

OLD POINT FINANCIAL CORP  
Form 10-Q  
August 15, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011

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  
(State or other jurisdiction of incorporation or  
organization)

54-1265373  
(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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Yes  No

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

4,955,259 shares of common stock (\$5.00 par value) outstanding as of July 29, 2011

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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>2011<br>(unaudited) | December 31,<br>2010 |
|--|---------------------------------|----------------------|
| Assets   |                                 |                      |
| Cash and due from banks  | \$ 14,057,558                   | \$ 15,603,331        |
| Federal funds sold   | 17,899,977                      | 12,827,818           |
| Cash and cash equivalents  | 31,957,535                      | 28,431,149           |
| Securities available-for-sale, at fair value   | 194,183,314                     | 206,091,712          |
| Securities held-to-maturity<br>(fair value approximates \$2,270,068 and \$1,956,720)                             | 2,252,000                       | 1,952,000            |
| Restricted securities  | 3,890,300                       | 4,319,600            |
| Loans, net of allowance for loan losses of \$9,973,887 and \$13,227,791  | 529,156,513                     | 573,390,522          |
| Premises and equipment, net  | 29,972,528                      | 29,615,688           |
| Bank owned life insurance  | 18,425,251                      | 18,019,727           |
| Foreclosed assets, net of valuation allowance of \$1,978,500 and \$2,123,930                                     | 10,796,790                      | 11,447,794           |
| Other assets   | 11,792,029                      | 13,573,303           |
|  | \$ 832,426,260                  | \$ 886,841,495       |
| Liabilities & Stockholders' Equity   |                                 |                      |
| Deposits:  |                                 |                      |
| Noninterest-bearing deposits   | \$ 152,630,762                  | \$ 129,207,887       |
| Savings deposits   | 224,357,708                     | 225,209,590          |
| Time deposits  | 303,454,343                     | 324,796,068          |
| Total deposits   | 680,442,813                     | 679,213,545          |
| Federal funds purchased and other borrowings   | 839,348                         | 731,332              |
| Overnight repurchase agreements  | 27,798,975                      | 50,757,247           |
| Term repurchase agreements   | 2,787,837                       | 38,959,359           |
| Federal Home Loan Bank advances  | 35,000,000                      | 35,000,000           |
| Accrued expenses and other liabilities   | 1,472,292                       | 1,228,363            |
| Total liabilities  | 748,341,265                     | 805,889,846          |
| Commitments and contingencies  |                                 |                      |
| Stockholders' equity:  |                                 |                      |
| Common stock, \$5 par value, 10,000,000 shares authorized; 4,955,259 and 4,936,989 shares issued and outstanding | 24,776,295                      | 24,684,945           |
| Additional paid-in capital   | 16,225,604                      | 16,026,062           |
| Retained earnings  | 43,695,110                      | 42,809,769           |
| Accumulated other comprehensive loss, net  | (612,014 )                      | (2,569,127 )         |
| Total stockholders' equity   | 84,084,995                      | 80,951,649           |

|  |               |               |
|--|---------------|---------------|
| Total liabilities and stockholders' equity | \$832,426,260 | \$886,841,495 |
|--|---------------|---------------|

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<br>June 30, |                   |
|--|--------------------------------|-------------------|------------------------------|-------------------|
|  | 2011                           | 2010              | 2011                         | 2010              |
|  | (unaudited)                    |                   | (unaudited)                  |                   |
| <b>Interest and Dividend Income:</b>   |                                |                   |                              |                   |
| Interest and fees on loans   | \$8,190,911                    | \$9,258,835       | \$16,593,318                 | \$18,745,051      |
| Interest on federal funds sold   | 5,911                          | 28,137            | 14,156                       | 48,483            |
| <b>Interest on securities:</b>   |                                |                   |                              |                   |
| Taxable  | 896,051                        | 849,035           | 1,798,769                    | 1,653,291         |
| Tax-exempt   | 38,073                         | 73,643            | 77,407                       | 167,526           |
| Dividends and interest on all other securities   | 21,183                         | 11,581            | 33,394                       | 22,367            |
| <b>Total interest and dividend income</b>  | <b>9,152,129</b>               | <b>10,221,231</b> | <b>18,517,044</b>            | <b>20,636,718</b> |
| <b>Interest Expense:</b>   |                                |                   |                              |                   |
| Interest on savings deposits   | 103,162                        | 98,479            | 208,349                      | 193,458           |
| Interest on time deposits  | 1,143,845                      | 1,703,128         | 2,409,810                    | 3,564,055         |
| Interest on federal funds purchased, securities sold under agreements to repurchase and other borrowings | 17,577                         | 182,823           | 70,689                       | 361,148           |
| Interest on Federal Home Loan Bank advances  | 425,046                        | 710,632           | 845,421                      | 1,540,257         |
| <b>Total interest expense</b>  | <b>1,689,630</b>               | <b>2,695,062</b>  | <b>3,534,269</b>             | <b>5,658,918</b>  |
| <b>Net interest income</b>   | <b>7,462,499</b>               | <b>7,526,169</b>  | <b>14,982,775</b>            | <b>14,977,800</b> |
| Provision for loan losses  | 500,000                        | 1,300,000         | 2,300,000                    | 6,000,000         |
| <b>Net interest income, after provision for loan losses</b>  | <b>6,962,499</b>               | <b>6,226,169</b>  | <b>12,682,775</b>            | <b>8,977,800</b>  |
| <b>Noninterest Income:</b>   |                                |                   |                              |                   |
| Income from fiduciary activities   | 759,924                        | 780,963           | 1,530,896                    | 1,601,848         |
| Service charges on deposit accounts  | 1,055,175                      | 1,280,064         | 2,066,753                    | 2,594,741         |
| Other service charges, commissions and fees  | 820,528                        | 753,989           | 1,558,372                    | 1,444,806         |
| Income from bank owned life insurance  | 203,196                        | 210,478           | 404,916                      | 599,323           |
| Gain on sale of available-for-sale securities, net   | 50,955                         | 0                 | 50,955                       | 76                |
| Other operating income   | 61,694                         | 102,272           | 144,822                      | 184,820           |
| <b>Total noninterest income</b>  | <b>2,951,472</b>               | <b>3,127,766</b>  | <b>5,756,714</b>             | <b>6,425,614</b>  |
| <b>Noninterest Expense:</b>  |                                |                   |                              |                   |
| Salaries and employee benefits   | 4,895,566                      | 4,621,668         | 9,525,369                    | 9,152,750         |
| Occupancy and equipment  | 1,050,379                      | 1,050,934         | 2,135,885                    | 2,150,317         |
| FDIC insurance   | 266,297                        | 316,905           | 671,479                      | 646,181           |
| Data processing  | 338,796                        | 305,153           | 666,399                      | 601,808           |
| Customer development   | 217,834                        | 217,931           | 439,470                      | 440,230           |
| Advertising  | 142,375                        | 174,296           | 286,534                      | 350,281           |
| Loan expenses  | 229,897                        | 241,583           | 417,544                      | 363,873           |
| Other outside service fees   | 157,122                        | 107,739           | 300,838                      | 199,586           |
| Employee professional development  | 178,896                        | 117,139           | 312,207                      | 260,039           |
| Postage and courier expense  | 119,979                        | 134,781           | 243,284                      | 270,402           |
| Legal and audit expenses   | 219,628                        | 214,607           | 363,027                      | 319,738           |
| Loss (gain) on write-down/sale of foreclosed assets  | 268,595                        | (4,787 )          | 457,550                      | (51,047 )         |

