$7,961 | 3.68 % |           | \$7,027 | 3.66 % |

\*Computed on a fully tax-equivalent basis using a 34% rate; the tax-equivalent adjustment to interest income was \$230 thousand and \$224 thousand for the three months ended September 30, 2017 and 2016, respectively.

\*\*Annualized

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## AVERAGE BALANCE SHEETS, NET INTEREST INCOME\* AND RATES\*

|   | For the nine months ended September 30, |                         |              |                 |                         |              |
|---|---|-------------------------|--------------|-----------------|-------------------------|--------------|
|   | 2017                                    |                         |              | 2016            |                         |              |
|   | Average Balance                         | Interest Income/Expense | Yield/Rate** | Average Balance | Interest Income/Expense | Yield/Rate** |
|   | (dollars in thousands)                  |                         |              |                 |                         |              |
| <b>ASSETS</b>   |   |                         |              |                 |                         |              |
| Loans held for investment*  | \$656,937                               | \$21,607                | 4.39 %       | \$580,900       | \$19,717                | 4.53 %       |
| Loans held for sale   | 373                                     | 20                      | 7.15 %       | 0               | 0                       | 0.00 %       |
| Investment securities:  |   |                         |              |                 |                         |              |
| Taxable   | 104,059                                 | 1,474                   | 1.89 %       | 104,631         | 1,376                   | 1.75 %       |
| Tax-exempt*   | 69,274                                  | 1,867                   | 3.59 %       | 65,610          | 1,713                   | 3.48 %       |
| Total investment securities   | 173,333                                 | 3,341                   | 2.57 %       | 170,241         | 3,089                   | 2.42 %       |
| Interest-bearing due from banks                                     | 1,502                                   | 12                      | 1.07 %       | 7,867           | 30                      | 0.51 %       |
| Federal funds sold  | 1,096                                   | 6                       | 0.73 %       | 1,549           | 4                       | 0.34 %       |
| Other investments   | 2,075                                   | 98                      | 6.30 %       | 1,491           | 76                      | 6.80 %       |
| Total earning assets  | 835,316                                 | \$25,084                | 4.00 %       | 762,048         | \$22,916                | 4.01 %       |
| Allowance for loan losses   | (8,851 )                                |                         |              | (7,893 )        |                         |              |
| Other non-earning assets  | 102,726                                 |                         |              | 120,346         |                         |              |
| Total assets  | \$929,191                               |                         |              | \$874,501       |                         |              |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                         |   |                         |              |                 |                         |              |
| Time and savings deposits:  |   |                         |              |                 |                         |              |
| Interest-bearing transaction accounts                               | \$28,121                                | \$7                     | 0.03 %       | \$17,559        | \$7                     | 0.05 %       |
| Money market deposit accounts                                       | 234,446                                 | 202                     | 0.11 %       | 219,907         | 129                     | 0.08 %       |
| Savings accounts  | 82,160                                  | 31                      | 0.05 %       | 78,033          | 29                      | 0.05 %       |
| Time deposits   | 206,150                                 | 1,599                   | 1.03 %       | 209,654         | 1,572                   | 1.00 %       |
| Total time and savings deposits                                     | 550,877                                 | 1,839                   | 0.45 %       | 525,153         | 1,737                   | 0.44 %       |
| Federal funds purchased, repurchase agreements and other borrowings | 24,684                                  | 26                      | 0.14 %       | 26,151          | 20                      | 0.10 %       |
| Federal Home Loan Bank advances                                     | 25,879                                  | 233                     | 1.20 %       | 12,372          | 177                     | 1.91 %       |
| Total interest-bearing liabilities                                  | 601,440                                 | 2,098                   | 0.47 %       | 563,676         | 1,934                   | 0.46 %       |
| Demand deposits   | 226,103                                 |                         |              | 209,147         |                         |              |
| Other liabilities   | 5,477                                   |                         |              | 6,507           |                         |              |
| Stockholders' equity  | 96,171                                  |                         |              | 95,171          |                         |              |
| Total liabilities and stockholders' equity                          | \$929,191                               |                         |              | \$874,501       |                         |              |
| Net interest margin   |   | \$22,986                | 3.67 %       |                 | \$20,982                | 3.67 %       |

\*Computed on a fully tax-equivalent basis using a 34% rate; the tax-equivalent adjustment to interest income was \$730 thousand and \$680 thousand for the nine months ended September 30, 2017 and 2016, respectively.

\*\*Annualized

## Provision for Loan Losses

The provision for loan losses is a charge against earnings necessary to maintain the allowance for loan losses at a level consistent with management's evaluation of the portfolio. This expense is based on management's estimate of probable credit losses inherent to the loan portfolio. Management's evaluation included credit quality trends, collateral values, discounted cash flow analysis, loan volumes, geographic, borrower and industry concentrations, the findings of internal credit quality assessments and results from external regulatory examinations. These factors, as well as

identified impaired loans, historical losses and current economic and business conditions, were used in developing estimated loss factors for determining the loan loss provision. Based on its analysis of the adequacy of the allowance for loan losses, management concluded that the provision was appropriate.

The provision for loan losses was \$2.9 million in the first nine months of 2017, compared to \$1.3 million in the first nine months of 2016. For the three months ended September 30, the Company added \$1.3 million in 2017 and reversed \$100 thousand from its provision for loan losses in 2016.

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Approximately \$1.1 million of the provision for loan losses in the nine months ended September 30, 2017 was due to growth in loans, which required the Company to set aside additional funds. The remainder of the increase was primarily due to the deteriorating condition of a long-standing borrowing relationship, which the Company charged down to the value of its collateral, less costs to sell, during the nine months ended September 30, 2017.

Net loans charged off as a percent of total loans on an annualized basis were 0.42% for the first nine months of 2017, or \$3.0 million, compared to 0.28%, or \$1.3 million, in the first nine months of 2016. In the three months ended September 30, 2017 and 2016, Net loans charged off as a percent of total loans on an annualized basis were 0.59% and 0.04%, respectively.

