OLD POINT FINANCIAL CORP
Form 10-Q
November 13, 2013

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

FORM 10-Q

(Mark One)
X QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2013

or

o 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 o 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 o No

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

Large accelerated filer o  Accelerated filer o

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

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

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

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

OLD POINT FINANCIAL CORPORATION

FORM 10-Q

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

Old Point Financial Corporation and Subsidiaries
Consolidated Balance Sheets

| | September 30, 2013 (unaudited) | December 31, 2012 |
|---|---|---|
| Assets | | |
| Cash and due from banks | $15,527,275 | $15,982,070 |
| Interest-bearing due from banks | 49,255,719 | 24,732,329 |
| Federal funds sold | 1,930,976 | 1,602,847 |
| Cash and cash equivalents | 66,713,970 | 42,317,246 |
| Securities available-for-sale, at fair value | 158,147,372 | 329,455,812 |
| Securities held-to-maturity (fair value approximates $94,838,359 and $573,500) | 93,819,137 | 570,000 |
| Restricted securities | 2,378,100 | 2,561,900 |
| Loans, net of allowance for loan losses of $6,979,663 and $7,324,310 | 473,187,156 | 463,808,457 |
| Premises and equipment, net | 38,463,873 | 32,528,350 |
| Bank-owned life insurance | 22,471,938 | 21,824,197 |
| Other real estate owned, net of valuation allowance of $1,716,858 and $1,870,285 | 6,888,213 | 6,573,398 |
| Other assets | 14,486,743 | 7,859,344 |
| Total assets | $876,556,502 | $907,498,704 |
| Liabilities & Stockholders' Equity | | |
| Deposits: | | |
| Noninterest-bearing deposits | $180,462,289 | $176,740,312 |
| Savings deposits | 279,577,902 | 268,252,782 |
| Time deposits | 270,783,394 | 308,822,642 |
| Total deposits | 730,823,585 | 753,815,736 |
| Overnight repurchase agreements | 37,019,654 | 35,945,800 |
| Term repurchase agreements | 411,065 | 1,279,574 |
| Federal Home Loan Bank advances | 25,000,000 | 25,000,000 |
| Accrued expenses and other liabilities | 3,145,411 | 2,157,558 |
| Total liabilities | 796,399,715 | 818,198,668 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock, $5 par value, 10,000,000 shares authorized;4,959,009 shares issued and outstanding | 24,795,045 | 24,795,045 |
| Additional paid-in capital | 16,391,845 | 16,391,845 |

| | | |
|---|---|---|
| Retained earnings | 50,464,644 | 48,304,609 |
| Accumulated other comprehensive loss, net | (11,494,747 ) | (191,463 ) |
| Total stockholders' equity | 80,156,787 | 89,300,036 |
| Total liabilities and stockholders' equity | $876,556,502 | $907,498,704 |

See Notes to Consolidated Financial Statements.

Old Point Financial Corporation and Subsidiaries
Consolidated Statements of Income

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (unaudited) | | (unaudited) | |
| Interest and Dividend Income: | | | | |
| Interest and fees on loans | $5,883,652 | $6,494,629 | $17,782,921 | $20,313,095 |
| Interest on due from banks | 35,694 | 16,871 | 68,501 | 43,151 |
| Interest on federal funds sold | 161 | 401 | 912 | 1,164 |
| Interest on securities: | | | | |
| Taxable | 949,535 | 1,229,293 | 3,526,071 | 3,830,193 |
| Tax-exempt | 369,008 | 201,758 | 920,990 | 443,967 |
| Dividends and interest on all other securities | 25,283 | 15,275 | 69,401 | 60,467 |
| Total interest and dividend income | 7,263,333 | 7,958,227 | 22,368,796 | 24,692,037 |
| | | | | |
| Interest Expense: | | | | |
| Interest on savings deposits | 71,252 | 95,052 | 227,107 | 283,291 |
| Interest on time deposits | 757,102 | 971,078 | 2,406,837 | 2,910,056 |
| Interest on federal funds purchased, securities sold under agreements to repurchase and other borrowings | 7,120 | 10,415 | 26,561 | 42,438 |
| Interest on Federal Home Loan Bank advances | 308,584 | 337,550 | 915,688 | 1,187,642 |
| Total interest expense | 1,144,058 | 1,414,095 | 3,576,193 | 4,423,427 |
| Net interest income | 6,119,275 | 6,544,132 | 18,792,603 | 20,268,610 |
| Provision for loan losses | 300,000 | 750,000 | 800,000 | 1,950,000 |
| Net interest income, after provision for loan losses | 5,819,275 | 5,794,132 | 17,992,603 | 18,318,610 |
| | | | | |
| Noninterest Income: | | | | |
| Income from fiduciary activities | 868,598 | 776,615 | 2,634,092 | 2,396,266 |
| Service charges on deposit accounts | 1,081,896 | 1,050,152 | 3,114,761 | 3,153,461 |
| Other service charges, commissions and fees | 880,544 | 853,989 | 2,651,134 | 2,531,050 |
| Income from bank-owned life insurance | 215,307 | 693,745 | 647,133 | 1,142,626 |
| Income from Old Point Mortgage | 99,150 | 51,168 | 403,474 | 176,466 |
| Gain (loss) on sale of available-for-sale securities, net | (5,185) | 619,936 | (25,717) | 1,703,805 |
| Other operating income | 56,525 | 60,027 | 169,460 | 150,691 |
| Total noninterest income | 3,196,835 | 4,105,632 | 9,594,337 | 11,254,365 |
| | | | | |
| Noninterest Expense: | | | | |
| Salaries and employee benefits | 4,554,101 | 5,259,880 | 14,280,611 | 15,440,042 |
| Occupancy and equipment | 1,098,172 | 1,110,635 | 3,289,055 | 3,273,568 |
| Data processing | 412,555 | 448,854 | 1,247,015 | 1,222,757 |
| FDIC insurance | 172,382 | 284,042 | 529,357 | 851,194 |
| Customer development | 186,030 | 189,037 | 597,508 | 595,925 |
| Legal and audit expense | 155,900 | 174,672 | 390,561 | 582,784 |
| Other outside service fees | 112,795 | 135,881 | 321,683 | 429,248 |
| Employee professional development | 142,651 | 125,844 | 455,432 | 455,828 |
| Postage and courier expense | 119,773 | 118,179 | 362,804 | 361,490 |
| Advertising | 52,863 | 138,733 | 300,233 | 430,345 |
| Stationery and supplies | 111,188 | 116,733 | 326,911 | 334,572 |

| | | | | |
|---|---|---|---|---|
| Bad checks and other losses | 107,525 | 103,070 | 246,745 | 240,517 |
| Capital stock tax | 104,808 | 61,404 | 296,999 | 185,114 |
| Loss on write-down/sale of other real estate owned | 65,234 | 99,960 | 268,910 | 736,594 |
| Other operating expense | 380,172 | 385,306 | 1,136,902 | 1,108,340 |
| Total noninterest expense | 7,776,149 | 8,752,230 | 24,050,726 | 26,248,318 |
| Income before income taxes | 1,239,961 | 1,147,534 | 3,536,214 | 3,324,657 |
| Income tax expense | 202,617 | 73,346 | 582,738 | 533,961 |
| Net income | $1,037,344 | $1,074,188 | $2,953,476 | $2,790,696 |
| | | | | |
| Basic Earnings per Share: | | | | |
| Average shares outstanding | 4,959,009 | 4,959,009 | 4,959,009 | 4,959,009 |
| Net income per share of common stock | $0.21 | $0.22 | $0.60 | $0.56 |
| | | | | |
| Diluted Earnings per Share: | | | | |
| Average shares outstanding | 4,959,009 | 4,959,009 | 4,959,009 | 4,959,009 |
| Net income per share of common stock | $0.21 | $0.22 | $0.60 | $0.56 |

See Notes to Consolidated Financial Statements.

Old Point Financial Corporation
Consolidated Statements of Comprehensive Income (Loss)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (unaudited) | | (unaudited) | |
| Net income | $1,037,344 | $1,074,188 | $2,953,476 | $2,790,696 |
| Other comprehensive income (loss), net | | | | |
| Unrealized gains (losses) on available-for-sale securities, net | (3,125,290) | 2,153,604 | (11,348,274) | 2,403,011 |
| Amortization of unrealized losses on securities transferred to held-to-maturity, net of tax | 44,990 | 0 | 44,990 | 0 |
| Other comprehensive income (loss), net | (3,080,300) | 2,153,604 | (11,303,284) | 2,403,011 |
| Comprehensive income (loss) | $(2,042,956) | $3,227,792 | $(8,349,808) | $5,193,707 |

See Notes to Consolidated Financial Statements.

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

| (unaudited) | Shares of Common Stock | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|---|---|
| NINE MONTHS ENDED SEPTEMBER 30, 2013 | | | | | | |
| Balance at beginning of period | 4,959,009 | $24,795,045 | $16,391,845 | $48,304,609 | $(191,463) | $89,300,036 |
| Net income | 0 | 0 | 0 | 2,953,476 | 0 | 2,953,476 |
| Other comprehensive loss, net of tax | 0 | 0 | 0 | 0 | (11,303,284) | (11,303,284) |
| Cash dividends ($0.16 per share) | 0 | 0 | 0 | (793,441) | 0 | (793,441) |
| Balance at end of period | 4,959,009 | $24,795,045 | $16,391,845 | $50,464,644 | $(11,494,747) | $80,156,787 |
| NINE MONTHS ENDED SEPTEMBER 30, 2012 | | | | | | |
| Balance at beginning of period | 4,959,009 | $24,795,045 | $16,309,983 | $45,109,268 | $(349,581) | $85,864,715 |
| Net income | 0 | 0 | 0 | 2,790,696 | 0 | 2,790,696 |
| Other comprehensive income, net of tax | 0 | 0 | 0 | 0 | 2,403,011 | 2,403,011 |
| Stock compensation expense | 0 | 0 | 81,060 | 0 | 0 | 81,060 |
| Cash dividends ($0.15 per share) | 0 | 0 | 0 | (743,851) | 0 | (743,851) |
| Balance at end of period | 4,959,009 | $24,795,045 | $16,391,043 | $47,156,113 | $2,053,430 | $90,395,631 |

See Notes to Consolidated Financial Statements.