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|                                   |             |             |             |            |
|-----------------------------------|-------------|-------------|-------------|------------|
| Other operating expenses          | 415,108     | 477,516     | 847,955     | 1,005,920  |
| Total noninterest expense         | 8,500,472   | 7,975,465   | 16,667,541  | 15,710,078 |
| Income (loss) before income taxes | 1,413,499   | 1,378,470   | 1,771,948   | (306,664 ) |
| Income tax expense (benefit)      | 378,238     | 370,374     | 391,994     | (369,133 ) |
| Net income                        | \$1,035,261 | \$1,008,096 | \$1,379,954 | \$62,469   |

Basic Earnings per Share:

|                                      |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|
| Average shares outstanding           | 4,954,970 | 4,925,910 | 4,946,210 | 4,923,025 |
| Net income per share of common stock | \$0.21    | \$0.21    | \$0.28    | \$0.01    |

Diluted Earnings per Share:

|                                      |           |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|
| Average shares outstanding           | 4,954,970 | 4,932,233 | 4,946,210 | 4,933,023 |
| Net income per share of common stock | \$0.21    | \$0.20    | \$0.28    | \$0.01    |

See Notes to Consolidated Financial Statements.



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

| (unaudited)   | Shares of<br>Common<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total         |
|---|------------------------------|-----------------|----------------------------------|----------------------|---|---------------|
| <b>FOR THE SIX MONTHS ENDED JUNE 30, 2011</b>   |                              |                 |                                  |                      |   |               |
| Balance at beginning of period  | 4,936,989                    | \$ 24,684,945   | \$ 16,026,062                    | \$ 42,809,769        | \$ (2,569,127)                                | \$ 80,951,649 |
| Comprehensive income:   |                              |                 |                                  |                      |   |               |
| Net income  | 0                            | 0               | 0                                | 1,379,954            | 0   | 1,379,954     |
| Unrealized holding gains arising during the period (net of tax, \$1,008,210, and reclassification adjustment) | 0                            | 0               | 0                                | 0                    | 1,957,113                                     | 1,957,113     |
| Total comprehensive income  | 0                            | 0               | 0                                | 1,379,954            | 1,957,113                                     | 3,337,067     |
| Exercise of stock options   | 18,270                       | 91,350          | 144,455                          | 0                    | 0   | 235,805       |
| Stock compensation expense  | 0                            | 0               | 55,087                           | 0                    | 0   | 55,087        |
| Cash dividends (\$0.10 per share)   | 0                            | 0               | 0                                | (494,613 )           | 0   | (494,613 )    |
| Balance at end of period  | 4,955,259                    | \$ 24,776,295   | \$ 16,225,604                    | \$ 43,695,110        | \$ (612,014 )                                 | \$ 84,084,995 |

**FOR THE SIX MONTHS ENDED JUNE 30, 2010**

|   |           |               |               |               |                |               |
|---|-----------|---------------|---------------|---------------|----------------|---------------|
| Balance at beginning of period  | 4,916,535 | \$ 24,582,675 | \$ 15,768,840 | \$ 42,518,889 | \$ (1,261,951) | \$ 81,608,453 |
| Comprehensive income:   |           |               |               |               |                |               |
| Net income  | 0         | 0             | 0             | 62,469        | 0              | 62,469        |
| Unrealized holding gains arising during the period (net of tax, \$459,084, and reclassification adjustment) | 0         | 0             | 0             | 0             | 891,164        | 891,164       |

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|  |           |               |               |               |               |               |
|--|-----------|---------------|---------------|---------------|---------------|---------------|
| Total comprehensive income                         | 0         | 0             | 0             | 62,469        | 891,164       | 953,633       |
| Exercise of stock options                          | 9,375     | 46,875        | 56,726        | 0             | 0             | 103,601       |
| Tax benefit from disqualification of stock options | 0         | 0             | 10,503        | 0             | 0             | 10,503        |
| Stock compensation expense                         | 0         | 0             | 56,908        | 0             | 0             | 56,908        |
| Cash dividends (\$0.15 per share)                  | 0         | 0             | 0             | (738,512 )    | 0             | (738,512 )    |
| Balance at end of period                           | 4,925,910 | \$ 24,629,550 | \$ 15,892,977 | \$ 41,842,846 | \$ (370,787 ) | \$ 81,994,586 |

See Notes to Consolidated Financial Statements.

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Old Point Financial Corporation and Subsidiaries  
Consolidated Statements of Cash Flows

