

OLD POINT FINANCIAL CORP  
Form 10-Q  
August 08, 2017  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934  
For the quarterly period ended June 30, 2017

or

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

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

Commission File Number: 000-12896

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

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

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

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

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

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

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

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

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Large accelerated filer

Accelerated filer

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

Emerging growth company

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

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

Yes No

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

4,987,646 shares of common stock (\$5.00 par value) outstanding as of July 31, 2017

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OLD POINT FINANCIAL CORPORATION

FORM 10-Q

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

Old Point Financial Corporation and Subsidiaries  
Consolidated Balance Sheets

|  | June 30,<br>2017   | December<br>31, 2016 |
|--|--|----------------------|
|  | (dollars in thousands<br>except per share data)<br>(unaudited) |                      |
| Assets   |  |                      |
| Cash and due from banks  | \$27,121   | \$21,885             |
| Interest-bearing due from banks  | 1,708  | 1,667                |
| Federal funds sold   | 1,543  | 2,302                |
| Cash and cash equivalents  | 30,372   | 25,854               |
| Securities available-for-sale, at fair value   | 167,586  | 199,365              |
| Restricted securities  | 3,102  | 970                  |
| Loans held for sale  | 1,600  | 0                    |
| Loans held for investment, net of allowance for loan losses of \$8,710 and \$8,245                               | 671,079  | 595,637              |
| Premises and equipment, net  | 38,370   | 39,324               |
| Bank-owned life insurance  | 25,604   | 25,206               |
| Other real estate owned, net of valuation allowance of \$0 and \$1,026   | 0  | 1,067                |
| Other assets   | 14,805   | 15,543               |
| Total assets   | \$952,518  | \$902,966            |
| Liabilities & Stockholders' Equity   |  |                      |
| Deposits:  |  |                      |
| Noninterest-bearing deposits   | \$224,785  | \$228,641            |
| Savings deposits   | 348,223  | 344,452              |
| Time deposits  | 204,172  | 211,409              |
| Total deposits   | 777,180  | 784,502              |
| Overnight repurchase agreements  | 23,221   | 18,704               |
| Federal Home Loan Bank advances  | 50,000   | 0                    |
| Accrued expenses and other liabilities   | 5,209  | 5,770                |
| Total liabilities  | 855,610  | 808,976              |
| Commitments and contingencies  |  |                      |
| Stockholders' equity:  |  |                      |
| Common stock, \$5 par value, 10,000,000 shares authorized; 4,984,151 and 4,961,258 shares issued and outstanding | 24,921   | 24,806               |
| Additional paid-in capital   | 16,758   | 16,427               |
| Retained earnings  | 57,973   | 56,965               |
| Accumulated other comprehensive loss, net  | (2,744 )   | (4,208 )             |
| Total stockholders' equity   | 96,908   | 93,990               |

|  |           |           |
|--|-----------|-----------|
| Total liabilities and stockholders' equity | \$952,518 | \$902,966 |
|--|-----------|-----------|

See Notes to Consolidated Financial Statements.

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Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Income

|  | Three Months Ended<br>June 30,                          |         | Six Months Ended June<br>30, |          |
|--|---|---------|------------------------------|----------|
|  | 2017  | 2016    | 2017                         | 2016     |
|  | (unaudited, dollars in thousands except per share data) |         |                              |          |
| <b>Interest and Dividend Income:</b>   |   |         |                              |          |
| Interest and fees on loans   | \$7,110   | \$6,560 | \$13,890                     | \$12,973 |
| Interest on due from banks   | 3   | 1       | 8                            | 5        |
| Interest on federal funds sold   | 2   | 1       | 5                            | 2        |
| <b>Interest on securities:</b>   |   |         |                              |          |
| Taxable  | 491   | 471     | 987                          | 1,019    |
| Tax-exempt   | 420   | 376     | 847                          | 760      |
| Dividends and interest on all other securities   | 35  | 26      | 49                           | 41       |
| Total interest and dividend income   | 8,061   | 7,435   | 15,786                       | 14,800   |
| <b>Interest Expense:</b>   |   |         |                              |          |
| Interest on savings deposits   | 73  | 54      | 137                          | 109      |
| Interest on time deposits  | 520   | 517     | 1,039                        | 1,034    |
| Interest on federal funds purchased, securities sold under agreements to repurchase and other borrowings | 8   | 8       | 13                           | 14       |
| Interest on Federal Home Loan Bank advances  | 72  | 3       | 72                           | 144      |
| Total interest expense   | 673   | 582     | 1,261                        | 1,301    |
| Net interest income  | 7,388   | 6,853   | 14,525                       | 13,499   |
| Provision for loan losses  | 1,000   | 1,250   | 1,650                        | 1,400    |
| Net interest income, after provision for loan losses   | 6,388   | 5,603   | 12,875                       | 12,099   |
| <b>Noninterest Income:</b>   |   |         |                              |          |
| Income from fiduciary activities   | 951   | 877     | 1,917                        | 1,778    |
| Service charges on deposit accounts  | 916   | 1,021   | 1,843                        | 1,996    |
| Other service charges, commissions and fees  | 1,075   | 1,033   | 2,091                        | 2,051    |
| Income from bank-owned life insurance  | 199   | 217     | 397                          | 432      |
| Income from mortgage banking activities  | 284   | 80      | 290                          | 89       |
| Gain on sale of available-for-sale securities, net   | 87  | 6       | 87                           | 515      |
| Gain on acquisition of Old Point Mortgage  | 550   | 0       | 550                          | 0        |
| Other operating income   | 29  | 52      | 79                           | 90       |
| Total noninterest income   | 4,091   | 3,286   | 7,254                        | 6,951    |
| <b>Noninterest Expense:</b>  |   |         |                              |          |
| Salaries and employee benefits   | 5,449   | 4,890   | 10,546                       | 10,044   |
| Occupancy and equipment  | 1,454   | 1,390   | 2,903                        | 2,748    |
| Data processing  | 441   | 435     | 855                          | 857      |
| FDIC insurance   | 98  | 156     | 194                          | 321      |
| Customer development   | 154   | 154     | 298                          | 304      |
| Legal and audit expenses   | 214   | 295     | 388                          | 497      |
| Other outside service fees   | 306   | 178     | 505                          | 361      |
| Employee professional development  | 219   | 179     | 455                          | 327      |
| Capital stock tax  | 138   | 127     | 281                          | 262      |

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|  |         |        |         |         |
|--|---------|--------|---------|---------|
| ATM and other losses                             | 155     | 83     | 332     | 170     |
| Prepayment fee on Federal Home Loan Bank advance | 0       | 0      | 0       | 391     |
| Loss (gain) on other real estate owned           | (18 )   | 9      | (18 )   | 108     |
| Other operating expenses                         | 660     | 589    | 1,237   | 1,186   |
| Total noninterest expense                        | 9,270   | 8,485  | 17,976  | 17,576  |
| Income before income taxes                       | 1,209   | 404    | 2,153   | 1,474   |
| Income tax expense (benefit)                     | 48      | (148 ) | 50      | (99 )   |
| Net income                                       | \$1,161 | \$552  | \$2,103 | \$1,573 |

|                                      |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|
| Basic earnings per share             |           |           |           |           |
| Weighted average shares outstanding  | 4,984,151 | 4,959,009 | 4,980,728 | 4,959,009 |
| Net income per share of common stock | \$0.23    | \$0.11    | \$0.42    | \$0.32    |

|                                      |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|
| Diluted earnings per share           |           |           |           |           |
| Weighted average shares outstanding  | 4,996,880 | 4,959,009 | 4,993,916 | 4,959,009 |
| Net income per share of common stock | \$0.23    | \$0.11    | \$0.42    | \$0.32    |

See Notes to Consolidated Financial Statements.

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Old Point Financial Corporation and Subsidiaries  
 Consolidated Statements of Comprehensive Income

|  | Three Months<br>Ended<br>June 30,<br>2017 |         | Six Months<br>Ended<br>June 30,<br>2016 |         |
|--|---|---------|---|---------|
|  | 2017                                      | 2016    | 2017                                    | 2016    |
|  | (unaudited, dollars in thousands)         |         |   |         |
| Net income   | \$1,161                                   | \$552   | \$2,103                                 | \$1,573 |
| Other comprehensive income, net of tax               |   |         |   |         |
| Net unrealized gain on available-for-sale securities | 1,036                                     | 1,661   | 1,464                                   | 2,176   |
| Comprehensive income                                 | \$2,197                                   | \$2,213 | \$3,567                                 | \$3,749 |

See Notes to Consolidated Financial Statements.

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

|  | Shares of<br>Common<br>Stock<br>(unaudited, dollars in thousands except per share data) | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total     |
|--|---|-----------------|----------------------------------|----------------------|---|-----------|
| <b>SIX MONTHS ENDED JUNE 30, 2017</b>                        |   |                 |                                  |                      |   |           |
| Balance at beginning of period                               | 4,961,258   | \$ 24,806       | \$ 16,427                        | \$ 56,965            | \$ (4,208 )                                   | \$ 93,990 |
| Net income   | 0   | 0               | 0                                | 2,103                | 0   | 2,103     |
| Other comprehensive income, net of tax                       | 0   | 0               | 0                                | 0                    | 1,464   | 1,464     |
| Exercise of stock options                                    | 24,806  | 124             | 373                              | 0                    | 0   | 497       |
| Employee Stock Purchase Plan share issuance                  | 1,687   | 9               | 38                               | 0                    | 0   | 47        |
| Repurchase of common stock related to stock option exercises | (3,600 )  | (18 )           | (80 )                            | 0                    | 0   | (98 )     |
| Cash dividends (\$0.22 per share)                            | 0   | 0               | 0                                | (1,095 )             | 0   | (1,095 )  |
| Balance at end of period                                     | 4,984,151   | \$ 24,921       | \$ 16,758                        | \$ 57,973            | \$ (2,744 )                                   | \$ 96,908 |
| <b>SIX MONTHS ENDED JUNE 30, 2016</b>                        |   |                 |                                  |                      |   |           |
| Balance at beginning of period                               | 4,959,009   | \$ 24,795       | \$ 16,392                        | \$ 55,151            | \$ (3,162 )                                   | \$ 93,176 |
| Net income   | 0   | 0               | 0                                | 1,573                | 0   | 1,573     |
| Other comprehensive income, net of tax                       | 0   | 0               | 0                                | 0                    | 2,176   | 2,176     |
| Cash dividends (\$0.20 per share)                            | 0   | 0               | 0                                | (992 )               | 0   | (992 )    |
| Balance at end of period                                     | 4,959,009   | \$ 24,795       | \$ 16,392                        | \$ 55,732            | \$ (986 )                                     | \$ 95,933 |

See Notes to Consolidated Financial Statements.

Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Cash Flows

|   | Six Months Ended<br>June 30,         |           |
|---|--------------------------------------|-----------|
|   | 2017                                 | 2016      |
|   | (unaudited, dollars in<br>thousands) |           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                                      |           |
| Net income  | \$2,103                              | \$1,573   |
| Adjustments to reconcile net income to net cash provided by operating activities:               |                                      |           |
| Depreciation and amortization   | 1,394                                | 1,349     |
| Provision for loan losses   | 1,650                                | 1,400     |
| Net gain on sale of available-for-sale securities   | (87 )                                | (515 )    |
| Net amortization of securities  | 1,178                                | 1,060     |
| (Increase) in loans held for sale   | (1,600 )                             | 0         |
| Net (gain) loss on disposal of premises and equipment   | 4                                    | (3 )      |
| Net (gain) loss on write-down/sale of other real estate owned                                   | (18 )                                | 108       |
| Income from bank owned life insurance   | (397 )                               | (432 )    |
| Deferred tax (benefit) expense  | (352 )                               | 122       |
| (Increase) decrease in other assets   | 335                                  | (1,459 )  |
| Decrease in other liabilities   | (560 )                               | (316 )    |
| Net cash provided by operating activities   | 3,650                                | 2,887     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>   |                                      |           |
| Purchases of available-for-sale securities  | (22,899 )                            | (83,098 ) |
| Cash used in purchases of restricted securities, net  | (2,132 )                             | (866 )    |
| Proceeds from maturities and calls of available-for-sale securities                             | 44,555                               | 41,765    |
| Proceeds from sales of available-for-sale securities  | 6,480                                | 61,680    |
| Paydowns on available-for-sale securities   | 4,770                                | 5,899     |
| (Purchases) paydowns of consumer installment loans, net   | (7,623 )                             | 0         |
| Net increase in all other loans (including repayments on student loans)                         | (69,469 )                            | (30,889 ) |
| Proceeds from sales of other real estate owned  | 1,084                                | 924       |
| Payments for improvements to other real estate owned  | 0                                    | (52 )     |
| Purchases of premises and equipment   | (444 )                               | (476 )    |
| Net cash used in investing activities   | (45,678 )                            | (5,113 )  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |                                      |           |
| Decrease in noninterest-bearing deposits  | (3,856 )                             | (8,276 )  |
| Increase (decrease) in savings deposits   | 3,771                                | (9,438 )  |
| Decrease in time deposits   | (7,237 )                             | (1,756 )  |
| Increase (decrease) in federal funds purchased, repurchase agreements and other borrowings, net | 4,517                                | (2,086 )  |
| Increase in Federal Home Loan Bank advances   | 80,000                               | 55,000    |
| Repayment of Federal Home Loan Bank advances  | (30,000 )                            | (35,000 ) |
| Proceeds from exercise of stock options and ESPP issuance                                       | 544                                  | 0         |
| Repurchase and retirement of common stock   | (98 )                                | 0         |
| Cash dividends paid on common stock   | (1,095 )                             | (992 )    |
| Net cash provided by (used in) financing activities   | 46,546                               | (2,548 )  |

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|  |          |          |
|--|----------|----------|
| Net increase (decrease) in cash and cash equivalents | 4,518    | (4,774 ) |
| Cash and cash equivalents at beginning of period     | 25,854   | 36,990   |
| Cash and cash equivalents at end of period           | \$30,372 | \$32,216 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash payments for:

|            |         |         |
|------------|---------|---------|
| Interest   | \$1,236 | \$1,322 |
| Income tax | \$750   | \$0     |

SUPPLEMENTAL SCHEDULE OF NONCASH TRANSACTIONS

|   |         |          |
|---|---------|----------|
| Unrealized gain on securities available-for-sale                            | \$2,218 | \$3,297  |
| Former bank property transferred from fixed assets to foreclosed properties | \$0     | \$127    |
| Securities sold but not settled   | \$0     | \$24,483 |

See Notes to Consolidated Financial Statements.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

### Note 1. General

The accompanying unaudited consolidated financial statements of Old Point Financial Corporation (the Company) and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial position at June 30, 2017 and December 31, 2016, the statements of income and comprehensive income for the three and six months ended June 30, 2017 and 2016, and the statements of changes in stockholders' equity and cash flows for the six months ended June 30, 2017 and 2016. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year.