Old Point Financial Corporation and Subsidiaries
Consolidated Statements of Cash Flows

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2013 | 2012 |
| | (unaudited) | |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | $2,953,476 | $2,790,696 |
| | | |
| Depreciation and amortization | 1,471,114 | 1,411,040 |
| Provision for loan losses | 800,000 | 1,950,000 |
| Net (gain) loss on sale of available-for-sale securities | 25,717 | (1,703,805) |
| Net amortization of securities | 1,947,709 | 1,142,043 |
| Net loss on disposal of premises and equipment | 22,666 | 396 |
| Net loss on write-down/sale of other real estate owned | 268,910 | 736,594 |
| Income from bank owned life insurance | (647,133) | (1,142,626) |
| Stock compensation expense | 0 | 81,060 |
| Deferred tax (benefit) expense | (59,203) | 110,235 |
| (Increase) decrease in other assets | (777,574) | 1,653,149 |
| Increase in other liabilities | 987,853 | 993,695 |
| Net cash provided by operating activities | 6,993,535 | 8,022,477 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of available-for-sale securities | (12,742,008) | (277,741,641) |
| Purchases of held-to-maturity securities | (25,770,691) | 0 |
| Proceeds from sales of restricted securities | 183,800 | 889,100 |
| Proceeds from maturities and calls of securities | 35,340,464 | 59,843,643 |
| Proceeds from sales of available-for-sale securities | 62,131,923 | 147,178,925 |
| (Increase) decrease in loans made to customers | (11,610,600) | 53,071,871 |
| Proceeds from sales of other real estate owned | 1,386,147 | 2,461,219 |
| Proceeds from payout on bank-owned life insurance policy | 0 | 1,109,296 |
| Purchases of premises and equipment | (7,935,599) | (2,226,964) |
| Net cash provided by (used in) investing activities | 40,983,436 | (15,414,551) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Increase in noninterest-bearing deposits | 3,721,977 | 12,551,450 |
| Increase in savings deposits | 11,325,120 | 15,417,220 |
| Increase (decrease) in time deposits | (38,039,248) | 12,826,761 |
| Increase in federal funds purchased, repurchase agreements and other borrowings | 205,345 | 2,062,241 |
| Decrease in Federal Home Loan Bank advances | 0 | (10,000,000) |
| Cash dividends paid on common stock | (793,441) | (743,851) |
| Net cash provided by (used in) financing activities | (23,580,247) | 32,113,821 |
| | | |
| Net increase in cash and cash equivalents | 24,396,724 | 24,721,747 |
| Cash and cash equivalents at beginning of period | 42,317,246 | 24,854,656 |
| Cash and cash equivalents at end of period | $66,713,970 | $49,576,403 |
| | | |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | |
| Cash payments for: | | |

| | | |
|---|---|---|
| Interest | $3,664,860 | $4,526,922 |
| Income tax | $550,000 | $600,000 |
| | | |
| SUPPLEMENTAL SCHEDULE OF NONCASH TRANSACTIONS | | |
| Unrealized gain (loss) on securities available-for-sale | $(10,962,474) | $3,640,925 |
| Loans transferred to other real estate owned | $1,431,901 | $564,480 |
| Former branch site transferred from fixed assets to other real estate owned | $506,296 | $0 |
| Securities transferred from available-for-sale to held-to-maturity | $68,015,458 | $0 |
| Unrealized loss on securities transferred from available-for-sale to held-to-maturity | $(6,231,880 ) | $0 |
| Amortization of unrealized loss on securities transferred to held-to-maturity | $68,166 | $0 |

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. General

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

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

AVAILABLE INFORMATION

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

SUBSEQUENT EVENTS

In accordance with Accounting Standards Codification (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) unrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

The Company is expanding the building of a current branch office. The Company signed a contract with a general contractor on April 19, 2012. The contract entitles the contractor to $2.1 million for Phase I of the construction, which includes site work and construction of the building shell. The Company signed an amendment to the contract with the general contractor on October 16, 2012 for the remainder of the construction. The revised contract entitles the contractor to $12.2 million for the construction of the building. As of the writing of this quarterly report on Form 10-Q, $9.3 million had been disbursed to the contractor. The Company anticipates that the total project will likely cost between $13.0 million and $15.0 million and be completed in the next six months.

On September 6, 2013, the Company completed the consolidation of two of its branches located in Chesapeake, Virginia. Because of their proximity, the branches were serving a customer base that could be more efficiently served by one branch. The furniture and equipment from the closed branch has been redeployed or disposed of.  The Company will be using the closed branch location for non-branch personnel; therefore this location will not be

transferred to other real estate owned (OREO).

On September 20, 2013, the Company completed the consolidation of two of its branches located in Newport News, Virginia. Because of their proximity, the branches were serving a customer base that could be more efficiently served by one branch. The value of furniture and equipment from the closed branch that has not been fully depreciated and needs to be redeployed is $8 thousand and the value of the furniture and equipment that needs to be disposed of is $6 thousand. The Company transferred to OREO the book value of the land and building for the closed branch location in the amount of $379 thousand in October 2013.

On October 1, 2013, Old Point Trust & Financial Services (Trust), a wholly-owned subsidiary of Old Point Financial Corporation, acquired Penact Associates, Inc. Trust paid $12 thousand for its assets and entered into three employee agreements.

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

Note 2. Securities

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | (in thousands) | | | |
| September 30, 2013 | | | | |
| Obligations of U.S. Government agencies | $570 | $ 2 | $ (5 ) | $567 |
| Obligations of state and political subdivisions | 25,669 | 3 | (716 ) | 24,956 |
| Mortgage-backed securities | 67,580 | 1,735 | 0 | 69,315 |
| Total | $93,819,000 | $ 1,740 | $ (721 ) | $94,838,000 |
| | | | | |
| December 31, 2012 | | | | |
| Obligations of U.S. Government agencies | $570 | $ 4 | $ 0 | $574,000 |

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | (in thousands) | | | |
| September 30, 2013 | | | | |
| Obligations of U.S. Government agencies | $15,193 | $ 249 | $ (378 ) | $15,064 |
| Obligations of state and political subdivisions | 51,362 | 77 | (4,389 ) | 47,050 |
| Mortgage-backed securities | 97,245 | 0 | (3,477 ) | 93,768 |
| Money market investments | 892 | 0 | 0 | 892 |
| Corporate bonds | 1,399 | 0 | (26 ) | 1,373 |
| Total | $166,091 | $ 326 | $ (8,270 ) | $158,147 |
| | | | | |
| December 31, 2012 | | | | |
| Obligations of U.S. Government agencies | $35,787 | $ 1,314 | $ (13 ) | $37,088 |
| Obligations of state and political subdivisions | 43,276 | 712 | (214 ) | 43,774 |
| Mortgage-backed securities | 246,132 | 1,966 | (743 ) | 247,355 |
| Money market investments | 541 | 0 | 0 | 541 |
| Corporate bonds and other securities | 700 | 0 | (2 ) | 698 |
| Total | $326,436 | $ 3,992 | $ (972 ) | $329,456 |

On August 31, 2013, the Company transferred $68.0 million of mortgage-back securities from available-for-sale to held-to-maturity. On the date of transfer, the transferred securities had an amortized cost of $74.2 million and an

unrealized loss of $6.2 million. The unrealized loss on the transferred securities continues to be recognized as a component of accumulated other comprehensive loss within the Company's consolidated stockholder's equity (net of income tax benefit) and will be amortized over the remaining life of the securities using the effective interest method. During the period of September 1, 2013 through September 30, 2013, amortization of this unrealized loss totaled $68 thousand.

OTHER-THAN-TEMPORARILY IMPAIRED SECURITIES

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

The present value of expected future cash flows is determined using the best-estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best-estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds, and structural support, including subordination and guarantees.

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, 2013 or the year ended December 31, 2012.

TEMPORARILY IMPAIRED SECURITIES

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

| | September 30, 2013 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Less Than Twelve Months | | More Than Twelve Months | | Total | | |
| | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Number of Securities |
| | (in thousands) | | | | | | |
| Securities Available-for-Sale | | | | | | | |
| Debt securities: | | | | | | | |
| Obligations of U.S. Government agencies | $378 | $4,454 | $0 | $0 | $378 | $4,454 | 1 |
| Obligations of state and political subdivisions | 4,251 | 40,686 | 138 | 1,944 | 4,389 | 42,630 | 83 |
| Mortgage-backed securities | 2,863 | 84,487 | 614 | 9,282 | 3,477 | 93,769 | 12 |
| Corporate bonds | 24 | 1,175 | 2 | 98 | 26 | 1,273 | 10 |
| Total securities available-for-sale | $7,516 | $130,802 | $754 | $11,324 | $8,270 | $142,126 | 106 |
| | | | | | | | |
| Securities Held-to-Maturity | | | | | | | |
| Obligations of U.S. Government agencies | $5 | $95 | $0 | $0 | $5 | $95 | 1 |
| Obligations of state and political subdivisions | 716 | 20,635 | 0 | 0 | 716 | 20,635 | 42 |
| Total securities held-to-maturity | $43 | $20,730 | $0 | $0 | $721 | $20,730 | 43 |

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

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

Restricted Securities

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

Note 3. Loans and the Allowance for Loan Losses

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

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Mortgage loans on real estate: | | |
| Residential 1-4 family | $ 81,982 | $ 77,267 |
| Commercial | 285,811 | 274,613 |
| Construction | 12,624 | 12,005 |
| Second mortgages | 12,976 | 14,315 |
| Equity lines of credit | 31,155 | 32,327 |
| Total mortgage loans on real estate | 424,548 | 410,527 |
| Commercial loans | 29,880 | 25,341 |
| Consumer loans | 10,260 | 13,146 |
| Other | 15,479 | 22,119 |
| Total loans | 480,167 | 471,133 |
| Less: Allowance for loan losses | 6,980 | 7,324 |
| Loans, net of allowance and deferred fees | $ 473,187 | $ 463,808 |

Overdrawn deposit accounts are reclassified as loans and included in the Other category in the table above. Overdrawn deposit accounts totaled $780 thousand and $1.6 million at September 30, 2013 and December 31, 2012, respectively.

CREDIT QUALITY INFORMATION

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

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

- Pass: Loans are of acceptable risk.
- Other Assets Especially Mentioned (OAEM): Loans have potential weaknesses that deserve management's close attention.
- Substandard: Loans reflect significant deficiencies due to several adverse trends of a financial, economic or managerial nature.
- Doubtful: Loans have all the weaknesses inherent in a substandard loan with added characteristics that make collection or liquidation in full based on currently existing facts, conditions and values highly questionable or improbable.

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

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

Credit Quality Information
As of September 30, 2013
(in thousands)

| | Pass | OAEM | Substandard | Total |
|---|---|---|---|---|
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | $75,763 | $1,175 | $ 5,044 | $81,982 |
| Commercial | 271,020 | 6,245 | 8,546 | 285,811 |
| Construction | 9,916 | 162 | 2,546 | 12,624 |
| Second mortgages | 12,905 | 0 | 71 | 12,976 |
| Equity lines of credit | 30,679 | 0 | 476 | 31,155 |
| Total mortgage loans on real estate | 400,283 | 7,582 | 16,683 | 424,548 |
| Commercial loans | 28,750 | 110 | 1,020 | 29,880 |
| Consumer loans | 10,229 | 0 | 31 | 10,260 |
| Other | 15,479 | 0 | 0 | 15,479 |
| Total | $454,741 | $7,692 | $ 17,734 | $480,167 |

Credit Quality Information
As of December 31, 2012
(in thousands)

| | Pass | OAEM | Substandard | Total |
|---|---|---|---|---|
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | $70,961 | $1,711 | $ 4,595 | $77,267 |
| Commercial | 258,195 | 6,781 | 9,637 | 274,613 |
| Construction | 8,651 | 254 | 3,100 | 12,005 |
| Second mortgages | 13,488 | 242 | 585 | 14,315 |
| Equity lines of credit | 31,704 | 239 | 384 | 32,327 |
| Total mortgage loans on real estate | 382,999 | 9,227 | 18,301 | 410,527 |
| Commercial loans | 23,997 | 209 | 1,135 | 25,341 |
| Consumer loans | 13,042 | 0 | 104 | 13,146 |
| Other | 22,119 | 0 | 0 | 22,119 |
| Total | $442,157 | $9,436 | $ 19,540 | $471,133 |

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

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, 2013

| | 30 - 59 Days Past Due | 60 - 89 Days Past Due | 90 or More Days Past Due | Total Past Due | Total Current Loans (1) | Total Loans | Recorded Investment > 90 Days Past Due and Accruing |
|---|---|---|---|---|---|---|---|
| | (in thousands) | | | | | | |
| Mortgage loans on real estate: | | | | | | | |
| Residential 1-4 family | $649 | $174 | $4,098 | $4,921 | $77,061 | $81,982 | $ 0 |
| Commercial | 1,263 | 0 | 2,608 | 3,871 | 281,940 | 285,811 | 0 |
| Construction | 0 | 402 | 2,545 | 2,947 | 9,677 | 12,624 | 0 |
| Second mortgages | 29 | 0 | 0 | 29 | 12,947 | 12,976 | 0 |
| Equity lines of credit | 121 | 0 | 0 | 121 | 31,034 | 31,155 | 0 |
| Total mortgage loans on real estate | 2,062 | 576 | 9,251 | 11,889 | 412,659 | 424,548 | 0 |
| Commercial loans | 35 | 1,025 | 0 | 1,060 | 28,820 | 29,880 | 0 |
| Consumer loans | 55 | 24 | 13 | 92 | 10,168 | 10,260 | 13 |
| Other | 62 | 17 | 5 | 84 | 15,395 | 15,479 | 5 |
| Total | $2,214 | $1,642 | $9,269 | $13,125 | $467,042 | $480,167 | $ 18 |

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

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

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

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

NONACCRUAL LOANS

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

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

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

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

Nonaccrual Loans by Class

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Mortgage loans on real estate: | | |
| Residential 1-4 family | $4,350 | $ 3,663 |
| Commercial | 3,005 | 3,037 |
| Construction | 2,546 | 3,065 |
| Second mortgages | 0 | 484 |
| Equity lines of credit | 0 | 286 |
| Total mortgage loans on real estate | 9,901 | 10,535 |
| Commercial loans | 0 | 97 |
| Consumer loans | 0 | 0 |
| Total | $9,901 | $ 10,632 |

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2013 | 2012 |

| | (in thousands) | |
|---|---|---|
| Interest income that would have been recorded under original loan terms | $482 | $823 |
| Actual interest income recorded for the period | 95 | 235 |
| Reduction in interest income on nonaccrual loans | $387 | $588 |

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 discussed further under Impaired Loans below.