|   | Six Months Ended<br>June 30, |              |
|---|------------------------------|--------------|
|   | 2011                         | 2010         |
|   | (unaudited)                  |              |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                              |              |
| Net income  | \$1,379,954                  | \$62,469     |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |              |
| Depreciation and amortization   | 918,871                      | 992,608      |
| Provision for loan losses   | 2,300,000                    | 6,000,000    |
| Net gain on sale of available-for-sale securities                                 | (50,955 )                    | (76 )        |
| Net amortization of securities  | 116,601                      | 7,208        |
| Net gain on disposal of premises and equipment                                    | (1,750 )                     | (3,773 )     |
| Net (gain) loss on write-down/sale of foreclosed assets                           | 457,550                      | (51,047 )    |
| Income from bank owned life insurance   | (404,916 )                   | (599,323 )   |
| Stock compensation expense  | 55,087                       | 56,908       |
| Deferred tax (benefit) expense  | 175,725                      | (1,368,017 ) |
| (Increase) decrease in other assets   | 65,965                       | (2,380,833 ) |
| Increase (decrease) in other liabilities  | 243,929                      | (157,150 )   |
| Net cash provided by operating activities   | 5,256,061                    | 2,558,974    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                              |              |
| Purchases of available-for-sale securities  | (44,356,861)                 | (94,172,153) |
| Purchases of held-to-maturity securities  | (1,700,000 )                 | (1,200,000 ) |
| Proceeds from maturities and calls of securities                                  | 36,906,936                   | 76,290,349   |
| Proceeds from sales of available-for-sale securities                              | 23,658,000                   | 7,584,000    |
| Proceeds from sales of restricted securities                                      | 429,300                      | 0            |
| Decrease in loans made to customers   | 41,934,009                   | 8,689,118    |
| Proceeds from sales of foreclosed assets  | 724,220                      | 1,001,547    |
| Purchases of bank owned life insurance  | 0                            | (940,000 )   |
| Purchases of premises and equipment   | (1,273,961 )                 | (472,159 )   |
| Net cash provided by (used in) investing activities                               | 56,321,643                   | (3,219,298 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                              |              |
| Increase in noninterest-bearing deposits  | 23,422,875                   | 9,959,624    |
| Increase (decrease) in savings deposits   | (851,882 )                   | 9,209,791    |
| Increase (decrease) in time deposits  | (21,341,725)                 | 5,016,388    |
| Decrease in federal funds purchased, repurchase agreements and other borrowings   | (59,021,778)                 | (3,467,777 ) |
| Decrease in Federal Home Loan Bank advances                                       | 0                            | (30,000,000) |
| Proceeds from exercise of stock options   | 235,805                      | 103,601      |
| Tax benefit from disqualification of stock options                                | 0                            | 10,503       |
| Cash dividends paid on common stock   | (494,613 )                   | (738,512 )   |
| Net cash used in financing activities   | (58,051,318)                 | (9,906,382 ) |
| Net increase (decrease) in cash and cash equivalents                              | 3,526,386                    | (10,566,706) |
| Cash and cash equivalents at beginning of period                                  | 28,431,149                   | 47,635,998   |
| Cash and cash equivalents at end of period  | \$31,957,535                 | \$37,069,292 |

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION**

Cash payments for:

|            |             |             |
|------------|-------------|-------------|
| Interest   | \$3,706,361 | \$5,893,247 |
| Income tax | \$0         | \$950,000   |

**SUPPLEMENTAL SCHEDULE OF NONCASH TRANSACTIONS**

|  |             |             |
|--|-------------|-------------|
| Unrealized gain on investment securities | \$2,965,323 | \$1,350,249 |
| Loans transferred to foreclosed assets   | \$1,540,310 | \$3,210,600 |

See Notes to Consolidated Financial Statements.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## Note 1. General

The accompanying unaudited consolidated financial statements of Old Point Financial Corporation (the Company) and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2011 and December 31, 2010, the results of operations for the three and six months ended June 30, 2011 and 2010 and statement of cash flows and changes in stockholders' equity for the six months ended June 30, 2011 and 2010. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2010 annual report on Form 10-K. Certain previously reported amounts have been reclassified to conform to current period presentation.

## AVAILABLE INFORMATION

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

## Note 2. Securities

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

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
|  | (in thousands)    |                              |                               |               |
| June 30, 2011                                      |                   |                              |                               |               |
| Obligations of U.S.<br>Government agencies         | \$ 1,970          | \$ 11                        | \$ 0                          | \$ 1,981      |
| Obligations of state and<br>political subdivisions | 282               | 7                            | 0                             | 289           |
| Total  | \$ 2,252          | \$ 18                        | \$ 0                          | \$ 2,270      |
| December 31, 2010                                  |                   |                              |                               |               |
| Obligations of U.S.<br>Government agencies         | \$ 1,670          | \$ 4                         | \$ (7 )                       | \$ 1,667      |
| Obligations of state and<br>political subdivisions | 282               | 8                            | 0                             | 290           |
| Total  | \$ 1,952          | \$ 12                        | \$ (7 )                       | \$ 1,957      |



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

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
|  | (in thousands)    |                              |                               |               |
| June 30, 2011                                      |                   |                              |                               |               |
| U.S. Treasury securities                           | \$ 600            | \$ 0                         | \$ 0                          | \$ 600        |
| Obligations of U.S.<br>Government agencies         | 188,007           | 1,487                        | (1 )                          | 189,493       |
| Obligations of state and<br>political subdivisions | 2,429             | 73                           | 0                             | 2,502         |
| Mortgage-backed securities                         | 168               | 2                            | 0                             | 170           |
| Money market investments                           | 1,418             | 0                            | 0                             | 1,418         |
| Total  | \$ 192,622        | \$ 1,562                     | \$ (1 )                       | \$ 194,183    |
| December 31, 2010                                  |                   |                              |                               |               |
| U.S. Treasury securities                           | \$ 600            | \$ 0                         | \$ 0                          | \$ 600        |
| Obligations of U.S.<br>Government agencies         | 201,601           | 513                          | (1,993 )                      | 200,121       |
| Obligations of state and<br>political subdivisions | 3,103             | 69                           | 0                             | 3,172         |
| Mortgage-backed securities                         | 374               | 8                            | 0                             | 382           |
| Money market investments                           | 1,817             | 0                            | 0                             | 1,817         |
| Total  | \$ 207,495        | \$ 590                       | \$ (1,993 )                   | \$ 206,092    |

**TEMPORARILY IMPAIRED SECURITIES**

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position. The Company had no held-to-maturity securities with unrealized losses at June 30, 2011.

|  | Less Than Twelve<br>Months    |               | June 30, 2011<br>More Than Twelve<br>Months |               | Total                         |               |
|--|-------------------------------|---------------|---|---------------|-------------------------------|---------------|
|  | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses               | Fair<br>Value | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|  | (in thousands)                |               |   |               |                               |               |
| Securities Available-for-Sale              |                               |               |   |               |                               |               |
| Obligations of U.S. Government<br>agencies | \$1                           | \$9,999       | \$0   | \$0           | \$1                           | \$9,999       |

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|  | Less Than Twelve Months |                  | December 31, 2010<br>More Than Twelve Months |            | Total                   |                  |
|--|-------------------------|------------------|--|------------|-------------------------|------------------|
|  | Gross Unrealized Losses | Fair Value       | Gross Unrealized Losses                      | Fair Value | Gross Unrealized Losses | Fair Value       |
| Securities Available-for-Sale            |                         |                  |  |            |                         |                  |
| Obligations of U. S. Government agencies | \$1,993                 | \$128,362        | \$0  | \$0        | \$1,993                 | \$128,362        |
| Securities Held-to-Maturity              |                         |                  |  |            |                         |                  |
| Obligations of U. S. Government agencies | \$7                     | \$762            | \$0  | \$0        | \$7                     | \$762            |
| <b>Total</b>                             | <b>\$2,000</b>          | <b>\$129,124</b> | <b>\$0</b>                                   | <b>\$0</b> | <b>\$2,000</b>          | <b>\$129,124</b> |

## Obligations of U.S. Government agencies

The U.S. Government agencies portfolio had one investment and fifteen investments with unrealized losses at June 30, 2011 and December 31, 2010, respectively. These unrealized losses were caused by increases in market interest rates. The contractual terms of those investments do not permit the issuer to sell the securities at a price less than the amortized cost basis of the investments. 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 at maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2011 or December 31, 2010.