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

### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, The Old Point National Bank of Phoebus (the Bank) and Old Point Trust & Financial Services N.A. (Trust). Also included are the accounts of Old Point Mortgage, LLC (OPM) which became a wholly-owned subsidiary of the Bank in the second quarter of 2017 (see "Acquisitions" section below). All significant intercompany balances and transactions have been eliminated in consolidation. The Company consolidates subsidiaries in which it holds, directly or indirectly, more than 50 percent of the voting rights or where it exercises control. Entities where the Company holds 20 to 50 percent of the voting rights, or has the ability to exercise significant influence, or both, are accounted for under the equity method. As discussed below, the Company consolidates entities deemed to be variable interest entities (VIEs) when it is determined to be the primary beneficiary.

### NATURE OF OPERATIONS

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

### VARIABLE INTEREST ENTITIES

A legal entity is referred to as a VIE if any of the following conditions exist, which are outlined in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) variable interest accounting guidance (FASB ASC 810-10-15-14): (1) the total equity investment at risk is insufficient to permit the legal entity to finance its activities without additional subordinated financial support from other parties, or (2) the entity has equity investors that cannot make significant decisions about the entity's operations or that do not absorb their proportionate share of the expected losses or receive the expected returns of the entity.

In addition, as specified in VIE accounting guidance (FASB ASC 810-10-25-38), a VIE must be consolidated by the Company if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that will absorb a majority of the expected losses, receive a majority of the expected residual returns, or both. At June 30, 2017, the Company had no VIEs that were consolidated.

#### ACQUISITIONS

On September 10, 2007, the Bank entered into a joint venture agreement with Tidewater Mortgage Services, Inc. (TMSI) to provide mortgage origination services through Old Point Mortgage, LLC (OPM), a joint venture between the Bank and TMSI. Per the terms of the joint venture agreement, TMSI and the Bank owned 51% and 49%, respectively, of OPM, and TMSI was the managing member.

On January 13, 2017, the Bank entered into a membership interest purchase agreement (the Purchase Agreement) with TMSI to purchase TMSI's 51% interest in OPM, with the Bank to be the sole member of OPM upon completion of the purchase. The purchase price was equal to the book value of TMSI's capital account based on the financial statements of OPM as of March 31, 2017.

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On April 20, 2017, the Bank completed its purchase of TMSI's interest in OPM, which terminated the joint venture agreement between TMSI and the Bank and made OPM a wholly-owned subsidiary of the Bank as of that date. OPM's fair value is based on its financials as of March 31, 2017 and was determined by an independent third party. As a result of the fair value calculation, the Company recognized income of \$550 thousand on the purchase in the second quarter of 2017, as indicated in the Consolidated Statements of Income. This gain was recorded in accordance with GAAP in order to reflect the fair value of the previous 49% equity interest.

The factors that contributed to the goodwill recognition were:

- The Bank's purchase of TMSI's 51% ownership at a price below fair value.
- The estimated reduction in operating expense from the elimination of management fees that were being paid to TMSI and the outsourcing of underwriting and secondary market sales.

The table below summarizes the goodwill recognition:

|  |         |
|--|---------|
| Consideration transferred                                      | \$1,534 |
| Acquisition-date fair value of previously-held equity interest | 2,002   |
| Total  | 3,536   |
| Net assets acquired  | 2,915   |
| Goodwill   | \$621   |

The Bank recognized approximately \$62 thousand in expenses related to the merger; \$50 thousand of the total was related to legal advice, and \$12 thousand was related to valuation services. These were included in legal and other outside service expenses in the Consolidated Statements of Income for 2016 and the first six months of 2017.

Note 2. Securities

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

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
|   | (in thousands)    |                              |                               |               |
| June 30, 2017                                   |                   |                              |                               |               |
| Obligations of U.S. Government agencies         | \$9,405           | \$ 3                         | \$ (90 )                      | \$9,318       |
| Obligations of state and political subdivisions | 69,532            | 691                          | (131 )                        | 70,092        |
| Mortgage-backed securities                      | 81,018            | 0                            | (1,116 )                      | 79,902        |
| Money market investments                        | 748               | 0                            | 0                             | 748           |
| Corporate bonds and other securities            | 7,199             | 152                          | (6 )                          | 7,345         |
| Other marketable equity securities              | 100               | 81                           | 0                             | 181           |
| Total   | \$168,002         | \$ 927                       | \$ (1,343 )                   | \$167,586     |
| December 31, 2016                               |                   |                              |                               |               |
| U.S. Treasury securities                        | \$20,000          | \$ 0                         | \$ 0                          | \$20,000      |
| Obligations of U.S. Government agencies         | 9,361             | 0                            | (166 )                        | 9,195         |
| Obligations of state and political subdivisions | 78,645            | 358                          | (1,016 )                      | 77,987        |
| Mortgage-backed securities                      | 85,649            | 18                           | (1,973 )                      | 83,694        |
| Money market investments                        | 647               | 0                            | 0                             | 647           |
| Corporate bonds and other securities            | 7,598             | 92                           | (12 )                         | 7,678         |
| Other marketable equity securities              | 100               | 64                           | 0                             | 164           |
| Total   | \$202,000         | \$ 532                       | \$ (3,167 )                   | \$199,365     |





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

|  | Three<br>Months<br>Ended<br>June 30,<br>2017 |      | Six Months<br>Ended<br>June 30,<br>2016 |       |
|--|--|------|---|-------|
| Securities Available-for-sale          |  |      |   |       |
| Realized gains on sales of securities  | \$87   | \$ 6 | \$87                                    | \$554 |
| Realized losses on sales of securities | 0  | 0    | 0                                       | (39 ) |
| Net realized gain                      | \$87   | \$ 6 | \$87                                    | \$515 |

#### OTHER-THAN-TEMPORARILY IMPAIRED SECURITIES

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

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

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

The Company has not recorded impairment charges through income on securities for the three or six months ended June 30, 2017 or the year ended December 31, 2016.



## TEMPORARILY IMPAIRED SECURITIES

The following table shows the number of securities with unrealized losses, and the gross unrealized losses and fair value of the Company's investments with unrealized losses that are deemed to be temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of the dates indicated:

|   | June 30, 2017                 |               |                               |               |                               |               |                            |
|---|-------------------------------|---------------|-------------------------------|---------------|-------------------------------|---------------|----------------------------|
|   | Less Than<br>Twelve Months    |               | More Than<br>Twelve<br>Months |               | Total                         |               | Number<br>of<br>Securities |
|   | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value |                            |
| Securities Available-for-Sale                   | (dollars in thousands)        |               |                               |               |                               |               |                            |
| Obligations of U.S. Government agencies         | \$3                           | \$2,263       | \$87                          | \$3,331       | \$90                          | \$5,594       | 7                          |
| Obligations of state and political subdivisions | 131                           | 14,938        | 0                             | 0             | 131                           | 14,938        | 20                         |
| Mortgage-backed securities                      | 1,116                         | 79,902        | 0                             | 0             | 1,116                         | 79,902        | 24                         |
| Corporate bonds                                 | 5                             | 1,994         | 1                             | 100           | 6                             | 2,094         | 14                         |
| Total securities available-for-sale             | \$1,255                       | \$99,097      | \$88                          | \$3,431       | \$1,343                       | \$102,528     | 65                         |
|   | December 31, 2016             |               |                               |               |                               |               |                            |
|   | Less Than Twelve<br>Months    |               | More Than<br>Twelve<br>Months |               | Total                         |               | Number<br>of<br>Securities |
|   | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value |                            |
| Securities Available-for-Sale                   | (dollars in thousands)        |               |                               |               |                               |               |                            |
| Obligations of U.S. Government agencies         | \$166                         | \$9,195       | \$0                           | \$0           | \$166                         | \$9,195       | 6                          |
| Obligations of state and political subdivisions | 1,016                         | 38,020        | 0                             | 0             | 1,016                         | 38,020        | 56                         |
| Mortgage-backed securities                      | 1,973                         | 80,680        | 0                             | 0             | 1,973                         | 80,680        | 23                         |
| Corporate bonds                                 | 11                            | 1,787         | 1                             | 100           | 12                            | 1,887         | 13                         |
| Total securities available-for-sale             | \$3,166                       | \$129,682     | \$1                           | \$100         | \$3,167                       | \$129,782     | 98                         |

Certain investments within the Company's portfolio had unrealized losses at June 30, 2017 and December 31, 2016, as shown in the tables above. The unrealized losses were caused by increases in market interest rates. Because the Company does not intend to sell the investments and management believes it is unlikely that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider the investments to be other-than-temporarily impaired at June 30, 2017 or December 31, 2016.

Restricted Securities

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

this stock until its value is recovered.

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

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

|   | June 30,<br>2017 | December<br>31, 2016 |
|---|------------------|----------------------|
|   | (in thousands)   |                      |
| Mortgage loans on real estate:                |                  |                      |
| Residential 1-4 family                        | \$ 100,381       | \$ 94,827            |
| Commercial                                    | 286,512          | 285,429              |
| Construction                                  | 25,768           | 23,116               |
| Second mortgages                              | 17,390           | 17,128               |
| Equity lines of credit                        | 53,467           | 51,024               |
| Total mortgage loans on real estate           | 483,518          | 471,524              |
| Commercial loans                              | 57,585           | 54,434               |
| Consumer loans                                | 126,132          | 58,907               |
| Other   | 12,554           | 19,017               |
| Total loans, net of deferred fees (1)         | 679,789          | 603,882              |
| Less: Allowance for loan losses               | (8,710 )         | (8,245 )             |
| Loans, net of allowance and deferred fees (1) | \$ 671,079       | \$ 595,637           |

(1) Net deferred loan fees totaled \$764 thousand and \$522 thousand at June 30, 2017 and December 31, 2016, respectively.

Overdrawn deposit accounts are reclassified as loans and included in the Other category in the table above. Overdrawn deposit accounts totaled \$495 thousand and \$536 thousand at June 30, 2017 and December 31, 2016, respectively.

## CREDIT QUALITY INFORMATION

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

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

Pass: Loans are of acceptable risk.

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

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

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

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



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

Credit Quality Information

As of June 30, 2017

(in thousands)

|                                     | Pass      | OAEM     | Substandard | Doubtful | Total     |
|-------------------------------------|-----------|----------|-------------|----------|-----------|
| Mortgage loans on real estate:      |           |          |             |          |           |
| Residential 1-4 family              | \$98,779  | \$0      | \$ 1,602    | \$ 0     | \$100,381 |
| Commercial                          | 263,009   | 9,516    | 13,987      | 0        | 286,512   |
| Construction                        | 24,963    | 75       | 730         | 0        | 25,768    |
| Second mortgages                    | 16,773    | 456      | 161         | 0        | 17,390    |
| Equity lines of credit              | 53,117    | 0        | 350         | 0        | 53,467    |
| Total mortgage loans on real estate | 456,641   | 10,047   | 16,830      | 0        | 483,518   |
| Commercial loans                    | 54,721    | 1,124    | 1,740       | 0        | 57,585    |
| Consumer loans                      | 125,998   | 0        | 134         | 0        | 126,132   |
| Other                               | 12,554    | 0        | 0           | 0        | 12,554    |
| Total                               | \$649,914 | \$11,171 | \$ 18,704   | \$ 0     | \$679,789 |

Credit Quality Information

As of December 31, 2016

(in thousands)

|                                     | Pass      | OAEM     | Substandard | Doubtful | Total     |
|-------------------------------------|-----------|----------|-------------|----------|-----------|
| Mortgage loans on real estate:      |           |          |             |          |           |
| Residential 1-4 family              | \$92,458  | \$1,138  | \$ 1,231    | \$ 0     | \$94,827  |
| Commercial                          | 260,948   | 10,014   | 14,467      | 0        | 285,429   |
| Construction                        | 22,219    | 162      | 735         | 0        | 23,116    |
| Second mortgages                    | 16,445    | 475      | 208         | 0        | 17,128    |
| Equity lines of credit              | 50,387    | 500      | 137         | 0        | 51,024    |
| Total mortgage loans on real estate | 442,457   | 12,289   | 16,778      | 0        | 471,524   |
| Commercial loans                    | 49,979    | 2,278    | 2,177       | 0        | 54,434    |
| Consumer loans                      | 58,741    | 0        | 166         | 0        | 58,907    |
| Other                               | 19,017    | 0        | 0           | 0        | 19,017    |
| Total                               | \$570,194 | \$14,567 | \$ 19,121   | \$ 0     | \$603,882 |

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## AGE ANALYSIS OF PAST DUE LOANS BY CLASS