#### Noninterest Income

Noninterest income was \$3.4 million and \$10.6 million, respectively, in the three and nine months ended September 30, 2017, an increase of \$34 thousand or 1.02% from the third quarter of 2016 and an increase of \$337 thousand or 3.28% from the nine months ended September 30, 2016. The changes between 2016 and 2017 resulted primarily from (1) nonrecurring gains associated with the initial implementation in the first quarter of 2016 of a new strategy for the investment portfolio, resulting in increased activity within the investment portfolio that was not repeated in 2017, and (2) a nonrecurring gain associated with the acquisition in the second quarter of 2017 of the outstanding interest in Old Point Mortgage, LLC, which is now included in the Company's consolidated financial statements.

#### Year-to-Date Review

Unless otherwise noted, all comparisons in this section are between the nine months ended September 30, 2017 and 2016.

Gains on sales of available-for-sale securities decreased \$433 thousand. While management continued to monitor the investment portfolio and make changes congruent with its strategy for the investment portfolio, purchases and sales in the first nine months of 2017 were fewer than in the first nine months of 2016, with correspondingly smaller gains.

As a result of the purchase of the outstanding ownership interest in OPM in the second quarter of 2017, the Bank became the sole member of OPM. In accordance with GAAP, the Company recorded income of \$550 thousand related to the fair value of its previously-held equity interest in OPM, reflected as a gain on acquisition of Old Point Mortgage in the Consolidated Statements of Income.

Income from mortgage banking activities increased \$186 thousand. The Company's consolidated financial statements now include OPM, with its income reported in noninterest income as income from mortgage banking activities. In 2016, the Bank owned only 49% of OPM and accounted for its investment under the equity method. Under this method, the Bank recorded its proportionate share of OPM's net income (all income net of all expenses, including income tax). With the completion of the full acquisition of OPM, the Bank now receives 100% of OPM's operating results. The Bank's investment in OPM is also now accounted for on a consolidated basis, and as a result, OPM's gross revenues are reported in noninterest income and its expenses are reported in individual categories of noninterest expense, rather than as a net figure in noninterest income. The increase from a 49% to 100% ownership interest and the conversion from equity to consolidation accounting led to the significant increase in this category.

Other significant changes in noninterest income were as follows:

- Income from fiduciary activities (increased \$184 thousand or 6.98%): This account is heavily impacted by the market value of assets under management, and improvements in the stock market during the fourth quarter of 2016 and first nine months of 2017 increased income in this category.
- Service charges on deposit accounts (decreased \$191 thousand or 6.29%): Lower overdraft fee income and lower service charges on both personal and business accounts were the primary reasons for the decline in this account. Increased regulation of overdraft fee income has reduced the Company's income in this category in

prior years, a decline that continued in 2017.

- Other service charges, commissions and fees (increased \$122 thousand or 4.04%): This account increased primarily due to increases in merchant processing fee income and debit card fee income.

#### Third Quarter Review

Unless otherwise noted, all comparisons in this section are between the third quarter of 2017 and the third quarter of 2016.

Income from fiduciary activities increased \$45 thousand or 5.24% and other service charges, commissions and fees increased \$82 thousand or 8.47%. Both changes were for the reasons discussed in the "Year-to-Date Review" section above.

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### Noninterest Expense

Noninterest expense increased \$827 thousand or 3.15% when comparing the nine months ended September 30, 2017 to the same period in 2016 and increased \$427 thousand or 4.91% when comparing the third quarters of 2017 and 2016.

### Year-to-Date Review

Unless otherwise noted, all comparisons in this section are between the nine months ended September 30, 2017 and 2016.

Noninterest expense in 2016 was impacted by the Company's early payoff of an FHLB advance in the first quarter of that year, which required the Company to pay a fee of \$391 thousand. The lack of such a fee in 2017, along with decreases in certain categories of noninterest expense, reduces the impact of increases in other categories of noninterest expense.

- Salaries and employee benefits (increased \$543 thousand or 3.59%): In the second quarter of 2017, the Company accrued for the compensation package provided to its retiring Chief Financial Officer. In addition to this accrual, the consolidation of OPM increased salary and commission expenses, as did the hiring of additional lending staff to support the Company's strategic plan.
- Occupancy and equipment (increased \$226 thousand or 5.48%): The Company continues to improve its disaster recovery plan, building on the more sophisticated disaster recovery plan initially begun in the third quarter of 2015. New service contracts and purchases of depreciable equipment both contributed to the increase in occupancy and equipment.
- Legal and audit expenses (decreased \$265 thousand or 30.49%): The inclusion in the 2016 proxy statement and the implementation of stockholder-approved proposals following the 2016 Annual Meeting of Stockholders increased legal and audit expense during 2016, while there were no equivalent expenses in 2017.
- Other outside service fees (increased \$236 thousand or 42.07%): Due to the large increase in the Bank's auto dealer loan portfolio, costs to process and service these loans also increased.
- Employee professional development (increased \$177 thousand or 37.34%): The Company incurred higher recruiting costs associated with an executive search.
- Loan expenses (increased \$380 thousand or 368.93%): As with other outside service fees, the Bank's new dealer lending program increased the cost of credit reports, which are included in this line item. Expenses related to problem credits were also higher as the Company worked to reduce nonperforming assets.
- ATM and other losses (increased \$134 thousand or 44.52%): Branch robberies and fraud losses increased this expense in the first half of 2017. The Company has implemented improvements to its fraud detection process and continues to monitor new frauds to determine if additional changes are necessary.
- Loss (gain) on other real estate owned (decreased \$171 thousand or 111.76%): In 2016 and 2017, the Company worked diligently to sell the properties held in other real estate owned, with the last two sales closing in the second quarter of 2017. Prior to 2017, both properties had already been written down to the anticipated sales price (less costs to sell); the Company recorded a small gain on the final sales in 2017, as compared to a loss in the first half of 2016.

The Company's income tax expense decreased \$119 thousand, due to both lower taxable income and a lower effective tax rate. The Company's effective tax rate remains low due to its investments in tax-exempt securities and its receipt of federal income tax credits for its investment in certain housing projects. As the Company's income before taxes was lower in 2017 than in 2016 while the amount of tax-exempt income and tax credits increased, the Company's effective tax rate for the first nine months of 2017 is negative.

### Third Quarter Review

Unless otherwise noted, all comparisons in this section are between the third quarter of 2017 and the third quarter of 2016.

The most significant changes in quarterly noninterest expense were in four line items: occupancy and equipment (increased \$71 thousand or 5.17%); legal and audit expenses (decreased \$156 thousand or 41.94%); other outside service fees (increased \$92 thousand or 46.00%); and loan expenses (increased \$256 thousand or 556.52%). All of these categories were affected by the same factors as discussed above for the year-to-date periods.