## OTHER-THAN-TEMPORARILY IMPAIRED SECURITIES

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

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

The Company has a process in place to identify debt securities that could potentially have a credit 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.

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The Company has not recorded impairment charges on securities for the quarter ended June 30, 2011 or the year ended December 31, 2010.

The 2011 and 2010 unrealized losses relate to obligations of U.S. Government agencies. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and industry analysts' reports. The unrealized losses are a result of changes in market interest rates and not credit issues. Since the Company has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available-for-sale, no declines are deemed to be other than temporary.

The restricted securities category on the balance sheets is comprised of Federal Home Loan Bank of Atlanta (FHLB) and Federal Reserve Bank (FRB) stock. 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.

The Company evaluated the positive and negative factors of FHLB stock for impairment and determined the stock not to be impaired at June 30, 2011 or December 31, 2010. This analysis is based on the following information. The FHLB reported net income of approximately \$278 million for 2010, and paid a quarterly dividend for all four quarters of 2010. In 2011, the FHLB reported net income of approximately \$51 million for the first quarter and \$38 million for the second quarter, and declared a first-quarter dividend in May 2011.

Note 3. Loans and the Allowance for Loan Losses

The following is a summary of the balances in each segment of the Company's loan portfolio:

|   | June 30,<br>2011<br>(in<br>thousands) | December<br>31,<br>2010 |
|---|---------------------------------------|-------------------------|
| Mortgage loans on real estate:            |                                       |                         |
| Residential 1-4 family                    | \$ 82,387                             | \$ 89,690               |
| Commercial                                | 313,671                               | 344,347                 |
| Construction                              | 21,299                                | 19,206                  |
| Second mortgages                          | 15,192                                | 16,105                  |
| Equity lines of credit                    | 36,650                                | 39,048                  |
| Total mortgage loans on real estate       | 469,199                               | 508,396                 |
| Commercial loans                          | 34,931                                | 36,053                  |
| Consumer loans                            | 19,958                                | 24,389                  |
| Other                                     | 15,043                                | 17,781                  |
| Total loans                               | 539,131                               | 586,619                 |
| Less: Allowance for loan losses           | (9,974 )                              | (13,228 )               |
| Loans, net of allowance and deferred fees | \$ 529,157                            | \$ 573,391              |

Overdrawn deposit accounts are reclassified as loans and included in the Other category in the table above. Overdrawn deposit accounts totaled \$609 thousand and \$607 thousand at June 30, 2011 and December 31, 2010, respectively.



Index**CREDIT QUALITY INFORMATION**

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

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

- Pass: Loans are of acceptable risk.
- Other Assets Especially Mentioned (OAEM): Loans have potential weaknesses that deserve management's close attention.
- Substandard: Loans reflect significant deficiencies due to several adverse trends of a financial, economic or managerial nature.
- Doubtful: Loans have all the weaknesses inherent in a substandard loan with added characteristics that make collection or liquidation in full based on currently existing facts, conditions and values highly questionable or improbable.
- Loss: Loans have been charged off because they are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

The following table presents credit quality exposures by internally assigned risk ratings:

Credit Quality Information  
As of June 30, 2011  
(in thousands)

|                                     | Pass      | OAEM     | Substandard | Doubtful | Total     |
|-------------------------------------|-----------|----------|-------------|----------|-----------|
| Mortgage loans on real estate:      |           |          |             |          |           |
| Residential 1-4 family              | \$71,108  | \$4,796  | \$ 6,483    | \$0      | \$82,387  |
| Commercial                          | 284,180   | 8,738    | 20,753      | 0        | 313,671   |
| Construction                        | 19,519    | 1,418    | 362         | 0        | 21,299    |
| Second mortgages                    | 14,261    | 0        | 931         | 0        | 15,192    |
| Equity lines of credit              | 35,591    | 143      | 916         | 0        | 36,650    |
| Total mortgage loans on real estate | 424,659   | 15,095   | 29,445      | 0        | 469,199   |
| Commercial loans                    | 32,943    | 1,372    | 616         | 0        | 34,931    |
| Consumer loans                      | 19,798    | 0        | 160         | 0        | 19,958    |
| Other                               | 15,043    | 0        | 0           | 0        | 15,043    |
| Total                               | \$492,443 | \$16,467 | \$ 30,221   | \$0      | \$539,131 |

Credit Quality Information  
As of December 31, 2010  
(in thousands)

|                                     | Pass     | OAEM    | Substandard | Doubtful | Total    |
|-------------------------------------|----------|---------|-------------|----------|----------|
| Mortgage loans on real estate:      |          |         |             |          |          |
| Residential 1-4 family              | \$75,803 | \$2,383 | \$ 11,504   | \$0      | \$89,690 |
| Commercial                          | 287,551  | 23,969  | 30,000      | 2,827    | 344,347  |
| Construction                        | 18,052   | 0       | 1,154       | 0        | 19,206   |
| Second mortgages                    | 15,010   | 0       | 1,095       | 0        | 16,105   |
| Equity lines of credit              | 37,206   | 1,109   | 733         | 0        | 39,048   |
| Total mortgage loans on real estate | 433,622  | 27,461  | 44,486      | 2,827    | 508,396  |

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|                  |           |          |          |         |           |
|------------------|-----------|----------|----------|---------|-----------|
| Commercial loans | 33,275    | 2,179    | 599      | 0       | 36,053    |
| Consumer loans   | 23,981    | 1        | 407      | 0       | 24,389    |
| Other            | 17,693    | 87       | 1        | 0       | 17,781    |
| Total            | \$508,571 | \$29,728 | \$45,493 | \$2,827 | \$586,619 |

As of June 30, 2011 and December 31, 2010 the Company did not have any loans internally classified as Loss.