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

## Age Analysis of Past Due Loans as of June 30, 2017

|                                     | 30 - 59<br>Days<br>Past<br>Due<br>(in thousands) | 60 - 89<br>Days<br>Past<br>Due | 90 or<br>More<br>Days<br>Past<br>Due | Total<br>Past<br>Due | Total<br>Current<br>Loans <sup>(1)</sup> | Total<br>Loans | Recorded<br>Investment<br>> 90 Days<br>Past Due<br>and<br>Accruing |
|-------------------------------------|--|--------------------------------|--------------------------------------|----------------------|--|----------------|--|
| Mortgage loans on real estate:      |  |                                |                                      |                      |  |                |  |
| Residential 1-4 family              | \$408  | \$0                            | \$1,042                              | \$1,450              | \$98,931                                 | \$100,381      | \$ 394   |
| Commercial                          | 180  | 3,718                          | 803                                  | 4,701                | 281,811                                  | 286,512        | 0  |
| Construction                        | 0  | 0                              | 0                                    | 0                    | 25,768                                   | 25,768         | 0  |
| Second mortgages                    | 62   | 0                              | 0                                    | 62                   | 17,328                                   | 17,390         | 0  |
| Equity lines of credit              | 27   | 0                              | 451                                  | 478                  | 52,989                                   | 53,467         | 150  |
| Total mortgage loans on real estate | 677  | 3,718                          | 2,296                                | 6,691                | 476,827                                  | 483,518        | 544  |
| Commercial loans                    | 473  | 630                            | 124                                  | 1,227                | 56,358                                   | 57,585         | 0  |
| Consumer loans                      | 1,604  | 538                            | 2,904                                | 5,046                | 121,086                                  | 126,132        | 2,823  |
| Other                               | 55   | 5                              | 3                                    | 63                   | 12,491                                   | 12,554         | 3  |
| Total                               | \$2,809  | \$4,891                        | \$5,327                              | \$13,027             | \$666,762                                | \$679,789      | \$ 3,370   |

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

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

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

|                                     | 30 - 59<br>Days<br>Past<br>Due<br>(in thousands) | 60 - 89<br>Days<br>Past<br>Due | 90 or<br>More<br>Days<br>Past<br>Due | Total<br>Past<br>Due | Total<br>Current<br>Loans <sup>(1)</sup> | Total<br>Loans | Recorded<br>Investment<br>> 90 Days<br>Past Due<br>and<br>Accruing |
|-------------------------------------|--|--------------------------------|--------------------------------------|----------------------|--|----------------|--|
| Mortgage loans on real estate:      |  |                                |                                      |                      |  |                |  |
| Residential 1-4 family              | \$564  | \$0                            | \$496                                | \$1,060              | \$93,767                                 | \$94,827       | \$ 218   |
| Commercial                          | 2,280  | 1,625                          | 227                                  | 4,132                | 281,297                                  | 285,429        | 0  |
| Construction                        | 162  | 0                              | 0                                    | 162                  | 22,954                                   | 23,116         | 0  |
| Second mortgages                    | 0  | 200                            | 188                                  | 388                  | 16,740                                   | 17,128         | 58   |
| Equity lines of credit              | 394  | 9                              | 86                                   | 489                  | 50,535                                   | 51,024         | 0  |
| Total mortgage loans on real estate | 3,400  | 1,834                          | 997                                  | 6,231                | 465,293                                  | 471,524        | 276  |



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|                  |         |         |         |          |           |           |          |
|------------------|---------|---------|---------|----------|-----------|-----------|----------|
| Commercial loans | 5       | 0       | 86      | 91       | 54,343    | 54,434    | 0        |
| Consumer loans   | 1,876   | 713     | 2,684   | 5,273    | 53,634    | 58,907    | 2,603    |
| Other            | 41      | 12      | 5       | 58       | 18,959    | 19,017    | 5        |
| Total            | \$5,322 | \$2,559 | \$3,772 | \$11,653 | \$592,229 | \$603,882 | \$ 2,884 |

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

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

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

#### NONACCRUAL LOANS

The Company generally places commercial loans (including construction loans and commercial loans secured and not secured by real estate) in nonaccrual status when the full and timely collection of interest or principal becomes uncertain, part of the principal balance has been charged off and no restructuring has occurred or the loan reaches 90 days past due, unless the credit is well-secured and in the process of collection.

Under regulatory rules, consumer loans, which are loans to individuals for household, family and other personal expenditures, and consumer loans secured by real estate (including residential 1 - 4 family mortgages, second mortgages, and equity lines of credit) are not required to be placed in nonaccrual status. Although consumer loans and consumer loans secured by real estate are not required to be placed in nonaccrual status, the Company may elect to place these loans in nonaccrual status, if necessary to avoid a material overstatement of interest income. Generally, consumer loans secured by real estate are placed in nonaccrual status only when payments are 120 days past due.

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

When management places a loan in nonaccrual status, the accrued unpaid interest receivable is reversed against interest income and the loan is accounted for by the cash basis or cost recovery method, until it qualifies for return to accrual status or is charged off. Generally, loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured, or when the borrower has resumed paying the full amount of the scheduled contractual interest and principal payments for at least six months.

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

| Nonaccrual Loans by Class           | June 30,       | December |
|-------------------------------------|----------------|----------|
|                                     | 2017           | 31, 2016 |
|                                     | (in thousands) |          |
| Mortgage loans on real estate       |                |          |
| Residential 1-4 family              | \$648          | \$ 598   |
| Commercial                          | 8,916          | 6,033    |
| Second mortgages                    | 0              | 129      |
| Equity lines of credit              | 301            | 87       |
| Total mortgage loans on real estate | 9,865          | 6,847    |
| Commercial loans                    | 1,610          | 231      |
| Consumer loans                      | 81             | 81       |
| Total                               | \$11,556       | \$ 7,159 |

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

|   | Six Months<br>Ended June<br>30,<br>2017 2016<br>(in<br>thousands) |       |
|---|---|-------|
| Interest income that would have been recorded under original loan terms | \$241   | \$101 |
| Actual interest income recorded for the period                          | 180   | 85    |
| Reduction in interest income on nonaccrual loans                        | \$61  | \$16  |

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## TROUBLED DEBT RESTRUCTURINGS

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

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

The following tables present TDRs during the periods indicated, by class of loan.

There were no troubled debt restructurings in the three months ended June 30, 2016.

Troubled Debt Restructurings by Class  
For the Three Months Ended June 30, 2017

|                        | Recorded<br>Number<br>of<br>Modifications | Investment<br>Prior to<br>Modification<br>(dollars in thousands) | Recorded<br>Investment<br>After<br>Modification | Current<br>Investment<br>on<br>June 30,<br>2017 |
|------------------------|---|--|---|---|
| Commercial real estate | 2   | \$ 3,663   | \$ 3,663  | \$ 3,663  |

Troubled Debt Restructurings by Class  
For the Six Months Ended June 30, 2017

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

Troubled Debt Restructurings by Class  
For the Six Months Ended June 30, 2016

|                  | Recorded<br>Number<br>of<br>Modifications | Investment<br>Prior to<br>Modification<br>(dollars in thousands) | Recorded<br>Investment<br>After<br>Modification | Current<br>Investment<br>on June 30,<br>2016 |
|------------------|---|--|---|--|
| Commercial loans | 1   | \$ 152   | \$ 152  | \$ 110                                       |

The loans restructured in the first six months of 2017 and 2016 were given below-market rates for debt with similar risk characteristics. At June 30, 2017 and December 31, 2016, the Company had no outstanding commitments to

disburse additional funds on any TDR. At December 31, 2016, the Company had \$10 thousand in loans secured by residential 1 - 4 family real estate that were in the process of foreclosure. There were no loans secured by residential 1 - 4 family real estate in the process of foreclosure at June 30, 2017.

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

All TDRs are factored into the determination of the allowance for loan losses and included in the impaired loan analysis, as discussed below.

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## IMPAIRED LOANS

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

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

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

## Impaired Loans by Class

|                                     | As of June 30, 2017      |                   |                |                      | For the six months ended<br>June 30, 2017 |                     |
|-------------------------------------|--------------------------|-------------------|----------------|----------------------|---|---------------------|
|                                     | Unpaid Principal Balance | Without Allowance | With Allowance | Associated Allowance | Average Recorded Investment               | Interest Recognized |
| Mortgage loans on real estate:      |                          |                   |                |                      |   |                     |
| Residential 1-4 family              | \$2,512                  | \$2,001           | \$ 457         | \$ 56                | \$2,435                                   | \$ 45               |
| Commercial                          | 13,232                   | 11,888            | 436            | 53                   | 14,361                                    | 276                 |
| Construction                        | 94                       | 0                 | 94             | 20                   | 357                                       | 3                   |
| Second mortgages                    | 485                      | 203               | 254            | 16                   | 511                                       | 10                  |
| Equity lines of credit              | 335                      | 53                | 248            | 19                   | 203                                       | 0                   |
| Total mortgage loans on real estate | \$16,658                 | \$14,145          | \$ 1,489       | \$ 164               | \$17,867                                  | \$ 334              |
| Commercial loans                    | 1,660                    | 103               | 1,507          | 496                  | 1,772                                     | 42                  |
| Consumer loans                      | 81                       | 81                | 0              | 0                    | 81  | 0                   |
| Total                               | \$18,399                 | \$14,329          | \$ 2,996       | \$ 660               | \$19,720                                  | \$ 376              |

## Impaired Loans by Class

|                                     | As of December 31, 2016  |                   |                |                      | For the Year Ended<br>December 31, 2016 |                     |
|-------------------------------------|--------------------------|-------------------|----------------|----------------------|---|---------------------|
|                                     | Unpaid Principal Balance | Without Allowance | With Allowance | Associated Allowance | Average Recorded Investment             | Interest Recognized |
| Mortgage loans on real estate:      |                          |                   |                |                      |   |                     |
| Residential 1-4 family              | \$2,496                  | \$1,835           | \$ 622         | \$ 75                | \$2,741                                 | \$ 119              |
| Commercial                          | 16,193                   | 11,095            | 4,274          | 415                  | 11,885                                  | 727                 |
| Construction                        | 619                      | 528               | 96             | 22                   | 496                                     | 43                  |
| Second mortgages                    | 526                      | 309               | 141            | 17                   | 511                                     | 25                  |
| Equity lines of credit              | 87                       | 86                | 0              | 0                    | 46                                      | 3                   |
| Total mortgage loans on real estate | \$19,921                 | \$13,853          | \$ 5,133       | \$ 529               | \$15,679                                | \$ 917              |
| Commercial loans                    | 1,077                    | 0                 | 989            | 271                  | 827                                     | 74                  |
| Consumer loans                      | 81                       | 81                | 0              | 0                    | 68                                      | 1                   |
| Total                               | \$21,079                 | \$13,934          | \$ 6,122       | \$ 800               | \$16,574                                | \$ 992              |

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

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

identify potential problems before other personnel. In addition, meetings with loan officers and upper management are held to discuss problem loans and review risk grades. Nonetheless, in order to avoid over-reliance upon loan officers for problem loan identification, the Company's loan review system provides for review of loans and risk grades by individuals who are independent of the loan approval process. Risk grades and historical loss rates (determined by migration analysis) by risk grades are used as a component of the calculation of the allowance for loan losses.

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## ALLOWANCE FOR LOAN LOSSES

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and probable losses inherent in the loan portfolio. The Company segments the loan portfolio into categories as defined by Schedule RC-C of the Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income Form 041 (Call Report). Loans are segmented into the following pools: commercial, real estate-construction, real estate-mortgage, consumer and other loans. The Company also sub-segments the real estate-mortgage segment into four classes: residential 1-4 family, commercial real estate, second mortgages and equity lines of credit.

The Company uses an internally developed risk evaluation model in the estimation of the credit risk process. The model and assumptions used to determine the allowance are independently validated and reviewed to ensure that the theoretical foundation, assumptions, data integrity, computational processes and reporting practices are appropriate and properly documented.

Each portfolio segment has risk characteristics as follows:

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

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

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

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

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

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

Management also provides an allocated component of the allowance for loans that are specifically identified that may be impaired, and are individually analyzed for impairment. An allocated allowance is established when the present value of expected future cash flows from the impaired loan (or the collateral value or observable market price of the impaired loan) is lower than the carrying value of that loan.

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

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## ALLOWANCE FOR LOAN LOSSES BY SEGMENT

The total allowance reflects management's estimate of losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses of \$8.7 million adequate to cover loan losses inherent in the loan portfolio at June 30, 2017.

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

## ALLOWANCE FOR LOAN LOSSES AND RECORDED INVESTMENT IN LOANS

(in thousands)

| For the Six Months Ended<br>June 30, 2017               | Commercial | Real Estate<br>-<br>Construction | Real<br>Estate -<br>Mortgage<br>(1) | Consumer   | Other     | Total      |
|---|------------|----------------------------------|-------------------------------------|------------|-----------|------------|
| Allowance for Loan Losses:                              |            |                                  |                                     |            |           |            |
| Balance at the beginning of period                      | \$ 1,493   | \$ 846                           | \$ 5,267                            | \$ 455     | \$ 184    | \$ 8,245   |
| Charge-offs   | (138 )     | 0                                | (983 )                              | (63 )      | (72 )     | (1,256 )   |
| Recoveries  | 25         | 0                                | 6                                   | 11         | 29        | 71         |
| Provision for loan losses                               | 342        | (456 )                           | 985                                 | 780        | (1 )      | 1,650      |
| Ending balance  | \$ 1,722   | \$ 390                           | \$ 5,275                            | \$ 1,183   | \$ 140    | \$ 8,710   |
| Ending balance individually evaluated for<br>impairment | \$ 496     | \$ 20                            | \$ 144                              | \$ 0       | \$ 0      | \$ 660     |
| Ending balance collectively evaluated for<br>impairment | 1,226      | 370                              | 5,131                               | 1,183      | 140       | 8,050      |
| Ending balance  | \$ 1,722   | \$ 390                           | \$ 5,275                            | \$ 1,183   | \$ 140    | \$ 8,710   |
| Loan Balances:  |            |                                  |                                     |            |           |            |
| Ending balance individually evaluated for<br>impairment | \$ 1,610   | \$ 94                            | \$ 15,540                           | \$ 81      | \$ 0      | \$ 17,325  |
| Ending balance collectively evaluated for<br>impairment | 55,975     | 25,674                           | 442,210                             | 126,051    | 12,554    | 662,464    |
| Ending balance  | \$ 57,585  | \$ 25,768                        | \$ 457,750                          | \$ 126,132 | \$ 12,554 | \$ 679,789 |
| For the Year Ended<br>December 31, 2016                 | Commercial | Real Estate<br>-<br>Construction | Real<br>Estate -<br>Mortgage<br>(1) | Consumer   | Other     | Total      |
| Allowance for Loan Losses:                              |            |                                  |                                     |            |           |            |
| Balance at the beginning of period                      | \$ 633     | \$ 985                           | \$ 5,628                            | \$ 279     | \$ 213    | \$ 7,738   |
| Charge-offs   | (915 )     | 0                                | (504 )                              | (204 )     | (147 )    | (1,770 )   |
| Recoveries  | 79         | 3                                | 197                                 | 28         | 40        | 347        |
| Provision for loan losses                               | 1,696      | (142 )                           | (54 )                               | 352        | 78        | 1,930      |
| Ending balance  | \$ 1,493   | \$ 846                           | \$ 5,267                            | \$ 455     | \$ 184    | \$ 8,245   |
| Ending balance individually evaluated for<br>impairment | \$ 271     | \$ 22                            | \$ 507                              | \$ 0       | \$ 0      | \$ 800     |
| Ending balance collectively evaluated for<br>impairment | 1,222      | 824                              | 4,760                               | 455        | 184       | 7,445      |
| Ending balance  | \$ 1,493   | \$ 846                           | \$ 5,267                            | \$ 455     | \$ 184    | \$ 8,245   |

## Loan Balances:

|  |           |           |            |           |           |            |
|--|-----------|-----------|------------|-----------|-----------|------------|
| Ending balance individually evaluated for impairment | \$ 989    | \$ 624    | \$ 18,362  | \$ 81     | \$ 0      | \$ 20,056  |
| Ending balance collectively evaluated for impairment | 53,445    | 22,492    | 430,046    | 58,826    | 19,017    | 583,826    |
| Ending balance                                       | \$ 54,434 | \$ 23,116 | \$ 448,408 | \$ 58,907 | \$ 19,017 | \$ 603,882 |

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

## CHANGES IN ACCOUNTING METHODOLOGY

There were no changes in the Company's accounting methodology for the allowance for loan losses in the first six months of 2017.

