

ONE Gas, Inc.
Form 10-Q
October 30, 2018

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2018.

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____.

Commission file number 001-36108

ONE Gas, Inc.
(Exact name of registrant as specified in its charter)

Oklahoma 46-3561936
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)

15 East Fifth Street, Tulsa, OK 74103
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (918) 947-7000

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).

Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

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

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

Yes ___ No X

On October 23, 2018, the Company had 52,526,346 shares of common stock outstanding.

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ONE Gas, Inc.

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As used in this Quarterly Report, references to “we,” “our,” “us” or the “company” refer to ONE Gas, Inc., an Oklahoma corporation, and its predecessors and subsidiaries, unless the context indicates otherwise.

The statements in this Quarterly Report that are not historical information, including statements concerning plans and objectives of management for future operations, economic performance or related assumptions, are forward-looking statements. Forward-looking statements may include words such as “anticipate,” “estimate,” “expect,” “project,” “intend,” “plan,” “believe,” “should,” “goal,” “forecast,” “guidance,” “could,” “may,” “continue,” “might,” “potential,” “scheduled,” “likely,” and terms of similar meaning. Although we believe that our expectations regarding future events are based on reasonable assumptions, we can give no assurance that such expectations or assumptions will be achieved. Important factors that could cause actual results to differ materially from those in the forward-looking statements are described under Part I, Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations, “Forward-Looking Statements,” in this Quarterly Report and under Part I, Item IA, “Risk Factors,” in our Annual Report.

INFORMATION AVAILABLE ON OUR WEBSITE

We make available, free of charge, on our website (www.onegas.com) copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, amendments to those reports filed or furnished to the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act and reports of holdings of our securities filed by our officers and directors under Section 16 of the Exchange Act as soon as reasonably practicable after filing such material electronically or otherwise furnishing it to the SEC. Copies of our Code of Business Conduct and Ethics, Corporate Governance Guidelines and Director Independence Guidelines are also available on our website, and we will provide copies of these documents upon request. Our website and any contents thereof are not incorporated by reference into this report.

We also use Twitter®, LinkedIn® and Facebook® as additional channels of distribution to reach public investors. Information contained on our website, posted on our Facebook® page or disseminated through Twitter® or LinkedIn®, and any corresponding applications, are not incorporated by reference into this report.

We also make available on our website the Interactive Data Files required to be submitted and posted pursuant to Rule 405 of Regulation S-T.

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GLOSSARY - The abbreviations, acronyms and industry terminology used in this Quarterly Report are defined as follows:

AAO	Accounting Authority Order
ADIT	Accumulated deferred income tax
ALJ	Administrative law judge
Annual Report	Annual Report on Form 10-K for the year ended December 31, 2017
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
Bcf	Billion cubic feet
CERCLA	Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended
Clean Air Act	Federal Clean Air Act, as amended
Clean Water Act	Federal Water Pollution Control Amendments of 1972, as amended
Code	Internal Revenue Code of 1986, as amended
COSA	Cost-of-Service Adjustment
DOT	United States Department of Transportation
EPA	United States Environmental Protection Agency
EPS	Earnings per share
Exchange Act	Securities Exchange Act of 1934, as amended
FASB	Financial Accounting Standards Board
GAAP	Accounting principles generally accepted in the United States of America
GPAC	Gas Pipeline Advisory Committee
GRIP	Texas Gas Reliability Infrastructure Program
GSRS	Kansas Gas System Reliability Surcharge
Heating Degree Day or HDD	A measure designed to reflect the demand for energy needed for heating based on the extent to which the daily average temperature falls below a reference temperature for which no heating is required, usually 65 degrees Fahrenheit
KCC	Kansas Corporation Commission
KDHE	Kansas Department of Health and Environment
LDC	Local distribution company
MGP	Manufactured Gas Plant
MMcf	Million cubic feet
Moody's	Moody's Investors Service, Inc.
NOL	Net operating loss
NPRM	Notice of Proposed Rulemaking
NYMEX	New York Mercantile Exchange
OCC	Oklahoma Corporation Commission
ONE Gas	ONE Gas, Inc.
ONE Gas Credit Agreement	ONE Gas' \$700 million amended and restated revolving credit agreement, as amended, which expires on October 5, 2023
ONEOK	ONEOK, Inc. and its subsidiaries
PBRC	Performance-Based Rate Change
PHMSA	United States Department of Transportation Pipeline and Hazardous Materials Safety Administration
Pipeline Safety, Regulatory Certainty and Job Creation Act	Pipeline Safety, Regulatory Certainty and Job Creation Act of 2011, as amended
Quarterly Report(s)	Quarterly Report(s) on Form 10-Q
RRC	Railroad Commission of Texas
S&P	Standard & Poor's Ratings Services

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SAB	Staff Accounting Bulletin
SEC	Securities and Exchange Commission
Securities Act	Securities Act of 1933, as amended
Senior Notes	ONE Gas' registered notes consisting of \$300 million of 2.07 percent senior notes due 2019, \$300 million of 3.61 percent senior notes due 2024 and \$600 million of 4.658 percent notes due 2044
Separation and Distribution Agreement	Separation and Distribution Agreement dated January 14, 2014, between ONEOK and ONE Gas
WNA	Weather-normalization adjustments
XBRL	eXtensible Business Reporting Language

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PART I - FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

ONE Gas, Inc.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
	(Thousands of dollars, except per share amounts)			
Revenues				
Revenues from contracts with customers	\$235,757	\$244,402	\$1,162,162	\$1,054,595
Other revenues	2,523	2,740	7,103	22,644
Total revenues	238,280	247,142	1,169,265	1,077,239
Cost of natural gas	51,256	58,769	495,834	404,495
Net margin	187,024	188,373	673,431	672,744
Operating expenses				
Operations and maintenance	96,443	91,058	302,103	293,030
Depreciation and amortization	40,344	38,423	118,991	113,293
General taxes	13,996	13,799	44,763	43,518
Total operating expenses	150,783	143,280	465,857	449,841
Operating income	36,241	45,093	207,574	222,903
Other expense, net	(1,929)	(3,715)	(6,287)	(11,022)
Interest expense, net	(12,365)	(11,495)	(36,720)	(34,281)
Income before income taxes	21,947	29,883	164,567	177,600
Income taxes	(5,671)	(11,086)	(37,037)	(61,724)
Net income	\$16,276	\$18,797	\$127,530	\$115,876
Earnings per share				
Basic	\$0.31	\$0.36	\$2.42	\$2.21
Diluted	\$0.31	\$0.36	\$2.41	\$2.19
Average shares (thousands)				
Basic	52,736	52,488	52,678	52,539
Diluted	53,112	52,926	52,969	52,984
Dividends declared per share of stock	\$0.46	\$0.42	\$1.38	\$1.26

See accompanying Notes to Consolidated Financial Statements.

ONE Gas, Inc.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	(Thousands of dollars)			
Net income	\$16,276	\$18,797	\$127,530	\$115,876
Other comprehensive income, net of tax				
Change in pension and other postemployment benefit plan liability, net of tax of \$(68), \$(81), \$(487) and \$(242), respectively	203	128	326	386
Total other comprehensive income, net of tax	203	128	326	386
Comprehensive income	\$16,479	\$18,925	\$127,856	\$116,262
See accompanying Notes to Consolidated Financial Statements.				

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ONE Gas, Inc.

CONSOLIDATED BALANCE SHEETS

	September 30, 2018	December 31, 2017
(Unaudited)		
Assets	(Thousands of dollars)	
Property, plant and equipment		
Property, plant and equipment	\$5,964,287	\$5,713,912
Accumulated depreciation and amortization	1,768,381	1,706,327
Net property, plant and equipment	4,195,906	4,007,585
Current assets		
Cash and cash equivalents	12,430	14,413
Accounts receivable, net	132,436	298,768
Materials and supplies	40,363	39,672
Natural gas in storage	126,481	130,154
Regulatory assets	49,039	88,180
Other current assets	13,762	17,807
Total current assets	374,511	588,994
Goodwill and other assets		
Regulatory assets	375,059	405,189
Goodwill	157,953	157,953
Other assets	49,528	47,157
Total goodwill and other assets	582,540	610,299
Total assets	\$5,152,957	\$5,206,878

See accompanying Notes to Consolidated Financial Statements.

ONE Gas, Inc.
CONSOLIDATED BALANCE SHEETS
(Continued)

(Unaudited)	September 30, 2018	December 31, 2017				
	(Thousands of dollars)					
Equity and Liabilities						
Equity and long-term debt						
Common stock, \$0.01 par value: authorized 250,000,000 shares; issued 52,598,005 shares and outstanding 52,526,346 shares at September 30, 2018;	\$526	\$ 526				
issued 52,598,005 and outstanding 52,312,516 shares at December 31, 2017						
Paid-in capital	1,725,361	1,737,551				
Retained earnings	300,547	246,121				
Accumulated other comprehensive income (loss)	(5,167)	(5,493)				
Treasury stock, at cost: 71,659 shares at September 30, 2018 and 285,489 shares at December 31, 2017	(4,643)	(18,496)				
Total equity	2,016,624	1,960,209				
Long-term debt, excluding current maturities, and net of issuance costs of \$7,402 and \$8,033, respectively	893,880	1,193,257				
Total equity and long-term debt	2,910,504	3,153,466				
Current liabilities		168	169	-	(1)	168
More than ten years	1,983	1,986	-	(13)	1,973	2.32 %
	23,551	23,693	-	(466)	23,227	1.52 %
Mortgage-backed securities						
Five to ten years	3,009	3,068	-	(114)	2,954	1.71 %
More than ten years	17,377	17,501	1	(608)	16,894	2.38 %
	20,386	20,569	1	(722)	19,848	2.28 %
Subordinated debt						
Five to ten years	4,050	4,096	-	(34)	4,062	3.08 %
Total investment securities	\$47,987	\$ 48,358	\$ 1	\$(1,222)	\$ 47,137	1.97 %
December 31, 2017						
US Government Agencies						
One to five years	\$21,400	\$ 21,561	\$ -	\$(276)	\$ 21,285	1.44 %
More than ten years	2,411	2,415	-	(17)	2,398	1.74 %
	23,811	23,976	-	(293)	23,683	1.47 %
Mortgage-backed securities						
Five to ten years	3,400	3,472	-	(43)	3,429	1.72 %
More than ten years	18,518	18,655	1	(145)	18,511	2.39 %
	21,918	22,127	1	(188)	21,940	2.28 %

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Subordinated debt							
Five to ten years	4,050	4,103	11	(26)	4,088	3.08%
Total investment securities	\$49,779	\$ 50,206	\$ 12	\$(507)	\$ 49,711	1.96%

At June 30, 2018, the Company had investment securities with a fair value of \$7,971,000 pledged to secure borrowings from the Federal Home Loan Bank of Atlanta (“FHLB”). At December 31, 2017, the Company had no investment securities pledged to secure borrowings from the FHLB. There were no investment securities pledged to secure deposit repurchase agreements at June 30, 2018 or December 31, 2017.

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

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
Gross realized gains	\$ -	\$ -	\$ -	\$ -
Gross realized losses	-	-	-	(9)
	\$ -	\$ -	\$ -	\$ (9)

The Company sold approximately \$2 million of investment securities available for sale at a loss of \$9,000 for the six months ended June 30, 2017. The sale of these securities, which had fixed interest rates, allowed the Company to decrease its exposure to the anticipated upward movement in interest rates that would result in unrealized losses being recognized in shareholders' equity.

Investment securities available for sale that have an unrealized loss position at June 30, 2018 and December 31, 2017 are detailed below (in thousands):

	Securities in a loss position for less than 12 Months		Securities in a loss position for more than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2018						
US Government Agencies	\$6,058	\$ (169)	\$17,169	\$ (297)	\$23,227	\$ (466)
Mortgage-backed securities	18,400	(665)	1,396	(57)	19,796	(722)
Subordinated debt	1,488	(34)	-	-	1,488	(34)
	\$25,946	\$ (868)	\$18,565	\$ (354)	\$44,511	\$ (1,222)
December 31, 2017						
US Government Agencies	\$6,153	\$ (76)	\$17,530	\$ (217)	\$23,683	\$ (293)
Mortgage-backed securities	20,227	(160)	1,651	(28)	21,878	(188)
Subordinated debt	1,021	(26)	-	-	1,021	(26)

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\$27,401 \$ (262) \$19,181 \$ (245) \$46,582 \$ (507)

All of the unrealized losses are attributable to increases in interest rates and not to credit deterioration. Currently, the Company believes that it is probable that the Company will be able to collect all amounts due according to the contractual terms of the investments. Because the decline in market value is attributable to changes in interest rates and not to credit quality, and because it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other than temporarily impaired at June 30, 2018.