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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 of past due loans. 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, either because they are (1) well-secured and in the process of collection or (2) real estate loans or loans exempt under regulatory rules from being classified as nonaccrual. 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 at June 30, 2011

|   | 30 - 59<br>Days Past<br>Due | 60 - 89<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due | Total Past<br>Due<br>(in thousands) | Total<br>Current<br>Loans (1) | Total<br>Loans | Recorded<br>Investment<br>> 90 Days<br>Past Due<br>and<br>Accruing |
|---|-----------------------------|-----------------------------|--------------------------------|-------------------------------------|-------------------------------|----------------|--|
| Mortgage loans<br>on real estate:         |                             |                             |                                |                                     |                               |                |  |
| Residential 1-4<br>family                 | \$562                       | \$0                         | \$764                          | \$1,326                             | \$81,061                      | \$82,387       | \$252  |
| Commercial                                | 1,847                       | 0                           | 1,131                          | 2,978                               | 310,693                       | 313,671        | 0  |
| Construction                              | 0                           | 0                           | 0                              | 0                                   | 21,299                        | 21,299         | 0  |
| Second mortgages                          | 365                         | 0                           | 124                            | 489                                 | 14,703                        | 15,192         | 0  |
| Equity lines of<br>credit                 | 460                         | 38                          | 0                              | 498                                 | 36,152                        | 36,650         | 0  |
| Total mortgage<br>loans on real<br>estate | 3,234                       | 38                          | 2,019                          | 5,291                               | 463,908                       | 469,199        | 252  |
| Commercial loans                          | 215                         | 30                          | 13                             | 258                                 | 34,673                        | 34,931         | 13   |
| Consumer loans                            | 361                         | 113                         | 1                              | 475                                 | 19,483                        | 19,958         | 1  |
| Other                                     | 66                          | 0                           | 0                              | 66                                  | 14,977                        | 15,043         | 0  |
| Total                                     | \$3,876                     | \$181                       | \$2,033                        | \$6,090                             | \$533,041                     | \$539,131      | \$266  |

## Age Analysis of Past Due Loans at December 31, 2010

|                                   | 30 - 59<br>Days Past<br>Due | 60 - 89<br>Days Past<br>Due | 90 or More<br>Days Past<br>Due | Total Past<br>Due<br>(in thousands) | Total<br>Current<br>Loans (1) | Total<br>Loans | Recorded<br>Investment<br>> 90 Days<br>Past Due<br>and<br>Accruing |
|-----------------------------------|-----------------------------|-----------------------------|--------------------------------|-------------------------------------|-------------------------------|----------------|--|
| Mortgage loans<br>on real estate: |                             |                             |                                |                                     |                               |                |  |
| Residential 1-4<br>family         | \$1,550                     | \$85                        | \$1,641                        | \$3,276                             | \$86,414                      | \$89,690       | \$0  |

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|                                     |         |       |          |          |           |           |      |
|-------------------------------------|---------|-------|----------|----------|-----------|-----------|------|
| Commercial                          | 240     | 617   | 10,555   | 11,412   | 332,935   | 344,347   | 0    |
| Construction                        | 0       | 0     | 16       | 16       | 19,190    | 19,206    | 16   |
| Second mortgages                    | 475     | 0     | 187      | 662      | 15,443    | 16,105    | 33   |
| Equity lines of credit              | 597     | 0     | 22       | 619      | 38,429    | 39,048    | 0    |
| Total mortgage loans on real estate | 2,862   | 702   | 12,421   | 15,985   | 492,411   | 508,396   | 49   |
| Commercial loans                    | 78      | 11    | 0        | 89       | 35,964    | 36,053    | 0    |
| Consumer loans                      | 297     | 49    | 69       | 415      | 23,974    | 24,389    | 23   |
| Other                               | 79      | 0     | 1        | 80       | 17,701    | 17,781    | 1    |
| Total                               | \$3,316 | \$762 | \$12,491 | \$16,569 | \$570,050 | \$586,619 | \$73 |

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

#### NONACCRUAL LOANS

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

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Generally, consumer loans not secured by real estate or other collateral are placed in nonaccrual status only when part of the principal has been charged off. These loans are charged off or written down to the net realizable value of the collateral when deemed uncollectible, due to bankruptcy or other factors, or when they reach 90 days past due based on loan product, industry practice, terms and other factors.

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

The following table presents loans in nonaccrual status by class of loan:

|                                     | June 30,<br>2011 | December<br>31, 2010 |
|-------------------------------------|------------------|----------------------|
| Mortgage loans on real estate:      |                  |                      |
| Residential 1-4 family              | \$ 4,249         | \$ 6,302             |
| Commercial                          | 3,685            | 13,281               |
| Construction                        | 0                | 37                   |
| Second mortgages                    | 489              | 540                  |
| Equity lines of credit              | 401              | 427                  |
| Total mortgage loans on real estate | 8,824            | 20,587               |
| Commercial loans                    | 120              | 178                  |
| Consumer loans                      | 15               | 116                  |
| Other                               | 0                | 0                    |
| Total                               | \$ 8,959         | \$ 20,881            |

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:

|   | June 30,<br>2011<br>(in<br>thousands) |
|---|---------------------------------------|
| Interest income that would have been recorded under original loan terms | \$ 723                                |
| Actual interest income recorded for the period                          | 194                                   |
| Reduction in interest income on nonaccrual loans                        | \$ 529                                |

**IMPAIRED LOANS**

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming commercial loans, but also include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate to a below-market rate, payment extensions, forgiveness of principal, forbearance or other



actions intended to maximize collection. When management identifies a loan as impaired, the impairment is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, except when the sole or remaining source of repayment for the loan is the operation or liquidation of the collateral. In these cases, management uses the current fair value of the collateral, less selling costs when foreclosure is probable, instead of the discounted cash flows. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

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

The following table includes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable. Also presented are the average recorded investments in the impaired loans and the related amount of interest recognized during 2010 and the first six months of 2011. The average balances are calculated based on the month-end balance of the loans for the year ended December 31, 2010 and on the daily average balance for the six months ended June 30, 2011.