Income tax expense for the quarter was down from the comparable period last year due to lower net income before taxes. As in the year-to-date periods discussed above, the Company's investments in tax-exempt securities and low-income housing projects have generally helped to keep its effective tax rate low, which management expects will continue.

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## Balance Sheet Review

Unless otherwise noted, all comparisons in this section are between balances at December 31, 2016 and September 30, 2017.

Assets as of September 30, 2017 were \$954.5 million, an increase of \$51.5 million or 5.71%, with net loans held for investment growing \$96.4 million. During the first half of 2017, loan growth was primarily funded by increases in low-cost deposits. However, deposit balances declined during June of 2017 and did not show consistent growth again until September of 2017. As of September 30, 2017, total deposits were \$2.1 million or 0.26% lower than at December 31, 2016. Historically, the Company's deposit balances have shown similar seasonal variations in June and July, with balances growing again in the latter part of the third quarter and in the fourth quarter. Management monitors available liquidity closely and adjusts deposit rates according to the Company's needs. To supplement its deposit base, the Company funded loan growth from the securities portfolio (\$35.3 million) and additional FHLB advances (\$45.0 million).

The majority of the Company's loan growth was in the consumer loans category and was driven by indirect dealer lending. In September 2016, the Company re-opened its dealer lending department. The consumer auto loan portfolio grew \$83.6 million in the first nine months of 2017, which contributed positively to interest income during 2017; management expects this trend will continue in the future. While there are risks inherent in any new loan program, the Company has hired knowledgeable staff and put in place programs and policies to mitigate those risks. Management is monitoring the allowance for loan losses carefully and will make changes as the portfolio ages.

Consumer loans were also increased by the purchase of \$8.9 million in consumer installment loans. The Company maintains a dedicated reserve account funded by the seller of these consumer installment loans, with the balance in the reserve averaging 10 - 12% of the outstanding principal balance. Any loan losses in this portfolio are covered first by the reserve account; loans are charged against the allowance for loan losses only if the funds available in the reserve account are not sufficient.

Average assets for the first nine months of 2017 were \$929.2 million compared to \$874.5 million for the first nine months of 2016, an increase of 6.25%. Comparing the first nine months of 2017 to the first nine months of 2016, average loan growth of \$76.0 million was funded by average deposit growth (\$42.7 million), average FHLB advances (\$13.5 million), and average available liquidity from cash and due from banks (\$20.5 million).

The Company's holdings of "Alt-A" type mortgage loans such as adjustable rate and nontraditional type loans were inconsequential, amounting to less than 1.00% of the Company's loan portfolio as of September 30, 2017.

The Company does not have a formal program for subprime lending. The Company is required by law to comply with the requirements of the Community Reinvestment Act (the CRA), which imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of their local communities, including low- and moderate-income borrowers. In order to comply with the CRA and meet the credit needs of its local communities, the Company finds it necessary to make certain loans with subprime characteristics.

For the purposes of this discussion, a "subprime loan" is defined as a loan to a borrower having a credit score of 660 or below. The majority of the Company's subprime loans are to customers in the Company's local market area. The following table details the Company's loans with subprime characteristics that were secured by 1-4 family first mortgages, 1-4 family open-end loans (i.e., equity lines of credit) and 1-4 family junior lien loans (e.g., second mortgages) for which the Company has recorded a credit score in its system.

Loans Secured by 1 - 4 Family  
First Mortgages,

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1 - 4 Family Open-end and 1 - 4  
Family Junior Liens  
As of September 30, 2017  
(dollars in thousands)

|              | <u>Amount</u> | <u>Percent</u> |
|--------------|---------------|----------------|
| Subprime     | \$21,406      | 12.88 %        |
| Non-subprime | 144,829       | 87.12 %        |
|              | \$166,235     | 100.00 %       |

Total loans \$700,996

Percentage of Real  
Estate-Secured Subprime  
Loans to Total Loans 3.05 %

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In addition to the subprime loans secured by real estate discussed above, as of September 30, 2017, the Company had an additional \$14.2 million in subprime consumer loans that were not government guaranteed, were unsecured, or were secured by collateral other than real estate. Together with the subprime loans secured by real estate, the Company's total subprime loans as of September 30, 2017 were \$35.6 million, amounting to 5.08% of the Company's total loans at September 30, 2017.

Additionally, the Company has no investments secured by "Alt-A" type mortgage loans such as adjustable rate and nontraditional type mortgages or subprime loans.

#### Liquidity

Liquidity is the ability of the Company to meet present and future financial obligations through either the sale or maturity of existing assets or the acquisition of additional funds through liability management. Liquid assets include cash, interest-bearing deposits with banks, federal funds sold, investments in securities and loans maturing within one year. The Company's internal sources of such liquidity are deposits, loan and investment repayments and securities available-for-sale. As of September 30, 2017, the Bank's unpledged, available-for-sale securities totaled \$93.2 million. The Company's primary external source of liquidity is advances from the FHLB.

A major source of the Company's liquidity is its large, stable deposit base. In addition, secondary liquidity sources are available through the use of borrowed funds if the need should arise, including secured advances from the FHLB. As of the end of the third quarter of 2017, the Company had \$141.0 million in FHLB borrowing availability based on loans and securities currently available for pledging, less advances currently outstanding. The Company believes that the availability at the FHLB is sufficient to meet future cash-flow needs. The Company also has available short-term, unsecured borrowed funds in the form of federal funds lines of credit with correspondent banks. As of the end of the third quarter of 2017, the Company had \$55.0 million available in federal funds lines to address any short-term borrowing needs.

As disclosed in the Company's consolidated statements of cash flows, net cash provided by operating activities was \$7.0 million, net cash used in investing activities was \$64.8 million and net cash provided by financing activities was \$47.4 million for the nine months ended September 30, 2017. Combined, this contributed to a \$10.4 million decrease in cash and cash equivalents for the nine months ended September 30, 2017.

Management is not aware of any market or institutional trends, events or uncertainties that are expected to have a material effect on the liquidity, capital resources or operations of the Company. Nor is management aware of any current recommendations by regulatory authorities that would have a material effect on liquidity, capital resources or operations.