Note 5 – Loans and allowance for loan losses

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

	June 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Construction and land development				
Residential	\$5,961	1.48 %	\$5,361	1.45 %
Commercial	30,693	7.61 %	25,456	6.91 %
	36,654	9.09 %	30,817	8.36 %
Commercial real estate				
Owner occupied	98,541	24.43 %	85,004	23.06 %
Non-owner occupied	80,535	19.97 %	70,845	19.21 %
Multifamily	11,352	2.81 %	9,386	2.55 %
Farmland	245	0.06 %	270	0.07 %
	190,673	47.27 %	165,505	44.89 %
Consumer real estate				
Home equity lines	22,566	5.59 %	22,849	6.20 %
Secured by 1-4 family residential				
First deed of trust	58,808	14.58 %	57,919	15.71 %
Second deed of trust	9,269	2.30 %	7,460	2.02 %
	90,643	22.47 %	88,228	23.93 %
Commercial and industrial loans (except those secured by real estate)	41,092	10.19 %	36,506	9.90 %
Guaranteed student loans	42,133	10.45 %	45,805	12.42 %
Consumer and other	2,155	0.53 %	1,848	0.50 %
Total loans	403,350	100.0 %	368,709	100.0 %
Deferred fees and costs, net	786		699	
Less: allowance for loan losses	(3,208)		(3,239)	
	\$400,928		\$366,169	

The Bank has a purchased portfolio of rehabilitated student loans guaranteed by the Department of Education (“DOE”). The guarantee covers approximately 98% of principal and accrued interest. The loans are serviced by a third-party servicer that specializes in handling the special needs of the DOE student loan programs.

At June 30, 2018 and December 31, 2017, the Company had loans of \$40,275,000 and \$29,615,000 pledged to secure borrowings from the FHLB, respectively.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on nonaccrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due as long as the remaining recorded investment in the loan is deemed fully collectible. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all principal and interest amounts contractually due are brought to current and future payments are reasonably assured.

The following table provides information on nonaccrual loans segregated by type at the dates indicated (dollars in thousands):

	June 30, 2018	December 31, 2017
Construction and land development		
Commercial	\$41	\$ 43
	41	43
Commercial real estate		
Owner occupied	-	183
Non-owner occupied	515	-
	515	183
Consumer real estate		
Home equity lines	130	135
Secured by 1-4 family residential		
First deed of trust	627	1,000
Second deed of trust	66	67
	823	1,202
Commercial and industrial loans (except those secured by real estate)	536	870
Consumer and other	12	22
Total loans	\$1,927	\$ 2,320

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

Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. These assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;

- Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;

Risk rated 6 loans are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any; and

Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

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

	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	Total Loans
June 30, 2018					
Construction and land development					
Residential	\$5,961	\$-	\$-	\$ -	\$5,961
Commercial	29,186	1,136	371	-	30,693
	35,147	1,136	371	-	36,654
Commercial real estate					
Owner occupied	91,988	3,351	3,202	-	98,541
Non-owner occupied	80,020	-	515	-	80,535
Multifamily	11,183	169	-	-	11,352
Farmland	245	-	-	-	245
	183,436	3,520	3,717	-	190,673
Consumer real estate					
Home equity lines					
Secured by 1-4 family residential	21,492	934	140	-	22,566
First deed of trust	55,290	2,286	1,232	-	58,808
Second deed of trust	8,960	178	131	-	9,269
	85,742	3,398	1,503	-	90,643
Commercial and industrial loans (except those secured by real estate)					
Guaranteed student loans	38,592	1,749	736	15	41,092
Consumer and other	42,133	-	-	-	42,133
	2,141	-	14	-	2,155
Total loans	\$387,191	\$9,803	\$6,341	\$ 15	\$403,350

December 31, 2017					
Construction and land development					
Residential	\$5,361	\$-	\$-	\$-	\$5,361
Commercial	24,305	1,108	43	-	25,456
	29,666	1,108	43	-	30,817
Commercial real estate					
Owner occupied	78,791	2,716	3,497	-	85,004
Non-owner occupied	70,845	-	-	-	70,845
Multifamily	9,210	176	-	-	9,386
Farmland	270	-	-	-	270
	159,116	2,892	3,497	-	165,505
Consumer real estate					
Home equity lines					
Secured by 1-4 family residential	21,777	932	140	-	22,849
First deed of trust	53,591	2,637	1,691	-	57,919

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Second deed of trust	7,140	181	139	-	7,460
	82,508	3,750	1,970	-	88,228
Commercial and industrial loans (except those secured by real estate)	35,143	139	529	695	36,506
Guaranteed student loans	45,805	-	-	-	45,805
Consumer and other	1,826	4	18	-	1,848
Total loans	\$354,064	\$7,893	\$6,057	\$695	\$368,709

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

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
June 30, 2018							
Construction and land development							
Residential	\$-	\$ -	\$ -	\$-	\$5,961	\$5,961	\$ -
Commercial	-	-	-	-	30,693	30,693	-
	-	-	-	-	36,654	36,654	-
Commercial real estate							
Owner occupied	-	-	-	-	98,541	98,541	-
Non-owner occupied	-	-	-	-	80,535	80,535	-
Multifamily	-	-	-	-	11,352	11,352	-
Farmland	-	-	-	-	245	245	-
	-	-	-	-	190,673	190,673	-
Consumer real estate							
Home equity lines	64	-	-	64	22,502	22,566	-
Secured by 1-4 family residential							
First deed of trust	244	10	-	254	58,554	58,808	-
Second deed of trust	186	-	-	186	9,083	9,269	-
	494	10	-	504	90,139	90,643	-
Commercial and industrial loans (except those secured by real estate)							
Guaranteed student loans	1,788	1,312	6,577	9,677	32,456	42,133	6,577
Consumer and other	4	-	-	4	2,151	2,155	-
Total loans	\$2,294	\$ 1,322	\$ 6,577	\$10,193	\$393,157	\$403,350	\$ 6,577

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
December 31, 2017							
Construction and land development							
Residential	\$-	\$-	\$ -	\$-	\$5,361	\$5,361	\$ -
Commercial	-	-	-	-	25,456	25,456	-
	-	-	-	-	30,817	30,817	-

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Commercial real estate							
Owner occupied	-	-	-	-	85,004	85,004	-
Non-owner occupied	-	-	-	-	70,845	70,845	-
Multifamily	-	-	-	-	9,386	9,386	-
Farmland	-	-	-	-	270	270	-
	-	-	-	-	165,505	165,505	-
Consumer real estate							
Home equity lines	18	-	-	18	22,831	22,849	-
Secured by 1-4 family residential							
First deed of trust	457	-	-	457	57,462	57,919	-
Second deed of trust	91	-	-	91	7,369	7,460	-
	566	-	-	566	87,662	88,228	-
Commercial and industrial loans (except those secured by real estate)	-	3	-	3	36,503	36,506	-
Guaranteed student loans	2,891	1,300	7,229	11,420	34,385	45,805	7,229
Consumer and other	2	-	-	2	1,846	1,848	-
Total loans	\$3,459	\$1,303	\$7,229	\$11,991	\$356,718	\$368,709	\$7,229

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

Loans are considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts when due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Loans evaluated individually for impairment include non-performing loans, such as loans on non-accrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Impaired loans are set forth in the following table as of the dates indicated (in thousands):

	June 30, 2018		
	Unpaid		
	Recorded	Principal	Related
	Investment	Balance	Allowance
With no related allowance recorded			
Construction and land development			
Commercial	\$819	\$ 917	\$ -
	819	917	-
Commercial real estate			
Owner occupied	3,806	3,806	-
Non-owner occupied	2,626	2,626	-
	6,432	6,432	-
Consumer real estate			
Home equity lines	705	705	-
Secured by 1-4 family residential			
First deed of trust	2,689	2,689	-
Second deed of trust	651	858	-
	4,045	4,252	-
Commercial and industrial loans (except those secured by real estate)	440	787	-
Consumer and other	1	1	-
	11,737	12,389	-
With an allowance recorded			
Commercial real estate			
Owner occupied	1,470	1,485	13
	1,470	1,485	13
Consumer real estate			
Secured by 1-4 family residential			
First deed of trust	448	470	46
Second deed of trust	165	165	7
	613	635	53
Commercial and industrial loans (except those secured by real estate)	400	599	141
Consumer and other	13	13	13
	2,496	2,732	220
Total			
Construction and land development			
Commercial	819	917	-
	819	917	-
Commercial real estate			
Owner occupied	5,276	5,291	13
Non-owner occupied	2,626	2,626	-
	7,902	7,917	13
Consumer real estate			
Home equity lines	705	705	-

Secured by 1-4 family residential,			
First deed of trust	3,137	3,159	46
Second deed of trust	816	1,023	7
	4,658	4,887	53
Commercial and industrial loans (except those secured by real estate)	840	1,386	141
Consumer and other	14	14	13
	\$14,233	\$ 15,121	\$ 220

	December 31, 2017		
	Unpaid		
	Recorded	Principal	Related
	Investment	Balance	Allowance
With no related allowance recorded			
Construction and land development			
Commercial	\$ 502	\$ 600	\$ -
	502	600	-
Commercial real estate			
Owner occupied	3,879	3,879	-
Non-owner occupied	2,153	2,153	-
	6,032	6,032	-
Consumer real estate			
Home equity lines	577	577	-
Secured by 1-4 family residential			
First deed of trust	3,931	3,931	-
Second deed of trust	505	713	-
	5,013	5,221	-
Commercial and industrial loans (except those secured by real estate)	480	827	-
Consumer and other	3	3	-
	12,030	12,683	-
With an allowance recorded			
Commercial real estate			
Owner occupied	1,491	1,506	18
	1,491	1,506	18
Consumer real estate			
Home equity lines	135	135	2
Secured by 1-4 family residential			
First deed of trust	814	814	98
Second deed of trust	85	85	4
	1,034	1,034	104
Commercial and industrial loans (except those secured by real estate)	740	740	375
Consumer and other	19	19	18
	3,284	3,299	515
Total			
Construction and land development			
Commercial	502	600	-
	502	600	-
Commercial real estate			
Owner occupied	5,370	5,385	18
Non-owner occupied	2,153	2,153	-
	7,523	7,538	18
Consumer real estate			

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Home equity lines	712	712	2
Secured by 1-4 family residential, First deed of trust	4,745	4,745	98
Second deed of trust	590	798	4
	6,047	6,255	104
Commercial and industrial loans (except those secured by real estate)	1,220	1,567	375
Consumer and other	22	22	18
	\$15,314	\$ 15,982	\$ 515

The following is a summary of average recorded investment in impaired loans with and without a valuation allowance and interest income recognized on those loans for the periods indicated (in thousands):

	For the Three Months Ended June 30, 2018 Average Interest Recorded Investment Recognized		For the Six Months Ended June 30, 2018 Average Interest Recorded Investment Recognized	
With no related allowance recorded				
Construction and land development				
Commercial	\$657	\$ 7	\$478	\$ 13
	657	7	478	13
Commercial real estate				
Owner occupied	1,903	40	3,753	80
Non-owner occupied	3,220	205	2,401	231
	5,123	245	6,154	311
Consumer real estate				
Home equity lines	353	-	475	-
Secured by 1-4 family residential				
First deed of trust	1,345	15	3,431	46
Second deed of trust	1,893	12	604	23
	3,591	27	4,510	69
Commercial and industrial loans (except those secured by real estate)	220	12	455	20
Consumer and other	2	1	2	1
	9,593	292	11,599	414
With an allowance recorded				
Construction and land development				
Commercial	-	-	116	-
Commercial real estate				
Owner occupied	735	11	1,591	22
	735	11	1,591	22
Consumer real estate				
Home equity line	741	-	101	-
Secured by 1-4 family residential				
First deed of trust	224	8	660	15
Second deed of trust	149	4	125	4
	1,114	12	886	19
Commercial and industrial loans (except those secured by real estate)	283	-	665	-

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Consumer and other	462	-	10	-
	2,594	23	3,268	41
Total				
Construction and land development				
Commercial	657	7	594	13
	657	7	594	13
Commercial real estate				
Owner occupied	2,638	51	5,344	102
Non-owner occupied	3,220	205	2,401	231
	5,858	256	7,745	333
Consumer real estate				
Home equity lines	1,094	-	576	-
Secured by 1-4 family residential,				
First deed of trust	1,569	23	4,091	61
Second deed of trust	2,042	16	729	27
	4,705	39	5,396	88
Commercial and industrial loans				
(except those secured by real estate)	503	12	1,120	20
Consumer and other	464	1	12	1
	\$12,187	\$ 315	\$14,867	\$ 455