|                                     | Impaired Loans by Class<br>(in thousands) |  |                                |          |                         | Six Months Ended June 30,<br>2011 |                                  |
|-------------------------------------|---|--|--------------------------------|----------|-------------------------|-----------------------------------|----------------------------------|
|                                     | As of June 30, 2011                       |  |                                |          | Associated<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|                                     | Unpaid<br>Principal<br>Balance            | Recorded Investment<br>Without<br>Valuation<br>Allowance | With<br>Valuation<br>Allowance |          |                         |                                   |                                  |
| Mortgage loans on real estate:      |   |  |                                |          |                         |                                   |                                  |
| Residential 1-4 family              | \$ 4,233                                  | \$ 4,065   | \$ 160                         | \$ 76    | \$ 5,024                | \$ 113                            |                                  |
| Commercial                          | 3,811                                     | 653  | 3,032                          | 782      | 9,174                   | 4                                 |                                  |
| Construction                        | 0   | 0  | 0                              | 0        | 0                       | 0                                 |                                  |
| Second mortgages                    | 495                                       | 97   | 392                            | 49       | 500                     | 11                                |                                  |
| Equity lines of credit              | 402                                       | 260  | 141                            | 10       | 403                     | 12                                |                                  |
| Total mortgage loans on real estate | \$ 8,941                                  | \$ 5,075   | \$ 3,725                       | \$ 917   | \$ 15,101               | \$ 140                            |                                  |
| Commercial loans                    | 128                                       | 0  | 120                            | 93       | 133                     | 0                                 |                                  |
| Total                               | \$ 9,069                                  | \$ 5,075   | \$ 3,845                       | \$ 1,010 | \$ 15,234               | \$ 140                            |                                  |

|                                | Impaired Loans by Class<br>(in thousands) |  |                                |       |                         | Year Ended December 31,<br>2010   |                                  |
|--------------------------------|---|--|--------------------------------|-------|-------------------------|-----------------------------------|----------------------------------|
|                                | As of December 31, 2010                   |  |                                |       | Associated<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|                                | Unpaid<br>Principal<br>Balance            | Recorded Investment<br>Without<br>Valuation<br>Allowance | With<br>Valuation<br>Allowance |       |                         |                                   |                                  |
| Mortgage loans on real estate: |   |  |                                |       |                         |                                   |                                  |
| Residential 1-4 family         | \$ 5,850                                  | \$ 5,008   | \$ 810                         | \$ 70 | \$ 4,298                | \$ 320                            |                                  |

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|  |           |          |           |          |           |        |
|--|-----------|----------|-----------|----------|-----------|--------|
| Commercial                             | 13,319    | 3,798    | 9,400     | 2,827    | 14,320    | 593    |
| Construction                           | 0         | 0        | 0         | 0        | 194       | 5      |
| Second mortgages                       | 508       | 100      | 404       | 62       | 377       | 33     |
| Equity lines of credit                 | 405       | 262      | 143       | 11       | 300       | 24     |
| Total mortgage loans<br>on real estate | \$ 20,082 | \$ 9,168 | \$ 10,757 | \$ 2,970 | \$ 19,489 | \$ 975 |
| Commercial loans                       | 184       | 178      | 0         | 0        | 73        | 13     |
| Total                                  | \$ 20,266 | \$ 9,346 | \$ 10,757 | \$ 2,970 | \$ 19,562 | \$ 988 |

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

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, may depend on interest rates or may fluctuate in active trading markets.

To determine the balance of the allowance account for each segment of the loan portfolio, management pools each segment by risk grade individually and applies a historical loss percentage. At June 30, 2011 and December 31, 2010, the historical loss percent was based on losses sustained in each segment of the portfolio over the previous eight quarters.

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

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

**THE COMPANY'S ESTIMATION PROCESS**

The allowance for loan losses is the accumulation of various components that are calculated based on independent methodologies. Management's estimate is based on certain observable, historical data that management believes are

most reflective of the underlying credit losses being estimated. In addition, impaired loans are separately identified for evaluation and are measured based on the present value of expected future cash flows, the observable market price of the loans or the fair value of the collateral. Also, various qualitative factors are applied to each segment of the loan portfolio.

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## ALLOWANCE FOR LOAN LOSSES BY SEGMENT

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses of \$10.0 million adequate to cover loan losses inherent in the loan portfolio at June 30, 2011. The following table presents, by portfolio segment, the changes in the allowance for loan losses and the recorded investment in loans. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

## ALLOWANCE FOR LOAN LOSSES AND RECORDED INVESTMENT IN LOANS

|  | (in thousands) |                               |                           |           |           |            |
|--|----------------|-------------------------------|---------------------------|-----------|-----------|------------|
|  | Commercial     | Real Estate -<br>Construction | Real Estate<br>- Mortgage | Consumer  | Other     | Total      |
| June 30, 2011  |                |                               |                           |           |           |            |
| Allowance for Loan Losses:                           |                |                               |                           |           |           |            |
| Balance at the beginning of period                   | \$ 799         | \$ 441                        | \$ 11,498                 | \$ 357    | \$ 133    | \$ 13,228  |
| Charge-offs  | (755 )         | 0                             | (5,094 )                  | (180 )    | (109 )    | (6,138 )   |
| Recoveries   | 19             | 0                             | 476                       | 65        | 24        | 584        |
| Provision for loan losses                            | 981            | (63 )                         | 1,152                     | 109       | 121       | 2,300      |
| Ending balance                                       | \$ 1,044       | \$ 378                        | \$ 8,032                  | \$ 351    | \$ 169    | \$ 9,974   |
| Ending balance individually evaluated for impairment | \$ 93          | \$ 0                          | \$ 917                    | \$ 0      | \$ 0      | \$ 1,010   |
| Ending balance collectively evaluated for impairment | 951            | 378                           | 7,115                     | 351       | 169       | 8,964      |
| Ending balance                                       | \$ 1,044       | \$ 378                        | \$ 8,032                  | \$ 351    | \$ 169    | \$ 9,974   |
| Loan Balances:                                       |                |                               |                           |           |           |            |
| Ending balance individually evaluated for impairment | \$ 120         | \$ 0                          | \$ 8,800                  | \$ 0      | \$ 0      | \$ 8,920   |
| Ending balance collectively evaluated for impairment | 34,811         | 21,299                        | 439,100                   | 19,958    | 15,043    | 530,211    |
| Ending balance                                       | \$ 34,931      | \$ 21,299                     | \$ 447,900                | \$ 19,958 | \$ 15,043 | \$ 539,131 |
| December 31, 2010                                    |                |                               |                           |           |           |            |
| Allowance for Loan Losses:                           |                |                               |                           |           |           |            |
| Balance at the beginning of period                   | \$ 935         | \$ 354                        | \$ 5,552                  | \$ 672    | \$ 351    | \$ 7,864   |
| Charge-offs  | (556 )         | (126 )                        | (2,971 )                  | (655 )    | (180 )    | (4,488 )   |
| Recoveries   | 192            | 0                             | 636                       | 155       | 69        | 1,052      |
| Provision for loan losses                            | 228            | 213                           | 8,281                     | 185       | (107 )    | 8,800      |
| Ending balance                                       | \$ 799         | \$ 441                        | \$ 11,498                 | \$ 357    | \$ 133    | \$ 13,228  |
| Ending balance individually evaluated for impairment | \$ 0           | \$ 0                          | \$ 2,970                  | \$ 0      | \$ 0      | \$ 2,970   |
| Ending balance collectively evaluated for impairment | 799            | 441                           | 8,528                     | 357       | 133       | 10,258     |
| Ending balance                                       | \$ 799         | \$ 441                        | \$ 11,498                 | \$ 357    | \$ 133    | \$ 13,228  |
| Loan Balances:                                       |                |                               |                           |           |           |            |
| Ending balance individually evaluated for impairment | \$ 178         | \$ 0                          | \$ 19,925                 | \$ 0      | \$ 0      | \$ 20,103  |
|  | 35,875         | 19,206                        | 469,265                   | 24,389    | 17,781    | 566,516    |