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

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

| | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification | Current Investment on September 30, 2013 |
|---|---|---|---|---|
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | 3 | $ 488 | $ 488 | $ 487 |

Troubled Debt Restructuings by Class
For the Three Months Ended September 30, 2012
(dollars in thousands)

| | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification | Current Investment on September 30, 2012 |
|---|---|---|---|---|
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | 1 | $ 93 | $ 87 | $ 71 |
| Commercial | 1 | 467 | 467 | 425 |
| Total | 2 | $ 560 | $ 554 | $ 496 |

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

| | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification | Current Investment on September 30, 2013 |
|---|---|---|---|---|
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | 6 | $ 1,164 | $ 1,164 | $ 1,158 |
| Commercial | 1 | 207 | 207 | 200 |
| Total | 7 | $ 1,371 | $ 1,371 | $ 1,358 |

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

| | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification | Current Investment on September 30, 2012 |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | 1 | $ 93 | $ 87 | $ 72 |
| Commercial | 3 | 3,486 | 2,928 | 2,782 |
| Second mortgages | 1 | 111 | 145 | 139 |
| Total | 5 | $ 3,690 | $ 3,160 | $ 2,993 |

The seven loans restructured in the first nine months of 2013 were all given below-market rates for debt with similar risk characteristics. During the first nine months of 2012, three restructurings were given principal reductions totaling $530 thousand; one of the three loans given principal reductions was also given a below-market rate for debt with similar risk characteristics; and two loans were given below-market rates but were not given principal reductions.

The following table presents TDRs for the three and nine months ended September 30, 2013 for which there was a payment default where the default occurred within twelve months of restructuring.

Restructurings that Subsequently Defaulted
As of September 30, 2013
(in thousands)

| | Recorded Investment in Defaulting Loans |
|---|---|
| Mortgage loans on real estate | |
| Residential 1 - 4 family | $79,000 |
| Commercial | 1,829,000 |
| Total | $1,908,000 |

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

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

IMPAIRED LOANS

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

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

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

Impaired Loans by Class
(in thousands)

| | As of September 30, 2013 | | | | For the nine months ended September 30, 2013 | |
|---|---|---|---|---|---|---|
| | Unpaid Principal Balance | Recorded Investment Without Valuation Allowance | Recorded Investment With Valuation Allowance | Associated Allowance | Average Recorded Investment | Interest Income Recognized |
| Mortgage loans on real estate: | | | | | | |
| Residential 1-4 family | $5,943 | $1,443 | $4,236 | $1,065 | $5,053 | $71 |
| Commercial | 12,563 | 3,472 | 6,156 | 571 | 10,414 | 317 |
| Construction | 3,305 | 0 | 2,546 | 149 | 2,880 | 0 |
| Second mortgages | 147 | 7 | 135 | 135 | 546 | 5 |
| Equity lines of credit | 0 | 0 | 0 | 0 | 193 | 0 |
| Total mortgage loans on real estate | $21,958 | $4,922 | $13,073 | $1,920 | $19,086 | $393 |
| Commercial loans | 0 | 0 | 0 | 0 | 8 | 0 |
| Consumer loans | 16 | 0 | 16 | 0 | 17 | 1 |
| Total | $21,974 | $4,922 | $13,089 | $1,920 | $19,111 | $394 |

Impaired Loans by Class
(in thousands)

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

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

Loan officers are responsible for continual portfolio analysis and prompt identification and reporting of problem loans, which includes assigning a risk grade to each applicable loan at its origination and revising such grade as the situation dictates. Loan officers maintain frequent contact with borrowers, which should enable the loan officer to identify potential problems before other personnel. In addition, meetings with loan officers and upper management are held to discuss problem loans and review risk grades. Nonetheless, in order to avoid over-reliance upon loan officers for problem loan identification, the Company's loan review system provides for review of loans and risk grades by individuals who are independent of the loan approval process. Risk grades and historical loss rates by risk grades are used as a component of the calculation of the allowance for loan losses.

ALLOWANCE FOR LOAN LOSSES

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. Prior to the September 30, 2013 calculation of the allowance for loan losses, the Company segmented certain loans in the portfolio by product type according to internally established criteria. Beginning with the September 30, 2013 calculation, the Company segmented the loans in the portfolio by the categories defined by Schedule RC-C of the Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income Form 041 (Call Report). Management believes that using the Call Report categories to segment loans for this purpose results in increased efficiency and accuracy in the determination of the adequacy of the allowance for loan losses. Loans were and continue to be 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. While the pools remain the same, management believes the use of the Call Report criteria to categorize loans within the pools results in loans being placed in the pool that most closely reflects each loan's risk profile.

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.

The use of the Call Report categories did not result in any change to the segments' risk characteristics. 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.

Prior to September 30, 2013, management pooled each segment by risk grade and applied a historical loss percentage to determine the balance of the allowance account for each segment of the loan portfolio. Beginning with the calculation for September 30, 2013, the Company converted the analysis of the adequacy of the allowance for loan loss to a software program that uses migration analysis on pooled segments by risk grade or by days past due. 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. The migration analysis applied to all pools is able to track the risk grading and historical performance of individual loans throughout an eight-quarter period, which provides management with more information regarding trends (or migrations) in a particular loan segment. Management believes the additional

information provided by the migration analysis results in more accurate historical loss information.

THE COMPANY'S ESTIMATION PROCESS

Loans are either individually evaluated for impairment or pooled with like loans and collectively evaluated for impairment. Also, various qualitative factors are applied to each segment of the loan portfolio. The allowance for loan losses is the accumulation of these components. Management's estimate is based on certain observable, historical data that management believes are most reflective of the underlying credit losses being estimated.

Management provides an allocated component of the allowance for loans that are individually evaluated for impairment. An allocated allowance is established when the discounted value of future cash flows from the impaired loan (or the collateral value or observable market price of the impaired loan) is lower than the carrying value of that loan. This allocation represents the sum of management's estimated losses on each loan.

Loans collectively evaluated for impairment are pooled, with a historical loss rate applied to each pool. This historical loss rate at September 30, 2013 was based on a migration analysis of the portfolio over the previous eight quarters. At December 31, 2012, the historical loss percentage was based on losses sustained in each segment of the portfolio over the previous eight quarters. See the discussion of changes in accounting methodology below for additional explanation.

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 loan losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses of $7.0 million adequate to cover loan losses inherent in the loan portfolio at September 30, 2013.

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 September 30, 2013 | Commercial | Real Estate - Construction | Real Estate - Mortgage | Consumer | Other | Total |
|---|---|---|---|---|---|---|
| Allowance for Loan Losses: | | | | | | |
| Balance at the beginning of period | $ 677 | $ 187 | $6,179 | $ 204 | $77 | $7,324 |
| Charge-offs | (120) | (99) | (1,037) | (83) | (123) | (1,462) |
| Recoveries | 67 | 4 | 137 | 60 | 50 | 318 |
| Provision for loan losses | (368) | 516 | 504 | (13) | 161 | 800 |
| Ending balance | $ 256 | $ 608 | $5,783 | $ 168 | $165 | $6,980 |
| Ending balance individually evaluated for impairment | $ 0 | $ 149 | $1,771 | $ 0 | $0 | $1,920 |
| Ending balance collectively evaluated for impairment | 256 | 459 | 4,012 | 168 | 165 | 5,060 |
| Ending balance | $ 256 | $ 608 | $5,783 | $ 168 | $165 | $6,980 |
| Loan Balances: | | | | | | |
| Ending balance individually evaluated for impairment | $ 0 | $ 2,546 | $15,449 | $ 16 | $0 | $18,011 |
| Ending balance collectively evaluated for impairment | 29,880 | 10,078 | 396,475 | 10,244 | 15,479 | 462,156 |
| Ending balance | $ 29,880 | $ 12,624 | $411,924 | $ 10,260 | $15,479 | $480,167 |

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

CHANGES IN ACCOUNTING METHODOLOGY

On September 30, 2013, the Company converted the analysis of the adequacy of the allowance for loan loss from a manual input process using Excel spreadsheets to a more automated process using information downloaded from the loan subsystem to a software program. The program streamlines reserve estimation with a consistent and defensible methodology, automates a cumbersome, manual process to allow more time for analysis, and minimizes the risk of human error which ensures better and more accurate calculations. The automation is primarily used to input and aggregate information and to provide the analysis regarding migration trends. It enhances but does not replace management's subjective analysis of historical loss rates, credit risk and qualitative factors.

The change in the calculation is in the method by which the historic loss on balances collectively evaluated for impairment is determined. Prior to September 30, 2013, management pooled each segment by risk grade and applied a historical loss percentage to determine the balance of the allowance account for each segment of the loan portfolio. Beginning with the September 30, 2013 calculation, the Company uses migration analysis on pooled segments by risk grade or by days past due. In addition, the collectively evaluated impairment pools were based on internally defined product types under the previous method. Beginning with the September 30, 2013, calculation, the collectively evaluated impairment pools are categorized using federal Call Report definitions.

Under the previous method, the pass loan pool actual loss experience was 0% but this experience was given an override in a very conservative manner by using the loss experience for the entire loan portfolio for the average of the past eight quarters. This method was considered extremely conservative as it included the historical loss experience for the riskier OAEM and Substandard rated credits which were already accounted for in their own allocations. Under the current method, which uses migration analysis, an override is no longer needed because migration analysis tracks the movement of loans through the various loan classifications in order to estimate the percentage of losses likely to be incurred in the Company's current portfolio.
The following table represents the effect on the loan loss provision for the nine months ended September 30, 2013 as a result of the changes to the methodology from 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 | $(368) | $ (346) | $ (22) |
| Real estate - construction | 516 | 371 | 145 |
| Real estate - mortgage | 504 | 859 | (355) |
| Consumer loans | (13) | (64) | 51 |
| Other | 161 | 36 | 125 |
| Total | $800 | $ 856 | $ (56) |

Under the previous method, the provisions for real estate – construction and real estate – mortgage were calculated on the same pool of loans, with loss rates for that aggregated pool applied to the loan balances in those segments, even though the two segments have different risk characteristics and performance history. Under the current method, the historical loss rate on construction loans is calculated separately from other real estate loans, providing a more precise estimate of the Company's true historical losses.

The other loans segment in the table above includes overdrafts on deposit accounts. The new method allows management to perform a more granular analysis of overdrawn accounts.

Note 4. Share-Based Compensation

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

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

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

Stock option activity for the nine months ended September 30, 2013 is summarized below:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Options outstanding, January 1, 2013 | 156,960 | $ 22 | | |
| Granted | 0 | 0 | | |
| Exercised | 0 | 0 | | |
| Canceled or expired | (2,500 ) | 22 | | |
| Options outstanding, September 30, 2013 | 154,460 | $ 22 | 2.71 | $ 0 |
| Options exercisable, September 30, 2013 | 154,460 | $ 22 | 2.71 | $ 0 |

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

No options were exercised during the nine months ended September 30, 2013.