	For the Three Months Ended June 30, 2017		For the Six Months Ended June 30, 2017	
	Average Interest Recorded Investment	Income Recognized	Average Interest Recorded Investment	Income Recognized
With no related allowance recorded				
Construction and land development				
Commercial	\$101	\$ 1	\$92	\$ 2
	101	1	92	2
Commercial real estate				
Owner occupied	2,578	8	1,824	58
Non-owner occupied	2,207	29	2,300	59
	4,785	37	4,124	117
Consumer real estate				
Home equity lines	872	-	863	1
Secured by 1-4 family residential				
First deed of trust	3,489	22	3,646	62
Second deed of trust	521	7	579	18
	4,882	29	5,088	81
Commercial and industrial loans (except those secured by real estate)	485	6	488	14
Consumer and other	2	-	1	-
	10,255	73	9,793	214
With an allowance recorded				
Construction and land development				
Commercial	472	12	477	12
	472	12	477	12
Commercial real estate				
Owner occupied	2,937	41	3,593	41
	2,937	41	3,593	41
Consumer real estate				
Home equity line	70	6	35	6
Secured by 1-4 family residential				
First deed of trust	1,084	-	1,299	18
Second deed of trust	174	2	132	2
	1,328	8	1,466	26
Commercial and industrial loans (except those secured by real estate)	95	4	50	4
Consumer and other	3	-	1	-
	4,835	65	5,587	83
Total				
Construction and land development				
Commercial	573	13	569	14
	573	13	569	14

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Commercial real estate				
Owner occupied	5,515	49	5,417	99
Non-owner occupied	2,207	29	2,300	59
	7,722	78	7,717	158
Consumer real estate				
Home equity lines	942	6	898	7
Secured by 1-4 family residential,				
First deed of trust	4,573	22	4,945	80
Second deed of trust	695	9	711	20
	6,210	37	6,554	107
Commercial and industrial loans				
(except those secured by real estate)	580	10	538	18
Consumer and other	5	-	2	-
	\$15,090	\$ 138	\$15,380	\$ 297

Included in impaired loans are loans classified as troubled debt restructurings (“TDRs”). A modification of a loan’s terms constitutes a TDR if the creditor grants a concession to the borrower for economic or legal reasons related to the borrower’s financial difficulties that it would not otherwise consider. For loans classified as impaired TDRs, the Company further evaluates the loans as performing or nonaccrual. To restore a nonaccrual loan that has been formally restructured in a TDR to accrual status, we perform a current, well documented credit analysis supporting a return to accrual status based on the borrower’s financial condition and prospects for repayment under the revised terms. Otherwise, the TDR must remain in nonaccrual status. The analysis considers the borrower’s sustained historical repayment performance for a reasonable period to the return-to-accrual date, but may take into account payments made for a reasonable period prior to the restructuring if the payments are consistent with the modified terms. A sustained period of repayment performance generally would be a minimum of six months and would involve payments in the form of cash or cash equivalents.

An accruing loan that is modified in a TDR can remain in accrual status if, based on a current well-documented credit analysis, collection of principal and interest in accordance with the modified terms is reasonably assured, and the borrower has demonstrated sustained historical repayment performance for a reasonable period before modification. The following is a summary of performing and nonaccrual TDRs and the related specific valuation allowance by portfolio segment for the periods indicated (dollars in thousands).

	Total	Performing	Nonaccrual	Specific Valuation Allowance
June 30, 2018				
Construction and land development				
Commercial	\$448	\$ 448	\$ -	\$ -
	448	448	-	-
Commercial real estate				
Owner occupied	4,136	4,136	-	13
Non-owner occupied	2,112	2,112	-	-
	6,248	6,248	-	13
Consumer real estate				
Secured by 1-4 family residential				
First deeds of trust	2,590	2,047	543	46
Second deeds of trust	816	750	66	7
	3,406	2,797	609	53
Commercial and industrial loans (except those secured by real estate)	341.25	303	38	-
	\$10,443	\$ 9,796	\$ 647	\$ 66
Number of loans	46	38	8	10

	Total	Performing	Nonaccrual	Specific Valuation Allowance
December 31, 2017				
Construction and land development				
Commercial	\$459	\$ 459	\$ -	\$ -
	459	459	-	-
Commercial real estate				
Owner occupied	4,188	4,005	183	18
Non-owner occupied	2,153	2,153	-	-
	6,341	6,158	183	18
Consumer real estate				
Secured by 1-4 family residential				
First deeds of trust	3,398	2,709	689	57
Second deeds of trust	590	523	67	4
	3,988	3,232	756	61
Commercial and industrial loans (except those secured by real estate)	385	344	41	-
	\$11,173	\$ 10,193	\$ 980	\$ 79
Number of loans	50	43	7	10

The following provides information about TDRs identified during the indicated periods (dollars in thousands).

	Six Months Ended June 30, 2018		Six Months Ended June 30, 2017	
	Pre- Modification Number of Loans	Post- Modification Recorded Balance	Pre- Modification Number of Loans	Post- Modification Recorded Balance
Secured by 1-4 family residential				
First deed of trust	1	\$ 73	1	\$ 190
Second deed of trust	-	-	1	68
	1	\$ 73	2	\$ 258

There were no defaults on TDRs that were modified as TDRs during the prior twelve month period.

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

	Beginning Balance	Provision for (Recovery of) Loan Losses	Charge-offs	Recoveries	Ending Balance
Three Months Ended June 30, 2018					
Construction and land development					
Residential	\$ 26	\$ 9	\$ -	\$ 1	\$ 36
Commercial	189	5	-	2	196
	215	14	-	3	232
Commercial real estate					
Owner occupied	662	57	-	-	719
Non-owner occupied	537	30	-	-	567
Multifamily	60	12	-	-	72
Farmland	2	-	-	-	2
	1,261	99	-	-	1,360
Consumer real estate					
Home equity lines	277	(41)	-	1	237
Secured by 1-4 family residential					
First deed of trust	527	(59)	(7)	15	476
Second deed of trust	54	(25)	-	27	56
	858	(125)	(7)	43	769
Commercial and industrial loans (except those secured by real estate)					
Student loans	604	(54)	(314)	168	404
Consumer and other	107	12	(28)	-	91
Unallocated	27	3	-	-	30
	271	51	-	-	322
	\$ 3,343	\$ -	\$ (349)	\$ 214	\$ 3,208

	Beginning Balance	Provision for (Recovery of) Loan Losses	Charge-offs	Recoveries	Ending Balance
Three Months Ended June 30, 2017					
Construction and land development					
Residential	\$ 41	\$ (4)	\$ -	\$ 1	\$ 38
Commercial	249	(36)	-	-	213
	290	(40)	-	1	251
Commercial real estate					
Owner occupied	619	(104)	-	-	515
Non-owner occupied	404	12	-	-	416
Multifamily	44	(4)	-	-	40

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Farmland	3	-	-	-	3
	1,070	(96)	-	974
Consumer real estate					
Home equity lines	256	(6)	-	250
Secured by 1-4 family residential					
First deed of trust	532	33	(107	)	462
Second deed of trust	139	(29	)	-	127
	927	(2	)	(107	21
					839
Commercial and industrial loans					
(except those secured by real estate)	292	3	-	7	302
Student loans	105	22	(28	)	99
Consumer and other	14	(6	)	-	9
Unallocated	674	119	-	-	793
	\$ 3,372	\$ -	\$ (135	)	\$ 30
					\$ 3,267

	Beginning Balance	Provision for (Recovery of) Loan Losses	Charge-offs	Recoveries	Ending Balance
Six Months Ended June 30, 2018					
Construction and land development					
Residential	\$ 32	\$ 3	\$ -	\$ 1	\$ 36
Commercial	165	28	-	3	196
	197	31	-	4	232
Commercial real estate					
Owner occupied	624	95	-	-	719
Non-owner occupied	500	(151)	-	218	567
Multifamily	60	12	-	-	72
Farmland	3	(1)	-	-	2
	1,187	(45)	-	218	1,360
Consumer real estate					
Home equity lines	268	(32)	-	1	237
Secured by 1-4 family residential					
First deed of trust	502	(2)	(41)	17	476
Second deed of trust	47	22	(45)	32	56
	817	(12)	(86)	50	769
Commercial and industrial loans (except those secured by real estate)					
Student loans	108	43	(60)	-	91
Consumer and other	27	18	(21)	6	30
Unallocated	347	(25)	-	-	322
	\$ 3,239	\$ -	\$ (481)	\$ 450	\$ 3,208

	Beginning Balance	Provision for (Recovery of) Loan Losses	Charge-offs	Recoveries	Ending Balance
Six Months Ended June 30, 2017					
Construction and land development					
Residential	\$ 41	\$ (4)	\$ -	\$ 1	\$ 38
Commercial	300	(87)	-	-	213
	341	(91)	-	1	251
Commercial real estate					
Owner occupied	611	(109)	-	13	515
Non-owner occupied	406	10	-	-	416
Multifamily	56	(16)	-	-	40
Farmland	3	-	-	-	3
	1,076	(115)	-	13	974
Consumer real estate					
Home equity lines	271	(22)	-	1	250

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Secured by 1-4 family residential						
First deed of trust	447	100	(107)	22	462
Second deed of trust	136	(32)	-	23	127
	854	46	(107	)	46	839
Commercial and industrial loans (except those secured by real estate)	223	69	-		10	302
Student loans	158	11	(70	)	-	99
Consumer and other	8	-	(2	)	3	9
Unallocated	713	80	-		-	793
	\$ 3,373	\$ -	\$ (179	)	\$ 73	\$ 3,267

	Beginning Balance	Provision for (Recovery of) Loan Losses	Charge-offs	Recoveries	Ending Balance
Year Ended December 31, 2017					
Construction and land development					
Residential	\$ 41	\$ (10)	\$ -	\$ 1	\$ 32
Commercial	300	(108)	(31)	4	165
	341	(118)	(31)	5	197
Commercial real estate					
Owner occupied	611	-	-	13	624
Non-owner occupied	406	94	-	-	500
Multifamily	56	4	-	-	60
Farmland	3	-	-	-	3
	1,076	98	-	13	1,187
Consumer real estate					
Home equity lines	271	(5)	-	2	268
Secured by 1-4 family residential					
First deed of trust	447	98	(107)	64	502
Second deed of trust	136	(123)	-	34	47
	854	(30)	(107)	100	817
Commercial and industrial loans (except those secured by real estate)					
Student loans	158	96	(146)	-	108
Consumer and other	8	4	(2)	17	27
Unallocated	713	(366)	-	-	347
	\$ 3,373	\$ -	\$ (286)	\$ 152	\$ 3,239

The allowance for loan losses at each of the periods presented includes an amount that could not be identified to individual types of loans referred to as the unallocated portion of the allowance. We recognize the inherent imprecision in estimates of losses due to various uncertainties and the variability related to the factors used in the calculation of the allowance. We concluded that the unallocated portion of the allowance was acceptable given the continued higher level of classified assets. The allowance for loan losses included an unallocated portion of approximately \$322,000, \$347,000, and \$793,000 at June 30, 2018, December 31, 2017, and June 30, 2017, respectively.

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

	Recorded Investment in Loans			Loans		
	Allowance		Collectively	Ending		Collectively
	Ending	Balance Individually		Balance	Individually	
As of June 30, 2018						
Construction and land development						
Residential	\$36	\$ -	\$ 36	\$5,961	\$ -	\$ 5,961
Commercial	196	-	196	30,693	819	29,874
	232	-	232	36,654	819	35,835
Commercial real estate						
Owner occupied	719	13	706	98,541	5,276	93,265
Non-owner occupied	567	-	567	80,535	2,626	77,909
Multifamily	72	-	72	11,352	-	11,352
Farmland	2	-	2	245	-	245
	1,360	13	1,347	190,673	7,902	182,771
Consumer real estate						
Home equity lines	237	-	237	22,566	705	21,861
Secured by 1-4 family residential						
First deed of trust	476	46	430	58,808	3,137	55,671
Second deed of trust	56	7	49	9,269	816	8,453
	769	53	716	90,643	4,658	85,985
Commercial and industrial loans						
(except those secured by real estate)	404	141	263	41,092	840	40,252
Student loans	91	-	91	42,133	-	42,133
Consumer and other	352	13	339	2,155	14	2,141
	\$3,208	\$ 220	\$ 2,988	\$403,350	\$ 14,233	\$ 389,117

	Recorded Investment in Loans			Loans		
	Allowance		Collectively	Ending		Collectively
	Ending	Balance Individually		Balance	Individually	
Year Ended December 31, 2017						
Construction and land development						
Residential	\$32	\$ -	\$ 32	\$5,361	\$ -	\$ 5,361
Commercial	165	-	165	25,456	502	24,954
	197	-	197	30,817	502	30,315
Commercial real estate						

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Owner occupied	624	18	606	85,004	5,370	79,634
Non-owner occupied	500	-	500	70,845	2,153	68,692
Multifamily	60	-	60	9,386	-	9,386
Farmland	3	-	3	270	-	270
	1,187	18	1,169	165,505	7,523	157,982
Consumer real estate						
Home equity lines	268	2	266	22,849	712	22,137
Secured by 1-4 family residential						
First deed of trust	502	98	404	57,919	4,745	53,174
Second deed of trust	47	4	43	7,460	590	6,870
	817	104	713	88,228	6,047	82,181
Commercial and industrial loans (except those secured by real estate)	556	375	181	36,506	1,220	35,286
Student loans	108	-	108	45,805	-	45,805
Consumer and other	374	18	356	1,848	22	1,826
	\$3,239	\$ 515	\$ 2,724	\$368,709	\$ 15,314	\$ 353,395

Note 6 – Deposits

Deposits as of June 30, 2018 and December 31, 2017 were as follows (dollars in thousands):

	June 30, 2018		December 31, 2017		
	Amount	%	Amount	%	
Demand accounts	120,718	27.9 %	\$ 104,138	25.3 %	
Interest checking accounts	48,742	11.3 %	48,042	11.7 %	
Money market accounts	83,016	19.2 %	82,523	20.1 %	
Savings accounts	29,042	6.7 %	27,596	6.7 %	
Time deposits of \$250,000 and over	21,362	4.9 %	21,592	5.2 %	
Other time deposits	130,103	30.0 %	127,733	31.0 %	
Total	\$432,983	100.0%	\$411,624	100.0%	

Note 7 – Borrowings

The Company uses both short-term and long-term borrowings to supplement deposits when they are available at a lower overall cost to the Company or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank of Atlanta, the Bank is required to own capital stock in the FHLB and is authorized to apply for advances from the FHLB. The Company held \$1,299,200 in FHLB stock at June 30, 2018 and \$920,000 at December 31, 2017 which is held at cost and included in other assets. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses to which the advances may be put, as well as on the size of the advances and repayment provisions. The FHLB borrowings are secured by the pledge of investment securities, commercial loans and 1-4 family residential loans. The Company had FHLB advances of \$20,500,000 at June 30, 2018 and \$12,300,000 at December 31, 2017 maturing through 2021.