Based on the Company's management of liquid assets, the availability of borrowed funds, and the Company's ability to generate liquidity through liability funding, management believes that the Company maintains overall liquidity sufficient to satisfy its depositors' requirements and to meet its customers' future borrowing needs.

Notwithstanding the foregoing, the Company's ability to maintain sufficient liquidity may be affected by numerous factors, including economic conditions nationally and in the Company's markets. Depending on its liquidity levels, its capital position, conditions in the capital markets and other factors, the Company may from time to time consider the issuance of debt, equity, other securities or other possible capital markets transactions, the proceeds of which could provide additional liquidity for the Company's operations.

#### Nonperforming Assets

Nonperforming assets consist of nonaccrual loans, loans past due 90 days or more and accruing interest, restructured loans that are accruing interest and not performing according to their modified terms, and OREO. See Note 3 of the Notes to the Consolidated Financial Statements included in this quarterly report on Form 10-Q for an explanation of

the loan categories. OREO consists of real estate from foreclosures on loan collateral and one former Bank building.

The majority of the loans past due 90 days or more and accruing interest are student loans with principal and interest amounts that are 97 - 98% guaranteed by the federal government. When a loan changes from "past due 90 days or more and accruing interest" status to "nonaccrual" status, the loan is reviewed for impairment. In most cases, if the loan is considered impaired, then the difference between the value of the collateral and the principal amount outstanding on the loan is charged off. If the Company is waiting on an appraisal to determine the collateral's value or is in negotiations with the borrower or other parties that may affect the value of the collateral, management allocates funds to the allowance for loan losses to cover the anticipated deficiency, based on information available to management at that time.

In the case of TDRs, the restructuring may be to modify to an unsecured loan (e.g., a short sale) that the borrower can afford to repay. In these circumstances, the entire balance of the loan would be specifically allocated for, unless the present value of expected future cash flows was more than the current balance on the loan. It would not be charged off if the loan documentation supports the borrower's ability to repay the modified loan.

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The following table presents information on nonperforming assets, as of the dates indicated:

## NONPERFORMING ASSETS

|  | September<br>30,<br>2017<br>(in thousands) | December<br>31,<br>2016 | Increase<br>(Decrease) |
|--|--|-------------------------|------------------------|
| Nonaccrual loans   |  |                         |                        |
| Commercial   | \$771                                      | \$ 231                  | \$ 540                 |
| Real estate-construction                                   | 518  | -                       | 518                    |
| Real estate-mortgage (1)                                   | 8,923                                      | 6,847                   | 2,076                  |
| Consumer loans   | -  | 81                      | (81 )                  |
| Total nonaccrual loans                                     | \$10,212                                   | \$ 7,159                | \$ 3,053               |
| Loans past due 90 days or more and accruing interest       |  |                         |                        |
| Commercial   | \$473                                      | \$ -                    | \$ 473                 |
| Real estate-mortgage (1)                                   | 1,026                                      | 276                     | 750                    |
| Consumer loans (2)   | 2,482                                      | 2,603                   | (121 )                 |
| Other  | 2  | 5                       | (3 )                   |
| Total loans past due 90 days or more and accruing interest | \$3,983                                    | \$ 2,884                | \$ 1,099               |
| Restructured loans   |  |                         |                        |
| Commercial   | \$100                                      | \$ 144                  | \$ (44 )               |
| Real estate-construction                                   | 93   | 96                      | (3 )                   |
| Real estate-mortgage (1)                                   | 13,586                                     | 11,616                  | 1,970                  |
| Total restructured loans                                   | \$13,779                                   | \$ 11,856               | \$ 1,923               |
| Less nonaccrual restructured loans (included above)        | 8,321                                      | 2,838                   | 5,483                  |
| Less restructured loans currently in compliance (3)        | 5,458                                      | 9,018                   | (3,560 )               |
| Net nonperforming, accruing restructured loans             | \$-  | \$ -                    | \$ -                   |
| Nonperforming loans  | \$14,195                                   | \$ 10,043               | \$ 4,152               |
| Other real estate owned                                    |  |                         |                        |
| Construction, land development, and other land             | \$-  | \$ 940                  | \$ (940 )              |
| Former bank building                                       | -  | 127                     | (127 )                 |
| Total other real estate owned                              | \$-  | \$ 1,067                | \$ (1,067 )            |
| Total nonperforming assets                                 | \$14,195                                   | \$ 11,110               | \$ 3,085               |

(1) The real estate-mortgage segment includes residential 1 – 4 family, commercial real estate, second mortgages and equity lines of credit.

(2) Amounts listed include student loans with principal and interest amounts that are 97 - 98% guaranteed by the federal government. The portion of these guaranteed loans that is past due 90 days or more totaled \$4.1 million at September 30, 2017 and \$4.8 million at December 31, 2016.

(3) As of September 30, 2017 and December 31, 2016, all of the Company's restructured accruing loans were performing in compliance with their modified terms.

Nonperforming assets as of September 30, 2017 were \$14.2 million, \$3.1 million higher than nonperforming assets as of December 31, 2016. Nonaccrual loans increased \$3.1 million when comparing the balances as of September 30, 2017 to December 31, 2016. See Note 3 of the Notes to the Consolidated Financial Statements included in this

quarterly report on Form 10-Q for additional information about the change in nonaccrual loans. Management has set aside specific allocations on those loans where it is deemed appropriate based on the information available to management at this time regarding the cash flow, anticipated financial performance, and collateral securing these loans. Management believes that the collateral and/or discounted cash flow on these loans will be sufficient to cover balances for which it has no specific allocation.

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The majority of the balance of nonaccrual loans at September 30, 2017 was related to a few large credit relationships. Of the \$10.2 million of nonaccrual loans at September 30, 2017, \$7.7 million, or approximately 75.40%, was comprised of three credit relationships of \$3.7 million, \$2.3 million, and \$1.8 million. All loans in these relationships have been analyzed to determine whether the cash flow of the borrower and the collateral pledged to secure the loans is sufficient to cover outstanding principal balances. The Company has set aside specific allocations for those loans without sufficient cash flow or collateral and charged off any balance that management does not expect to collect.

The majority of the loans that make up the nonaccrual balance have been written down to their net realizable value. If the Company is waiting on an appraisal to determine the collateral's value, management allocates funds to cover the deficiency to the allowance for loan losses based on information available to management at the time. As shown in the table above, the majority of nonaccrual loans at September 30, 2017 and December 31, 2016 were collateralized by real estate.