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



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Note 5. Pension Plan

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

| Three months ended September 30, | 2013 | 2012 |
|---|---|---|
| | Pension Benefits | |
| Interest cost | $63,178 | $72,889 |
| Expected return on plan assets | (87,165) | (82,743) |
| Loss related to early retirement plan | 0 | 291,829 |
| Amortization of net loss | 76,771 | 84,330 |
| Net periodic pension plan cost | $52,784 | $366,305 |

| Nine months ended September 30, | 2013 | 2012 |
|---|---|---|
| Interest cost | $189,144 | $216,389 |
| Expected return on plan assets | (263,963) | (277,743) |
| Loss related to early retirement plan | 0 | 291,829 |
| Amortization of net loss | 225,819 | 196,830 |
| Net periodic pension plan cost | $151,000 | $427,305 |

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

Note 6. Stockholders' Equity and Earnings per Share

STOCKHOLDERS' EQUITY – OTHER COMPREHENSIVE INCOME (LOSS)

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Affected Line Item on Consolidated Statement of Income |
|---|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 | |
| Available-for-sale securities | | | | | |
| Realized gains (losses) on sales of securities | $ (5) | $ 620 | $ (26) | $ 1,704 | Gain (loss) on sale of available-for-sale securities, net |
| Tax effect | (2) | 211 | (9) | 579 | Income tax expense |
| | $ (3) | $ 409 | $ (17) | $ 1,125 | Net of tax |

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

| | Unrealized Gains (Losses) on Securities | Unrealized Losses on Securities Transferred to Held-to-Maturity | Defined Benefit Pension Plans | Accumulated Other Comprehensive Loss |
|---|---|---|---|---|
| | (in thousands) | | | |
| Nine Months Ended September 30, 2013 | | | | |
| Balance at beginning of period | $1,992 | $ 0 | $(2,184) | $ 0 |
| Net change for the period | (7,235) | (4,068) | 0 | (11) |
| Balance at end of period | $(5,243) | $ (4,068) | $(2,184) | $ (11) |

| | Unrealized Gains (Losses) on Securities | Unrealized Losses on Securities Transferred to Held-to-Maturity | Defined Benefit Pension Plans | Accumulated Other Comprehensive Loss |
|---|---|---|---|---|
| | (in thousands) | | | |
| Nine Months Ended September 30, 2012 | | | | |
| Balance at beginning of period | $ 1,525 | $ 0 | $ (1,875) | $ (1,875) |
| Net change for the period | 2,403 | 0 | $ 0 | 0 |
| Balance at end of period | $ 3,928 | $ 0 | (1,875) | $ 2 |

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

| | Nine Months Ended September 30, 2013 | | |
|---|---|---|---|
| | Pretax | Tax Expense (Benefit) | Net-of-Tax |
| | (in thousands) | | |
| Unrealized losses on securities | | | |
| Unrealized holding losses arising during the period | $ (10,988) | $ (3,736) | $ (7,252) |
| Less reclassification adjustment for losses recognized in income | (26) | (9) | (17) |
| Net unrealized losses on securities | (10,962) | (3,727) | (7,235) |
| Market adjustment on securities transferred to held-to-maturity | | | |
| Unrealized loss transferred | (6,232) | (2,119) | (4,113) |
| Amortization | 68 | 23 | 45 |
| Net effect of market adjustment on securities transferred to held-to-maturity | (6,164) | (2,096) | (4,068) |
| Total decrease in other comprehensive loss | $ (17,126) | $ (5,823) | $ (11,303) |

| | Nine Months Ended September 30, 2012 | | |
|---|---|---|---|
| | Pretax | Tax Expense (Benefit) | Net-of-Tax |
| | (in thousands) | | |
| Unrealized gains on securities | | | |
| Unrealized holding gains arising during the period | $5,345 | $1,817 | $3,528 |
| Less reclassification adjustment for gains recognized in income | 1,704 | 579 | 1,125 |
| Net unrealized gains on securities | 3,641 | 1,238 | 2,403,000 |
| | | | |
| Total increase in other comprehensive loss | $3,641 | $1,238 | $2,403 |

EARNINGS PER COMMON SHARE

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

The Company did not include an average of 155 thousand potential common shares attributable to outstanding stock options in the diluted earnings per share calculation for the first nine months of 2013 because they were antidilutive.

Note 7. Recent Accounting Pronouncements

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

In July 2013, the FASB issued ASU 2013-11, "Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." The amendments in this ASU provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

Note 8. Fair Value Measurements

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

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

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

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.

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 September 30, 2013 Using (in thousands) | | |
|---|---|---|---|---|
| Description | Balance | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-sale securities | | | | |
| Obligations of U.S. Government agencies | $15,064 | $0 | $15,064 | $ 0 |
| Obligations of state and political subdivisions | 47,050 | 0 | 47,050 | 0 |
| Mortgage-backed securities | 93,768 | 0 | 93,768 | 0 |
| Money market investments | 892 | 0 | 892 | 0 |
| Corporate bonds | 1,373 | 0 | 1,373 | 0 |
| Total available-for-sale securities | $158,147 | $0 | $158,147 | $ 0 |

| Description | Balance | Fair Value Measurements at December 31, 2012 Using (in thousands) Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Available-for-sale securities | | | | |
| Obligations of U.S. Government agencies | $37,088 | $0 | $37,088 | $ 0 |
| Obligations of state and political subdivisions | 43,774 | 0 | 43,774 | 0 |
| Mortgage-backed securities | 247,355 | 0 | 247,355 | 0 |
| Money market investments | 541 | 0 | 541 | 0 |
| Corporate bonds | 698 | 0 | 698 | 0 |
| Total available-for-sale securities | $329,456 | $0 | $329,456 | $ 0 |

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

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. 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.

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 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.

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 interest rate of the loan 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 30, 2013 Using (in thousands) | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Impaired loans | | | | |
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | $3,001 | $0 | $ 0 | $ 3,001 |
| Commercial | 2,201 | 0 | 0 | 2,201 |
| Construction | 2,396 | 0 | 0 | 2,396 |
| Total | $7,598 | $0 | $ 0 | $ 7,598 |
| | | | | |
| Other real estate owned | | | | |
| Residential 1-4 family | $216 | $0 | $ 0 | $ 216 |
| Commercial | 2,444 | 0 | 0 | 2,444 |
| Construction | 3,722 | 0 | 0 | 3,722 |
| Total | $6,382 | $0 | $ 0 | $ 6,382 |

| | Fair Value | Carrying Value at December 31, 2012 Using (in thousands) Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Impaired loans | | | | |
| Mortgage loans on real estate: | | | | |
| Residential 1-4 family | $3,009 | $0 | $ 0 | $ 3,009 |
| Commercial | 2,271 | 0 | 0 | 2,271 |
| Second mortgages | 42 | 0 | 0 | 42 |
| Total mortgage loans on real estate | $5,322 | $0 | $ 0 | $ 5,322 |
| Commercial loans | 64 | 0 | 0 | 64 |
| Total | $5,386 | $0 | $ 0 | $ 5,386 |
| | | | | |
| Other real estate owned | | | | |
| Residential 1-4 family | $676 | $0 | $ 0 | $ 676 |
| Commercial | 2,094 | 0 | 0 | 2,094 |
| Construction | 3,804 | 0 | 0 | 3,804 |
| Total | $6,574 | $0 | $ 0 | $ 6,574 |

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

| Description | Fair Value at September 30, 2013 (in thousands) | Quantitative Information About Level 3 Fair Value Measurements Valuation Techniques | Unobservable Input | Range (Average) |
|---|---|---|---|---|
| Impaired loans | | | | |
| Residential 1-4 family real estate | 3,001 | Market comparables | Selling costs | 13% - 14% (13%) |
| | | | Liquidation discount | 6.50 % |
| Commercial real estate | 2,201 | Market comparables | Selling costs | 5% - 14% (10%) |
| | | | Liquidation discount | 10 % |
| Construction | 2,396 | Market comparables | Selling costs | 10 % |
| | | | Liquidation discount | 15.50 % |
| | | | | |
| Other real estate owned | | | | |

| | | | | |
|---|---|---|---|---|
| Residential 1-4 family | 216 | Market comparables | Selling costs | 6% - 10% (6%) |
| Commercial | 2,444 | Market comparables | Selling costs | 6% - 10% (6%) |
| Construction | 3,722 | Market comparables | Selling costs | 6% - 10% (6%) |

| Description | Fair Value at December 31, 2012 (in thousands) | Quantitative Information About Level 3 Fair Value Measurements | | |
|---|---|---|---|---|
| | | Valuation Techniques | Unobservable Input | Range (Average) |
| Impaired loans | | | | |
| Residential 1-4 family real estate | 3,009 | Market comparables | Differences in comparables | 0% - 5% (5%) |
| | | | Selling costs | 4.75% - 6% (6%) |
| Commercial real estate | 2,271 | Market comparables | Selling costs | 0% - 6% (4%) |
| Second mortgages | 42 | Market comparables | Selling costs | 6 % |
| Commercial loans | 64 | Market comparables | Differences in comparables | 25 % |
| Other real estate owned | | | | |
| Residential 1-4 family | 676 | Market comparables | Selling costs | 6% - 10% (6%) |
| Commercial | 2,094 | Market comparables | Selling costs | 6% - 10% (6%) |
| Construction | 3,804 | Market comparables | Selling costs | 6% - 10% (6%) |

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 Federal Reserve Bank 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 Federal Reserve Bank 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. 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. 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. Fair values for non-performing loans are estimated as described above.

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.

DEPOSIT LIABILITIES

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 deposits 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.

SHORT-TERM BORROWINGS

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.

LONG-TERM BORROWINGS

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, 2013 and December 31, 2012, the fair value of fees charged for loan commitments and irrevocable letters of credit was immaterial.

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

| | | Fair Value Measurements at September 30, 2013 Using (in thousands) | | |
|---|---|---|---|---|
| | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | | |
| Cash and cash equivalents | $66,714 | $66,714 | $ 0 | $ 0 |
| Securities available-for-sale | 158,147 | 0 | 158,147 | 0 |
| Securities held-to-maturity | 93,819 | 0 | 94,838 | 0 |
| Restricted securities | 2,378 | 0 | 2,378 | 0 |
| Loans, net of allowances for loan losses | 473,187 | 0 | 0 | 475,990 |
| Bank owned life insurance | 22,472 | 0 | 22,472 | 0 |
| Accrued interest receivable | 2,340 | 0 | 2,340 | 0 |
| | | | | |
| Liabilities | | | | |
| Deposits | $730,824 | $0 | $ 734,017 | $ 0 |
| Overnight repurchase agreements | 37,020 | 0 | 37,020 | 0 |
| Term repurchase agreements | 411 | 0 | 411 | 0 |
| Federal Home Loan Bank advances | 25,000 | 0 | 27,814 | 0 |
| Accrued interest payable | 350 | 0 | 350 | 0 |

| | | Fair Value Measurements at December 31, 2012 Using (in thousands) | | |
|---|---|---|---|---|
| | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | | |
| Cash and cash equivalents | $42,317 | $42,317 | $ 0 | $ 0 |
| Securities available-for-sale | 329,456 | 0 | 329,456 | 0 |
| Securities held-to-maturity | 570 | 0 | 574 | 0 |

| | | | | |
|---|---|---|---|---|
| Restricted securities | 2,562 | 0 | 2,562 | 0 |
| Loans, net of allowances for loan losses | 463,809 | 0 | 0 | 466,492 |
| Bank owned life insurance | 21,824 | 0 | 21,824 | 0 |
| Accrued interest receivable | 2,420 | 0 | 2,420 | 0 |
| | | | | |
| Liabilities | | | | |
| Deposits | $ 753,816 | $ 0 | $ 757,923 | $ 0 |
| Overnight repurchase agreements | 35,946 | 0 | 35,946 | 0 |
| Term repurchase agreements | 1,280 | 0 | 1,282 | 0 |
| Federal Home Loan Bank advances | 25,000 | 0 | 28,681 | 0 |
| Accrued interest payable | 439 | 0 | 439 | 0 |

Note 9. 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 interest 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.