The Company uses federal funds purchased and repurchase agreements for short-term borrowing needs. Securities sold under agreements to repurchase are classified as borrowings and generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities. The carrying value of these short-term borrowing agreements was \$668,000 and

\$1,584,000 at June 30, 2018 and December 31, 2017, respectively.

Note 8 – Trust preferred securities

During the first quarter of 2005, Southern Community Financial Capital Trust I, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On February 24, 2005, \$5.2 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest (three-month LIBOR plus 2.15%) which adjusts, and is payable, quarterly. The interest rate at June 30, 2018 was 4.27%. The securities were redeemable at par beginning on March 15, 2010 and each quarter after such date until the securities mature on March 15, 2035. No amounts have been redeemed at June 30, 2018 and there are no plans to do so. The principal asset of the Trust is \$5.2 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

During the third quarter of 2007, Village Financial Statutory Trust II, a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable securities. On September 20, 2007, \$3.6 million of Trust Preferred Capital Notes were issued through a pooled underwriting. The securities have LIBOR-indexed floating rate of interest (three-month LIBOR plus 1.4%) which adjusts, and is also payable, quarterly. The interest rate at June 30, 2018 was 3.52%. The securities may be redeemed at par at any time commencing in December 2012 until the securities mature in 2037. No amounts have been redeemed at June 30, 2018 and there are no plans to do so. The principal asset of the Trust is \$3.6 million of the Company's junior subordinated debt securities with like maturities and like interest rates to the Trust Preferred Capital Notes.

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

The obligations of the Company with respect to the issuance of the Trust Preferred Capital Notes constitute a full and unconditional guarantee by the Company of the Trust's obligations with respect to the Trust Preferred Capital Notes. Subject to certain exceptions and limitations, the Company may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related Trust Preferred Capital Notes and require a deferral of common dividends. The Company is current on these interest payments.

Note 9 – Subordinated Debt Offering

On March 21, 2018, the Company issued \$5,700,000 of fixed-to-floating rate subordinated notes due March 31, 2028 in a private placement. The Company received \$5,539,000 in net proceeds after deducting issuance costs. The subordinated notes accrue interest at a fixed rate of 6.50% for the first five years until March 31, 2023; thereafter, the subordinated notes will accrue interest at an annual floating rate equal to three-month LIBOR plus a spread of 3.73% until maturity or early redemption. The Company may redeem the subordinated notes in whole or in part, on or after March 31, 2023. The subordinated notes are unsecured and subordinated in right of payment to all of the Company's existing and future senior indebtedness, whether secured or unsecured, including claims of depositors and general creditors, and rank equally in right of payment with any unsecured, subordinated indebtedness that the Company may incur in the future. At June 30, 2018, the carrying value of the notes totaled \$5,547,000.

Note 10 – Stock incentive plan

The Village Bank and Trust Financial Corp. Incentive Plan, which was adopted on February 28, 2006, authorized the issuance of up to 48,750 shares of common stock (after the reverse stock split in 2014) (the “2006 Plan”). On May 26, 2015, the Company’s shareholders approved the adoption of the Village Bank and Trust Financial Corp. 2015 Stock Incentive Plan (the “2015 Plan”) authorizing the issuance of up to 60,000 shares of common stock. The 2015 Plan was adopted to replace the 2006 Plan and any new awards will be made pursuant to the 2015 Plan. The prior awards made under the 2006 Plan were unchanged by the adoption of the 2015 Plan and continue to be governed by the terms of the 2006 Plan.

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

	Six Months Ended June 30, 2018			2017			Intrinsic Value
	Options	Weighted Average Exercise Price	Fair Value Per Share	Options	Weighted Average Exercise Price	Fair Value Per Share	
Options outstanding, beginning of period	2,245	\$ 24.17	\$12.88	2,337	\$ 24.21	\$12.76	
Granted	-	-	-	-	-	-	
Forfeited	-	-	-	-	-	-	
Exercised	-	-	-	-	-	-	
Options outstanding, end of period	2,245	\$ 24.17	\$12.88	2,337	\$ 24.21	\$12.76	\$ -
Options exercisable, end of period	2,245			2,337			

During the first quarter of 2018, we granted certain officers 1,590 restricted shares of common stock with a weighted average fair value of \$32.42 on the date of grant. These restricted stock awards vest over three years. During the second quarter of 2017, we granted certain officers 600 restricted shares of common stock with a weighted average fair value of \$28.83 at the date of grant. These restricted stock awards vest over two years. During the third quarter of 2017, we granted certain officers 5,450 restricted shares of common stock with a weighted average fair value of \$31.00 at the date of grant. These restricted stock awards vest over three years. During the fourth quarter of 2017, we granted certain officers 660 restricted shares of common stock with a weighted average fair value of \$30.65 at the date of grant. These restricted stock awards vest over one year.

The total number of shares underlying non-vested restricted stock was 20,197 and 30,098 at June 30, 2018 and 2017, respectively.

The fair value of the stock is based on the grant date of the award and the expense is recognized over the vesting period. Unrecognized stock-based compensation related to nonvested share based compensation arrangements granted under the stock incentive plan as of June 30, 2018 and 2017, was \$268,946 and \$413,281, respectively. The time based unrecognized compensation of \$204,788 is expected to be recognized over a weighted average period of 1.69 years.

Stock-based compensation expense was approximately \$117,000 and \$120,000 for the six months ended June 30, 2018 and 2017, respectively.

Note 11 — Fair value

The Company determines the fair value of its financial instruments based on the requirements established in Accounting Standards Codification (“ASC”) 820: *Fair Value Measurements*, which provides a framework for measuring fair value under GAAP and requires an entity to maximize the use of observable inputs when measuring fair value. ASC 820 defines fair value as the exit price, the price that would be received for an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date under current market conditions.

ASC 820 establishes a hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair values hierarchy is as follows:

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

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

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

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

Securities: Fair values for securities available-for-sale are obtained from an independent pricing service. The prices are not adjusted. The independent pricing service uses industry-standard models to price U.S. Government agency obligations and mortgage backed securities that consider various assumptions, including time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the

underlying financial instruments, as well as other relevant economic measures. Securities of obligations of state and political subdivisions are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. Substantially all assumptions used by the independent pricing service are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace (Levels 1 and 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any, market activity, then the security would fall to the lowest level of the hierarchy (Level 3).

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

Other Real Estate Owned: Other real estate owned assets are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. Subsequently, real estate owned assets are carried at lower of cost or fair value less estimated costs to sell. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

Assets held for sale: Assets held for sale were transferred from premises and equipment at the lower of cost less accumulated depreciation or fair value at the date of transfer. The Company periodically evaluates the value of assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the assets held for sale as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the asset held for sale as nonrecurring Level 3.

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

**Fair Value Measurement
at June 30, 2018 Using**

	Quoted Prices in Active Markets for Identical Assets	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Carrying	Value	(Level 1)	(Level 3)
Financial Assets - Recurring			
US Government Agencies	\$23,227	\$ -	\$ 23,227
Mortgage-backed securities	19,848	-	19,848
Subordinated debt	4,062	-	1,488
			2,574
Financial Assets - Non-Recurring			
Impaired loans	2,276	-	-
Assets held for sale	610	-	-
Other real estate owned	732	-	-

**Fair Value Measurement
at December 31, 2017 Using**

	Quoted Prices in Active Markets for Identical Assets	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Carrying	Value	(Level 1)	(Level 3)
Financial Assets - Recurring			
US Government Agencies	\$23,683	\$ -	\$ 23,683
Mortgage-backed securities	21,940	-	21,940
Subordinated debt	4,088	757	1,531
			1,800
Financial Assets - Non-Recurring			
Impaired loans	2,769	-	-
Assets held for sale	610	-	-
Other real estate owned	1,788	-	-

The following tables present qualitative information about Level 3 fair value measurements for financial instruments measured at fair value at June 30, 2018 and December 31, 2017 (dollars in thousands):

June 30, 2018				Range
	Fair Value Estimate	Valuation Techniques	Unobservable Input	(Weighted Average)
Impaired loans - real estate secured	\$2,017	Appraisal (1) or Internal Valuation (2)	Selling costs Discount for lack of marketability and age of appraisal	6%-10% (7%) 6%-30% (10%)
Impaired loans - non-real estate secured	\$259	Appraisal (1) or Discounted Cash Flow	Selling costs Discount for lack of marketability or practical life	10 % 0%-50% (20%)
Assets held for sale	\$610	Appraisal (1) or Internal Valuation (2)	Selling costs Discount for lack of marketability and age of appraisal	6%-10% (7%) 6%-30% (15%)
Other real estate owned	\$732	Appraisal (1) or Internal Valuation (2)	Selling costs	6%-10% (7%)

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

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

December 31, 2017				Range
	Fair Value Estimate	Valuation Techniques	Unobservable Input	(Weighted Average)
Impaired loans - real estate secured	\$2,403	Appraisal (1) or Internal Valuation (2)	Selling costs Discount for lack of marketability and age of appraisal	6%-10% (7%) 6%-30% (10%)
Impaired loans - non-real estate secured	\$366	Appraisal (1) or Discounted Cash Flow	Selling costs	10 %

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			Discount for lack of marketability or practical life	0%-50% (20%)
Assets held for sale	\$610	Appraisal (1) or Internal Valuation (2)	Selling costs	6%-10% (7%)
			Discount for lack of marketability and age of appraisal	6%-30% (15%)
Other real estate owned	\$1,788	Appraisal (1) or Internal Valuation (2)	Selling costs	6%-10% (7%)

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

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

On January 1, 2018, the Company adopted ASU 2016-01, “*Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.*” ASU 2016-01 makes targeted improvements to several areas of U.S. GAAP including the disclosure of the fair value of financial instruments that are not measured at fair value on a recurring basis. Specifically, the new guidance (i) eliminates the requirements to disclose the methods and significant assumptions used to estimate the fair value and the description of the changes therein, if any, during the period, (ii) requires the use of the exit price notion, prospectively, in calculating the fair values of financial instruments not measured at fair value on a recurring basis and (iii) eliminates the guidance that allowed the use of the entry price notion to calculate the fair value of certain financial instruments, such as loans and long-term debt. For example, the Company has historically estimated the fair value for loans reported at amortized cost on its balance sheet by examining the average rates per the terms of these loans, and comparing those average rates to the current rates offered by the Company (i.e., the entry price notion). Utilizing the exit price notion requires the Company to estimate fair value of these loans based on the price that would be received to sell these loans in an orderly transaction between market participants at the measurement date.

In accordance with the prospective adoption of ASU No. 2016-01 as previously discussed, the fair value of loans as of June 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

	Level in Fair Value Hierarchy	June 30, 2018		December 31, 2017	
		Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
(In thousands)					
Financial assets					
Cash	Level 1	\$ 15,728	\$ 15,728	\$ 17,810	\$ 17,810
Investment securities available for sale	Level 1	-	-	757	757
Investment securities available for sale	Level 2	44,563	44,563	47,154	47,154
Investment securities available for sale	Level 3	2,574	2,574	1,800	1,800
Federal Home Loan Bank stock	Level 2	1,299	1,299	920	920
Loans held for sale	Level 2	9,106	9,106	8,047	8,047
Loans	Level 3	401,074	395,046	365,940	366,035
Impaired loans	Level 3	2,276	2,276	2,769	2,769
Assets held for sale	Level 3	610	610	610	610
Other real estate owned	Level 3	732	732	1,788	1,788
Bank owned life insurance	Level 3	7,350	7,350	7,268	7,268
Accrued interest receivable	Level 2	2,444	2,444	2,600	2,600
Financial liabilities					
Deposits	Level 2	432,983	430,456	411,624	411,044

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FHLB borrowings	Level 2	20,500	20,491	12,300	12,294
Trust preferred securities	Level 2	8,764	9,288	8,764	9,099
Other borrowings	Level 2	668	668	1,584	1,584
Accrued interest payable	Level 2	149	149	93	93

Note 12 – Segment Reporting

The Company has two reportable segments: traditional commercial banking and mortgage banking. Revenues from commercial banking operations consist primarily of interest earned on loans and securities and fees from deposit services. Mortgage banking operating revenues consist principally of interest earned on mortgage loans held for sale, gains on sales of loans in the secondary mortgage market, and loan origination fee income.