Loans past due 90 days or more and accruing interest increased \$1.1 million. As of September 30, 2017, \$2.3 million of the \$4.0 million of loans past due 90 days or more and accruing interest were student loans on which the Company expects to experience minimal losses. Because the federal government has provided guarantees of repayment of these student loans in an amount ranging from 97% to 98% of the total principal and interest of the loans, management does not expect even significant increases in past due student loans to have a material effect on the Company. Net of past due government-guaranteed student loans, loans past due 90 days or more and accruing interest increased \$1.4 million primarily due to the maturity of a single real estate mortgage loan that was renewed in October; the majority of the remainder is guaranteed by the SBA.

Total restructured loans increased by \$1.9 million from December 31, 2016 to September 30, 2017 primarily due to paydowns and charge-offs on restructured loans, partially offset by the restructuring of two additional loans. All accruing TDRs are performing in accordance with their modified terms and have been evaluated for impairment, with any necessary reserves recorded as needed.

The Company's two remaining OREO properties were sold in the second quarter of 2017, and no additional properties were added.

Management believes the Company has excellent credit quality review processes in place to identify problem loans quickly. This allows management to work with problem loan relationships to identify any payment shortfall and assist these borrowers to improve performance or correct the problems.

#### Allowance for Loan Losses

The allowance for loan losses is based on several components. The first component of the allowance for loan losses is determined based on specifically identified loans that may become impaired. These loans are individually analyzed for impairment and include nonperforming loans and both performing and nonperforming TDRs. This component may also include loans considered impaired for other reasons, such as outdated financial information on the borrower or guarantors or financial problems of the borrower, including operating losses, marginal working capital, inadequate cash flow, or business interruptions. Changes in TDRs and nonperforming loans affect the dollar amount of the allowance. Increases in the impairment allowance for TDRs and nonperforming loans are reflected as an increase in the allowance for loan losses except in situations where the TDR or nonperforming loan does not require a specific allocation (i.e. the present value of expected future cash flows or the collateral value is considered sufficient).

The majority of the Company's TDRs and nonperforming loans are collateralized by real estate. When reviewing loans for impairment, the Company obtains current appraisals when applicable. If the Company is waiting on an appraisal to determine the collateral's value or is in negotiations with the borrower or other parties that may affect the value of the collateral, any loan balance that is in excess of the estimated appraised value is allocated in the allowance. As of September 30, 2017 and December 31, 2016, the impaired loan component of the allowance for loan losses was \$439

thousand and \$800 thousand, respectively.

The second component of the allowance consists of qualitative factors and includes items such as economic conditions, growth trends, loan concentrations, changes in certain loans, changes in underwriting, changes in management and legal and regulatory changes. For the September 30, 2017 calculation, the qualitative factor that had the most significant impact on the allowance was the one impacted by changes in collateral-dependent loans, which increased the allowance.

Historical loss is the final component of the allowance for loan losses and is calculated based on the migration of loans from performing to charge-off over a period of time that management deems appropriate to provide a reasonable estimate of losses inherent in the loan portfolio. With the December 31, 2016 calculation, the historical loss was based on four migration periods of twelve quarters each. Beginning with the September 30, 2017 calculation, management added four additional migration periods to its analysis to better reflect the risks inherent in the loan portfolio. This change is discussed in more detail below.

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Both the historical loss and qualitative factor components of the allowance are applied to loans evaluated collectively for impairment. The portfolio is segmented based on the loan classifications set by the Federal Financial Institutions Examination Council in the instructions for the call report applicable to the Bank. Consumer loans not secured by real estate and made to individuals for household, family and other personal expenditures are segmented into pools based on whether the loan's payments are current (including loans 1 – 29 days past due), or are 30 – 59 days past due, 60 – 89 days past due, or 90 days or more past due. All other loans, including loans to consumers that are secured by real estate, are segmented by the Company's internally assigned risk grades: substandard, other assets especially mentioned (OAEM, rated just above substandard), and pass (all other loans).

During the nine months ended September 30, 2017, the Company saw a decrease of \$1.3 million in loans rated OAEM and a decrease of \$2.1 million in loans rated substandard, based on internally assigned risk grades. The Company may also assign loans to the risk grades of doubtful or loss, but as of September 30, 2017 and December 31, 2016, the Company had no loans in these categories.

On a combined basis, the historical loss and qualitative factor components amounted to \$8.5 million and \$7.4 million as of September 30, 2017 and December 31, 2016, respectively, with the increase primarily attributable to growth in the loan portfolio.

The allowance for loan losses was 1.28% of total loans on September 30, 2017 and 1.37% of total loans on December 31, 2016. As of September 30, 2017, the allowance for loan losses was 63.06% of both nonperforming assets and nonperforming loans, compared to 74.21% and 82.10%, respectively, as of December 31, 2016. The decrease in the allowance as a percent of total loans is primarily due to declines in loans rated OAEM and substandard, as well as charge-offs on certain loans for which the Company had a specific allocation. Although the allowance as a percent of nonperforming loans decreased between December 31, 2016 and September 30, 2017, management believes it has provided an adequate reserve for nonperforming loans at September 30, 2017.

#### Change in Migration Periods

Historical loss rates calculated by migration analysis are determined by the performance of a loan over a period of time (the migration period). Multiple migration periods can also be calculated, allowing the Company to assess the migration of loans based on more than one starting point. For example, the Company could run a migration analysis that begins on June 30, 2014 and follows the performance of the loans outstanding on that date through June 30, 2017, assessing changes in risk ratings and the amount of any charge-offs to determine the historical loss rate. The Company could then run a second migration analysis that begins on September 30, 2014 and follows those loans through September 30, 2017 to calculate a second historical loss rate. These two loss rates would then be averaged to determine the overall loss rate applied to the loan portfolio.

The length of a migration period can also be extended. Adding additional quarters to the migration analysis extends the period over which the loan could cease to perform, increasing the number of loans that default and thus also increasing the historical loss rates. While a longer migration period provides a more conservative estimate of expected future losses, extending the migration period too far can provide less accurate estimates if there have been changes in the economy or the Company's loan management processes.