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, 2013 and 2012 follows:

| | Three Months Ended September 30, 2013 | | | | |
|---|---|---|---|---|---|
| | Bank | Trust | Unconsolidated Parent | Eliminations | Consolidated |
| Revenues | | | | | |
| Interest and dividend income | $7,252,616 | $10,855 | $ 1,125,059 | $(1,125,197 ) | $7,263,333 |
| Income from fiduciary activities | 0 | 868,598 | 0 | 0 | 868,598 |
| Other income | 2,229,311 | 114,202 | 50,100 | (65,376 ) | 2,328,237 |
| Total operating income | 9,481,927 | 993,655 | 1,175,159 | (1,190,573 ) | 10,460,168 |
| | | | | | |
| Expenses | | | | | |
| Interest expense | 1,144,196 | 0 | 0 | (138 ) | 1,144,058 |
| Provision for loan losses | 300,000 | 0 | 0 | 0 | 300,000 |
| Salaries and employee benefits | 3,895,967 | 552,542 | 105,592 | 0 | 4,554,101 |
| Other expenses | 2,976,347 | 233,674 | 77,403 | (65,376 ) | 3,222,048 |
| Total operating expenses | 8,316,510 | 786,216 | 182,995 | (65,514 ) | 9,220,207 |
| | | | | | |
| Income before taxes | 1,165,417 | 207,439 | 992,164 | (1,125,059 ) | 1,239,961 |
| | | | | | |
| Income tax expense (benefit) | 177,434 | 70,363 | (45,180 ) | 0 | 202,617 |
| | | | | | |
| Net income | $987,983 | $137,076 | $ 1,037,344 | $(1,125,059 ) | $1,037,344 |
| | | | | | |
| Total assets | $871,935,454 | $5,585,758 | $ 80,160,864 | $(81,125,574) | $876,556,502 |

| | Three Months Ended September 30, 2012 | | | | |
|---|---|---|---|---|---|
| | Bank | Trust | Unconsolidated Parent | Eliminations | Consolidated |
| Revenues | | | | | |
| Interest and dividend income | $7,950,468 | $7,488 | $ 1,105,705 | $(1,105,434 ) | $7,958,227 |
| Income from fiduciary activities | 0 | 776,615 | 0 | 0 | 776,615 |
| Other income | 3,224,829 | 119,464 | 165,000 | (180,276 ) | 3,329,017 |
| Total operating income | 11,175,297 | 903,567 | 1,270,705 | (1,285,710 ) | 12,063,859 |

| | | | | | |
|---|---|---|---|---|---|
| Expenses | | | | | |
| Interest expense | 1,414,414 | 0 | 1,585 | (1,904) | 1,414,095 |
| Provision for loan losses | 750,000 | 0 | 0 | 0 | 750,000 |
| Salaries and employee benefits | 4,600,299 | 531,492 | 128,089 | 0 | 5,259,880 |
| Other expenses | 3,356,522 | 243,821 | 72,283 | (180,276) | 3,492,350 |
| Total operating expenses | 10,121,235 | 775,313 | 201,957 | (182,180) | 10,916,325 |
| Income before taxes | 1,054,062 | 128,254 | 1,068,748 | (1,103,530) | 1,147,534 |
| Income tax expense (benefit) | 35,348 | 43,438 | (5,440) | 0 | 73,346 |
| Net income | $1,018,714 | $84,816 | $ 1,074,188 | $(1,103,530) | $1,074,188 |
| Total assets | $883,610,555 | $5,335,378 | $ 90,524,865 | $(91,584,920) | $887,885,878 |

| | Nine Months Ended September 30, 2013 | | | | |
|---|---|---|---|---|---|
| | Bank | Trust | Unconsolidated Parent | Eliminations | Consolidated |
| Revenues | | | | | |
| Interest and dividend income | $22,339,561 | $30,065 | $ 3,181,900 | $(3,182,730 ) | $22,368,796 |
| Income from fiduciary activities | 0 | 2,634,092 | 0 | 0 | 2,634,092 |
| Other income | 6,647,281 | 358,942 | 150,300 | (196,278 ) | 6,960,245 |
| Total operating income | 28,986,842 | 3,023,099 | 3,332,200 | (3,379,008 ) | 31,963,133 |
| | | | | | |
| Expenses | | | | | |
| Interest expense | 3,577,023 | 0 | 0 | (830 ) | 3,576,193 |
| Provision for loan losses | 800,000 | 0 | 0 | 0 | 800,000 |
| Salaries and employee benefits | 12,334,787 | 1,621,208 | 324,616 | 0 | 14,280,611 |
| Other expenses | 9,117,323 | 677,292 | 171,778 | (196,278 ) | 9,770,115 |
| Total operating expenses | 25,829,133 | 2,298,500 | 496,394 | (197,108 ) | 28,426,919 |
| | | | | | |
| Income before taxes | 3,157,709 | 724,599 | 2,835,806 | (3,181,900 ) | 3,536,214 |
| | | | | | |
| Income tax expense (benefit) | 454,543 | 245,865 | (117,670 ) | 0 | 582,738 |
| | | | | | |
| Net income | $2,703,166 | $478,734 | $ 2,953,476 | $(3,181,900 ) | $2,953,476 |
| | | | | | |
| Total assets | $871,935,454 | $5,585,758 | $ 80,160,864 | $(81,125,574) | $876,556,502 |

| | Nine Months Ended September 30, 2012 | | | | |
|---|---|---|---|---|---|
| | Bank | Trust | Unconsolidated Parent | Eliminations | Consolidated |
| Revenues | | | | | |
| Interest and dividend income | $24,664,745 | $26,440 | $ 2,866,213 | $(2,865,361 ) | $24,692,037 |
| Income from fiduciary activities | 0 | 2,396,266 | 0 | 0 | 2,396,266 |
| Other income | 8,520,811 | 383,816 | 495,000 | (541,528 ) | 8,858,099 |
| Total operating income | 33,185,556 | 2,806,522 | 3,361,213 | (3,406,889 ) | 35,946,402 |
| | | | | | |
| Expenses | | | | | |
| Interest expense | 4,424,381 | 0 | 4,719 | (5,673 ) | 4,423,427 |
| Provision for loan losses | 1,950,000 | 0 | 0 | 0 | 1,950,000 |
| Salaries and employee benefits | 13,413,051 | 1,632,145 | 394,846 | 0 | 15,440,042 |
| Other expenses | 10,445,457 | 728,845 | 175,502 | (541,528 ) | 10,808,276 |
| Total operating expenses | 30,232,889 | 2,360,990 | 575,067 | (547,201 ) | 32,621,745 |
| | | | | | |
| Income before taxes | 2,952,667 | 445,532 | 2,786,146 | (2,859,688 ) | 3,324,657 |
| | | | | | |
| Income tax expense (benefit) | 387,534 | 150,977 | (4,550 ) | 0 | 533,961 |
| | | | | | |
| Net income | $2,565,133 | $294,555 | $ 2,790,696 | $(2,859,688 ) | $2,790,696 |
| | | | | | |
| Total assets | $883,610,555 | $5,335,378 | $ 90,524,865 | $(91,584,920) | $887,885,878 |

The accounting policies of the segments are the same as those described in the summary of significant accounting policies reported in the Company's 2012 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 10. Commitments and Contingencies

There have been no material changes in the Company's commitments and contingencies from those disclosed in the Company's 2012 annual report on Form 10-K. For a discussion of the Company's branch office expansion, see Note 1 of the Notes to the Consolidated Financial Statements included in this quarterly report on Form 10-Q.

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

The following discussion is intended to assist readers in understanding and evaluating the financial condition, changes in financial condition and the results of operations of the Company. The Company consists of the parent company and its wholly-owned subsidiaries, The Old Point National Bank of Phoebus (the Bank) and Old Point Trust & Financial Services, N. A. (Trust), collectively referred to as the Company. This discussion should be read in conjunction with the consolidated financial statements and other financial information contained elsewhere in this report.

Caution About Forward-Looking Statements

In addition to historical information, this report may contain forward-looking statements. For this purpose, any statement that is not a statement of historical fact may be deemed to be a forward-looking statement. These forward-looking statements may include, but are not limited to, statements regarding profitability including the focus on reducing time deposits, the net interest margin, strategies for managing the net interest margin and the expected impact of such efforts, liquidity, levels of cash and cash equivalents, the loan portfolio and expected trends in the quality of the loan portfolio, the allowance and provision for loan losses, the securities portfolio, interest rate sensitivity, asset quality, levels of net loan charge-offs and nonperforming assets, noninterest expense (and components of noninterest expense), the cost of expanding a current office building, noninterest income (and components of noninterest income), income taxes, expected impact of efforts to restructure the balance sheet, expected yields on the loan and securities portfolios, expected rates on interest-bearing liabilities, market risk, expected effects of the federal government's shut-down and automatic spending cuts (commonly known as sequestration), business and growth strategies, investment strategy and financial and other goals. Forward-looking statements often use words such as "believes," "expects," "plans," "may," "will," "should," "projects," "contemplates," "anticipates," "forecasts," "intends" or other words of similar meaning. These statements can also be identified by the fact that they do not relate strictly to historical or current facts. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, and actual results could differ materially from historical results or those anticipated by such statements.

There are many factors that could have a material adverse effect on the operations and future prospects of the Company including, but not limited to, changes in interest rates, general economic conditions, the effects of the federal government shut-down and sequestration on the Company's service area and the allowance for loan losses, the quality or composition of the loan or investment portfolios, the effects of management's investment strategy and strategy to manage the net interest margin, the adequacy of the Company's credit quality review processes, the level of nonperforming assets and charge-offs, the local real estate market, volatility and disruption in national and international financial markets, government intervention in the U.S. financial system, FDIC premiums and/or assessments, demand for loan and other banking products, levels of noninterest income and expense, deposit flows, competition, adequacy of the allowance for loan losses and changes in accounting principles, policies and guidelines. The Company could also be adversely affected by monetary and fiscal policies of the U.S. Government, as well as any regulations or programs implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) or other legislation and policies of the Office of the Comptroller of the Currency, U.S. Treasury and the Federal Reserve Board.

In July 2010, the President signed into law the Dodd-Frank Act, which implements far-reaching changes across the financial regulatory landscape. It is not clear what other impacts the Dodd-Frank Act, regulations promulgated thereunder and other regulatory initiatives of the Treasury and other bank regulatory agencies will have on the financial markets and the financial services industry.

These risks and uncertainties, in addition to the risks and uncertainties identified in the Company's 2012 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.

General

The Company is the parent company of the Bank and Trust. The Bank is a locally managed community bank serving the Hampton Roads localities of Hampton, Newport News, Norfolk, Virginia Beach, Chesapeake, Williamsburg/James City County, York County and Isle of Wight County. The Bank currently has 18 branch offices. In the first quarter of 2013 the Bank completed its combination of two of its branches located in Williamsburg. In the third quarter of 2013, the Bank consolidated two branches in Chesapeake and two branches in Newport News. Trust is a wealth management services provider.

Critical Accounting Policies and Estimates

During the third quarter of 2013, the Company changed its method for calculating the allowance for loan and lease losses. This change is discussed in detail in Note 3 of the Notes to the Consolidated Financial Statements included in this quarterly report on Form 10-Q. Other than this change, as of September 30, 2013, there have been no significant changes with regard to the critical accounting policies and estimates disclosed in the Company's 2012 annual report on Form 10-K.

Earnings Summary

Net income for the third quarter of 2013 was $1.0 million or $0.21 per diluted share as compared to net income of $1.1 million or $0.22 per diluted share for the third quarter of 2012. There were several primary differences between 2012 and 2013 that contributed to this result. In the third quarter of 2012, income from bank-owned life insurance was significantly impacted by the receipt of $475 thousand in proceeds from the death benefit on an insured former officer, while no such proceeds were received in the third quarter of 2013. In addition, sales of available-for-sale securities resulted in net gains for the third quarter of 2012, but sales of available-for-sale securities during the third quarter of 2013 resulted in net losses. Finally, income taxes and capital stock taxes were higher during the third quarter of 2013 than during the third quarter of 2012.