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

The following table presents segment information as of and for the three and six months ended June 30, 2018 and 2017 (in thousands):

	Commercial Banking	Mortgage Banking	Eliminations	Consolidated Totals
Three Months Ended June 30, 2018				
Revenues				
Interest income	\$ 5,079	\$ 73	\$ -	\$ 5,152
Gain on sale of loans	-	1,422	-	1,422
Other revenues	588	188	(51)	725
Total revenues	5,667	1,683	(51)	7,299
Expenses				
Interest expense	924	-	-	924
Salaries and benefits	2,140	832	-	2,972
Commissions	-	480	-	480
Other expenses	1,903	277	(51)	2,129
Total operating expenses	4,967	1,589	(51)	6,505
Income before income taxes	\$ 700	\$ 94	\$ -	\$ 794
Total assets	\$ 508,158	\$ 9,628	\$ (11,434)	\$ 506,352

	Commercial Banking	Mortgage Banking	Eliminations	Consolidated Totals
Three Months Ended June 30, 2017				
Revenues				
Interest income	\$ 4,127	\$ 68	\$ (3	) \$ 4,192
Gain on sale of loans	-	1,424	-	1,424
Other revenues	563	212	(52	) 723
Total revenues	4,690	1,704	(55	) 6,339
Expenses				
Interest expense	670	3	(3	) 670
Salaries and benefits	2,063	985	-	3,048
Commissions	-	382	-	382
Other expenses	1,763	197	(52	) 1,908
Total operating expenses	4,496	1,567	(55	) 6,008
Income before income taxes	\$ 194	\$ 137	\$ -	\$ 331
Total assets	\$ 464,067	\$ 11,075	\$ (12,887	) \$ 462,255

	Commercial Banking	Mortgage Banking	Eliminations	Consolidated Totals
Six Months Ended June 30, 2018				
Revenues				
Interest income	\$ 9,809	\$ 120	\$ -	\$ 9,929
Gain on sale of loans	-	2,451	-	2,451
Other revenues	1,146	305	(100	) 1,351
Total revenues	10,955	2,876	(100	) 13,731
Expenses				
Interest expense	1,690	-	-	1,690
Salaries and benefits	4,264	1,651	-	5,915
Commissions	-	802	-	802
Other expenses	3,601	545	(100	) 4,046
Total operating expenses	9,555	2,998	(100	) 12,453
Income (loss) before income taxes	\$ 1,400	\$ (122	) \$ -	\$ 1,278
Total assets	\$ 508,158	\$ 9,628	\$ (11,434	) \$ 506,352

	Commercial Banking	Mortgage Banking	Eliminations	Consolidated Totals
Six Months Ended June 30, 2017				
Revenues				
Interest income	\$ 8,200	\$ 133	\$ (9	) \$ 8,324
Gain on sale of loans	-	2,800	-	2,800
Other revenues	1,114	345	(96	) 1,363
Total revenues	9,314	3,278	(105	) 12,487
Expenses				
Interest expense	1,309	9	(9	) 1,309
Salaries and benefits	4,081	1,977	-	6,058
Commissions	-	748	-	748
Other expenses	3,139	449	(96	) 3,492
Total operating expenses	8,529	3,183	(105	) 11,607
Income (loss) before income taxes	\$ 785	\$ 95	\$ -	\$ 880
Total assets	\$ 464,067	\$ 11,075	\$ (12,887	) \$ 462,255

Note 13 – Shareholders’ Equity and Regulatory Matters

Preferred Stock

On May 1, 2009, as part of the Capital Purchase Program established by the U.S. Department of the Treasury (the “Treasury”) under the Emergency Economic Stabilization Act of 2008, the Company entered into a Letter Agreement and Securities Purchase Agreement—Standard Terms with the Treasury, pursuant to which the Company sold (i) 14,738 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$4.00 per share, having a liquidation preference of \$1,000 per share (the “preferred stock”) and (ii) a warrant (the “Warrant”) to purchase 499,029 shares of the Company’s common stock at an initial exercise price of \$4.43 per share, subject to certain anti-dilution and other adjustments, for an aggregate purchase price of \$14,738,000 in cash. As a result of the Company’s 1 for 16 reverse stock split completed in August 2014, the number of shares underlying the Warrant and the exercise price per share were adjusted to 31,190 and \$70.88, respectively.

The Warrant was immediately exercisable. The Warrant provides for the adjustment of the exercise price and the number of shares of common stock issuable upon exercise pursuant to customary anti-dilution provisions, such as upon stock splits or distributions of securities or other assets to holders of common stock, and upon certain issuances of common stock at or below a specified price relative to the then-current market price of common stock. The Warrant expires ten years from the issuance date.

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

During the first quarter of 2017, the Company received approval from state and federal regulators allowing the Bank to pay a special dividend to the Company for the sole purpose of paying all accrued and unpaid dividends on the preferred stock through February 15, 2017, as well as to redeem 688 shares of the total 5,715 shares outstanding. The accrued and unpaid dividends paid on February 15, 2017 amounted to \$2,911,000. The 688 shares were redeemed on February 24, 2017 at a redemption price of \$1,000 per share plus accrued dividends from February 15, 2017 to the redemption date.

During the second quarter of 2017, the Company received approval from the state regulators allowing the Bank to pay a special dividend to the Company for the purpose of paying the preferred stock dividend due on May 15, 2017. No other dividends were paid by the Bank to the Company during 2017.

At December 31, 2017, the aggregate amount of the Company's total accrued dividend payments on the preferred stock was \$56,000 and reflected as a reduction of retained earnings.

During the first quarter of 2018, the Company used the proceeds from the subordinated note issuance to redeem the remaining 5,027 shares (\$5,027,000 aggregate liquidation value) of preferred stock plus accrued dividends of \$56,554.

Common Stock

On August 6, 2014, the Company filed Articles of Amendment to its Articles of Incorporation with the Virginia State Corporation Commission to affect a reverse stock split of its outstanding common stock which became effective on August 8, 2014. As a result of the reverse split, every sixteen shares of the Company's issued and outstanding common stock were consolidated into one issued and outstanding share of common stock.

On March 27, 2015, the Company completed a rights offering to shareholders (the "Rights Offering") and concurrent standby offering to Kenneth R. Lehman (the "Standby Offering"), in which the Company issued an aggregate of 1,051,866 shares of common stock (the total number of shares offered) at \$13.87 per share for aggregate gross proceeds of \$14,589,381 (including the value of the Company's preferred stock exchanged by Mr. Lehman for shares

of common stock of \$4,618,813). In connection with the Rights Offering, 283,293 shares were issued to shareholders upon exercise of their basic subscription rights and 191,773 shares were issued to shareholders upon exercise of their oversubscription privileges (approximately 36.9% of the total number of shares requested pursuant to oversubscription privileges). In connection with the Standby Offering, Mr. Lehman purchased an aggregate of 576,800 shares of the Company's common stock, 333,007 of which were issued in exchange for 9,023 shares of the Company's preferred stock and 243,793 of which were purchased for cash. Also, as part of the Standby Offering, Mr. Lehman forgave \$2,215,009 in accrued and unpaid dividends on the preferred stock.

Accumulated Other Comprehensive Loss

The following table presents the cumulative balances of the components of accumulated other comprehensive income, net of deferred taxes of \$270,000 and \$120,000 as of June 30, 2018 and December 31, 2017 (in thousands):

	June 30, 2018	December 31, 2018
Net unrealized losses on securities	\$(965)	\$ (391)
Net unrecognized losses on defined benefit plan	(57)	(61)
Total other comprehensive loss	\$(1,022)	\$ (452)

Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under the capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures are established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 Capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 Capital to average assets (the Leverage ratio).

In July 2013, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation ("FDIC") approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements will increase for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio ("CET1 ratio") of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which when fully phased-in, effectively results in a minimum CET1 ratio of 7.0%. Basel III

raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance-sheet exposures. Management expects that the capital ratios for the Company and the Bank under Basel III will continue to exceed the well capitalized minimum capital requirements.

The capital amounts and ratios at June 30, 2018 and December 31, 2017 for the Bank are presented in the table below (dollars in thousands):

	Actual Amount	Ratio	For Capital Adequacy Purposes Amount	Ratio	To be Well Capitalized Amount	Ratio
June 30, 2018						
Total capital (to risk- weighted assets)						
Village Bank	\$47,134	12.10 %	\$ 31,151	8.00 %	\$ 38,939	10.00 %
Tier 1 capital (to risk- weighted assets)						
Village Bank	43,926	11.28 %	23,363	6.00 %	31,151	8.00 %
Leverage ratio (Tier 1 capital to average assets)						
Village Bank	43,926	9.00 %	19,523	4.00 %	24,403	5.00 %
Common equity tier 1 (to risk- weighted assets)						
Village Bank	43,926	11.28 %	17,522	4.50 %	25,310	6.50 %
December 31, 2017						
Total capital (to risk- weighted assets)						
Village Bank	\$45,504	12.88 %	\$ 28,268	8.00 %	\$ 35,335	10.00 %
Tier 1 capital (to risk- weighted assets)						
Village Bank	42,265	11.96 %	21,201	6.00 %	26,268	8.00 %
Leverage ratio (Tier 1 capital to average assets)						
Village Bank	42,265	9.18 %	18,422	4.00 %	23,028	5.00 %
Common equity tier 1 (to risk- weighted assets)						
Village Bank	42,265	11.96 %	15,901	4.50 %	22,968	6.50 %

Note 14 – Commitments and contingencies

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

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

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

	June 30, 2018	December 31, 2017
Undisbursed credit lines	\$60,211	\$ 65,495
Commitments to extend or originate credit	25,076	13,888
Standby letters of credit	4,297	4,615
Total commitments to extend credit	\$89,584	\$ 83,998

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

Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in

extending loans to customers.

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

Prior Agreements with Regulators – In February 2012, the Bank entered into a Stipulation and Consent to the Issuance of a Consent Order with the FDIC and the Virginia Bureau of Financial Institutions (the “Supervisory Authorities”), and the Supervisory Authorities issued the related Consent Order effective February 3, 2012 (the “Consent Order”). In June 2012, the Company entered into a similar written agreement (the “Written Agreement”) with the Reserve Bank. As a result of the steps the Company and the Bank took to, among other things, improve asset quality, increase capital, augment management and board oversight, and increase earnings, the Consent Order was terminated effective December 14, 2015. In place of the Consent Order, the Bank’s Board of Directors made certain written assurances to the Supervisory Authorities in the form of a Memorandum of Understanding (“MOU”) that became effective November 17, 2015. Due to further improvements by the Company and the Bank in asset quality and earnings, and the correction of a prior Regulation W violation, the MOU was terminated effective May 12, 2016, and the Written Agreement was terminated effective July 28, 2016.

Note 15 – Income Taxes

The net deferred tax asset is included in other assets on the balance sheet. Accounting Standards Codification Topic 740, *Income Taxes*, requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. Management considers both positive and negative evidence and analyzes changes in near-term market conditions as well as other factors which may impact future operating results. In making such judgments, significant weight is given to evidence that can be objectively verified. The deferred tax assets are analyzed quarterly for changes affecting realization.

On December 22, 2017, the President signed into law the Tax Cuts and Jobs Act of 2017 (the “Tax Reform Act”). The Tax Reform Act includes a number of changes in existing tax law impacting businesses. One of the most significant changes is a permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction took effect on January 1, 2018. GAAP requires companies to re-value their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment.

As of December 31, 2017, the Company had net deferred tax assets of \$11 million. The Company recorded a re-valuation of its deferred tax assets and liabilities as of December 31, 2017, at the new rate of 21%, based upon balances in existence at the date of enactment. As a result, the Company's net deferred tax assets were written down by approximately \$4,181,000 in the fourth quarter of 2017 with a corresponding increase in tax expense. Although the Tax Reform Act had a significant negative impact on the Company’s earnings for 2017 as a result of the re-valuation of its deferred tax assets and liabilities, the reduction in the corporate tax rate to 21% is expected to have a significant positive benefit to the Company in 2018 and beyond.