Increasing the number of migration periods, as opposed to lengthening the individual migration periods, provides the Company with an average loss rate that is less affected by unusual balances in the segments of the portfolio. Because migration analysis follows only those loans outstanding at the beginning of the migration period, a significant change in the balance of a loan pool during the migration period can produce results that are not indicative of the performance of the pool.

For example, a migration period of twelve quarters (three years) may apply to a pool of loans that has a balance of \$300 thousand at the beginning of the migration period. If a new loan of \$150 thousand is added to the pool in the

following quarter, and this loan is charged off ten quarters later, the migration analysis would show a loss rate of 50%, based on the original outstanding balance of \$300 thousand and a charge-off of \$150 thousand. In this example, the 50% loss rate calculated for the migration period would result from the unique timing and loan balance factors within the period and would not necessarily provide an appropriate reflection of the performance of the loans in the pool. By using multiple migration periods, such unusual situations have less of an impact on the calculated historical loss rate, providing a more accurate representation of the losses expected to be incurred.

As part of the quarterly calculation, management reviews the length of the migration periods and the number of migration periods used. To better reflect the risks inherent in the loan portfolio, in the third quarter of 2017, the Company increased the number of migration periods from four to eight. As with the methodology in prior quarters, each migration period covers twelve quarters, with the most recent migration period ending with the current quarter (in this case, September 30, 2017).

#### Capital Resources

Total stockholders' equity as of September 30, 2017 was \$97.6 million, an increase of \$3.7 million or 3.88% from \$94.0 million at December 31, 2016.

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For purposes of the Basel III Final Rules (i) common equity Tier 1 capital (CET1) consists principally of common stock (including surplus) and retained earnings; (ii) Tier 1 capital consists principally of CET1 plus non-cumulative preferred stock and related surplus, and certain grandfathered cumulative preferred stock and trust preferred securities; and (iii) Tier 2 capital consists principally of qualifying subordinated debt and preferred stock, and limited amounts of the allowance for loan losses. Total Capital is Tier 1 plus Tier 2 capital. Each regulatory capital classification is subject to certain adjustments and limitations, as implemented by the Basel III Final Rules. The Basel III Final Rules also implement a "countercyclical capital buffer," generally designed to absorb losses during periods of economic stress and to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk. The Basel III Final Rules are discussed in detail in the Company's 2016 annual report on Form 10-K.

The following is a summary of the Company's capital ratios at September 30, 2017. As shown below, these ratios were all well above the regulatory minimum levels and demonstrate that the Company's capital position remains strong.

|                              | 2017<br>Regulatory<br>Minimums |   | September<br>30, 2017 |   |
|------------------------------|--------------------------------|---|-----------------------|---|
| Common Equity Tier 1 Capital | 4.500                          | % | 12.06                 | % |
| Tier 1 Capital               | 6.000                          | % | 12.06                 | % |
| Tier 1 Leverage              | 4.000                          | % | 10.47                 | % |
| Total Capital                | 8.000                          | % | 13.16                 | % |
| Capital Conservation Buffer  | 1.250                          | % | 5.16                  | % |

Book value per share was \$19.50 at September 30, 2017 as compared to \$19.45 at September 30, 2016. Cash dividends were \$1.6 million or \$0.33 per share in the first nine months of 2017 and \$1.5 million or \$0.30 per share in the first nine months of 2016.

#### Contractual Obligations

In the normal course of business there are various outstanding contractual obligations of the Company that will require future cash outflows. In addition, there are commitments and contingent liabilities, such as commitments to extend credit that may or may not require cash outflows.

As of September 30, 2017, there have been no material changes outside the ordinary course of business in the Company's contractual obligations disclosed in the Company's 2016 annual report on Form 10-K.

#### Off-Balance Sheet Arrangements

As of September 30, 2017, there were no material changes in the Company's off-balance sheet arrangements disclosed in the Company's 2016 annual report on Form 10-K.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates, and equity prices. The Company's primary component of market risk is interest rate volatility. Fluctuations in interest rates will impact the amount of interest income and expense the Company receives or pays on a significant portion of its assets and liabilities and the market value of its interest-earning assets and interest-bearing liabilities, excluding those which have a very short-term until maturity. Management is responsible for reviewing the interest rate sensitivity position of the Company and establishing policies to monitor and limit exposure to this risk.

Three complementary modeling techniques are utilized to measure and monitor the exposure to interest rate risk: static gap analysis, earnings simulation analysis, and economic value of equity (EVE) analysis. Static gap measures the aggregate dollar volume of rate-sensitive assets relative to rate-sensitive liabilities re-pricing over various time horizons. This metric does not effectively capture the re-pricing characteristics or embedded optionality of the Company's assets and liabilities, so it is not relied upon or addressed here. Earnings simulation measures the potential effect of changes in market interest rates on future net interest income. This analysis incorporates management's assumptions for product pricing and pre-payment expectations and is the Company's preferred tool to assess its interest rate sensitivity in the short- to medium-term. The simulation utilizes a "static" balance sheet approach, which assumes that management makes no changes to the composition of the balance sheet to mitigate the impact of interest rate changes. EVE modeling estimates the fair value of assets and liabilities in different interest rate environments using discounted cash flow analysis. The net economic value of equity is the economic value of all assets minus the economic value of all liabilities. This measure provides an indication of the future earnings capacity of the balance sheet, and the change in EVE over different rate scenarios is a measure of long-term interest rate risk. The Company places less emphasis on EVE results due to the inherent imprecision of cash flow estimations and the limited utility of a static balance sheet assumption over the long-term.

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The Company determines the overall magnitude of interest sensitivity risk and then formulates policies governing asset generation and pricing, funding sources and pricing, and off-balance sheet commitments. These decisions are based on management's expectations regarding future interest rate movements, the state of the national and regional economy, and other financial and business risk factors.

When the Company is liability sensitive, net interest income should improve if interest rates fall since liabilities will reprice faster than assets (depending on the optionality or prepayment speeds of the assets). Conversely, if interest rates rise, net interest income should decline. When the Company is asset sensitive, net interest income should improve if interest rates rise and fall if rates fall. The rate change model assumes that these changes will occur gradually over the course of a year.