Ending balance collectively  
evaluated for impairment

|                |           |           |            |           |           |            |
|----------------|-----------|-----------|------------|-----------|-----------|------------|
| Ending balance | \$ 36,053 | \$ 19,206 | \$ 489,190 | \$ 24,389 | \$ 17,781 | \$ 586,619 |
|----------------|-----------|-----------|------------|-----------|-----------|------------|

CHANGES IN ACCOUNTING METHODOLOGY

There were no changes in the Company's accounting methodology for the allowance for loan losses during the quarter ended June 30, 2011.

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## Note 4. Share-Based Compensation

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

There were no options granted in the first six months of 2011 or in 2010.

On March 9, 2008, the Company's 1998 Stock Option Plan expired. Options to purchase 197,795 shares of common stock were outstanding under the Company's 1998 Stock Option Plan at June 30, 2011. 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, 2011 is summarized below:

|                                      | Shares    | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|--------------------------------------|-----------|--|---|--|
| Options outstanding, January 1, 2011 | 225,127   | \$ 19.62                                 |   |  |
| Granted                              | 0         | 0  |   |  |
| Exercised                            | (18,270 ) | 12.91                                    |   |  |
| Canceled or expired                  | (9,062 )  | 19.14                                    |   |  |
| Options outstanding, June 30, 2011   | 197,795   | \$ 20.27                                 | 4.21  | \$ 0   |
| Options exercisable, June 30, 2011   | 158,811   | \$ 20.32                                 | 3.70  | \$ 0   |

The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on June 30, 2011. This amount changes based on changes in the market value of the Company's common stock. As of June 30, 2011, the outstanding options had no intrinsic value because the exercise prices of all outstanding options were above the market value of a share of the Company's common stock.

No in-the-money options were exercised during the six months ended June 30, 2011. However, four option-holders chose to exercise options where the option price was greater than the current market value. Proceeds from these exercises were \$236 thousand.

As of June 30, 2011, there was \$137 thousand of unrecognized compensation cost related to nonvested options. This cost is expected to be recognized over a weighted-average period of 15 months.

## Note 5. Pension Plan

The Company provides pension benefits for eligible participants through a non-contributory defined benefit pension plan. The plan was frozen effective September 30, 2006; therefore, no additional participants will be added to the



plan. The components of net periodic pension plan cost are as follows:

| Three months ended June 30,    | 2011             | 2010      |
|--------------------------------|------------------|-----------|
|                                | Pension Benefits |           |
| Interest cost                  | \$ 76,032        | \$ 78,431 |
| Expected return on plan assets | (104,965)        | (97,296)  |
| Amortization of net loss       | 42,586           | 31,701    |
| Net periodic pension plan cost | \$ 13,653        | \$ 12,836 |

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| Six months ended June 30,      | 2011             | 2010       |
|--------------------------------|------------------|------------|
|                                | Pension Benefits |            |
| Interest cost                  | \$ 152,064       | \$ 156,862 |
| Expected return on plan assets | (209,929)        | (194,591)  |
| Amortization of net loss       | 85,171           | 63,403     |
| Net periodic pension plan cost | \$ 27,306        | \$ 25,674  |

At June 30, 2011, management had not yet determined the amount, if any, that the Company will contribute to the plan in the year ending December 31, 2011.

#### Note 6. Earnings per Share

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

The Company did not include an average of 208 thousand potential common shares attributable to outstanding stock options in the diluted earnings per share calculation for the first half of 2011 because they were antidilutive.

#### Note 7. Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2010-06, "Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements." ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The new disclosure guidance significantly expands the existing requirements and will lead to greater transparency into a company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period became effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures, will be required for periods beginning on or after December 15, 2010. The Company has included the required disclosures in its consolidated financial statements.

In December 2010, the FASB issued ASU 2010-28, "When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts." The amendments in this ASU modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In December 2010, the FASB issued ASU 2010-29, "Disclosure of Supplementary Pro Forma Information for Business Combinations." The guidance requires pro forma disclosure for business combinations that occurred in the current

reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma information should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. ASU 2010-29 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

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The SEC has issued Final Rule No. 33-9002, “Interactive Data to Improve Financial Reporting”, which requires companies to submit financial statements in XBRL (extensible business reporting language) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. GAAP were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers are required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011.

In March 2011, the SEC issued Staff Accounting Bulletin (SAB) 114. This SAB revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as a part of the FASB’s Codification. The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing through the SAB Series. The effective date for SAB 114 is March 28, 2011. The adoption of the new guidance did not have a material impact on the Company’s consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02, “A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring.” The amendments in this ASU clarify the guidance on a creditor’s evaluation of whether it has granted a concession to a debtor. The amendments also clarify the guidance on a creditor’s evaluation of whether a debtor is experiencing financial difficulty. The amendments in this Update are effective for the first interim or annual period beginning on or after June 15, 2011. Early adoption is permitted. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, an entity may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company is currently assessing the impact that ASU 2011-02 will have on its consolidated financial statements.

In April 2011, the FASB issued ASU 2011-03, “Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements.” The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, “Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRSs).” This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and IFRSs. The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The Company is currently assessing the impact that ASU 2011-04 will have on its consolidated financial statements.

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In June 2011, the FASB issued ASU 2011-05, “Comprehensive Income (Topic 220) – Presentation of Comprehensive Income.” The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders’ equity. The amendments require that all non-owner changes in stockholders’ equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. The Company is currently assessing the impact that ASU 2011-05 will have on its consolidated financial statements.

### Note 8. Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurements and Disclosures topic of FASB ASU 2010-06, 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.

### FAIR VALUE HIERARCHY

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity

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

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

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

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

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

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### CASH AND CASH EQUIVALENTS

The carrying amounts of cash and short-term instruments approximate fair values.

### INVESTMENT SECURITIES

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Securities are classified as Level 2 if quoted market prices are not available. Fair value is estimated using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes and credit spreads. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified in Level 3.