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## Note 4. Low-Income Housing Tax Credits

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

The investments in these funds were recorded as other assets on the consolidated balance sheets and were \$3.7 million and \$3.9 million at June 30, 2017 and December 31, 2016, respectively. The expected terms of these investments and the related tax benefits run through 2032. Total projected tax credits to be received for 2017 are \$466 thousand, which is based on the most recent quarterly estimates received from the funds. Additional capital calls expected for the funds totaled \$1.2 million at both June 30, 2017 and December 31, 2016, and are recorded in accrued expenses and other liabilities on the corresponding consolidated balance sheet.

|                                    | Three<br>Months<br>Ended<br>June 30,<br>2017 |      | Six Months<br>Ended<br>June 30,<br>2016 |       | Affected Line Item on<br>Consolidated Statements of Income |
|------------------------------------|--|------|---|-------|--|
|                                    | 2017   | 2016 | 2017                                    | 2016  |  |
|                                    | (in thousands)                               |      |   |       |  |
| Tax credits and other tax benefits |  |      |   |       |  |
| Amortization of operating losses   | \$98   | \$74 | \$178                                   | \$147 | ATM and other losses                                       |
| Tax benefit of operating losses*   | 33   | 25   | 61                                      | 50    | Income tax expense   |
| Tax credits                        | 138  | 71   | 233                                     | 172   | Income tax expense   |
| Total tax benefits                 | \$171  | \$96 | \$294                                   | \$222 |  |

\* Computed using a 34% taxable rate

## Note 5. Borrowings

Short-Term Borrowings

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

The Company maintains federal funds lines with several correspondent banks to address short-term borrowing needs. At June 30, 2017 and December 31, 2016 the remaining credit available from these lines totaled \$55.0 million. The Company has a collateral dependent line of credit with the FHLB with remaining credit availability of \$225.1 million and \$270.0 as of June 30, 2017 and December 31, 2016, respectively.

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

|  | June 30,<br>2017 | December<br>31, 2016 |
|--|------------------|----------------------|
|--|------------------|----------------------|

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|   | (in thousands) |           |      |   |
|---|----------------|-----------|------|---|
| Overnight repurchase agreements               | \$23,221       | \$ 18,704 |      |   |
| FHLB advances                                 | 50,000         | 0         |      |   |
| Total short-term borrowings                   | \$73,221       | \$ 18,704 |      |   |
| Maximum month-end outstanding balance         | \$73,221       | \$ 68,864 |      |   |
| Average outstanding balance during the period | 36,406         | 39,364    |      |   |
| Average interest rate (year-to-date)          | 0.46           | %         | 0.59 | % |
| Average interest rate at end of period        | 0.85           | %         | 0.10 | % |

Long-Term Borrowings

The Company had no long-term borrowings at June 30, 2017 or December 31, 2016.

Note 6. Share-Based Compensation

The Company has adopted an employee stock purchase plan and offers share-based compensation through its equity compensation plans. Share-based compensation arrangements include stock options, restricted and unrestricted stock awards, restricted stock units, performance-based awards and stock appreciation rights. Accounting standards require all share-based payments to employees to be valued using a fair value method on the date of grant and to be expensed based on that fair value over the applicable vesting period. The Company accounts for forfeitures during the vesting period as they occur.

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The Company's 1998 Stock Option Plan, pursuant to which stock options could be granted to key employees and non-employee directors, expired on March 9, 2008. Stock options that were outstanding on March 9, 2008 remained outstanding in accordance with their terms, but no new awards could be granted under the plan after March 9, 2008. Options to purchase 35,799 shares of common stock were outstanding under the Company's 1998 Stock Option Plan at June 30, 2017. The exercise price of each option equals the market price of the Company's common stock on the date of the grant and each option's maximum term is ten years.

Stock option activity for the six months ended June 30, 2017 is summarized below:

|                                      | Shares   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Remaining<br>Contractual<br>Life<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|--------------------------------------|----------|--|--|--|
| Options outstanding, January 1, 2017 | 60,605   | \$ 20.05                                 |  |  |
| Granted                              | 0        | 0  |  |  |
| Exercised                            | (24,806) | 20.05                                    |  |  |
| Canceled or expired                  | 0        | 0  |  |  |
| Options outstanding, June 30, 2017   | 35,799   | \$ 20.05                                 | 0.29   | \$ 459   |
| Options exercisable, June 30, 2017   | 35,799   | \$ 20.05                                 | 0.29   | \$ 459   |

The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current fair value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on June 30, 2017. This amount changes based on changes in the fair value of the Company's common stock.

During the six months ended June 30, 2017, the Company received \$497 thousand from the exercise of stock options. No options were exercised during the six months ended June 30, 2016.

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

The Old Point Financial Corporation 2016 Incentive Stock Plan permits the issuance of up to 300,000 shares of common stock for awards to key employees and non-employee directors of the Company and its subsidiaries in the form of stock options, restricted stock, restricted stock units, stock appreciation rights, stock awards and performance units. The Company did not award any equity compensation under the Incentive Stock Plan during 2016 or the six months ended June 30, 2017.

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

Total stock purchases under the ESPP amounted to 999 shares during 2016. 1,687 shares were purchased under the ESPP during the six months ended June 30, 2017. At June 30, 2017, the Company had 247,314 remaining shares reserved for issuance under this plan.





## Note 7. Pension Plan

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

| Three months ended June 30,    | 2017           | 2016  |
|--------------------------------|----------------|-------|
|                                | (in thousands) |       |
| Interest cost                  | \$67           | \$70  |
| Expected return on plan assets | (94)           | (98)  |
| Amortization of net loss       | 123            | 140   |
| Net periodic pension plan cost | \$96           | \$112 |
| Six months ended June 30,      | 2017           | 2016  |
|                                | (in thousands) |       |
| Interest cost                  | \$134          | \$140 |
| Expected return on plan assets | (188)          | (196) |
| Amortization of net loss       | 245            | 280   |
| Net periodic pension plan cost | \$191          | \$224 |

On November 23, 2016, the Company's Board of Directors voted to terminate the pension plan, effective January 31, 2017. The Company anticipates completing the transfer of all liabilities and administrative responsibilities under the plan by the end of the fourth quarter of 2017. At June 30, 2017, management had not yet determined the amount to be contributed to terminate the pension plan.

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

## STOCKHOLDERS' EQUITY – Accumulated Other Comprehensive Loss

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

|                                       | Three Months Ended June 30, 2017 |      | Six Months Ended June 30, 2016 |       | Affected Line Item on Consolidated Statements of Income |
|---------------------------------------|----------------------------------|------|--------------------------------|-------|---|
|                                       | 2017                             | 2016 | 2017                           | 2016  |   |
| Available-for-sale securities         |                                  |      |                                |       |   |
| Realized gains on sales of securities | \$87                             | \$6  | \$87                           | \$515 | Gain on sale of available-for-sale securities, net      |
| Tax effect                            | 30                               | 2    | 30                             | 175   | Income tax expense                                      |
|                                       | \$57                             | \$4  | \$57                           | \$340 |   |

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

|                                | Unrealized<br>Gains<br>(Losses) Defined Accumulated<br>on Benefit Other<br>Available-for-Sale Comprehensive<br>Securities Plans Loss<br>(in thousands) |            |             |
|--------------------------------|--|------------|-------------|
| Six Months Ended June 30, 2017 |  |            |             |
| Balance at beginning of period | \$ (1,739)   | \$ (2,469) | \$ (4,208 ) |
| Net change for the period      | 1,464  | 0          | 1,464       |
| Balance at end of period       | \$ (275 )  | \$ (2,469) | \$ (2,744 ) |
| Six Months Ended June 30, 2016 |  |            |             |
| Balance at beginning of period | \$ (576 )  | \$ (2,586) | \$ (3,162 ) |
| Net change for the period      | 2,176  | 0          | 2,176       |
| Balance at end of period       | \$ 1,600   | \$ (2,586) | \$ (986 )   |

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

|  | Six Months Ended June 30,<br>2017<br>Pretax Tax Net-of-Tax<br>(in thousands) |         |          |
|--|--|---------|----------|
| Unrealized gains on available-for-sale securities:                           |  |         |          |
| Unrealized holding gains arising during the period                           | \$2,305  | \$784   | \$ 1,521 |
| Reclassification adjustment for gains recognized in income                   | (87 )  | (30 )   | (57 )    |
| Total change in accumulated other comprehensive loss, net                    | \$2,218  | \$754   | \$ 1,464 |
| Six Months Ended June 30,<br>2016<br>Pretax Tax Net-of-Tax<br>(in thousands) |  |         |          |
| Unrealized gains on available-for-sale securities:                           |  |         |          |
| Unrealized holding gains arising during the period                           | \$3,812  | \$1,296 | \$ 2,516 |
| Reclassification adjustment for gains recognized in income                   | (515 )   | (175 )  | (340 )   |
| Total change in accumulated other comprehensive loss, net                    | \$3,297  | \$1,121 | \$ 2,176 |

## EARNINGS PER COMMON SHARE

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

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

|  | Net<br>Income<br>Available<br>to<br>Common<br>Shareholders<br>(Numerator)<br>(in thousands except per share<br>data) | Weighted<br>Average<br>Common<br>Shares<br>(Denominator) | Per<br>Share<br>Amount |
|--|--|--|------------------------|
| Three Months Ended June 30, 2017                                     |  |  |                        |
| Net income, basic  | \$1,161  | 4,984  | \$ 0.23                |
| Potentially dilutive common shares - stock options                   | 0  | 13   | 0                      |
| Potentially dilutive common shares - employee stock purchase program | 0  | 0  | 0                      |
| Diluted  | \$1,161  | 4,997  | \$ 0.23                |
| Three Months Ended June 30, 2016                                     |  |  |                        |
| Net income, basic  | \$552  | 4,959  | \$ 0.11                |
| Potentially dilutive common shares - stock options                   | 0  | 0  | 0                      |
| Potentially dilutive common shares - employee stock purchase program | 0  | 0  | 0                      |
| Diluted  | \$552  | 4,959  | \$ 0.11                |
| Six Months Ended June 30, 2017                                       |  |  |                        |
| Net income, basic  | \$2,103  | 4,981  | \$ 0.42                |
| Potentially dilutive common shares - stock options                   | 0  | 13   | 0                      |
| Potentially dilutive common shares - employee stock purchase program | 0  | 0  | 0                      |
| Diluted  | \$2,103  | 4,994  | \$ 0.42                |
| Six Months Ended June 30, 2016                                       |  |  |                        |
| Net income, basic  | \$1,573  | 4,959  | \$ 0.32                |
| Potentially dilutive common shares - stock options                   | 0  | 0  | 0                      |
| Potentially dilutive common shares - employee stock purchase program | 0  | 0  | 0                      |
| Diluted  | \$1,573  | 4,959  | \$ 0.32                |

The Company had no antidilutive shares in the second quarter or first six months of 2017. The Company did not include an average of 69 thousand potential common shares attributable to outstanding stock options in the diluted earnings per share calculation for both the three and six months ended June 30, 2016.

## Note 9. Recent Accounting Pronouncements

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

During June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for Securities and Exchange Commission (SEC) filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

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

During January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business." The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual

periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Company does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements.