For the nine months ended September 30, 2013, net income was $3.0 million, 5.83% higher than net income for the first nine months of 2012. When comparing the first nine months of 2013 to the same period in 2012, the reduction in interest and fees on loans and the loss on sale of available-for sale securities were more than offset by higher income from fiduciary activities, lower interest expense, lower provision for loan losses and lower noninterest expense. Continued improvement in asset quality, as evidenced by lower charge-offs in the first nine months of 2013 when compared to the first nine months of 2012, allowed management to reduce the provision for loan losses.

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. Although both total interest and dividend income and total interest expense decreased during the three and nine months ended September 30, 2013, as compared to the same periods in 2012, total interest and dividend income decreased more than total interest expense, causing net interest income to decrease for the three and nine months ended September 30, 2013 compared to the three and nine months ended September 30, 2012.

Net interest income, on a fully tax-equivalent basis, was $6.3 million in the third quarter of 2013, a decrease of $344 thousand from the third quarter of 2012. Net interest income, on a fully tax-equivalent basis, was $19.3 million for the first nine months of 2013, a decrease of $1.3 million from the same period in 2012.

The net interest margin was 3.17% in the third quarter of 2013, 16 basis points lower than the 3.33% net interest margin in the equivalent period in 2012. The year-to-date net interest margin for 2013 was 3.18%, down 29 basis points from 3.47% for the first nine months of 2012. While the average rate on liabilities continues to decrease, the rate of change continues to slow as most longer-term deposits have already re-priced. During 2013, management has

focused on increasing lower-cost deposits primarily through sales efforts by employees and has allowed higher-cost time deposits to decrease through attrition. This focus can be seen by the fact that average interest-bearing transaction accounts and money market and savings deposits increased by $30.4 million and average time deposits decreased by $32.6 million when comparing the third quarter of 2013 to the third quarter of 2012. The focus on lower-cost deposits has contributed to the continued reduction in the average rate on liabilities. Management expects to continue the strategy to manage the net interest margin through the reduction in higher-cost time deposits until loan demand recovers significantly.

In addition, the average yield on loans decreased from 5.54% for the third quarter of 2012 to 4.97% for the third quarter of 2013, and from 5.63% for the first nine months of 2012 to 5.09% for the same period in 2013, as higher-yielding loans paid off or were renewed at current, lower rates. During the nine months ended September 30, 2013, as compared to the nine months ended September 30, 2012, the Company's earning asset portfolio continued the shift it has experienced over the past several years, with securities comprising an increasing percent of total earning assets and loans comprising a smaller percent. Because investment securities typically yield less than loans, this shift to lower-yielding investment securities continued to negatively impact the Company's net interest margin in the nine months ended September 30, 2013.

In the third quarter of 2013, however, this trend began to slow. Loans represented a larger percent of average earning assets in the third quarter of 2013 than in the same period of 2012, although the Company was still heavily invested in lower-yielding securities, and funds at the Federal Reserve were higher, on average, during the third quarter of 2013 as compared to the third quarter of 2012. Management expects that, if the economy continues to improve, average loans will continue to increase and that loans will continue to increase as a percent of total earning assets, although the increases may be gradual and may not follow a consistent pattern.

Tax-equivalent interest income decreased by $614 thousand in the third quarter of 2013 and by $2.1 million for the first nine months of 2013 compared to the same periods of 2012. Average earning assets decreased $1.8 million for the third quarter of 2013 and increased $17.2 million for the first nine months of 2013 compared to the same periods in 2012. Interest expense decreased $270 thousand for the third quarter of 2013 and $847 thousand for the first nine months of 2013 as compared to the third quarter and first nine months of 2012, respectively. The decrease in interest expense is primarily a result of the 20 basis-point decrease in the average rate on interest-bearing liabilities for the first nine months of 2013 compared to the same period in 2012.

The yield on average earning assets and cost of average interest-bearing liabilities both decreased due to the Federal Open Market Committee (FOMC) lowering the Federal Funds Target Rate during 2008 from 4.25% to a range of 0.00% to 0.25%. The FOMC has kept the Federal Funds Target Rate unchanged through September 30, 2013. As higher-yielding earning assets and higher-cost interest-bearing liabilities that were opened prior to 2008 mature, they are being replaced with lower-yielding earning assets and lower-cost interest-bearing liabilities. Assuming that the FOMC keeps interest rates at current levels, management believes that the decrease of the average rate on interest-bearing liabilities will continue to slow as a high percentage of the Company's interest-bearing liabilities have already re-priced. Management also believes that the average yield on loans will continue to decline due to increased competition for loans in the Company's markets, and as loans are renewed or refinanced at lower current market rates.

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, | | | | | |
|---|---|---|---|---|---|---|
| | 2013 | | | 2012 | | |
| | Average Balance | Interest Income/ Expense | Yield/ Rate** | Average Balance | Interest Income/ Expense | Yield/ Rate** |
| (dollars in thousands) | | | | | | |
| ASSETS | | | | | | |
| Loans* | $474,753 | $ 5,893 | 4.97 % | $469,487 | $ 6,508 | 5.54 % |
| Investment securities: | | | | | | |
| Taxable | 200,342 | 949 | 1.89 % | 263,325 | 1,229 | 1.87 % |
| Tax-exempt* | 62,634 | 559 | 3.57 % | 29,382 | 306 | 4.17 % |
| Total investment securities | 262,976 | 1,508 | 2.29 % | 292,707 | 1,535 | 2.10 % |
| Interest-bearing due from banks | 55,152 | 36 | 0.26 % | 32,203 | 17 | 0.21 % |
| Federal funds sold | 1,760 | 0 | 0.00 % | 1,581 | 0 | 0.00 % |
| Other investments | 3,308 | 25 | 3.02 % | 3,757 | 16 | 1.70 % |
| Total earning assets | 797,949 | $ 7,462 | 3.74 % | 799,735 | $ 8,076 | 4.04 % |
| Allowance for loan losses | (7,249 ) | | | (7,378 ) | | |
| Other nonearning assets | 80,235 | | | 79,293 | | |
| Total assets | $870,935 | | | $871,650 | | |
| | | | | | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| Time and savings deposits: | | | | | | |
| Interest-bearing transaction accounts | $11,127 | $ 2 | 0.07 % | $11,852 | $ 1 | 0.03 % |
| Money market deposit accounts | 201,851 | 52 | 0.10 % | 181,677 | 80 | 0.18 % |
| Savings accounts | 64,350 | 17 | 0.11 % | 53,398 | 14 | 0.10 % |
| Time deposits, $100,000 or more | 122,771 | 355 | 1.16 % | 134,959 | 441 | 1.31 % |
| Other time deposits | 153,655 | 402 | 1.05 % | 174,072 | 529 | 1.22 % |
| Total time and savings deposits | 553,754 | 828 | 0.60 % | 555,958 | 1,065 | 0.77 % |
| Federal funds purchased, repurchase agreements and other borrowings | 28,418 | 7 | 0.10 % | 25,269 | 11 | 0.17 % |
| Federal Home Loan Bank advances | 25,000 | 309 | 4.94 % | 27,391 | 338 | 4.94 % |
| Total interest-bearing liabilities | 607,172 | 1,144 | 0.75 % | 608,618 | 1,414 | 0.93 % |
| Demand deposits | 179,656 | | | 172,308 | | |
| Other liabilities | 3,392 | | | 2,346 | | |
| Stockholders' equity | 80,715 | | | 88,378 | | |
| Total liabilities and stockholders' equity | $870,935 | | | $871,650 | | |
| Net interest margin | | $ 6,318 | 3.17 % | | $ 6,662 | 3.33 % |

*Computed on a fully tax-equivalent basis using a 34% rate
**Annualized

| | For the nine months ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2013 | | | 2012 | | |
| (dollars in thousands) | Average Balance | Interest Income/ Expense | Yield/ Rate** | Average Balance | Interest Income/ Expense | Yield/ Rate** |
| ASSETS | | | | | | |
| Loans* | $466,801 | $17,809 | 5.09 % | $482,014 | $20,363 | 5.63 % |
| Investment securities: | | | | | | |
| Taxable | 249,939 | 3,526 | 1.88 % | 251,878 | 3,830 | 2.03 % |
| Tax-exempt* | 49,563 | 1,395 | 3.75 % | 21,771 | 673 | 4.12 % |
| Total investment securities | 299,502 | 4,921 | 2.19 % | 273,649 | 4,503 | 2.19 % |
| Interest-bearing due from banks | 36,134 | 69 | 0.25 % | 29,001 | 43 | 0.20 % |
| Federal funds sold | 1,824 | 1 | 0.07 % | 1,755 | 1 | 0.08 % |
| Other investments | 3,430 | 69 | 2.68 % | 4,100 | 61 | 1.98 % |
| Total earning assets | 807,691 | $22,869 | 3.78 % | 790,519 | $24,971 | 4.21 % |
| Allowance for loan losses | (7,359 ) | | | (7,897 ) | | |
| Other nonearning assets | 82,821 | | | 79,620 | | |
| Total assets | $883,153 | | | $862,242 | | |
| | | | | | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| Time and savings deposits: | | | | | | |
| Interest-bearing transaction accounts | $11,288 | $5 | 0.06 % | $11,617 | $5 | 0.06 % |
| Money market deposit accounts | 197,280 | 176 | 0.12 % | 176,865 | 238 | 0.18 % |
| Savings accounts | 61,390 | 46 | 0.10 % | 52,476 | 40 | 0.10 % |
| Time deposits, $100,000 or more | 128,732 | 1,120 | 1.16 % | 129,353 | 1,271 | 1.31 % |
| Other time deposits | 161,042 | 1,287 | 1.07 % | 172,853 | 1,638 | 1.26 % |
| Total time and savings deposits | 559,732 | 2,634 | 0.63 % | 543,164 | 3,192 | 0.78 % |
| Federal funds purchased, repurchase agreements and other borrowings | 30,545 | 26 | 0.11 % | 29,442 | 43 | 0.19 % |
| Federal Home Loan Bank advances | 25,000 | 916 | 4.89 % | 32,445 | 1,188 | 4.88 % |
| Total interest-bearing liabilities | 615,277 | 3,576 | 0.77 % | 605,051 | 4,423 | 0.97 % |
| Demand deposits | 178,927 | | | 167,701 | | |
| Other liabilities | 3,125 | | | 2,133 | | |
| Stockholders' equity | 85,824 | | | 87,357 | | |
| Total liabilities and stockholders' equity | $883,153 | | | $862,242 | | |
| Net interest margin | | $19,293 | 3.18 % | | $20,548 | 3.47 % |

*Computed on a fully tax-equivalent basis using a 34% rate
**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 credit losses that may be sustained in the loan portfolio. Management's evaluation included credit quality trends, collateral values, the findings of internal credit quality assessments and results from external bank 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.

The provision for loan losses was $300 thousand in the third quarter of 2013, as compared to $750 thousand in the third quarter of 2012 and was $800 thousand for the first nine months of 2013, as compared to $2.0 million for the first nine months of 2012. Management concluded that the provision was appropriate based on its analysis of the adequacy of the allowance for loan losses. The lower provision in the third quarter of 2013, as compared to the provision for the third quarter of 2012, was due to lower charge-offs and improvements in asset quality.

Net loans charged off were $1.1 million for the first nine months of 2013 as compared to $3.1 million for the first nine months of 2012. On an annualized basis, net loan charge-offs were 0.32% of total loans for the first nine months of 2013 compared with 0.91% for the same period in 2012. Net loans charged off for the first nine months of 2013 were relatively low as compared to net charge-offs of the past few years. Management anticipates that net charge-offs for the fourth quarter of 2013 will be below the elevated level of net charge-offs that occurred in 2010, 2011, and 2012 due to improvements in asset quality and stabilization of the economy and housing prices. If, however, sequestration has negative consequences that are more severe than those currently expected by management, borrowers may be less likely to repay loans, net charge-offs may increase, and higher contributions to the allowance for loan losses in the form of increased provisions may be necessary. The federal government shut-down in October of 2013 had a negative effect on local economic conditions, and furloughs related to the shut-down may impact borrowers' ability to repay loans. These consequences of the October 2013 shut-down, and similar consequences of any future shut-down that may occur, may also result in increased net charge-offs and higher contributions to the allowance for loan losses in the form of increased provisions.