In assessing the Company's ability to realize its net deferred tax asset, management considers whether it is more likely than not that some portion or all of the net deferred tax asset will or will not be realized. The Company's ultimate realization of the net deferred tax asset is dependent upon the generation of future taxable income during the periods in which temporary differences become deductible. Management considers the nature and amount of historical and projected future taxable income, the scheduled reversal of deferred tax assets and liabilities, and available tax planning strategies in making this assessment. The amount of net deferred taxes recognized could be impacted by changes to any of these variables.

Each quarter, the Company weighs both the positive and negative information with respect to realization of the net deferred tax asset and analyzes its position as to whether or not a valuation allowance is required. Over the past several quarters, the positive information has been increasing while the negative information has been decreasing. The Company has demonstrated consistent earnings while its level of non-performing assets, which was the primary cause of the Company's losses, has steadily decreased.

Given the consistent earnings and improving asset quality, the Company's analysis concluded that, it is more likely than not that the Company will generate sufficient taxable income within the applicable carry-forward periods to realize its net deferred tax asset.

There was \$153,000 and \$225,000 in income tax expense recorded for the three and six month period ended June 30, 2018, respectively, compared to \$94,000 and \$227,000 for the for the three and six months period ended June 30, 2017, respectively.

The net operating losses available to offset future taxable income amounted to \$22,155,000 at June 30, 2018 and begin expiring in 2028.

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Company recorded franchise tax expense of approximately \$80,000 and \$161,000 for the three and six months ended June 30, 2018, respectively, compared to \$86,000 and \$171,000 for the three and six months ended June 30, 2017, respectively.

Note 16 – Recent accounting pronouncements

In February 2016, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2016-02, “Leases (Topic 842).” Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative

period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company has determined that the provisions of ASU-2016-02 may result in an increase in assets to recognize the present value of the lease obligations with a corresponding increase in liabilities; however, the Company does not expect this to have a material impact on the Company's financial position, results of operations or cash flows.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in the ASU are effective beginning after December 15, 2019 and for interim periods within that year. Early adoption is permitted beginning after December 15, 2018. Entities will apply the amendments in this ASU through a cumulative-effect adjustment to retained earnings in the first period effective. While the Company is currently evaluating the provisions of ASU No. 2016-13 to determine the potential impact the new standard will have on the Company’s Consolidated Financial Statements, it has taken steps to prepare for the implementation when it becomes effective, such as forming an internal task force, gathering pertinent data, consulting with outside professionals, and evaluating its current IT systems. This guidance may result in material changes in the Company's accounting for credit losses on financial instruments.

In March 2017, the FASB issued ASU 2017-08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, the Company is required to apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company does have exposure and is assessing the impact of ASU 2017-08, and may choose early adoption. Overall, the Company does not expect it to have a material impact on its consolidated financial statements.

In February 2018, the FASB issued ASU 2018-03, “Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.” The amendments provide targeted improvements to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Specifically, the amendments include clarifications related to: measurement elections, transition requirements, and adjustments associated with equity securities without readily determinable fair values; fair value measurement requirements for forward contracts and purchased options on equity securities; presentation requirements for hybrid financial liabilities for which the fair value option has been elected; and measurement requirements for liabilities denominated in a foreign currency for which the fair value option has been elected. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-03 to have a material impact on its consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, “Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” The amendments expand the scope of Topic 718 to include share-based payments issued to non-employees for goods or services, which were previously excluded. The amendments will align the accounting for share-based payments to nonemployees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-07 to have a material impact on its consolidated financial statements.

Item 2 - Management's Discussion and Analysis OF Financial condition and results of operations

Caution about forward-looking statements

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

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

- changes in assumptions underlying the establishment of allowances for loan losses, and other estimates;
- the risks of changes in interest rates on levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities;
- the effects of future economic, business and market conditions;
- legislative and regulatory changes, including the Dodd-Frank Wall Street Reform and Consumer Protection Act and other changes in banking, securities, and tax laws and regulations and their application by our regulators, and changes in scope and cost of FDIC insurance and other coverages;
- our inability to maintain our regulatory capital position;
- the Company's computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance, or other disruptions despite security measures implemented by the Company;
- changes in market conditions, specifically declines in the residential and commercial real estate market, volatility and disruption of the capital and credit markets, soundness of other financial institutions we do business with;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- changes in operations of the mortgage company as a result of the activity in the residential real estate market;
- exposure to repurchase loans sold to investors for which borrowers failed to provide full and accurate information on or related to their loan application or for which appraisals have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor;
- governmental monetary and fiscal policies;
- changes in accounting policies, rules and practices;

reliance on our management team, including our ability to attract and retain key personnel;
competition with other banks and financial institutions, and companies outside of the banking industry,
including those companies that have substantially greater access to capital and other resources;
demand, development and acceptance of new products and services;
problems with technology utilized by us;
changing trends in customer profiles and behavior; and
other factors described from time to time in our reports filed with the SEC.

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

General

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

Although we endeavor to minimize the credit risk inherent in the Company's loan portfolio, we must necessarily make various assumptions and judgments about the collectability of the loan portfolio based on our experience and evaluation of economic conditions. If such assumptions or judgments prove to be incorrect, the current allowance for loan losses may not be sufficient to cover loan losses and additions to the allowance may be necessary, which would have a negative impact on net income.

Results of operations

The following presents management's discussion and analysis of the financial condition of the Company at June 30, 2018 and December 31, 2017 and the results of operations for the Company for the three and six months ended June 30, 2018 and 2017. This discussion should be read in conjunction with the Company's consolidated financial statements and the notes thereto appearing elsewhere in this Quarterly Report.

Summary

For the three months ended June 30, 2018, the Company had net income and net income available to common shareholders of \$641,000, or \$0.45 per fully diluted share, compared to net income of \$237,000 and net income available to common shareholders of \$123,000, or \$0.09 per fully diluted share, for the same period in 2017. For the six months ended June 30, 2018, the Company had net income of \$1,053,000 and net income available to common shareholders of \$940,000 or \$0.66 per fully diluted share, compared to net income of \$653,000 and net income available to common shareholders of \$381,000, or \$0.27 per fully diluted share for the same period in 2017.

Net interest income

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

	For the Three Months Ended June 30,					
	2018		2017		Change	
	(dollars in thousands)					
Average interest-earning assets	\$ 451,057		\$ 404,740		\$ 46,317	
Interest income	\$ 5,152		\$ 4,192		\$ 960	
Yield on interest-earning assets	4.58	%	4.15	%	0.43	%
Average interest-bearing liabilities	\$ 341,022		\$ 311,766		\$ 29,256	
Interest expense	\$ 924		\$ 670		\$ 254	
Cost of interest-bearing liabilities	1.09	%	0.86	%	0.23	%
Net interest income	\$ 4,228		\$ 3,522		\$ 706	
Net interest margin	3.76	%	3.49	%	0.27	%

The increase in net interest income of \$706,000 in the second quarter of 2018 was a result of positive movements in interest income. Interest income increased by \$960,000 with interest income on loans held for investment increasing by \$875,000 and interest income on investment securities increasing by \$94,000. The increase in interest income on loans held for investment was attributable to an increase in average loans outstanding of \$51,056,000 and an increase in the yield of 30 basis points. The increase in interest income on securities was due to an increase in average

investment securities of \$4,342,000 and an increase in the yield of 65 basis points. Interest expense increased by \$254,000 as a result of an increase in average interest bearing liabilities of \$29,256,000 and an increase in the cost of interest bearing liabilities of 23 basis points.

	For the Six Months Ended June 30,					
	2018		2017		Change	
	(dollars in thousands)					
Average interest-earning assets	\$ 442,924		\$ 400,391		\$ 42,533	
Interest income	\$ 9,929		\$ 8,324		\$ 1,605	
Yield on interest-earning assets	4.52	%	4.19	%	0.33	%
Average interest-bearing liabilities	\$ 335,039		\$ 307,831		\$ 27,208	
Interest expense	\$ 1,690		\$ 1,309		\$ 381	
Cost of interest-bearing liabilities	1.02	%	0.86	%	0.16	%
Net interest income	\$ 8,239		\$ 7,015		\$ 1,224	
Net interest margin	3.75	%	3.53	%	0.22	%

The increase in net interest income of \$1,224,000 for the six months ended June 30, 2018 was a result of positive movements in interest income. Interest income increased \$1,605,000 with interest income on loans increasing \$1,423,000 and interest income on investments increasing by \$194,000. The increase in interest income on loans was attributable to an increase in average loans outstanding of \$42,597,000 and an increase in the yield of 23 basis points. The increase in interest income on securities was due to an increase in average investment securities of \$4,843,000 and an increase in the yield of 65 basis points. Interest expense increased by \$381,000 as a result of an increase in average interest bearing liabilities of \$27,208,000 and an increase in the cost of interest bearing liabilities of 16 basis points.

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

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	Three Months Ended June 30, 2018				Three Months Ended June 30, 2017			
	Average Balance	Interest Income/ Expense	Annualized Yield Rate		Average Balance	Interest Income/ Expense	Annualized Yield Rate	
Loans net of deferred fees	\$ 393,057	\$ 4,800	4.90	%	\$ 342,001	\$ 3,925	4.60	%
Loans held for sale	6,056	73	4.83	%	6,454	68	4.23	%
Investment securities	47,777	259	2.17	%	43,435	165	1.52	%
Federal funds and other	4,167	20	1.93	%	12,850	34	1.06	%
Total interest earning assets	451,057	5,152	4.58	%	404,740	4,192	4.15	%
Allowance for loan losses and deferred fees	(3,425)				(3,303)			
Cash and due from banks	10,623				10,649			
Premises and equipment, net	12,873				12,777			
Other assets	20,660				25,544			
Total assets	\$ 491,788				\$ 450,407			
Interest bearing deposits								
Interest checking	\$ 48,767	\$ 22	0.18	%	\$ 44,363	\$ 20	0.18	%
Money market	81,736	86	0.42	%	77,021	74	0.39	%
Savings	24,545	11	0.18	%	22,711	10	0.18	%
Certificates	154,553	540	1.40	%	152,798	485	1.27	%
Total	309,601	659	0.85	%	296,893	589	0.80	%
Borrowings	31,421	265	3.38	%	14,873	81	2.18	%
Total interest bearing liabilities	341,022	924	1.09	%	311,766	670	0.86	%
Noninterest bearing deposits	113,340				92,123			
Other liabilities	2,848				2,941			
Total liabilities	457,210				406,830			
Equity capital	34,578				43,577			
Total liabilities and capital	\$ 491,788				\$ 450,407			
Net interest income before provision for loan losses		\$ 4,228				\$ 3,522		
Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities			3.49	%			3.29	%
Annualized net interest margin (net interest income expressed as percentage of average earning assets)			3.76	%			3.49	%

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	Six Months Ended June 30, 2018				Six Months Ended June 30, 2017			
	Average Balance	Interest Income/Expense	Annualized Yield Rate		Average Balance	Interest Income/Expense	Annualized Yield Rate	
Loans net of deferred fees	\$ 384,143	\$ 9,241	4.85	%	\$ 341,546	\$ 7,818	4.62	%
Loans held for sale	5,160	120	4.69	%	6,491	133	4.13	%
Investment securities	48,412	522	2.17	%	43,569	328	1.52	%
Federal funds and other	5,209	46	1.78	%	8,785	45	1.03	%
Total interest earning assets	442,924	9,929	4.52	%	400,391	8,324	4.19	%
Allowance for loan losses and deferred fees	(3,320)				(3,303)			
Cash and due from banks	10,718				10,258			
Premises and equipment, net	12,929				12,771			
Other assets	20,912				25,598			
Total assets	\$ 484,163				\$ 445,715			
Interest bearing deposits								
Interest checking	\$ 48,096	\$ 43	0.18	%	\$ 43,910	\$ 39	0.18	%
Money market	82,612	169	0.41	%	74,732	142	0.38	%
Savings	24,124	21	0.18	%	22,258	19	0.17	%
Certificates	153,567	1,057	1.39	%	152,773	955	1.26	%
Total	308,399	1,290	0.84	%	293,673	1,155	0.79	%
Borrowings	26,640	400	3.03	%	14,158	154	2.19	%
Total interest bearing liabilities	335,039	1,690	1.02	%	307,831	1,309	0.86	%
Noninterest bearing deposits	109,231				90,506			
Other liabilities	2,933				3,798			
Total liabilities	447,203				402,135			
Equity capital	36,960				43,580			
Total liabilities and capital	\$ 484,163				\$ 445,715			
Net interest income before provision for loan losses		\$ 8,239				\$ 7,015		
Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities			3.50	%			3.33	%
Annualized net interest margin (net interest income expressed as percentage of average earning assets)			3.75	%			3.53	%

Provision for (recovery of) loan losses

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

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

The Company did not record a provision for loan losses for the three and six months ended June 30, 2018 and 2017.