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

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

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

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

#### Note 10. Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the "Fair Value Measurements and Disclosures" topics of FASB ASU 2010-06 and FASB ASU 2011-04, the fair value of a financial instrument is the price that would be received in the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement

date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimate of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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

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

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

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

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

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

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

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

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

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

|   | Balance   | Fair Value Measurements at<br>June 30, 2017 Using                                   |  |  |
|---|-----------|---|--|--|
|   |           | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities                   |           |   |  |  |
| Obligations of U.S. Government agencies         | \$9,318   | \$0   | \$9,318                                    | \$ 0   |
| Obligations of state and political subdivisions | 70,092    | 0   | 70,092                                     | 0  |
| Mortgage-backed securities                      | 79,902    | 0   | 79,902                                     | 0  |
| Money market investments                        | 748       | 0   | 748  | 0  |
| Corporate bonds                                 | 7,345     | 0   | 7,345                                      | 0  |
| Other marketable equity securities              | 181       | 0   | 181  | 0  |
| Total available-for-sale securities             | \$167,586 | \$0   | \$167,586                                  | \$ 0   |

|   | Balance   | Fair Value Measurements at<br>December 31, 2016 Using                               |   |  |
|---|-----------|---|---|--|
|   |           | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities                   |           |   |   |  |
| U.S. Treasury securities                        | \$20,000  | \$ 0  | \$20,000  | \$ 0   |
| Obligations of U.S. Government agencies         | 9,195     | 0   | 9,195   | 0  |
| Obligations of state and political subdivisions | 77,987    | 0   | 77,987  | 0  |
| Mortgage-backed securities                      | 83,694    | 0   | 83,694  | 0  |
| Money market investments                        | 647       | 0   | 647   | 0  |
| Corporate bonds                                 | 7,678     | 0   | 7,678   | 0  |
| Other marketable equity securities              | 164       | 0   | 164   | 0  |
| Total available-for-sale securities             | \$199,365 | \$ 0  | \$199,365   | \$ 0   |

ASSETS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

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

Impaired loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts when due from the borrower in accordance with the contractual terms of the loan. The measurement of fair value and loss associated with impaired loans can be based on the observable market price of the loan, the fair value of the collateral securing the loan, or the present value of the loan's expected future cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable, with the vast majority of the collateral in real estate.

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

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

#### Other Real Estate Owned (OREO)

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

#### Loans Held For Sale

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

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

|                                     | Carrying Value at June 30, 2017 |             |              |          |
|-------------------------------------|---------------------------------|-------------|--------------|----------|
|                                     | Using                           |             |              |          |
|                                     | Quoted                          |             |              |          |
|                                     | Prices in                       |             |              |          |
|                                     | Active                          |             |              |          |
|                                     | Markets                         | Significant |              |          |
|                                     | for                             | Other       | Significant  |          |
|                                     | Identical                       | Observable  | Unobservable |          |
| Fair                                | Assets                          | Inputs      | Inputs       |          |
| Value                               | (Level 1)                       | (Level 2)   | (Level 3)    |          |
|                                     | (in thousands)                  |             |              |          |
| Impaired loans                      |                                 |             |              |          |
| Mortgage loans on real estate:      |                                 |             |              |          |
| Residential 1-4 family              | \$401                           | \$ 0        | \$ 0         | \$ 401   |
| Commercial                          | 886                             | 0           | 0            | 886      |
| Construction                        | 74                              | 0           | 0            | 74       |
| Equity lines of credit              | 229                             | 0           | 0            | 229      |
| Total mortgage loans on real estate | \$1,590                         | \$ 0        | \$ 0         | \$ 1,590 |
| Commercial loans                    | 477                             | 0           | 0            | 477      |
| Total                               | \$2,067                         | \$ 0        | \$ 0         | \$ 2,067 |
| Loans                               |                                 |             |              |          |
| Loans held for sale                 | \$1,600                         | \$ 0        | \$ 1,600     | \$ 1,600 |

|                                     | Carrying Value at December 31, 2016 Using |             |              |          |
|-------------------------------------|---|-------------|--------------|----------|
|                                     | Quoted                                    |             |              |          |
|                                     | Prices in                                 |             |              |          |
|                                     | Active                                    |             |              |          |
|                                     | Markets                                   | Significant |              |          |
|                                     | for                                       | Other       | Significant  |          |
|                                     | Identical                                 | Observable  | Unobservable |          |
| Fair                                | Assets                                    | Inputs      | Inputs       |          |
| Value                               | (Level 1)                                 | (Level 2)   | (Level 3)    |          |
|                                     | (in thousands)                            |             |              |          |
| Impaired loans                      |   |             |              |          |
| Mortgage loans on real estate:      |   |             |              |          |
| Residential 1-4 family              | \$400                                     | \$ 0        | \$ 0         | \$ 400   |
| Commercial                          | 1,483                                     | 0           | 0            | 1,483    |
| Construction                        | 74  | 0           | 0            | 74       |
| Total mortgage loans on real estate | \$1,957                                   | \$ 0        | \$ 0         | \$ 1,957 |
| Commercial loans                    | 718                                       | 0           | 0            | 718      |
| Total                               | \$2,675                                   | \$ 0        | \$ 0         | \$ 2,675 |

|                         |       |      |      |        |
|-------------------------|-------|------|------|--------|
| Other real estate owned |       |      |      |        |
| Construction            | \$940 | \$ 0 | \$ 0 | \$ 940 |

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

## Quantitative Information About Level 3 Fair Value Measurements

|                                       | Fair Value<br>at<br>June 30,<br>2017<br>(dollars in<br>thousands) | Valuation Techniques | Unobservable Input   | Range<br>(Weighted<br>Average) |   |
|---------------------------------------|---|----------------------|----------------------|--------------------------------|---|
| Impaired loans                        |   |                      |                      |                                |   |
| Residential 1-4 family real estate    | \$ 401  | Market comparables   | Selling costs        | 7.25                           | % |
|                                       |   |                      | Liquidation discount | 4.00                           | % |
| Commercial real estate                | \$ 886  | Market comparables   | Selling costs        | 7.25                           | % |
|                                       |   |                      | Liquidation discount | 4.00                           | % |
| Construction                          | \$ 74   | Market comparables   | Selling costs        | 7.25                           | % |
|                                       |   |                      | Liquidation discount | 4.00                           | % |
| Equity lines of credit                | \$ 229  | Market comparables   | Selling costs        | 7.25                           | % |
|                                       |   |                      | Liquidation discount | 4.00                           | % |
| Commercial not secured by real estate | \$ 477  | Market comparables   | Liquidation discount | 42.89                          | % |

## Quantitative Information About Level 3 Fair Value Measurements

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

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

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

#### CASH AND CASH EQUIVALENTS

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

#### RESTRICTED SECURITIES

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

#### LOANS RECEIVABLE

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

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#### BANK-OWNED LIFE INSURANCE

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

#### DEPOSITS

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

#### OVERNIGHT REPURCHASE AGREEMENTS

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

#### FEDERAL HOME LOAN BANK ADVANCES

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

#### ACCRUED INTEREST

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

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

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

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

|  | Carrying Value | Fair Value Measurements at June 30, 2017 Using                 |   |   |
|--|----------------|--|---|---|
|  |                | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Assets</b>                            |                |  |   |   |
| Cash and cash equivalents                | \$30,372       | \$30,372   | \$0   | \$0                                       |
| Securities available-for-sale            | 167,586        | 0  | 167,586                                       | 0   |
| Restricted securities                    | 3,102          | 0  | 3,102   | 0   |
| Loans held for sale                      | 1,600          | 0  | 1,600   | 0   |
| Loans, net of allowances for loan losses | 671,079        | 0  | 0   | 670,589                                   |
| Bank-owned life insurance                | 25,604         | 0  | 25,604  | 0   |
| Accrued interest receivable              | 3,133          | 0  | 3,133   | 0   |
| <b>Liabilities</b>                       |                |  |   |   |
| Deposits                                 | \$777,180      | \$0  | \$776,825                                     | \$0                                       |
| Overnight repurchase agreements          | 23,221         | 0  | 23,221  | 0   |
| Federal Home Loan Bank advances          | 50,000         | 0  | 49,990  | 0   |
| Accrued interest payable                 | 253            | 0  | 253   | 0   |

  

|  | Carrying Value | Fair Value Measurements at December 31, 2016 Using             |   |   |
|--|----------------|--|---|---|
|  |                | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Assets</b>                            |                |  |   |   |
| Cash and cash equivalents                | \$25,854       | \$25,854   | \$0   | \$0                                       |
| Securities available-for-sale            | 199,365        | 0  | 199,365                                       | 0   |
| Restricted securities                    | 970            | 0  | 970   | 0   |
| Loans, net of allowances for loan losses | 595,637        | 0  | 0   | 594,190                                   |
| Bank-owned life insurance                | 25,206         | 0  | 25,206  | 0   |
| Accrued interest receivable              | 3,189          | 0  | 3,189   | 0   |
| <b>Liabilities</b>                       |                |  |   |   |
| Deposits                                 | \$784,502      | \$0  | \$783,450                                     | \$0                                       |

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|                                 |        |   |        |   |
|---------------------------------|--------|---|--------|---|
| Overnight repurchase agreements | 18,704 | 0 | 18,704 | 0 |
| Accrued interest payable        | 228    | 0 | 228    | 0 |

Note 11. Segment Reporting

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

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

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

|                                  | Three Months Ended June 30, 2017 |         |          |              |              |
|----------------------------------|----------------------------------|---------|----------|--------------|--------------|
|                                  | Bank                             | Trust   | Parent   | Eliminations | Consolidated |
|                                  | (in thousands)                   |         |          |              |              |
| Revenues                         |                                  |         |          |              |              |
| Interest and dividend income     | \$8,043                          | \$17    | \$1,311  | \$ (1,310)   | ) \$ 8,061   |
| Income from fiduciary activities | 0                                | 951     | 0        | 0            | 951          |
| Other income                     | 2,903                            | 252     | 50       | (65)         | ) 3,140      |
| Total operating income           | 10,946                           | 1,220   | 1,361    | (1,375)      | ) 12,152     |
| Expenses                         |                                  |         |          |              |              |
| Interest expense                 | 672                              | 0       | 0        | 1            | 673          |
| Provision for loan losses        | 1,000                            | 0       | 0        | 0            | 1,000        |
| Salaries and employee benefits   | 4,654                            | 684     | 111      | 0            | 5,449        |
| Other expenses                   | 3,471                            | 249     | 166      | (65)         | ) 3,821      |
| Total operating expenses         | 9,797                            | 933     | 277      | (64)         | ) 10,943     |
| Income before taxes              | 1,149                            | 287     | 1,084    | (1,311)      | ) 1,209      |
| Income tax expense (benefit)     | 27                               | 98      | (77)     | ) 0          | 48           |
| Net income                       | \$1,122                          | \$189   | \$1,161  | \$ (1,311)   | ) \$ 1,161   |
| Capital expenditures             | \$195                            | \$0     | \$0      | \$ 0         | \$ 195       |
| Total assets                     | \$946,734                        | \$5,956 | \$96,942 | \$ (97,114)  | ) \$ 952,518 |
| Three Months Ended June 30, 2016 |                                  |         |          |              |              |
|                                  | Bank                             | Trust   | Parent   | Eliminations | Consolidated |
|                                  | (in thousands)                   |         |          |              |              |
| Revenues                         |                                  |         |          |              |              |
| Interest and dividend income     | \$7,420                          | \$15    | \$725    | \$ (725)     | ) \$ 7,435   |
| Income from fiduciary activities | 0                                | 877     | 0        | 0            | 877          |
| Other income                     | 2,174                            | 250     | 50       | (65)         | ) 2,409      |
| Total operating income           | 9,594                            | 1,142   | 775      | (790)        | ) 10,721     |
| Expenses                         |                                  |         |          |              |              |
| Interest expense                 | 582                              | 0       | 0        | 0            | 582          |
| Provision for loan losses        | 1,250                            | 0       | 0        | 0            | 1,250        |
| Salaries and employee benefits   | 4,124                            | 679     | 87       | 0            | 4,890        |
| Other expenses                   | 3,183                            | 251     | 226      | (65)         | ) 3,595      |
| Total operating expenses         | 9,139                            | 930     | 313      | (65)         | ) 10,317     |
| Income before taxes              | 455                              | 212     | 462      | (725)        | ) 404        |
| Income tax expense (benefit)     | (131)                            | ) 72    | (89)     | ) 0          | (148)        |
| Net income                       | \$586                            | \$140   | \$551    | \$ (725)     | ) \$ 552     |

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|                      |            |          |           |              |            |
|----------------------|------------|----------|-----------|--------------|------------|
| Capital expenditures | \$ 105     | \$ 0     | \$ 0      | \$ 0         | \$ 105     |
| Total assets         | \$ 891,786 | \$ 5,814 | \$ 95,933 | \$ (95,860 ) | \$ 897,673 |

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|                                  | Six Months Ended June 30, 2017 |         |          |              |              |
|----------------------------------|--------------------------------|---------|----------|--------------|--------------|
|                                  | Bank                           | Trust   | Parent   | Eliminations | Consolidated |
|                                  | (in thousands)                 |         |          |              |              |
| Revenues                         |                                |         |          |              |              |
| Interest and dividend income     | \$15,751                       | \$34    | \$2,352  | \$ (2,351 )  | \$ 15,786    |
| Income from fiduciary activities | 0                              | 1,917   | 0        | 0            | 1,917        |
| Other income                     | 4,858                          | 510     | 100      | (131 )       | 5,337        |
| Total operating income           | 20,609                         | 2,461   | 2,452    | (2,482 )     | 23,040       |
| Expenses                         |                                |         |          |              |              |
| Interest expense                 | 1,260                          | 0       | 0        | 1            | 1,261        |
| Provision for loan losses        | 1,650                          | 0       | 0        | 0            | 1,650        |
| Salaries and employee benefits   | 8,909                          | 1,411   | 226      | 0            | 10,546       |
| Other expenses                   | 6,796                          | 514     | 251      | (131 )       | 7,430        |
| Total operating expenses         | 18,615                         | 1,925   | 477      | (130 )       | 20,887       |
| Income before taxes              | 1,994                          | 536     | 1,975    | (2,352 )     | 2,153        |
| Income tax expense (benefit)     | (5 )                           | 183     | (128 )   | 0            | 50           |
| Net income                       | \$1,999                        | \$353   | \$2,103  | \$ (2,352 )  | \$ 2,103     |
| Capital expenditures             | \$444                          | \$0     | \$0      | \$ 0         | \$ 444       |
| Total assets                     | \$946,734                      | \$5,956 | \$96,942 | \$ (97,114 ) | \$ 952,518   |
| Six Months Ended June 30, 2016   |                                |         |          |              |              |
|                                  | Bank                           | Trust   | Parent   | Eliminations | Consolidated |
|                                  | (in thousands)                 |         |          |              |              |
| Revenues                         |                                |         |          |              |              |
| Interest and dividend income     | \$14,771                       | \$29    | \$1,871  | \$ (1,871 )  | \$ 14,800    |
| Income from fiduciary activities | 0                              | 1,778   | 0        | 0            | 1,778        |
| Other income                     | 4,677                          | 526     | 100      | (130 )       | 5,173        |
| Total operating income           | 19,448                         | 2,333   | 1,971    | (2,001 )     | 21,751       |
| Expenses                         |                                |         |          |              |              |
| Interest expense                 | 1,301                          | 0       | 0        | 0            | 1,301        |
| Provision for loan losses        | 1,400                          | 0       | 0        | 0            | 1,400        |
| Salaries and employee benefits   | 8,486                          | 1,357   | 201      | 0            | 10,044       |
| Other expenses                   | 6,798                          | 512     | 352      | (130 )       | 7,532        |
| Total operating expenses         | 17,985                         | 1,869   | 553      | (130 )       | 20,277       |
| Income before taxes              | 1,463                          | 464     | 1,418    | (1,871 )     | 1,474        |
| Income tax expense (benefit)     | (103 )                         | 158     | (154 )   | 0            | (99 )        |
| Net income                       | \$1,566                        | \$306   | \$1,572  | \$ (1,871 )  | \$ 1,573     |
| Capital expenditures             | \$472                          | \$4     | \$0      | \$ 0         | \$ 476       |