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 these categories. OREO includes foreclosed assets, which consist of real estate from foreclosures on loan collateral, and a former branch site that is no longer in use by the Bank. The majority of the loans 90 days or more past due but still accruing interest are classified as substandard. Substandard loans are a component of the allowance for loan losses. 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 cover the deficiency to the allowance for loan losses 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.

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

NONPERFORMING ASSETS

| | September 30, 2013 | December 31, 2012 | Increase (Decrease) |
|---|---|---|---|
| | (in thousands) | | |
| Nonaccrual loans | | | |
| Commercial | $0 | $ 97 | $ (97 ) |
| Real estate-construction | 2,546 | 3,065 | (519 ) |
| Real estate-mortgage (1) | 7,355 | 7,470 | (115 ) |
| Total nonaccrual loans | $9,901 | $ 10,632 | $ (731 ) |
| Loans past due 90 days or more and accruing interest | | | |
| Commercial | $0 | $ 25 | $ (25 ) |
| Real estate-mortgage (1) | 0 | 408 | (408 ) |
| Consumer loans | 13 | 11 | 2 |
| Other | 5 | 3 | 2 |
| Total loans past due 90 days or more and accruing interest | $18 | $ 447 | $ (429 ) |
| Restructured loans | | | |
| Real estate-mortgage (1) | $10,002 | $ 8,810 | $ 1,192 |
| Consumer loans | 16 | 16 | 0 |
| Total restructured loans | $10,018 | $ 8,826 | $ 1,192 |
| Less nonaccrual restructured loans (included above) | 1,908 | 1,908 | 0 |
| Less restructured loans currently in compliance (2) | 8,110 | 6,918 | 1,192 |
| Net nonperforming, accruing restructured loans | $0 | $ 0 | $ 0 |
| Other real estate owned | | | |
| Construction, land development, and other land | $3,722 | 3,804 | $ (82 ) |
| 1-4 family residential properties | 216 | 676 | (460 ) |
| Nonfarm nonresidential properties | 2,444 | 2,094 | 350 |
| Former branch site | 506 | 0 | 506 |
| | $6,888 | $ 6,574 | $ 314 |
| Total nonperforming assets | $16,807 | $ 17,653 | $ (846 ) |

(1) The real estate-mortgage segment includes residential 1 – 4 family, commercial real estate, second mortgages and equity lines of credit.
(2) As of September 30, 2013 and December 31, 2012, all of the Company's restructured accruing loans were performing in compliance with their modified terms.

Nonperforming assets as of September 30, 2013 were $16.8 million, $846 thousand lower than nonperforming assets as of December 31, 2012. The nonperforming assets category of nonaccrual loans decreased $731 thousand and OREO increased by $314 thousand, when comparing the balances as of September 30, 2013 to December 31, 2012, due primarily to improvement in asset quality.

The majority of the balance of nonaccrual loans at September 30, 2013 was related to a few large credit relationships. Of the $9.9 million of nonaccrual loans at September 30, 2013, $7.1 million or approximately 71.71% was comprised of three credit relationships: $2.8 million, $2.5 million, and $1.8 million. The loans that make up the nonaccrual balance have been written down to their net realizable value. As shown in the table above, the majority of the nonaccrual loans were collateralized by real estate at September 30, 2013 and December 31, 2012. The increase in

troubled debts restructured between December 31, 2012 and September 30, 2013 was due to the Company's efforts to modify problem credits to assist borrowers and return the loans to performing status. The transfer of a former branch site from premises and equipment increased OREO by $506 thousand. Without this transfer, OREO would have decreased $192 thousand as the Company works to sell these properties. The former branch site is also listed for sale.

Management believes the Company has excellent credit quality review processes in place to identify problem loans quickly. The quality of the Company's loan portfolio has continued to improve over the past few years, with nonperforming assets generally stabilizing as troubled borrowers' finances have improved and troubled loans have been charged off or sold. Management remains cautious about the future and is well aware that if the economy does not continue to improve, or if the federal government shut-down or sequestration has a significant negative impact, nonperforming assets could increase in future periods. As was seen in prior years, the effect of a sustained increase in nonperforming assets would be lower earnings caused by larger contributions to the loan loss provision, which in turn would be driven by larger impairments in the loan portfolio and higher levels of loan charge-offs.

As of September 30, 2013, the allowance for loan losses was 41.53% of nonperforming assets and 70.37% of nonperforming loans. The allowance for loan losses as a percentage of nonperforming assets and as a percentage of nonperforming loans increased between December 31, 2012 and September 30, 2013, primarily due to management concerns about the possible negative consequences of the federal government shut-down and sequestration on local economic conditions and on borrowers' ability to repay loans. These percentages could increase further if the effects of the shut-down and sequestration on the Company's loan portfolio require increases in the allowance for loan losses. The definition of nonperforming loans is nonperforming assets less OREO. The allowance for loan losses was 1.45% and 1.55% of total loans on September 30, 2013 and December 31, 2012, respectively.

Allowance for Loan Losses

The allowance for loan losses is based on several components. Historical loss is one of these components. Historical loss is based on the Company's loss experience during the past eight quarters, which management believes reflects the risk related to each segment of loans in the current economic environment. The historical loss component of the allowance amounted to $2.7 million and $5.4 million as of September 30, 2013 and December 31, 2012, respectively. This decrease is primarily due to lower charge-offs for the first nine months of 2013 as compared to the level of charge-offs in certain quarters included in past historical loss periods. The Company uses a rolling eight-quarter average to calculate the historical loss component of the allowance, so higher charge-offs in the first nine months of 2011 are no longer included in the calculation as of September 30, 2013, which has caused the historical loss component to decrease. In addition, the Company began using a migration analysis to calculate the historical loss component beginning with the September 30, 2013 calculation. Management believes the additional information provided by the migration analysis results in more accurate historical loss information for the eight quarter period.

In evaluating the adequacy of the allowance, each segment of the loan portfolio is divided into several pools of loans. The Company first specifically identifies certain loans that may be impaired, and individually analyzes the estimated amount of impairment on these loans (regardless of risk rating). The remainder of the loan portfolio is then separated into pools, based on the loan classification per the instructions for the Bank's Call Report and collectively evaluated for impairment. 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 (rated just above substandard), and pass (all other loans).

Prior to September 30, 2013, all loans not individually evaluated for impairment were segmented by risk grade. See Note 3 of the Notes to the Consolidated Financial Statements included in this quarterly report on Form 10-Q for additional details on the changes made to the Company's methodology for calculating the allowance for the third quarter of 2013.

Historical loss rates are applied to the above pools of loans for each segment of the loan portfolio that are collectively evaluated for impairment. TDRs are always individually evaluated regardless of risk grade.

In addition, nonperforming loans and both performing and nonperforming TDRs are analyzed for impairment under U.S. GAAP and are allocated based on this analysis. The impairment amounts determined for the Company's TDRs and nonperforming loans are included in the loan balances individually evaluated for impairment section of the allowance. Therefore, changes in TDRs and nonperforming loans affect the dollar amount of the allowance. Unless 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), increases in the impairment analysis for TDRs and nonperforming loans are reflected as an increase in the allowance for loan losses.

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 has not yet received a current appraisal on loans being reviewed for impairment, any loan balance that is in excess of the estimated appraised value is allocated in the allowance. As of September 30, 2013 and December 31, 2012, the impaired loan component of the allowance for loan losses amounted to $1.9 million and $444 thousand, respectively. As shown in the impaired loan tables in Note 3 of the Notes to the Consolidated Financial Statements included in this quarterly report on Form 10-Q, the recorded investment in impaired loans at September 30, 2013 was $18.0 million, compared to a recorded investment in impaired loans at December 31, 2012 of $17.6 million. As of September 30, 2013, the impaired loan component of the allowance increased by $1.5 million as compared to the component's balance as of December 31, 2012. The recorded investment in impaired loans increased, while at the same time, some of the loans added to the impairment calculation had loan balances that were in excess of the estimated appraised values. Therefore, the total amount of the impairment associated with those loans increased and a larger allocation was appropriate

The final 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. The qualitative component of the allowance amounted to $2.4 million and $1.5 million as of September 30, 2013 and December 31, 2012, respectively. The major reasons for the increase in this component are the increase in loans and management's concern about the negative consequences of the federal government shut-down and sequestration.

As a result of management's analysis, the Company added, through the provision, $800 thousand to the allowance for loan losses in the nine months ended September 30, 2013. Management believes that the allowance has been appropriately funded for additional losses on existing loans, based on currently available information. If the federal government shut-down and/or sequestration result in increased historical loss rates, increases in impairment analyses or changes in certain qualitative factors related to the economic conditions, the current level of the allowance for loan losses may be insufficient and increases in the allowance may be needed.

Noninterest Income

For the third quarter and the first nine months of 2013, noninterest income decreased by $909 thousand and $1.7 million, respectively, when compared to the same periods in 2012. These decreases were mainly due to income from bank-owned life insurance and gains and losses on the sales of securities. In the third quarter of 2012, income from bank-owned life insurance was significantly impacted by the receipt of $475 thousand in proceeds from the death benefit on an insured former officer, while no such proceeds were received in the third quarter of 2013. Also in 2012, the Company restructured a portion of its investment portfolio to improve the portfolio's cash flow and increase its yields. Due to this restructuring, the Company posted income that included a net gain on sale of available-for-sale securities of $620 thousand for the third quarter of 2012 and $1.7 million for the first nine months of 2012. During the third quarter of 2013, however, the Company sold available-for-sale securities in an effort to reduce the investment portfolio's susceptibility to interest rate risk, which resulted in a net loss on sale of securities of $5 thousand and $26 thousand for the three and nine months ended September 30, 2013.

Other areas of noninterest income increased during the three and nine months ended September 30, 2013 over the comparable periods in 2012. Noninterest income improved in the categories of income from fiduciary activities, other service charges, commissions and fees, and income from Old Point Mortgage, LLC, which is a joint venture of the

Company. Income from fiduciary activities increased $92 thousand for the third quarter of 2013 and $238 thousand for the first nine months of 2013 as compared to the same periods in 2012. Accounts managed by Trust are assessed fees based on the market value of the account's assets; improvements in the equities markets led to higher asset values and thus higher fee income. In addition, Trust continues to open new accounts. Other service charges, commissions and fees grew $27 thousand for the third quarter of 2013 and $120 thousand for the first nine months of 2013 over the same periods in 2012. The majority of the increase in other service charges, commissions and fees was due to increased revenues from debit cards and merchant processing services. Income from Old Point Mortgage, LLC increased $48 thousand in the third quarter of 2013 and $227 thousand for the first nine months of 2013 as compared to the same periods in 2012.

The Company continues to focus on diversifying noninterest income in response to declining interest income. Management anticipates that noninterest income will continue to increase as the Company continues its efforts in this area.

Noninterest Expense

The Company's noninterest expense decreased by $976 thousand in the third quarter of 2013 and by $2.2 million during the first nine months of 2013, as compared to the same periods in 2012. Most categories of noninterest expense decreased, with the largest decreases seen in salaries and employee benefits, FDIC insurance, legal and audit expense, advertising and loss on write-down/sale of OREO.

Salary and employee benefits decreased $706 thousand in the third quarter 2013 and $1.2 million in the first nine months of 2013 as compared to the same periods in 2012. In 2012, the Company made early retirement offers to eligible employees and initiated a reduction in work force program to eliminate positions that had become unnecessary due to improvements in technology and efficiencies. Both the early retirement offer and the reduction in work force program provided severance packages to employees, which increased salaries and employee benefits expense in 2012. As of September 30, 2013 the Company had a full time equivalent (FTE) employee count of 282.5, which is 27.5 positions fewer than the FTE as of September 30, 2012.