The table below shows the Company's interest rate sensitivity for the periods and rate scenarios presented (dollars in thousands):

| Change in interest Rates | Change In Net Interest Income<br>As of September 30, |       |         |       |
|--------------------------|--|-------|---------|-------|
|                          | 2017   |       | 2016    |       |
|                          | %  | \$    | %       | \$    |
| +300 basis points        | (0.29)%  | (92 ) | 1.06 %  | 285   |
| +200 basis points        | (0.08)%  | (26 ) | 0.74 %  | 198   |
| +100 basis points        | 0.10 %   | 30    | 0.46 %  | 122   |
| Unchanged                | 0.00 %   | 0     | 0.00 %  | 0     |
| -50 basis points         | (0.77)%  | (242) | (0.46)% | (122) |
| -100 basis points        | (1.52)%  | (478) | (0.64)% | (171) |

#### Item 4. Controls and Procedures.

**Disclosure Controls and Procedures.** Management evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective as of the end of the period covered by this report to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

In designing and evaluating its disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

**Internal Control over Financial Reporting.** Management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). No changes in the Company's internal control over financial reporting occurred during the fiscal quarter ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. Because of its inherent limitations, a system of internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that

controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings.

There are no pending legal proceedings to which the Company, or any of its subsidiaries, is a party or to which the property of the Company or any of its subsidiaries is subject that, in the opinion of management, may materially impact the financial condition of the Company.

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Item 1A. Risk Factors.

The following risk factors should be considered in addition to the risk factors disclosed in the Company's 2016 annual report on Form 10-K:

Combining the Company and Citizens National may be more difficult, costly or time-consuming than we expect.

The success of the Pending Acquisition will depend, in part, on the Company's ability to realize the anticipated benefits and cost savings from integrating Citizens National into the Bank in a manner that permits growth opportunities and cost savings to be realized without materially disrupting the existing customer relationships of Citizens National or the Bank or decreasing revenues due to loss of customers. However, to realize these anticipated benefits and cost savings, the Company must successfully combine the businesses of the Bank and Citizens National. If the Company is not able to achieve these objectives, the anticipated benefits and cost savings of the Pending Acquisition may not be realized fully, or at all, or may take longer to realize than expected.

The Bank and Citizens National have operated, and, until the completion of the Pending Acquisition, will continue to operate, independently. The success of the Pending Acquisition and the future operating performance of the Company and the Bank will depend, in part, on the Company's ability to successfully integrate Citizens National into the Bank. The success of the Pending Acquisition will, in turn, depend on a number of factors, including the Company's ability to: (i) integrate the operations of Citizens National into the Bank; (ii) retain the deposits and customers of Citizens National and the Bank; (iii) control the incremental increase in noninterest expense arising from the Pending Acquisition in a manner that enables the combined bank to improve its overall operating efficiencies; and (iv) retain and integrate the appropriate personnel of Citizens National into the operations of the Bank. The integration of Citizens National and the Bank will require the dedication of the time and resources of the banks' management and may temporarily distract managements' attention from the day-to-day business of the banks. If the Bank is unable to successfully integrate Citizens National, the Bank may not be able to realize expected operating efficiencies and eliminate redundant costs.

The integration process in the Pending Acquisition could result in the loss of key employees, the disruption of each party's ongoing business, inconsistencies in standards, controls, procedures and policies that affect adversely either party's ability to maintain relationships with customers and employees or achieve the anticipated benefits of the Pending Acquisition. As with any merger of financial institutions, there also may be disruptions that cause the Bank and Citizens National to lose customers or cause customers to withdraw their deposits from Citizens National or the Bank, or other unintended consequences that could have a material adverse effect on the Company's results of operations or financial condition after the Pending Acquisition. These integration matters could have an adverse effect on each of Citizens National, the Company and the Bank during this transition period and for an undetermined period after completion of the Pending Acquisition.

Regulatory approvals may not be received, may take longer than expected or may impose conditions that are not presently anticipated or that could have an adverse effect on the surviving company following the Pending Acquisition.

Before the Pending Acquisition may be completed, the Company, the Bank and Citizens National must obtain approvals from the Federal Reserve, OCC and the Virginia State Corporation Commission. Other approvals, waivers or consents from regulators may also be required. In determining whether to grant these approvals the regulators consider a variety of factors, including the regulatory standing of each party, and the competitive effects of the contemplated transactions. An adverse development in either party's regulatory standing or these factors could result in an inability to obtain approval or delay their receipt. The CRA also requires that the bank regulatory authorities, in deciding whether to approve the Pending Acquisition, assess the records of performance of the Bank and Citizens National in meeting the credit needs of the communities they serve, including low and moderate income

neighborhoods. Each of the Bank and Citizens National currently maintains a CRA rating of "Satisfactory" from its primary federal regulator. As part of the review process under the CRA, it is not unusual for the bank regulatory authorities to receive protests and other adverse comments from community groups and others. Any such protests or adverse comments could prolong the period during which the Pending Acquisition are subject to review by the bank regulatory authorities.

These regulators may impose conditions on the completion of the Pending Acquisition or require changes to the terms of the Pending Acquisition. Such conditions or changes could have the effect of delaying or preventing completion of the Pending Acquisition or imposing additional costs on or limiting the revenues of the surviving company following the Pending Acquisition, any of which might have an adverse effect on the surviving company following the Pending Acquisition.

The Pending Acquisition may distract management of the Company, the Bank and Citizens National from their other responsibilities.

The Pending Acquisition could cause the respective management groups of the Company, the Bank and Citizens National to focus their time and energies on matters related to the transaction that otherwise would be directed to their business and operations. Any such distraction on the part of the Company's, the Bank's, or Citizen National's management could affect its ability to service existing business and develop new business and adversely affect the business and earnings of the Company, the Bank or Citizens National before the Pending Acquisition, or the business and earnings of the Company and the Bank after the Pending Acquisition.

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Termination of the Agreement and Plan of Reorganization by and among the Company, the Bank and Citizens National, dated October 27, 2017 (the merger agreement) could negatively impact the Company or Citizens National.

If the merger agreement is terminated, the Company's or Citizens National's business may be impacted adversely by the failure to pursue other beneficial opportunities due to the focus of management on the Pending Acquisition, without realizing any of the anticipated benefits of completing the Pending Acquisition. Additionally, if the merger agreement is terminated, the market price of the Company's common stock could decline to the extent that the current market price reflects a market assumption that the Pending Acquisition will be completed. Furthermore, costs relating to the Pending Acquisition, such as legal, accounting and financial advisory fees, must be paid even if the Pending Acquisition is not completed. If the merger agreement is terminated under certain circumstances, including circumstances involving a change in recommendation by the Citizens National's board of directors, Citizens National may be required to pay the Company a termination fee of \$375,000.