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

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

Caution About Forward-Looking Statements

In addition to historical information, this report may contain forward-looking statements. For this purpose, any statement that is not a statement of historical fact may be deemed to be a forward-looking statement. These forward-looking statements may include, but are not limited to, statements regarding profitability, including the focus on reducing higher-cost time deposits; the net interest margin; strategies for managing the net interest margin and the expected impact of such efforts; levels and sources of liquidity; the loan portfolio and expected trends in the quality of the loan portfolio; the effect of increased levels of past due student loans; the allowance and provision for loan losses; the securities portfolio; monetary policy actions of the Federal Open Market Committee; changes in interest rates; interest rate sensitivity; asset quality; levels of net loan charge-offs and nonperforming assets; levels of interest expense; levels and components of noninterest income and noninterest expense; income taxes; expected yields on the loan and securities portfolios; expected rates on interest-bearing liabilities; expected timing of and expense in connection with the anticipated termination of the pension plan; effect of the marketing agreement for insurance products; estimated levels of future tax credits and capital calls in connection with the Company's investment in housing equity funds; market risk; business and growth strategies; investment strategy; and financial and other goals. Forward-looking statements often use words such as "believes," "expects," "plans," "may," "will," "should," "projects," "contemplates," "anticipates," "forecasts," "intends" or other words of similar meaning. These statements can also be identified by the fact that they do not relate strictly to historical or current facts. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, and actual results could differ materially from historical results or those anticipated by such statements.

There are many factors that could have a material adverse effect on the operations and future prospects of the Company including, but not limited to, changes in interest rates and yields; general economic and general business conditions, including unemployment levels; uncertainty over future federal spending or the budget priorities of the new presidential administration, particularly in connection with the Department of Defense, on the Company's service area; the quality or composition of the loan or securities portfolios; changes in the volume and mix of interest-earning assets and interest-bearing liabilities; the effects of management's investment strategy and strategy to manage the net interest margin; the adequacy of the Company's credit quality review processes; the level of nonperforming assets and related charge-offs and recoveries; the performance of the Company's dealer lending program; the federal government's guarantee of repayment of student loans purchased by the Company; the ability of the Company to diversify its sources of noninterest income; the local real estate market; volatility and disruption in national and international financial markets; government intervention in the U.S. financial system; application of the Basel III capital standards to the Company and its subsidiaries; FDIC premiums and/or assessments; demand for loan and other banking products and financial services in the Company's primary service area; levels of noninterest income and expense; deposit flows; competition; the use of inaccurate assumptions in management's modeling systems; technology; any interruption or breach of security in the Company's information systems or those of the Company's third party vendors or other service providers; reliance on third parties for key services; adequacy of the allowance for loan losses; and changes in accounting principles, policies and guidelines. The Company could also be adversely

affected by monetary and fiscal policies of the U.S. Government, as well as any regulations or programs implemented pursuant to the Dodd-Frank Act or other legislation and policies of the Office of the Comptroller of the Currency, U.S. Treasury and the Federal Reserve Board.

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

#### Available Information

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

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## General

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

## Critical Accounting Policies and Estimates

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

## Overview

During 2017, one of the Company's strategic initiatives has been to grow and diversify the loan portfolio. As part of that initiative, the Company expanded its dealer lending program, with the dealer loan portfolio growing \$58.8 million between December 31, 2016 and June 30, 2017.

Net income for the first six months of 2017 was \$2.1 million, or \$0.42 per diluted share, compared to net income of \$1.6 million, or \$0.32 per diluted share, for the first six months of 2016. This 33.69% increase was the net effect of higher interest income, particularly on the loan portfolio; reduced interest expense; an increased provision for loan losses as a result of loan growth and higher levels of nonperforming assets; higher noninterest income, primarily in connection with the Old Point Mortgage acquisition in the second quarter of 2017; and higher noninterest expense, driven primarily by increases in salaries and employee benefits.

In the second quarter of 2017, net income was \$1.2 million, or increased \$609 thousand when compared to the second quarter of 2016. This increase in quarterly income was driven by many of the same factors that impacted year-to-date income, with the exception of the provision for loan losses. In the second quarter of 2017, the provision for loan losses was \$250 thousand lower than the provision in the second quarter of 2016. In the second quarter of 2016, the provision was elevated due to a charge-off on a single loan relationship. While loan growth in the second quarter of 2017 did affect the provision, the Company's largest charge-off during the quarter was on a loan for which it had already provided a specific reserve. Accordingly, the Company determined the \$1.0 million addition to the provision for the second quarter of 2017 was appropriate to provide for the loan growth during the quarter.

## Net Interest Income

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

For the six months ended June 30, 2017 net interest income was \$14.5 million, an increase of \$1.0 million compared to the prior year period, primarily due to increased interest and fees on loans associated with loan growth and lower interest expense on FHLB advances. For the second quarter of 2017, net interest income was \$7.3 million, an increase of \$251 thousand from the first quarter of 2017. The increases in net interest income were driven by higher earning asset balances.

Net interest income, on a fully tax-equivalent basis, was \$15.0 million for the six months ended June 30, 2017, compared to \$14.0 million for the six months ended June 30, 2016, an increase of 7.66%. For the second quarter of 2017, tax-equivalent net interest income was \$7.6 million, an increase of 7.88% from the second quarter of 2016.

Year-to-Date Review

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

Average loans increased \$62.5 million, with this increase in average balances offsetting a decline in loan yields of 16 basis points and increasing interest income on loans by \$915 thousand. In contrast, while average investment securities declined \$2.1 million, a 15-basis-point increase in the tax-equivalent yield on the portfolio provided an additional \$100 thousand in tax-equivalent interest income. During the second half of 2016 and the first half of 2017, management closely monitored the investment portfolio and was able to strategically buy and sell securities to improve the yield on the portfolio.

Average earning assets increased \$60.3 million, while the average yield declined 5 basis points. Although the yield on earning assets declined, the growth in loan volume helped to offset the effect. With a higher percent of the Company's average assets in loans--the highest yielding category on the Company's balance sheet--tax-equivalent interest income increased \$1.0 million.

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The growth in the average balance sheet was funded primarily through increases in deposits, with average deposits growing \$51.9 million. Low-cost deposits in particular grew \$54.8 million, with higher-cost time deposits decreasing \$3.0 million. While the cost of time deposits increased 2 basis points, the shift in the deposit mix toward less costly sources of funding resulted in a 1 basis point overall decrease in the cost of total time and savings deposits. This change in the deposit mix also helped reduce the effect of deposit growth on interest expense, with interest expense on deposits increasing only \$33 thousand. Management expects that the Company's solid base of low-cost deposits will continue to beneficially impact the net interest margin in 2017.

In addition to the change in the deposit mix, the mix of all interest-bearing liabilities also shifted toward lower-cost funding. The weighted-average cost of total interest-bearing liabilities decreased from 0.47% to 0.43%, primarily due to the payoff of an FHLB advance in February 2016. As can be seen in the following table, this paid off advance bore a rate significantly higher than other available funding sources in the current rate environment. Average FHLB advances increased \$6.1 million as the Company took out new short-term advances to fund temporary shortfalls in liquidity. The lower cost on interest-bearing liabilities offset the reduced yield on earning assets, keeping the Company's net interest margin at 3.67%.

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

#### Second Quarter Review

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

Comparisons between the second quarters of 2017 and 2016 are substantially the same as those for the six months ended June 30, 2017 and 2016. Growth in average loans of \$78.6 million offset a 21-basis-point decline in loan yields for a net increase in tax-equivalent loan interest income of \$549 thousand. A small decline in average investment securities was offset by improvements in the yield, resulting in \$88 thousand of additional tax-equivalent interest income. Average earning assets increased \$79.3 million, while the yield decreased 7 basis points. With the increase in earning assets concentrated in higher-yielding loans, average interest income increased \$649 thousand.

The increase in loans was funded primarily by growth in low-cost deposits (\$53.8 million), with the remainder provided by short-term FHLB advances (\$23.6 million). As market rates have increased, the rate on FHLB advances has also increased, with the cost increasing from 0.44% in the second quarter of 2016 to 1.09% in the second quarter of 2017. Although the Company's overall cost on time deposits is lower than the cost of FHLB advances, much of the balance in time deposits is from accounts opened in lower rate environments. The current market rates on time deposits in the Company's market area remain generally higher than the rates on short-term FHLB advances.

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

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

|   | For the quarter ended June 30, |                                |                  |                    |                                |                  |
|---|--------------------------------|--------------------------------|------------------|--------------------|--------------------------------|------------------|
|   | 2017                           |                                |                  | 2016               |                                |                  |
|   | Average<br>Balance             | Interest<br>Income/<br>Expense | Yield/<br>Rate** | Average<br>Balance | Interest<br>Income/<br>Expense | Yield/<br>Rate** |
|   | (dollars in thousands)         |                                |                  |                    |                                |                  |
| <b>ASSETS</b>   |                                |                                |                  |                    |                                |                  |
| Loans*  | \$659,926                      | \$7,142                        | 4.33 %           | \$581,281          | \$6,593                        | 4.54 %           |
| Investment securities:  |                                |                                |                  |                    |                                |                  |
| Taxable   | 103,485                        | 491                            | 1.90 %           | 109,300            | 471                            | 1.72 %           |
| Tax-exempt*   | 70,805                         | 636                            | 3.59 %           | 65,432             | 568                            | 3.47 %           |
| Total investment securities   | 174,290                        | 1,127                          | 2.59 %           | 174,732            | 1,039                          | 2.38 %           |
| Interest-bearing due from banks                                     | 1,316                          | 3                              | 0.91 %           | 1,097              | 1                              | 0.36 %           |
| Federal funds sold  | 1,248                          | 2                              | 0.64 %           | 1,415              | 1                              | 0.28 %           |
| Other investments   | 2,098                          | 35                             | 6.67 %           | 1,086              | 26                             | 9.58 %           |
| Total earning assets  | 838,878                        | \$8,309                        | 3.96 %           | 759,611            | \$7,660                        | 4.03 %           |
| Allowance for loan losses   | (9,025 )                       |                                |                  | (7,794 )           |                                |                  |
| Other non-earning assets  | 102,655                        |                                |                  | 107,155            |                                |                  |
| Total assets  | \$932,508                      |                                |                  | \$858,972          |                                |                  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                         |                                |                                |                  |                    |                                |                  |
| Time and savings deposits:  |                                |                                |                  |                    |                                |                  |
| Interest-bearing transaction accounts                               | \$28,438                       | \$2                            | 0.03 %           | \$14,150           | \$1                            | 0.03 %           |
| Money market deposit accounts                                       | 235,539                        | 60                             | 0.10 %           | 223,561            | 43                             | 0.08 %           |
| Savings accounts  | 82,217                         | 11                             | 0.05 %           | 77,903             | 10                             | 0.05 %           |
| Time deposits   | 203,819                        | 520                            | 1.02 %           | 207,908            | 517                            | 0.99 %           |
| Total time and savings deposits                                     | 550,013                        | 593                            | 0.43 %           | 523,522            | 571                            | 0.44 %           |
| Federal funds purchased, repurchase agreements and other borrowings | 26,302                         | 8                              | 0.12 %           | 26,582             | 8                              | 0.12 %           |
| Federal Home Loan Bank advances                                     | 26,374                         | 72                             | 1.09 %           | 2,747              | 3                              | 0.44 %           |
| Total interest-bearing liabilities                                  | 602,689                        | 673                            | 0.45 %           | 552,851            | 582                            | 0.42 %           |
| Demand deposits   | 227,880                        |                                |                  | 204,623            |                                |                  |
| Other liabilities   | 5,586                          |                                |                  | 6,603              |                                |                  |
| Stockholders' equity  | 96,353                         |                                |                  | 94,895             |                                |                  |
| Total liabilities and stockholders' equity                          | \$932,508                      |                                |                  | \$858,972          |                                |                  |
| Net interest margin   |                                | \$7,636                        | 3.64 %           |                    | \$7,078                        | 3.73 %           |

\*Computed on a fully tax-equivalent basis using a 34% rate; the tax-equivalent adjustment to interest income was \$248 thousand