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

	Six Months Ended June 30,				For Year Ended	
	2018	2017	2018	2017	December 31,	2017
	Provision	Provision	Loans	Loans	Provision	Loans
	(Recovery)	(Recovery)	Outstanding	Outstanding	(Recovery)	Outstanding
Construction and land development	\$31	\$36,654	\$(91)	\$34,950	\$(118)	\$30,817
Commercial real estate	(45)	190,673	(115)	138,393	98	165,505
Consumer real estate	(12)	90,643	46	77,500	(30)	88,228
Commercial and industrial	(10)	41,092	69	43,491	316	36,506
Guaranteed student loans	43	42,133	11	43,422	96	45,805
Consumer	18	2,155	-	1,985	4	1,848
Unallocated	(25)	-	80	-	(366)	-
	\$-	\$403,350	\$-	\$339,741	\$-	\$368,709

For more financial data and other information about the Allowance for loan losses refer to section, “Balance Sheet Analysis “ under Item 2 – “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, and Note 5 “Loans and allowance for loan losses” in the “Notes to Consolidated Financial Statements” contained in Item 1 of this Form 10-Q.

Noninterest income

Noninterest income includes service charges and fees on deposit accounts, fee income related to loan origination, gains and losses on sale of mortgage loans and securities held for sale, and rental income primarily on our previous headquarters building. The most significant noninterest income item has been mortgage banking income, net of commissions, representing 67% and 70% for the three month periods ended June 30, 2018 and 2017, respectively, and 65% and 69% for the six month periods ended June 30, 2018 and 2017, respectively.

	For the Three Months Ended		Change	
	June 30, 2018	2017	\$	%
	(dollars in thousands)			
Service charges and fees	\$482	\$459	\$23	5.0 %
Mortgage banking income, net	1,120	1,236	(116)	(9.4)%
Other	65	70	(5)	(7.1)%
Total noninterest income	\$1,667	\$1,765	\$(98)	(5.6)%

The decrease in mortgage banking income, net of commissions, is due primarily to an increase in commission expense from \$382,000 for the three months ended June 30, 2017 to \$480,000 for the three months ended June 30, 2018.

	For the Six Months Ended		Change	
	June 30, 2018	2017	\$	%
	(dollars in thousands)			
Service charges and fees	\$939	\$912	\$27	3.0 %
Mortgage banking income, net	1,937	2,369	(432)	(18.2)%
Gain (loss) on sale of investment securities	-	(9)	9	(100.0)%
Other	124	143	(19)	(13.3)%
Total noninterest income	\$3,000	\$3,415	\$(415)	(12.2)%

The decrease in mortgage banking income, net of commissions, is due to decreased activity by our mortgage banking segment as the mortgage market has been less favorable during the six months ended June 30, 2018 as inventory of houses for sale has been low. The gain on sale is recognized at the date of sale to the investor and mortgage loan sales decreased from \$88,924,000 for the six months ended June 30, 2017 to \$79,036,000 for the six months ended June 30, 2018.

Noninterest expense

	For the Three Months Ended		Change		
	June 30, 2018	2017	\$	%	
	(dollars in thousands)				
Salaries and benefits	\$2,972	\$3,048	\$(76)	(2.5)	%
Occupancy	345	284	61	21.5	%
Equipment	214	177	37	20.9	%
Supplies	47	62	(15)	(24.2)	%
Professional and outside services	802	727	75	10.3	%
Advertising and marketing	67	51	16	31.4	%
Foreclosed assets, net	(5)	30	(35)	(116.7)	%
FDIC insurance premium	79	69	10	14.5	%
Other operating expense	580	508	72	14.2	%
Total noninterest income	\$5,101	\$4,956	\$145	2.9	%

The decrease in salaries and benefits was due to staffing reductions associated with processing efficiencies gained in the mortgage segment.

Occupancy increased due to the opening of a new mortgage company branch, increase in snow removal expenses and building management fees.

The increase in professional and outside services was due to higher data processing expenses, as result of growth in loans and deposits, and higher legal expenses recognized during the second quarter of 2018 compared to the second quarter of 2017.

The decrease in expenses related to foreclosed assets is attributed to a decline in the other real estate owned balance from \$1,788,000 at June 30, 2017 to \$732,000 at June 30, 2018.

	For the Six Months Ended		Change		
	June 30, 2018	2017	\$	%	
	(dollars in thousands)				
Salaries and benefits	\$5,915	\$6,058	\$(143)	(2.4)	%
Occupancy	675	551	124	22.5	%
Equipment	430	360	70	19.4	%
Cease use lease obligation	-	(125)	125	(100.0)	%
Supplies	104	117	(13)	(11.1)	%
Professional and outside services	1,521	1,512	9	0.6	%
Advertising and marketing	147	140	7	5.0	%
Foreclosed assets, net	(74)	(162)	88	(54.3)	%

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FDIC insurance premium	156	138	18	13.0	%
Other operating expense	1,087	961	126	13.1	%
Total noninterest income	\$9,961	\$9,550	\$411	4.3	%

The decrease in salaries and benefits was due to staffing reductions associated with processing efficiencies gained in the mortgage segment.

Occupancy increased due to the opening of a new mortgage company branch, increase in snow removal expenses and building management fees.

During the fourth quarter of 2016, the Company recorded a loss from branch consolidation of \$252,000 related to a future lease obligation, which was settled for a lower amount late in the first quarter of 2017 resulting in a partial recovery of \$125,000.

The change in expense related to foreclosed assets was primarily due to the recognition of gains on the sale of foreclosed assets of \$218,000 during the first six months of 2017 compared to a gain of \$83,000 during first six months of 2018.

Income taxes

On December 22, 2017, the President signed into law the Tax Cuts and Jobs Act of 2017 (the “Tax Reform Act”). The Tax Reform Act includes a number of changes in existing tax law impacting businesses. One of the most significant changes is a permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction took effect on January 1, 2018. GAAP requires companies to re-value their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment.

Income tax expense for the three and six months ended June 30, 2018 was \$153,000 and \$225,000, respectively, resulting in an effective tax rate of 19.3% and 17.6%, respectively, compared to \$94,000 and \$227,000, or 28.4% and 25.8%, for the same periods in 2017. The lower effective tax rates in 2018 resulted from the reduction in the corporate income tax rate beginning in 2018.

The Company has a net deferred tax asset which is included in other assets on the balance sheet. For more financial data and other information about income taxes refer to Note 15 “Income Taxes” in the “Notes to Consolidated Financial Statements” contained in Item 1 of this Form 10-Q.

Balance Sheet Analysis

Investment securities

At June 30, 2018 and December 31, 2017, all of our investment securities were classified as available for sale.

For more financial data and other information about investment securities refer to Note 4 “Investment Securities Available for Sale” in the “Notes to Consolidated Financial Statements” contained in Item 1 of this Form 10-Q.

Loans

One of management's objectives is to improve the quality of the loan portfolio. The Company seeks to achieve this objective by maintaining rigorous underwriting standards coupled with regular evaluation of the creditworthiness of and the designation of lending limits for each borrower. The portfolio strategies include seeking industry, loan type and loan size diversification in order to minimize credit concentration risk. Management also focuses on originating loans in markets with which the Company is familiar. Additionally, as a significant amount of the loan losses we have experienced in the past is attributable to construction and land development loans, our strategy has shifted from reducing this type of lending to closely managing the quality and concentration in these loan types.

Approximately 79% of all loans are secured by mortgages on real property located principally in the Commonwealth of Virginia. We are much less reliant on real estate secured lending than was the case in 2012 when 90% of our loan portfolio consisted of this type of lending. Approximately 10% of the loan portfolio consists of rehabilitated student loans purchased by the Bank in 2017, 2016, 2015 and 2014 (see discussion following). The Company's commercial and industrial loan portfolio represents approximately 10% of all loans. Loans in this category are typically made to individuals, and small and medium-sized businesses, and range between \$250,000 and \$2.5 million. Based on underwriting standards, commercial and industrial loans may be secured in whole or in part by collateral such as liquid assets, accounts receivable, equipment, inventory, and real property. The collateral securing any loan may depend on the type of loan and may vary in value based on market conditions. The remainder of our loan portfolio is in consumer loans which represent less than 1% of the total.

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

	June 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Construction and land development				
Residential	\$5,961	1.48 %	\$5,361	1.45 %
Commercial	30,693	7.61 %	25,456	6.91 %
	36,654	9.09 %	30,817	8.36 %
Commercial real estate				
Owner occupied	98,541	24.43 %	85,004	23.06 %
Non-owner occupied	80,535	19.97 %	70,845	19.21 %
Multifamily	11,352	2.81 %	9,386	2.55 %
Farmland	245	0.06 %	270	0.07 %
	190,673	47.27 %	165,505	44.89 %
Consumer real estate				
Home equity lines	22,566	5.59 %	22,849	6.20 %
Secured by 1-4 family residential				
First deed of trust	58,808	14.58 %	57,919	15.71 %
Second deed of trust	9,269	2.30 %	7,460	2.02 %
	90,643	22.47 %	88,228	23.93 %
Commercial and industrial loans (except those secured by real estate)	41,092	10.19 %	36,506	9.90 %
Guaranteed student loans	42,133	10.45 %	45,805	12.42 %
Consumer and other	2,155	0.53 %	1,848	0.50 %
Total loans	403,350	100.0 %	368,709	100.0 %
Deferred fees and costs, net	786		699	
Less: allowance for loan losses	(3,208)		(3,239)	
	\$400,928		\$366,169	

For more financial data and other information about loans refer to Note 5 “Loans and allowance for loan losses” in the “Notes to Consolidated Financial Statements” contained in Item 1 of this Form 10-Q.

Allowance for loan losses

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan portfolio. For more financial data and other information about loans refer to Note 5 “Loans and allowance for loan losses” in the “Notes to Consolidated Financial Statements” contained in Item 1 of this Form 10-Q.

Asset quality

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

	June 30, 2018	December 31, 2017	June 30, 2017		
Nonaccrual loans	\$ 1,927	\$ 2,320	\$ 1,937		
Other real estate owned	732	1,788	1,788		
Total nonperforming assets	\$ 2,659	\$ 4,108	\$ 3,725		
Restructured loans (not included in nonaccrual loans above)	\$ 9,796	\$ 10,194	\$ 10,256		
Loans past due 90 days and still accruing ⁽¹⁾	\$ 6,577	\$ 7,229	\$ 8,058		
Nonperforming assets to loans ⁽²⁾	0.66 %	1.11 %	1.09 %		
Nonperforming assets to total assets	0.53 %	0.86 %	0.81 %		
Allowance for loan losses to nonaccrual loans	166.4 %	139.6 %	168.7 %		

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

⁽²⁾ Loans are net of deferred fees and costs.

The following table presents an analysis of the changes in nonperforming assets for the six months ended June 30, 2018 (in thousands):

	Nonaccrual Loans	Foreclosed Properties	Total
Balance December 31, 2107	\$ 2,320	\$ 1,788	\$4,108
Additions	559	-	559
Loans placed back on accrual	(250)	-	(250)
Transfers to OREO	-	-	-
Repayments	(247)	-	(247)
Charge-offs	(455)	-	(455)
Sales	-	(1,056)	(1,056)
Balance June 30, 2018	\$ 1,927	\$ 732	\$2,659

Nonperforming restructured loans are included in nonaccrual loans. Until a nonperforming restructured loan has performed in accordance with its restructured terms for a minimum of six months, it will remain on nonaccrual status.

Interest is accrued on outstanding loan principal balances, unless the Company considers collection to be doubtful. Commercial and unsecured consumer loans are designated as non-accrual when the Company considers collection of expected principal and interest doubtful. Mortgage loans and most other types of consumer loans past due 90 days or more may remain on accrual status if management determines that concern over our ability to collect principal and interest is not significant. When loans are placed on non-accrual status, previously accrued and unpaid interest is reversed against interest income in the current period and interest is subsequently recognized only to the extent cash is received. Interest accruals are resumed on such loans only when in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

Of the total nonaccrual loans of \$1,927,000 at June 30, 2018 that were considered impaired, six loans totaling \$428,000 had specific allowances for loan losses totaling \$152,000. This compares to \$2,320,000 in nonaccrual loans at December 31, 2017 of which thirteen loans totaling \$1,053,000 had specific allowances for loan losses of \$454,000.

Cumulative interest income that would have been recorded had nonaccrual loans been performing would have been approximately \$185,000 and \$124,000 for the six months ended June 30, 2018 and 2017, respectively.

Deposits

Deposits as of June 30, 2018 and December 31, 2017 were as follows (dollars in thousands):

	June 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Demand accounts	120,718	27.9 %	\$ 104,138	25.3 %
Interest checking accounts	48,742	11.3 %	48,042	11.7 %
Money market accounts	83,016	19.2 %	82,523	20.1 %
Savings accounts	29,042	6.7 %	27,596	6.7 %
Time deposits of \$250,000 and over	21,362	4.9 %	21,592	5.2 %
Other time deposits	130,103	30.0 %	127,733	31.0 %
Total	\$432,983	100.0 %	\$ 411,624	100.0 %

Total deposits increased by \$21,359,000, or 5.2%, from \$411,624,000 at December 31, 2017 to \$432,983,000 at June 30, 2018, as compared to an increase of \$22,114,000, or 5.8%, during the first six months of 2017. Checking and savings accounts increased by \$18,726,000, money market accounts increased by \$493,000 and time deposits increased by \$2,140,000 during the first six months of 2018. The cost of our interest-bearing deposits increased to 0.84% for the first six months of 2018 compared to 0.79% for the first six months of 2017.