The Company, the Bank and Citizens National will be subject to business uncertainties and contractual restrictions until the Pending Acquisition is completed.

Uncertainty about the effect of the Pending Acquisition on employees and customers may have an adverse effect on the Company, the Bank and Citizens National. These uncertainties may impair the Company's and Citizens National's ability to attract, retain and motivate key personnel until the Pending Acquisition is completed, and could cause customers and others that deal with the Company, the Bank and Citizens National to seek to change existing business relationships with the Company, the Bank and Citizens National. Retention of certain employees by the Company, the Bank and Citizens National may be challenging until the Pending Acquisition is completed, as certain employees may experience uncertainty about their future roles with the Company, the Bank or Citizens National. If key employees depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with the Company, the Bank or Citizens National, the Bank's or Citizens National's business, or the business of the combined company following the Pending Acquisition, could be harmed. The loss of key employees could adversely affect the Bank's ability to successfully conduct its business in the markets in which Citizens National now operates, which could have an adverse effect on the Company's financial results and the value of its common stock. In addition, subject to certain exceptions, the Company, the Bank and Citizens National have each agreed to operate its business in the ordinary course prior to completion of the Pending Acquisition and refrain from taking certain specified actions until the Pending Acquisition occurs, which may prevent the Company, the Bank or Citizens National from pursuing attractive business opportunities that may arise prior to completion of the Pending Acquisition.

If the Pending Acquisition is not completed, the Company and Citizens National will have incurred substantial expenses without realizing the expected benefits of the Pending Acquisition.

Each of the Company and Citizens National has incurred and will incur substantial expenses in connection with the negotiation and completion of the transactions contemplated by the merger agreement, as well as the costs and expenses of filing, printing and mailing a joint proxy statement/prospectus and all filing and other fees paid to the SEC in connection with the Pending Acquisition. If the Pending Acquisition is not completed, the Company and Citizens National would have to incur these expenses without realizing the expected benefits of the Pending Acquisition.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Pursuant to the Company's equity compensation plans, participants may pay the exercise price of certain awards or satisfy tax withholding requirements associated with awards by surrendering shares of the Company's common stock that the participants already own. Shares surrendered by participants of these plans are repurchased at current market value pursuant to the terms of the applicable awards. During the three months ended September 30, 2017, the Company repurchased 1,083 shares related to the exercise of awards.

During the three months ended September 30, 2017, the Company did not repurchase any shares pursuant to the Company's stock repurchase program.

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The following table summarizes repurchases of the Company's common stock that occurred during the three months ended September 30, 2017 in connection with the exercise of stock options.

| Period                               | Total<br>Number of<br>Shares<br>Purchased<br>(1) | Average<br>Price<br>Paid Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet<br>Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--------------------------------------|--|---------------------------------------|--|--|
| July 1, 2017-July 31, 2017           | 0  | \$ 0                                  | n/a  | n/a  |
| August 1, 2017-August 31, 2017       | 819  | 30.58                                 | n/a  | n/a  |
| September 1, 2017-September 30, 2017 | 264  | 30.49                                 | n/a  | n/a  |
| Total                                | 1,083  | \$ 30.56                              |  |  |

<sup>(1)</sup> These shares were repurchased in connection with payment of the exercise price upon the exercise of stock options. Accordingly, these shares are not included in the calculation of the 248,063 shares that may yet be purchased under the Company's stock repurchase program. The Company is authorized to repurchase, during any given calendar year, up to an aggregate of 5 percent of the shares of the Company's common stock outstanding as of January 1 of that calendar year.

### Item 3. Defaults Upon Senior Securities.

None.

### Item 4. Mine Safety Disclosures.

None.

### Item 5. Other Information.

The Company has made no changes to the process by which security holders may recommend nominees to its board of directors, which is discussed in the Company's Proxy Statement for the Company's 2017 Annual Meeting of Stockholders.

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Item 6. Exhibits.

| Exhibit No. | Description   |
|-------------|---|
| 2.1         | <u>Agreement and Plan of Reorganization, dated as of October 27, 2017, by and among Old Point Financial Corporation, The Old Point National Bank of Phoebus, and Citizens National Bank (incorporated by reference to Exhibit 2.1 to Form 8-K filed November 2, 2017)</u>   |
| 3.1         | <u>Articles of Incorporation of Old Point Financial Corporation, as amended effective June 22, 2000 (incorporated by reference to Exhibit 3.1 to Form 10-K filed March 12, 2009)</u>  |
| 3.1.1       | <u>Articles of Amendment to Articles of Incorporation of Old Point Financial Corporation, effective May 26, 2016 (incorporated by reference to Exhibit 3.1.1 to Form 8-K filed May 31, 2016)</u>  |
| 3.2         | <u>Bylaws of Old Point Financial Corporation, as amended and restated August 9, 2016 (incorporated by reference to Exhibit 3.2 to Form 10-Q filed August 10, 2016)</u>  |
| 10.19       | <u>Time-Based Restricted Stock Agreement, dated July 11, 2017, between Old Point Financial Corporation and Jeffrey W. Farrar (incorporated by reference to Exhibit 10.19 to Form 8-K filed July 13, 2017)</u>   |
| 31.1        | <u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>   |
| 31.2        | <u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>   |
| 32.1        | <u>Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>   |
| 101         | The following materials from Old Point Financial Corporation's quarterly report on Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Consolidated Balance Sheets (unaudited for September 30, 2017), (ii) Consolidated Statements of Income (unaudited), (iii) Consolidated Statements of Comprehensive Income (unaudited), (iv) Consolidated Statements of Changes in Stockholders' Equity (unaudited), (v) Consolidated Statements of Cash Flows (unaudited), and (vi) Notes to Consolidated Financial Statements (unaudited) |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OLD POINT FINANCIAL CORPORATION

November 14, 2017 /s/Robert F. Shuford, Sr.  
 Robert F. Shuford, Sr.  
 Chairman, President & Chief Executive Officer  
 (Principal Executive Officer)

November 14, 2017 /s/Jeffrey W. Farrar  
 Jeffrey W. Farrar

Chief Financial Officer & Senior Vice President/Finance  
(Principal Financial & Accounting Officer)