\*\*Annualized

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

|   | For the six months ended June 30, |                         |              |                 |                         |              |
|---|-----------------------------------|-------------------------|--------------|-----------------|-------------------------|--------------|
|   | 2017                              |                         |              | 2016            |                         |              |
|   | Average Balance                   | Interest Income/Expense | Yield/Rate** | Average Balance | Interest Income/Expense | Yield/Rate** |
| (dollars in thousands)  |                                   |                         |              |                 |                         |              |
| <b>ASSETS</b>   |                                   |                         |              |                 |                         |              |
| Loans*  | \$638,262                         | \$13,953                | 4.37 %       | \$575,812       | \$13,038                | 4.53 %       |
| Investment securities:  |                                   |                         |              |                 |                         |              |
| Taxable   | 105,303                           | 987                     | 1.87 %       | 112,804         | 1,019                   | 1.81 %       |
| Tax-exempt*   | 71,618                            | 1,283                   | 3.58 %       | 66,228          | 1,151                   | 3.48 %       |
| Total investment securities   | 176,921                           | 2,270                   | 2.57 %       | 179,032         | 2,170                   | 2.42 %       |
| Interest-bearing due from banks                                     | 1,710                             | 8                       | 0.94 %       | 1,901           | 5                       | 0.53 %       |
| Federal funds sold  | 1,422                             | 5                       | 0.70 %       | 1,526           | 2                       | 0.26 %       |
| Other investments   | 1,537                             | 49                      | 6.38 %       | 1,266           | 41                      | 6.48 %       |
| Total earning assets  | 819,852                           | \$16,285                | 3.97 %       | 759,537         | \$15,256                | 4.02 %       |
| Allowance for loan losses   | (8,710 )                          |                         |              | (7,815 )        |                         |              |
| Other non-earning assets  | 105,422                           |                         |              | 109,521         |                         |              |
| Total assets  | \$916,564                         |                         |              | \$861,243       |                         |              |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                         |                                   |                         |              |                 |                         |              |
| Time and savings deposits:  |                                   |                         |              |                 |                         |              |
| Interest-bearing transaction accounts                               | \$28,332                          | \$5                     | 0.04 %       | \$12,583        | \$2                     | 0.03 %       |
| Money market deposit accounts                                       | 235,798                           | 112                     | 0.09 %       | 223,097         | 88                      | 0.08 %       |
| Savings accounts  | 81,114                            | 20                      | 0.05 %       | 77,545          | 19                      | 0.05 %       |
| Time deposits   | 205,469                           | 1,039                   | 1.01 %       | 208,439         | 1,034                   | 0.99 %       |
| Total time and savings deposits                                     | 550,713                           | 1,176                   | 0.43 %       | 521,664         | 1,143                   | 0.44 %       |
| Federal funds purchased, repurchase agreements and other borrowings | 23,482                            | 13                      | 0.11 %       | 25,972          | 14                      | 0.11 %       |
| Federal Home Loan Bank advances                                     | 13,260                            | 72                      | 1.09 %       | 7,143           | 144                     | 4.03 %       |
| Total interest-bearing liabilities                                  | 587,455                           | 1,261                   | 0.43 %       | 554,779         | 1,301                   | 0.47 %       |
| Demand deposits   | 227,971                           |                         |              | 205,167         |                         |              |
| Other liabilities   | 5,715                             |                         |              | 6,615           |                         |              |
| Stockholders' equity  | 95,423                            |                         |              | 94,682          |                         |              |
| Total liabilities and stockholders' equity                          | \$916,564                         |                         |              | \$861,243       |                         |              |
| Net interest margin   |                                   | \$15,024                | 3.67 %       |                 | \$13,955                | 3.67 %       |

\*Computed on a fully tax-equivalent basis using a 34% rate; the tax-equivalent adjustment to interest income was \$499 thousand

\*\*Annualized

## Provision for Loan Losses

The provision for loan losses is a charge against earnings necessary to maintain the allowance for loan losses at a level consistent with management's evaluation of the portfolio. This expense is based on management's estimate of probable credit losses inherent to the loan portfolio. Management's evaluation included credit quality trends, collateral values, discounted cash flow analysis, loan volumes, geographic, borrower and industry concentrations, the findings of internal credit quality assessments and results from external regulatory examinations. These factors, as well as identified impaired loans, historical losses and current economic and business conditions, were used in developing estimated loss factors for determining the loan loss provision. Based on its analysis of the adequacy of the allowance

for loan losses, management concluded that the provision was appropriate.

The provision for loan losses was \$1.7 million in the first six months of 2017, compared to \$1.4 million in the first six months of 2016. For the second quarter, the Company added \$1.0 million in 2017 and \$1.3 million in 2016.

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Approximately \$500 thousand of the provision for loan losses in the six months ended June 30, 2017 was due to growth in loans, which required the Company to set aside additional funds. The remainder of the increase was primarily due to the deteriorating condition of a long-standing borrowing relationship. Based on changes in the collateral for this relationship, management charged off \$787 thousand in the second quarter of 2017. Because this charge-off was on a loan for which it had already provided a specific reserve, the Company determined the \$1.0 million addition to the provision for the second quarter of 2017 was appropriate.

Net loans charged off as a percent of total loans on an annualized basis were 0.35% for the first six months of 2017, or \$1.2 million, compared to 0.40%, or \$1.2 million, in the first six months of 2016.

#### Noninterest Income

Noninterest income was \$4.1 million and \$7.3 million, respectively, in the three and six months ended June 30, 2017, an increase of \$805 thousand or 24.50% from the second quarter of 2016 and an increase of \$303 thousand or 4.36% from the six months ended June 30, 2016. The changes in comparisons between 2016 and 2017 result primarily from (1) the initial implementation in the first quarter of 2016 of a new strategy for the investment portfolio, resulting in increased activity within the investment portfolio that was not repeated in 2017, and (2) the acquisition in the second quarter of 2017 of the outstanding interest in Old Point Mortgage, LLC, which is now included in the Company's consolidated financial statements.

In the fourth quarter of 2016, the Company entered into a marketing agreement that will provide an avenue for employees of the Company to make referrals for insurance products. The Company will also assist with marketing and will receive a commission based on referrals, while the operational aspects will be handled by the other party to the marketing agreement. Management expects this agreement to increase noninterest income beginning in the second half of 2017.

#### Year-to-Date Review

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

Gains on sales of available-for-sale securities decreased \$428 thousand. While management continued to monitor the investment portfolio and make changes congruent with the strategy for the investment portfolio, purchases and sales in the first half of 2017 were fewer than in the first quarter of 2016, with correspondingly smaller gains.

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

Income from mortgage banking activities increased \$201 thousand. The Company's consolidated financial statements now include OPM, with its income reported in noninterest income as income from mortgage banking activities. In 2016, the Bank owned only 49% of OPM and accounted for its investment under the equity method. Under this method, the Bank recorded its proportionate share of OPM's net income (all income net of all expenses, including income tax). With the completion of the full acquisition of OPM, the Bank now receives 100% of OPM's income. The Bank's investment in OPM is also now accounted for on a consolidated basis, and as a result, OPM's gross revenues are reported in noninterest income and its expenses are reported in individual categories of noninterest expense, rather than as a net figure in noninterest income. The increase from a 49% to 100% ownership interest and the conversion from equity to consolidation accounting led to the significant increase in this category.

Other significant changes in noninterest income were in income from fiduciary activities (increased \$139 thousand or 7.82%) and service charges on deposit accounts (decreased \$153 thousand or 7.67%). Income from fiduciary activities is heavily impacted by the market value of assets under management, and improvements in the stock market during

the fourth quarter of 2016 and first quarter of 2017 increased income in this category. Service charges on deposit accounts decreased primarily due to lower overdraft fee income and lower service charges on both personal and business accounts. Increased regulation of overdraft fee income has reduced the Company's income in this category in prior years, a decline that continued in the first half of 2017.

Second Quarter Review

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

Income from mortgage banking activities increased \$204 thousand and the Company recorded income of \$550 thousand related to its previously-held equity interest in OPM due to the purchase of OPM and subsequent conversion to consolidation accounting discussed above. Income from fiduciary activities increased \$74 thousand or 8.44%, while service charges on deposit accounts decreased \$105 thousand or 10.28%. Both changes were for the reasons discussed in the "Year-to-Date Review" section above.

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### Noninterest Expense

Noninterest expense increased \$785 thousand or 9.25%, when comparing the six months ended June 30, 2017 to the same period in 2016 and increased \$400 thousand or 2.28% when comparing the second quarters of 2017 and 2016.

### Year-to-Date Review

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

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

Salaries and employee benefits (increased \$502 thousand or 5.00%): In the second quarter of 2017, the Company accrued for the compensation package provided to its retiring Chief Financial Officer. In addition to this accrual, the consolidation of OPM increased salary and commission expenses, as did the hiring of additional lending staff to support the Company's strategic plan.

Occupancy and equipment (increased \$155 thousand or 5.64%): The Company continues to improve its disaster recovery plan, building on the more sophisticated disaster recovery plan initially begun in the third quarter of 2015. New service contracts and purchases of depreciable equipment both contributed to the increase in occupancy and equipment.

FDIC insurance (decreased \$127 thousand or 39.56%): Beginning in the third quarter of 2016, the FDIC made changes to the way that insurance premiums are calculated. Management expects the lower levels of expense to continue into the foreseeable future.

Legal and audit expenses (decreased \$109 thousand or 21.93%): The Company's 2016 proxy statement included numerous proposals, including changes to the Company's articles of incorporation, the addition of an employee stock purchase plan, and the addition of a new stock incentive plan, all of which required extensive review by outside legal counsel. The implementation of stockholder-approved proposals following the 2016 Annual Meeting of Stockholders also increased legal and audit expense during 2016, while there were no equivalent expenses in 2017.

Other outside service fees (increased \$144 thousand or 39.89%): Due to the large increase in the Bank's auto dealer loan portfolio, costs to process and service these loans also increased.

Employee professional development (increased \$128 thousand or 39.14%): Prior to the retirement of the Company's CFO in the second quarter of 2017, the Company retained a recruitment firm specializing in executive searches. Expenses for this firm are included in this category of noninterest expense.

ATM and other losses (increased \$162 thousand or 95.29%): Branch robberies and fraud losses increased this expense in the first half of 2017. The Company has implemented improvements to its fraud detection process and continues to monitor new frauds to determine if additional changes are necessary.

Loss (gain) on other real estate owned (decreased \$126 thousand or 116.67%): In 2016 and 2017, the Company worked diligently to sell the properties held in other real estate owned, with the last two sales closing in the second quarter of 2017. Prior to 2017, both properties had already been written down to the anticipated sales price (less costs to sell); the Company recorded a small gain on the final sales in 2017, as compared to a loss in the first half of 2016.

The Company's income tax expense increased \$149 thousand, due to both higher income before taxes and a higher effective tax rate. The Company's effective tax rate remains low due to its investments in tax-exempt securities and its receipt of federal income tax credits for its investment in certain housing projects. As the Company's income was higher in 2017 than in 2016 while the amount of credits received in each year is similar, the Company's effective tax rate increased from a net tax benefit to an effective tax rate of 2.32%.

### Second Quarter Review

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

The most significant changes in quarterly noninterest expense were in four line items: salaries and employee benefits (increased \$559 thousand or 11.43%); FDIC insurance (decreased \$58 thousand or 37.18%); legal and audit expenses (decreased \$81 thousand or 27.46%); other outside service fees (increased \$128 thousand or 71.91%); and ATM and other losses (increased \$72 thousand or 86.75%). All of these categories were affected by the same factors as discussed above for the year-to-date periods.

Income tax expense for the quarter was up from the comparable period last year, due to higher net income before taxes and a higher effective tax rate. The Company's effective tax rate was higher as taxable income increased more than both tax-exempt income and the Company's tax credits. As in the year-to-date periods discussed above, the Company's investments in tax-exempt securities and low-income housing projects have generally helped to keep its effective tax rate low, which management expects will continue.

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## Balance Sheet Review

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

Assets as of June 30, 2017 were \$952.5 million, an increase of \$49.6 million or 5.49%, with net loans growing \$76.9 million. During the first half of 2017, loan growth was primarily funded by increases in low-cost deposits. However, deposit balances declined during June, with the Company relying on net cash flows from the securities portfolio (\$30.8 million) and additional FHLB advances (\$50.0 million) to fund the shortfall. Total deposits declined \$7.3 million or 0.93%, from \$784.5 million at December 31, 2016 to \$777.2 million at June 30, 2017. Despite the overall decline in deposits, low-cost deposits were essentially flat, with almost all of the decrease in higher-cost time deposits. Management monitors available liquidity closely and adjusts deposit rates according to the Company's needs. The declines in deposits were offset by increases in overnight repurchase agreements and the portion of FHLB advances not used to fund loan growth.

The majority of the Company's loan growth was in the consumer loans category and was driven by indirect dealer lending. In September 2016, the Company re-opened its dealer lending department. The consumer auto loan portfolio grew \$58.8 million in the first half of 2017, which management expects will contribute positively to interest income in the future. While there are risks inherent in any new loan program, the Company has hired knowledgeable staff and put in place programs and policies to mitigate those risks. Management is monitoring the allowance for loan losses carefully and will make changes as the portfolio ages.

Consumer loans were also increased by the purchase of \$7.6 million in consumer installment loans. The Company maintains a dedicated reserve account funded by the seller of the consumer installment loans. The balance in the reserve account averages 10 - 12% of the outstanding principal balance of these purchased consumer loans. Any loan losses in this portfolio are covered first by the reserve account; loans are charged against the allowance for loan losses only if the funds available in the reserve account are not sufficient.

Average assets for the first six months of 2017 were \$916.6 million compared to \$861.2 million for the first six months of 2016, an increase of 6.42%. Comparing the first six months of 2017 to the first six months of 2016, average loan growth of \$62.5 million was funded by average deposit growth of \$51.9 million and a \$6.1 million increase in average FHLB advances.

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

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

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

Loans Secured by 1 - 4 Family  
First Mortgages,  
1 - 4 Family Open-end and 1 - 4  
Family Junior Liens

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As of June 30, 2017  
(dollars in thousands)

|              | <u>Amount</u> | <u>Percent</u> |
|--------------|---------------|----------------|
| Subprime     | \$22,097      | 13.41 %        |
| Non-subprime | 142,628       | 86.59 %        |
|              | \$164,725     | 100.00%        |

Total loans \$679,789

Percentage of Real  
Estate-Secured Subprime  
Loans to Total Loans 3.25 %

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In addition to the subprime loans secured by real estate discussed above, as of June 30, 2017, the Company had an additional \$10.4 million in subprime consumer loans that were not government guaranteed, were unsecured, or were secured by collateral other than real estate. Together with the subprime loans secured by real estate, the Company's total subprime loans as of June 30, 2017 were \$32.5 million, amounting to 4.78% of the Company's total loans at June 30, 2017.