FDIC insurance cost decreased $112 thousand when comparing the third quarter of 2013 to the third quarter of 2012 and decreased $322 thousand when comparing the first nine months of 2013 to the first nine months of 2012. Legal and audit expense decreased $19 thousand for the third quarter of 2013 and $192 thousand for the first nine months of 2013 when compared to the same periods in 2012. Loss on write-down/sale of OREO decreased $35 thousand for the third quarter of 2013 and $468 thousand for the first nine months of 2013 as compared to the third quarter and first nine months of 2012. The decrease in the loss on write-down/sale of OREO is largely attributable to the Company's ability to sell OREO for amounts closer to their book value as real estate market values have recovered, in addition to reducing write-downs on properties still held by the Company. Reductions in expenses for FDIC insurance, legal and audit expense and write down/sale of OREO have occurred as the Company has worked successfully to reduce and sell nonperforming assets. Advertising expense decreased $86 thousand and $130 thousand in the three and nine months ended September 30, 2013 when compared to the same periods in 2012 as the Company continued its focus on earned publicity rather than paid advertising.

The only significant increase in noninterest expense was in the Company's capital stock tax, which increased $43 thousand and $112 thousand in the three and nine months ended September 30, 2013 as compared to the same periods in 2012. The capital stock tax is paid to the state of Virginia instead of state income tax, and is based on the Company's capital less certain allowances. One such allowance is based on holdings of U.S. Government agency securities. As the composition of the Company's securities portfolio has changed between 2012 and 2013,the level of U.S. Government agency securities decreased significantly and provided a smaller deduction for the purposes of calculating the capital stock tax.

Balance Sheet Review

Assets as of September 30, 2013 were $876.6 million, a decrease of $30.9 million or 3.41%, compared to assets as of December 31, 2012. When comparing September 30, 2013 to December 31, 2012, securities available for sale decreased $171.3 million, securities held-to-maturity increased $93.2 million and interest-bearing due from banks increased $24.5 million.

During May and June of 2013, the 10-year Treasury rate increased approximately 100 basis points, following statements from the Federal Reserve that it was likely to begin slowing the pace of bond purchases under its quantitative easing program later in 2013. In the third quarter of 2013, however, Treasury rates began to decline again as the Federal Reserve exhibited signs of delaying plans to reduce purchases under its quantitative easing program, though long-term rates at September 30, 2013 remain elevated when compared to historical rates over the last two years. Increases in Treasury rates have led to declines in the market value of the Company's available-for-sale

securities portfolio in 2013. In the second quarter of 2013, management sold approximately $40.0 million of available-for-sale securities and purchased $10.8 million of shorter term tax-exempt municipal securities which were placed in the held-to-maturity portfolio, in order to reduce the portfolio's susceptibility to interest rate risk. To the same end, in the third quarter of 2013, management transferred securities with a book value of $74.2 million and a market value of $68.0 million from available-for-sale to held-to-maturity. All securities purchased in the third quarter of 2013 were placed in the held-to-maturity portfolio. A portion of the proceeds from the sale of securities funded net loan growth of $9.4 million between December 31, 2012 and September 30, 2013. The remaining proceeds increased the Company's cash and cash equivalents.

To manage its net interest margin, the Company continued to focus on reduction of higher-cost time deposits by lowering deposit rates and allowing time deposits to shrink through attrition. Time deposits decreased $38.0 million from $308.8 million on December 31, 2012 to $270.8 million at September 30, 2013. Provided the economy continues to improve, management believes that the loan growth and the reduction in time deposits that was experienced in the second and third quarters of 2013 will continue through the end of the year and a large portion of the current excess in the cash and cash equivalents will be absorbed.

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, 2013.

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 and 1-4 family junior lien loans for which the Company has recorded a credit score in its system.

Loans Secured by 1 - 4 Family
First Mortgages,
1 - 4 Family Open-end and 1 - 4
Family Junior Liens
As of September 30, 2013
(dollars in thousands)

| | Amount | Percent |
|---|---|---|
| Subprime | $19,461 | 18.10 % |
| Non-subprime | 88,080 | 81.90 % |
| | $107,541 | 100.00% |
| | | |
| Total loans | $480,167 | |
| | | |
| Percentage of Real Estate-Secured Subprime Loans to Total Loans | | 4.05 % |

In addition to the subprime loans secured by real estate discussed above, as of September 30, 2013, the Company had an additional $1.6 million in subprime consumer loans that were either unsecured or 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, 2013 were $21.1 million, amounting to 4.39% of the Company's total loans at September 30, 2013.

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

Average assets for the first nine months of 2013 were $883.2 million compared to $862.2 million for the first nine months of 2012. Average investment securities for the nine months ended September 30, 2013 as compared to the nine months ended September 30, 2012 increased $25.9 million, due to higher balances at the beginning of 2013. During the first quarter of 2013, excess funds from decreases in loans and increases in the lower-cost deposit categories of demand deposits, interest-bearing transaction accounts, money market deposit accounts and savings accounts were invested in securities. During the second and third quarters of 2013, as loan growth began to recover and time deposits continued to decrease, management reallocated funds from securities to loans by selling certain available-for-sale securities. For this reason, average securities for the three months ended September 30, 2013 decreased when compared to the same period in 2012, while a comparison of the nine-month periods shows an increase from 2012 to 2013.

Capital Resources

Total stockholders' equity as of September 30, 2013 was $80.2 million, down $9.1 million or 10.24% from $89.3 million at December 31, 2012. The fluctuations in the 10-year Treasury rate discussed above under Balance Sheet Review negatively affected the accumulated other comprehensive loss component of stockholders' equity, as unrealized losses on available-for-sale securities, net of tax, are reported in this section of the balance sheet. Rising rates have led to unrealized losses on the Company's available-for-sale securities portfolio, which are reported in the other comprehensive income item of stockholders' equity. At September 30, 2013, the unrealized gain (loss) on securities component of stockholder's equity was an unrealized loss of $5.2 million, compared to an unrealized gain of $2.0 million as of December 31, 2012 and an unrealized loss of $6.2 million as of June 30, 2013. 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, the Company does not consider the investments to be other-than temporarily impaired.

Under applicable banking regulations, total capital is comprised of core capital (Tier 1) and supplemental capital (Tier 2). Tier 1 capital consists of common stockholders' equity and retained earnings less goodwill. Tier 2 capital consists of certain qualifying debt and a qualifying portion of the allowance for loan losses. The following is a summary of the Company's capital ratios at September 30, 2013. As shown below, these ratios were all well above the regulatory minimum levels, and demonstrate that the Company's capital position remains strong.

| | 2013 Regulatory Minimums | September 30, 2013 |
|---|---|---|
| Tier 1 Leverage | 4.00% | 10.38% |
| Tier 1 | 4.00% | 15.05% |
| Total Capital | 8.00% | 16.19% |

Book value per share was $16.16 at September 30, 2013 as compared to $18.23 at September 30, 2012. Cash dividends were $298 thousand or $0.06 per share in the third quarter of 2013 and $248 thousand or $0.05 per share in the third quarter of 2012. The common stock of the Company has not been extensively traded.

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.

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 2013, the Company had $236.6 million in FHLB borrowing availability. The Company has available short-term, unsecured borrowed funds in the form of federal funds lines with correspondent banks. As of the end of the third quarter of 2013, the Company had $43.0 million available in federal funds lines to handle any short-term borrowing needs.

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 affect on liquidity, capital resources or operations. The Company's internal sources of such liquidity are deposits, loan and investment repayments and securities available-for-sale. As of September 30, 2013, the Bank's unpledged, available-for-sale securities totaled $123.9 million. The Company's primary external source of liquidity is advances from the FHLB.

As a result of the Company's management of liquid assets, the availability of borrowed funds and the 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.

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.

The Company is expanding the building of a current branch office. See the subsequent events disclosure in Note 1 of the Notes to the Consolidated Financial Statements included in this quarterly report on Form 10-Q.

As of September 30, 2013, other than those disclosed above, there have been no material changes outside the ordinary course of business in the Company's contractual obligations disclosed in the Company's 2012 annual report on Form 10-K.

Off-Balance Sheet Arrangements
As of September 30, 2013, there were no material changes in the Company's off-balance sheet arrangements disclosed in the Company's 2012 annual report on Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

An important element of earnings performance and the maintenance of sufficient liquidity is proper management of the interest sensitivity gap. The interest sensitivity gap is the difference between interest sensitive assets and interest sensitive liabilities in a specific time interval. This gap can be managed by re-pricing assets or liabilities, which are variable rate instruments, by replacing an asset or liability at maturity or by adjusting the interest rate during the life of the asset or liability. Matching the amounts of assets and liabilities maturing in the same time interval helps to offset interest rate risk and to minimize the impact of rising or falling interest rates on net interest income.

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. The Company uses computer simulations to measure the effect of various interest rate scenarios on net interest income. This modeling reflects interest rate changes and the related impact on net interest income and net income over specified time horizons.

Based on scheduled maturities only, the Company was liability sensitive as of September 30, 2013. It should be noted, however, that non-maturing deposit liabilities, which consist of interest checking, money market, and savings accounts, are less interest sensitive than other market driven deposits. At September 30, 2013, non-maturing deposit liabilities totaled $460.0 million or 62.95% of total deposit liabilities.

In a rising rate environment, changes in these deposit rates have historically lagged behind the changes in earning asset rates, thus mitigating the impact from the liability sensitivity position. The asset/liability model allows the Company to reflect the fact that non-maturing deposits are less rate sensitive than other deposits by using a decay rate. The decay rate is a type of artificial maturity that simulates maturities for non-maturing deposits over the number of months that more closely reflects historic data. Using the decay rate, the model reveals that the Company is asset sensitive.

When the Company is asset sensitive, net interest income should improve if interest rates rise since assets will re-price faster than liabilities. Conversely, if interest rates fall, net interest income should decline, depending on the optionality (prepayment speeds) of the assets. When the Company is liability sensitive, net interest income should fall if rates rise and rise if rates fall.

The most likely scenario represents the rate environment as management forecasts it to occur. Management uses a "static" test to measure the effects of changes in interest rates on net interest income. This test assumes that management takes no steps to adjust the balance sheet to respond to the rate change by re-pricing assets/liabilities, as discussed in the first paragraph of this section.

Under the rate environment forecasted by management, rate changes in 50 to 100 basis point increments are applied to assess the impact on the Company's earnings at September 30, 2013. The rate change model assumes that these

changes will occur gradually over the course of a year. The model reveals that a 50 basis point ramped decrease in rates would cause an approximate 0.07% annual decrease in net interest income. The model reveals that a 50 basis point ramped rise in rates would cause an approximate 0.66% annual increase in net interest income and that a 100 basis point ramped rise in rates would cause an approximate 0.99% increase in net interest income.

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, 2013 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.

Item 1A. Risk Factors.

There have been no material changes in the risk factors faced by the Company from those disclosed in the Company's 2012 annual report on Form 10-K.

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

Pursuant to the Company's stock option plans, participants may exercise stock options 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 stock options. During the quarter ended September 30, 2013, the Company did not repurchase any shares related to the exercise of stock options.

During the quarter ended September 30, 2013, the Company did not repurchase any shares pursuant to the Company's stock repurchase program.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

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Item 5. Other Information.

The Company has made no changes to the procedures by which security holders may recommend nominees to its board of directors.

Item 6. Exhibits.

| Exhibit No. | Description |
|---|---|
| 3.1 | 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) |
| 3.2 | Bylaws of Old Point Financial Corporation, as amended and restated March 8, 2011 (incorporated by reference to Exhibit 3.2 to Form 8-K filed March 10, 2011) |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | The following materials from Old Point Financial Corporation's quarterly report on Form 10-Q for the quarter ended September 30, 2013, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Consolidated Balance Sheets (unaudited for September 30, 2013), (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 13, 2013 /s/Robert F. Shuford, Sr.
Robert F. Shuford, Sr.
Chairman, President & Chief Executive Officer
(Principal Executive Officer)

November 13, 2013 /s/Laurie D. Grabow
Laurie D. Grabow

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