The variety of deposit accounts that we offer has allowed us to be competitive in obtaining funds and has allowed us to respond with flexibility to, although not to eliminate, the threat of disintermediation (the flow of funds away from depository institutions such as banking institutions into direct investment vehicles such as government and corporate securities). Our ability to attract and retain deposits, and our cost of funds, has been, and is expected to continue to be, significantly affected by money market conditions.

Borrowings

We utilize borrowings to supplement deposits to address funding or liability duration needs. For more financial data and other information about borrowings refer to Note 7 “Borrowings” in the “Notes to Consolidated Financial Statements” contained in Item 1 of this Form 10-Q.

Capital resources

Shareholders' equity at June 30, 2018 was \$34,794,000 compared to \$39,334,000 at December 31, 2017. The \$4.5 million decrease in shareholders' equity during the six months ended June 30, 2018 is primarily due to the redemption of the Company's remaining 5,027 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A on March 30, 2018.

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

	June 30, 2018	December 31, 2017		
Tier 1 capital				
Total bank equity capital	\$45,607	\$ 44,748		
Net unrealized loss on available-for-sale securities	964	401		
Defined benefit postretirement plan	58	51		
Dissallowed deferred tax asset	(2,703)	(2,935)		
Disallowed intangible assets	-	-		
Total Tier 1 capital	43,926	42,265		
Tier 2 capital				
Allowance for loan losses	3,208	3,239		
Total Tier 2 capital	3,208	3,239		
Total risk-based capital	47,134	45,504		
Risk-weighted assets	\$389,388	\$ 353,349		
Average assets	\$488,065	\$ 460,556		
Capital ratios				
Leverage ratio (Tier 1 capital to average assets)	9.00	%	9.18	%
Common equity tier 1 capital ratio (CET 1)	11.28	%	11.96	%
Tier 1 capital to risk-weighted assets	11.28	%	11.96	%
Total capital to risk-weighted assets	12.10	%	12.88	%
Equity to total assets	9.04	%	9.42	%

For more financial data and other information about capital resources, refer to Note 13 “Shareholders’ Equity and Regulatory Matters” in the “Notes to Consolidated Financial Statements” contained in Item 1 of this Form 10-Q.

Liquidity

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of

management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At June 30, 2018, our liquid assets, consisting of cash, cash equivalents and investment securities available for sale totaled \$62,865,000, or 12% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, approximately \$7,971,000 of these securities are pledged against current and potential fundings.

Our holdings of liquid assets plus the ability to maintain and expand our deposit base and borrowing capabilities serve as our principal sources of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain two federal funds lines of credit with correspondent banks totaling \$15 million for which there were borrowings against the lines of \$668,000 and \$1,584,000 at June 30, 2018 and December 31, 2017, respectively.

We are also a member of the FHLB, from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the Bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at June 30, 2018 was \$16.1 million, based on the Bank's qualifying collateral available to secure any future borrowings. However, we are able to pledge additional collateral to the FHLB in order to increase our available borrowing capacity up to 25% of assets. Liquidity provides us with the ability to meet normal deposit withdrawals, while also providing for the credit needs of customers. We are committed to maintaining liquidity at a level sufficient to protect depositors, provide for reasonable growth, and fully comply with all regulatory requirements.

At June 30, 2018, we had commitments to originate \$89,584,000 of loans. Fixed commitments to incur capital expenditures were approximately \$100,000 at June 30, 2018. Certificates of deposit scheduled to mature in the 12-month period ending June 30, 2019 totaled \$82,615,000. We believe that a significant portion of such deposits will remain with us. We further believe that deposit growth, loan repayments and other sources of funds will be adequate to meet our foreseeable short-term and long-term liquidity needs.

Interest rate sensitivity

An important element of asset/liability management is the monitoring of our sensitivity to interest rate movements. In order to measure the effects of interest rates on our net interest income, management takes into consideration the expected cash flows from the securities and loan portfolios and the expected magnitude of the repricing of specific asset and liability categories. We evaluate interest sensitivity risk and then formulate guidelines to manage this risk based on management's outlook regarding the economy, forecasted interest rate movements and other business factors. Our goal is to maximize and stabilize the net interest margin by limiting exposure to interest rate changes.

Contractual principal repayments of loans do not necessarily reflect the actual term of our loan portfolio. The average lives of mortgage loans are substantially less than their contractual terms because of loan prepayments and because of enforcement of due-on-sale clauses, which gives us the right to declare a loan immediately due and payable in the event, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. In addition, certain borrowers increase their equity in the security property by making payments in excess of those required under the terms of the mortgage.

The sale of fixed rate loans is intended to protect us from precipitous changes in the general level of interest rates. The valuation of adjustable rate mortgage loans is not as directly dependent on the level of interest rates as is the value of fixed rate loans. As with other investments, we regularly monitor the appropriateness of the level of adjustable rate mortgage loans in our portfolio and may decide from time to time to sell such loans and reinvest the proceeds in other adjustable rate investments.

Critical accounting policies

General

The accounting and reporting policies of the Company and its subsidiary are in accordance GAAP and conform to general practices within the banking industry. The Company's financial position and results of operations are affected by management's application of accounting policies, including estimates, assumptions and judgments made to arrive at the carrying value of assets and liabilities, and amounts reported for revenues, expenses and related disclosures. Different assumptions in the application of these policies could result in material changes in the Company's consolidated financial position and/or results of operations.

The more critical accounting and reporting policies include the Company's accounting for the allowance for loan losses, troubled debt restructurings, real estate acquired in settlement of loans and income taxes. The Company's accounting policies are fundamental to understanding the Company's consolidated financial position and consolidated results of operations.

The following is a summary of the Company's critical accounting policies that are highly dependent on estimates, assumptions, and judgments.

Allowance for loan losses

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan portfolio. We maintain policies and procedures that address the systems of controls over the following areas of maintenance of the allowance: the systematic methodology used to determine the appropriate level of the allowance to provide assurance they are maintained in accordance with GAAP; the accounting policies for loan charge-offs and recoveries; the assessment and measurement of impairment in the loan portfolio; and the loan grading system.

The allowance reflects management's best estimate of probable losses within the existing loan portfolio and of the risk inherent in various components of the loan portfolio, including loans identified as impaired as required by Financial Accounting Standards Board Codification Topic 310: *Receivables*. Loans evaluated individually for impairment include nonperforming loans, such as loans on nonaccrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment.

Loans are grouped by similar characteristics, including the type of loan, the assigned loan classification and the general collateral type. A loss rate reflecting the expected loss inherent in a group of loans is derived based upon historical net charge-off rates, the predominant collateral type for the group and the terms of the loan. The resulting estimate of losses for groups of loans is adjusted for relevant environmental factors and other conditions of the portfolio of loans and leases, including: borrower and industry concentrations; levels and trends in delinquencies, charge-offs and recoveries; changes in underwriting standards and risk selection; level of experience, ability and depth of lending management; and national and local economic conditions.

The amounts of estimated impairment for individually evaluated loans and groups of loans are added together for a total estimate of loan losses. This estimate of losses is compared to our allowance for loan losses as of the evaluation date and, if the estimate of losses is greater than the allowance, an additional provision to the allowance would be made. If the estimate of losses is less than the allowance, the degree to which the allowance exceeds the estimate is evaluated to determine whether the allowance falls outside a range of estimates. We recognize the inherent imprecision in estimates of losses due to various uncertainties and the variability related to the factors used in the calculation of the allowance. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the financial statements.

Troubled debt restructurings

A loan is accounted for as a troubled debt restructuring if we, for economic or legal reasons, grant a concession to a borrower considered to be experiencing financial difficulties that we would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or balance of the loan, a reduction of accrued interest, an extension of the maturity date or renewal of the loan at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans. Accruing troubled debt restructurings are generally excluded from nonperforming loans as it is considered probable that all contractual principal and interest due under the restructured terms will be collected. Troubled debt restructurings generally remain categorized as nonperforming loans and leases until a six-month payment history has been maintained.

In accordance with current accounting guidance, loans modified as troubled debt restructurings are, by definition, considered to be impaired loans. Impairment for these loans is measured on a loan-by-loan basis similar to other impaired loans as described above under *Allowance for loan losses*. Certain loans modified as troubled debt restructurings may have been previously measured for impairment under a general allowance methodology (i.e., pooling), thus at the time the loan is modified as a troubled debt restructuring the allowance will be impacted by the difference between the results of these two measurement methodologies. Loans modified as troubled debt restructurings that subsequently default are factored into the determination of the allowance in the same manner as other defaulted loans.

Other real estate owned

Other real estate owned represents properties acquired through foreclosure or physical possession. Write-downs to fair value less cost to sell of foreclosed assets at the time of transfer are charged to allowance for loan losses. Subsequent to foreclosure, the Company periodically evaluates the value of foreclosed assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed as incurred. The valuation allowance was \$67,000 and \$281,000 at June 30, 2018 and December 31, 2017, respectively. Fair value is based on an assessment of information available at the end of a reporting period and depends upon a number of factors, including historical experience, economic conditions, and issues specific to individual properties. The evaluation of these factors involves subjective estimates and judgments that may change.

Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established. Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if management projects lower levels of future taxable income.

On December 22, 2017, the President signed into law the Tax Reform Act. The Tax Reform Act includes a number of changes in existing tax law impacting businesses. One of the most significant changes is a permanent reduction in the

corporate income tax rate from 35% to 21%. The rate reduction took effect on January 1, 2018. GAAP requires companies to re-value their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment.

As of December 31, 2017, the Company had net deferred tax assets of \$11 million. The Company recorded a re-valuation of its deferred tax assets and liabilities as of December 31, 2017, at the new rate of 21%, based upon balances in existence at date of enactment. As a result, the Company's net deferred tax assets were written down by approximately \$4,181,000 in the fourth quarter of 2017 with a corresponding increase in tax expense. Although the Tax Reform Act had a significant negative impact on the Company's earnings for 2017 as a result of the re-valuation of its deferred tax assets and liabilities, the reduction in the corporate tax rate to 21% is expected to have a significant positive benefit to the Company in 2018 and beyond.

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable.

ITEM 4 – CONTROLS AND PROCEDURES

The Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) as of June 30, 2018. Based on that evaluation, management concluded that the Company's disclosure controls and procedures were effective as of June 30, 2018 in ensuring that all material information required to be disclosed in reports that it files or submits under the Exchange Act is recorded, processed summarized and reported with the time periods specified in SEC rules and regulations and that such information is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. There were no changes in our internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company's last fiscal quarter that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1 – LEGAL PROCEEDINGS

As previously disclosed by the Company, in March 2013, the Special Inspector General for the Troubled Asset Relief Program notified the Company that it was conducting an investigation of the Company. SIGTARP issued seven subpoenas from March 2013 to November 2016 requesting that the Company produce certain documents and other information. The Company has been cooperating fully with SIGTARP in providing the requested materials. The Company cannot predict the duration or the outcome of this investigation, including the effect the investigation and the costs associated with the investigation could have on the Company's business, financial condition, or results of operations.

In the course of its operations, the Company may become a party to legal proceedings. Except as described above, there are no material pending legal proceedings to which the Company is party or of which the property of the Company is subject.

ITEM 1A – RISK FACTORS

Not applicable.

ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4 – MINE SAFETY DISCLOSURES

None.

ITEM 5 – OTHER INFORMATION

Not applicable.

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ITEM 6 – EXHIBITS

Change in Control Agreement, dated May 22, 2018, by and between Village Bank and Trust Financial Corp. and 10.1 Donald M Kaloski, Jr. (incorporated by reference to Exhibit 101 of the Current Report on Form 8-K filed with the Securities and Exchange Commission on June 4, 2018).

31.1 Certification of Chief Executive Officer

31.2 Certification of Chief Financial Officer

32.1 Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

The following materials from the Village Bank and Trust Financial Corp. Quarterly Report on Form 10-Q for the quarter ended June 30, 2018 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Comprehensive Income (Loss), (iv) Consolidated Statements of Shareholders' Equity, (v) Consolidated Statements of Cash Flows, and (vi) Notes to Condensed Consolidated Financial Statements.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

VILLAGE BANK AND
TRUST FINANCIAL CORP.

Date: August 14, 2018 By: /s/ William G. Foster, Jr.
William G. Foster, Jr.
President and Chief Executive
Officer

Date: August 14, 2018 By: /s/ Donald M. Kaloski, Jr.
Donald M. Kaloski, Jr.
Executive Vice President and
Chief Financial Officer

EXHIBIT INDEX

Exhibit

Number Document

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