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

#### Liquidity

Liquidity is the ability of the Company to meet present and future financial obligations through either the sale or maturity of existing assets or the acquisition of additional funds through liability management. Liquid assets include cash, interest-bearing deposits with banks, federal funds sold, investments in securities and loans maturing within one year. The Company's internal sources of such liquidity are deposits, loan and investment repayments and securities available-for-sale. As of June 30, 2017, the Bank's unpledged, available-for-sale securities totaled \$91.9 million. The Company's primary external source of liquidity is advances from the FHLB.

A major source of the Company's liquidity is its large, stable deposit base. In addition, secondary liquidity sources are available through the use of borrowed funds if the need should arise, including secured advances from the FHLB. As of the end of the second quarter of 2017, the Company had \$130.9 million in FHLB borrowing availability based on loans and securities currently available for pledging, less advances currently outstanding. The Company believes that the availability at the FHLB is sufficient to meet future cash-flow needs. The Company also has available short-term, unsecured borrowed funds in the form of federal funds lines of credit with correspondent banks. As of the end of the second quarter of 2017, the Company had \$55.0 million available in federal funds lines to address any short-term borrowing needs.

As disclosed in the Company's consolidated statements of cash flows, net cash provided by operating activities was \$3.7 million, net cash used in investing activities was \$45.7 million and net cash provided by financing activities was \$46.5 million for the six months ended June 30, 2017. Combined, this contributed to a \$4.5 million increase in cash and cash equivalents for the six months ended June 30, 2017.

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

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

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

#### Nonperforming Assets

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

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

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

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

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

## NONPERFORMING ASSETS

|  | June 30,<br>2017<br>(in thousands) | December<br>31,<br>2016 | Increase<br>(Decrease) |
|--|------------------------------------|-------------------------|------------------------|
| Nonaccrual loans   |                                    |                         |                        |
| Commercial   | \$1,610                            | \$ 231                  | \$ 1,379               |
| Consumer loans   | 81                                 | 81                      | 0                      |
| Real estate-mortgage (1)                                   | 9,865                              | 6,847                   | 3,018                  |
| Total nonaccrual loans                                     | \$11,556                           | \$ 7,159                | \$ 4,397               |
| Loans past due 90 days or more and accruing interest       |                                    |                         |                        |
| Real estate-mortgage (1)                                   | \$544                              | \$ 276                  | \$ 268                 |
| Consumer loans (2)   | 2,823                              | 2,603                   | 220                    |
| Other  | 3                                  | 5                       | (2 )                   |
| Total loans past due 90 days or more and accruing interest | \$3,370                            | \$ 2,884                | \$ 486                 |
| Restructured loans   |                                    |                         |                        |
| Commercial   | \$103                              | \$ 144                  | \$ (41 )               |
| Real estate-construction                                   | 93                                 | 96                      | (3 )                   |
| Real estate-mortgage (1)                                   | 13,996                             | 11,616                  | 2,380                  |
| Total restructured loans                                   | \$14,192                           | \$ 11,856               | \$ 2,336               |
| Less nonaccrual restructured loans (included above)        | 8,553                              | 2,838                   | 5,715                  |
| Less restructured loans currently in compliance (3)        | 5,639                              | 9,018                   | (3,379 )               |
| Net nonperforming, accruing restructured loans             | \$0                                | \$ 0                    | \$ 0                   |
| Nonperforming loans  | \$14,926                           | \$ 10,043               | \$ 4,883               |
| Other real estate owned                                    |                                    |                         |                        |
| Construction, land development, and other land             | \$0                                | \$ 940                  | \$ (940 )              |
| Former bank building                                       | 0                                  | 127                     | (127 )                 |
| Total other real estate owned                              | \$0                                | \$ 1,067                | \$ (1,067 )            |
| Total nonperforming assets                                 | \$14,926                           | \$ 11,110               | \$ 3,816               |

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

(2) Amounts listed include student loans with principal and interest amounts that are 97 - 98% guaranteed by the federal government. The portion of these guaranteed loans that is past due 90 days or more totaled \$2.8 million at June 30, 2017 and \$2.6 million at December 31, 2016.

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

Nonperforming assets as of June 30, 2017 were \$14.9 million, \$3.8 million higher than nonperforming assets as of December 31, 2016. Nonaccrual loans increased \$4.4 million when comparing the balances as of June 30, 2017 to December 31, 2016. Two long-standing loan relationships were placed on nonaccrual status in the first quarter of 2017, based on declines in the borrowers' performance and changes in the status of the loans' collateral; the outstanding balances on these relationships totaled \$2.9 million as of June 30, 2017. Two additional relationships were placed on nonaccrual during the second quarter of 2017, with balances of \$1.5 million as of June 30, 2017. Together,

these four relationships make up the majority of the increase in nonaccrual loans between December 31, 2016 and June 30, 2017, with increases partially offset by the payoff and/or charge-off of other loans that were on nonaccrual status at December 31, 2016. Management has set aside specific allocations on those loans where it is deemed appropriate based on the information available to management at this time regarding the cash flow, anticipated financial performance, and collateral securing these loans. Management believes that the collateral and/or discounted cash flow on these loans will be sufficient to cover balances for which it has no specific allocation.

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The majority of the balance of nonaccrual loans at June 30, 2017 was related to a few large credit relationships. Of the \$11.6 million of nonaccrual loans at June 30, 2017, \$8.0 million, or approximately 69.23%, was comprised of three credit relationships of \$3.7 million, \$2.17 million, and \$2.16 million. All loans in these relationships have been analyzed to determine whether the cash flow of the borrower and the collateral pledged to secure the loans is sufficient to cover outstanding principal balances. The Company has set aside specific allocations for those loans without sufficient cash flow or collateral.

Loans past due 90 days or more and accruing interest increased \$486 thousand. As of June 30, 2017, \$2.8 million of the \$3.4 million of loans past due 90 days or more and accruing interest were student loans on which the Company expects to experience minimal losses. Because the federal government has provided guarantees of repayment of these student loans in an amount ranging from 97% to 98% of the total principal and interest of the loans, management does not expect even significant increases in past due student loans to have a material effect on the Company. Net of past due government-guaranteed student loans, loans past due 90 days or more and accruing interest increased \$251 thousand due to the maturity of a single real estate mortgage loan; management expects the renewal of this loan to be completed in the third quarter of 2017.

Total restructured loans increased by \$2.3 million from December 31, 2016 to June 30, 2017 primarily due to paydowns and charge-offs on restructured loans, partially offset by the restructuring of one additional loan. All accruing TDRs are performing in accordance with their modified terms.

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

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

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

#### Allowance for Loan Losses

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

The majority of the Company's TDRs and nonperforming loans are collateralized by real estate. When reviewing loans for impairment, the Company obtains current appraisals when applicable. If the Company is waiting on an appraisal to determine the collateral's value or is in negotiations with the borrower or other parties that may affect the value of the collateral, any loan balance that is in excess of the estimated appraised value is allocated in the allowance. As of June 30, 2017 and December 31, 2016, the impaired loan component of the allowance for loan losses was essentially unchanged, amounting to \$660 thousand and \$800 thousand, respectively.

The second component of the allowance consists of qualitative factors and includes items such as economic conditions, growth trends, loan concentrations, changes in certain loans, changes in underwriting, changes in management and legal and regulatory changes. For the June 30, 2017 calculation, the qualitative factors which had the most significant impact on the allowance were those affected by changes in past due loans and changes in collateral-dependent loans, with increases applied to the allowance in both cases.

Historical loss is the final component of the allowance for loan losses and is calculated based on the migration of loans from performing to charge-off over a period of time that management deems appropriate to provide a reasonable estimate of losses inherent in the loan portfolio. With the December 31, 2016 and June 30, 2017 calculation, the historical loss was based on four migration periods of twelve quarters each.

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

During the first half of 2017, the Company saw a decrease of \$3.4 million in loans rated as other assets especially mentioned (OAEM) and a decrease of \$417 thousand in loans rated substandard when comparing December 31, 2016 to June 30, 2017, based on internally assigned risk grades. The Company may also assign loans to the risk grades of doubtful or loss, but as of June 30, 2017 and December 31, 2016, the Company had no loans in these categories.

On a combined basis, the historical loss and qualitative factor components amounted to \$8.1 million and \$7.4 million as of June 30, 2017 and December 31, 2016, respectively, with the increase primarily attributable to growth in the loan portfolio.

The allowance for loan losses was 1.28% of total loans on June 30, 2017 and 1.37% of total loans on December 31, 2016. As of June 30, 2017, the allowance for loan losses was 58.35% of both nonperforming assets and nonperforming loans, compared to 74.21% and 82.10%, respectively, as of December 31, 2016. The decrease in the allowance as a percent of total loans is primarily due to declines in loans rated OAEM and substandard, as well as improvements in the financial condition of certain loans for which the Company has a specific allocation.

#### Capital Resources

Total stockholders' equity as of June 30, 2017 was \$96.9 million, an increase of \$2.9 million or 3.10% from \$94.0 million at December 31, 2016.

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

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

|                              | 2017<br>Regulatory<br>Minimums | June<br>30,<br>2017 |
|------------------------------|--------------------------------|---------------------|
| Common Equity Tier 1 Capital | 4.500                          | % 12.25 %           |
| Tier 1 Capital               | 6.000                          | % 12.25 %           |
| Tier 1 Leverage              | 4.000                          | % 10.63 %           |
| Total Capital                | 8.000                          | % 13.33 %           |
| Capital Conservation Buffer  | 1.250                          | % 5.33 %            |

Book value per share was \$19.44 at June 30, 2017 as compared to \$19.35 at June 30, 2016. Cash dividends were \$1.1 million or \$0.22 per share in the first six months of 2017 and \$992 thousand or \$0.20 per share in the first six months of 2016.

#### Contractual Obligations

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

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

#### Off-Balance Sheet Arrangements

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

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Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

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

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

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

Under the rate shock simulation utilized by management, rate changes in 50 to 100 basis point increments are applied to assess the impact on the Company's earnings at June 30, 2017. The rate change model assumes that these changes will occur gradually over the course of a year. The model reveals that a 50 basis point ramped decrease in rates would cause an approximate annual decrease of 0.35% in net interest income. The model reveals that a 50 basis point ramped rise in rates would cause an approximate annual decrease of 0.27% in net interest income and that a 100 basis point ramped rise in rates would cause an approximate annual decrease of 0.55% in net interest income. This seemingly incongruous result is due to the persistent, low-rate environment. Certain deposits and other funding liabilities cannot realistically re-price lower, so they are more sensitive to rising rates than falling rates.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures. Management evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial

Officer concluded that the Company's disclosure controls and procedures are effective as of the end of the period covered by this report to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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

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

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings.

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

### Item 1A. Risk Factors.

There have been no material changes in the risk factors faced by the Company from those disclosed in the Company's 2016 annual report on Form 10-K.

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

Pursuant to the Company's equity compensation plans, participants may pay the exercise price of certain awards or satisfy tax withholding requirements associated with awards by surrendering shares of the Company's common stock that the participants already own. Shares surrendered by participants of these plans are repurchased at current market value pursuant to the terms of the applicable awards. During the three months ended June 30, 2017, the Company repurchased 830 shares related to the exercise of awards.

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

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

| Period                       | Total<br>Number of<br>Shares<br>Purchased<br>(1) | Average<br>Price<br>Paid Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet<br>Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|------------------------------|--|---------------------------------------|--|--|
| April 1, 2017-April 30, 2017 | 830  | \$ 30.17                              | n/a  | n/a  |
| May 1, 2017-May 31, 2017     | 0  | 0.00                                  | n/a  | n/a  |
| June 1, 2017-June 30, 2017   | 0  | 0.00                                  | n/a  | n/a  |
| Total                        | 830  | \$ 30.17                              |  |  |

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

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

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Item 5. Other Information.

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

Item 6. Exhibits.

| Exhibit No. | Description   |
|-------------|---|
| 3.1         | Articles of Incorporation of Old Point Financial Corporation, as amended effective June 22, 2000 (incorporated by reference to Exhibit 3.1 to Form 10-K filed March 12, 2009)   |
| 3.1.1       | Articles of Amendment to Articles of Incorporation of Old Point Financial Corporation, effective May 26, 2016 (incorporated by reference to Exhibit 3.1.1 to Form 8-K filed May 31, 2016)   |
| 3.2         | Bylaws of Old Point Financial Corporation, as amended and restated August 9, 2016 (incorporated by reference to Exhibit 3.2 to Form 10-Q filed August 10, 2016)   |
| 10.6        | Base Salaries of Executive Officers of the Registrant (incorporated by reference to Exhibit 10.6 to Form 10-K filed March 15, 2017)   |
| 10.18       | Additional Employment Arrangement by and among Laurie D. Grabow and Old Point Financial Corporation and The Old Point National Bank of Phoebus dated as of May 23, 2017 (incorporated by reference to Exhibit 10.18 to Form 8-K filed May 23, 2017)   |
| 10.19       | Time-Based Restricted Stock Agreement, dated July 11, 2017, between Old Point Financial Corporation and Jeffrey W. Farrar (incorporated by reference to Exhibit 10.19 to Form 8-K filed July 13, 2017)  |
| 31.1        | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2        | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1        | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101         | The following materials from Old Point Financial Corporation's quarterly report on Form 10-Q for the quarter ended June 30, 2017, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Consolidated Balance Sheets (unaudited for June 30, 2017), (ii) Consolidated Statements of Income (unaudited), (iii) Consolidated Statements of Comprehensive Income (unaudited), (iv) Consolidated Statements of Changes in Stockholders' Equity (unaudited), (v) Consolidated Statements of Cash Flows (unaudited), and (vi) Notes to Consolidated Financial Statements (unaudited) |

SIGNATURES

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

OLD POINT FINANCIAL CORPORATION

August 8, 2017 /s/Robert F. Shuford, Sr.  
Robert F. Shuford, Sr.  
Chairman, President & Chief Executive Officer  
(Principal Executive Officer)

August 8, 2017 /s/Jeffrey W. Farrar  
Jeffrey W. Farrar  
Chief Financial Officer & Senior Vice President/Finance  
(Principal Financial & Accounting Officer)

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