### 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. Therefore, the carrying amounts of restricted securities approximate fair value.

### LOANS RECEIVABLE

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (e.g., 1-4 family residential), credit card loans, and other consumer loans are based on quoted market prices of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics. Fair values for other loans (e.g., commercial real estate and investment property mortgage loans, commercial and industrial loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for non-performing loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

### BANK OWNED LIFE INSURANCE

Bank owned life insurance represents insurance policies on certain officers of the Company. The cash value of the policies is estimated using information provided by the insurance carrier. These policies are carried at their cash value, which approximates the fair value.

### DEPOSIT LIABILITIES

The fair value of demand deposits, savings and certain money market deposits is the amount payable on demand at the reporting date. The fair value of certificates of deposits is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

### SHORT-TERM BORROWINGS

The carrying amounts of federal funds purchased, overnight repurchase agreements, and other short-term borrowings maturing within 90 days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

### LONG-TERM BORROWINGS

The fair values of the Company's long-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

### ACCRUED INTEREST

The carrying amounts of accrued interest approximate fair value.

### 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, 2011 and December 31, 2010, 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 are as follows:

|  | June 30, 2011   |            | December 31, 2010 |            |
|--|-----------------|------------|-------------------|------------|
|  | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
|  | (in thousands)  |            |                   |            |
| <b>Financial assets:</b>                     |                 |            |                   |            |
| Cash and cash equivalents                    | \$31,958        | \$31,958   | \$28,431          | \$28,431   |
| Securities available-for-sale                | 194,183         | 194,183    | 206,092           | 206,092    |
| Securities held-to-maturity                  | 2,252           | 2,270      | 1,952             | 1,957      |
| Restricted securities                        | 3,890           | 3,890      | 4,320             | 4,320      |
| Loans, net of allowances for loan losses     | 529,157         | 527,222    | 573,391           | 571,906    |
| Bank owned life insurance                    | 18,425          | 18,425     | 18,020            | 18,020     |
| Accrued interest receivable                  | 2,467           | 2,467      | 2,652             | 2,652      |
| <b>Financial liabilities:</b>                |                 |            |                   |            |
| Deposits                                     | \$680,443       | \$682,320  | \$679,214         | \$682,001  |
| Federal funds purchased and other borrowings | 839             | 839        | 731               | 731        |
| Overnight repurchase agreements              | 27,799          | 27,799     | 50,757            | 50,757     |
| Term repurchase agreements                   | 2,788           | 2,789      | 38,959            | 38,955     |
| Federal Home Loan Bank advances              | 35,000          | 39,076     | 35,000            | 39,260     |
| Accrued interest payable                     | 652             | 652        | 824               | 824        |

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

Debt and equity securities with readily determinable fair values are classified as “available-for-sale” and 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 securities are considered to be Level 2 securities.

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

| Description | Balance | Fair Value Measurements at June 30, 2011 Using       |   |   |
|-------------|---------|--|---|---|
|             |         | Quoted Prices in Active Markets for Identical Assets | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|             |         | (in thousands)                                       |   |   |

(Level 1)

|   |           |     |           |      |
|---|-----------|-----|-----------|------|
| Available-for-sale securities                   |           |     |           |      |
| U.S. Treasury securities                        | \$600     | \$0 | \$600     | \$ 0 |
| Obligations of U.S. Government agencies         | 189,493   | 0   | 189,493   | 0    |
| Obligations of state and political subdivisions | 2,502     | 0   | 2,502     | 0    |
| Mortgage-backed securities                      | 170       | 0   | 170       | 0    |
| Money market investments                        | 1,418     | 0   | 1,418     | 0    |
| Total available-for-sale securities             | \$194,183 | \$0 | \$194,183 | \$ 0 |

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| Description                                     | Balance    | Fair Value Measurements at December 31, 2010 Using (in thousands) |   |   |
|---|------------|---|---|---|
|   |            | Quoted Prices in Active Markets for Identical Assets (Level 1)    | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-sale securities                   |            |   |   |   |
| U.S. Treasury securities                        | \$ 600     | \$ 0  | \$ 600  | \$ 0                                      |
| Obligations of U.S. Government agencies         | 200,121    | 0   | 200,121                                       | 0   |
| Obligations of state and political subdivisions | 3,172      | 0   | 3,172   | 0   |
| Mortgage-backed securities                      | 382        | 0   | 382   | 0   |
| Money market investments                        | 1,817      | 0   | 1,817   | 0   |
| Total available-for-sale securities             | \$ 206,092 | \$ 0  | \$ 206,092                                    | \$ 0                                      |

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

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

**Impaired loans**

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. 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). 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.

**Foreclosed assets**

Loans are transferred to foreclosed assets when the collateral securing them is foreclosed on. The measurement of loss associated with foreclosed assets 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). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is

considered Level 3. Any fair value adjustments to foreclosed assets are recorded in the period incurred and expensed against current earnings.

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The following table presents the financial instruments carried on the consolidated balance sheets by caption and by level in the fair value hierarchy for which a nonrecurring change in fair value has been recorded:

| Description       | Fair Value | Carrying Value at June 30, 2011<br>(in thousands)                                   |   |  |
|-------------------|------------|---|---|--|
|                   |            | 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) |
| Assets:           |            |   |   |  |
| Impaired loans    | \$2,835    | \$0   | \$2,550   | \$ 285   |
| Foreclosed assets | \$10,797   | \$0   | \$10,797  | \$ 0   |

| Description       | Fair Value | Carrying Value at December 31, 2010<br>(in thousands)                            |   |  |
|-------------------|------------|--|---|--|
|                   |            | Quoted<br>Prices in<br>Active<br>Markets 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) |
| Assets:           |            |  |   |  |
| Impaired loans    | \$7,787    | \$523  | \$6,182   | \$ 1,082   |
| Foreclosed assets | \$11,448   | \$0  | \$11,448  | \$ 0   |

## Note 9. Segment Reporting

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

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

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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, 2011 and 2010 follows:

|                                  | Three Months Ended June 30, 2011 |             |               |                |               |
|----------------------------------|----------------------------------|-------------|---------------|----------------|---------------|
|                                  | Bank                             | Trust       | Parent        | Eliminations   | Consolidated  |
| <b>Revenues</b>                  |                                  |             |               |                |               |
| Interest and dividend income     | \$9,140,912                      | \$10,267    | \$ 1,128,474  | \$(1,127,524 ) | \$9,152,129   |
| Income from fiduciary activities | 0                                | 759,924     | 0             | 0              | 759,924       |
| Other income                     | 2,120,183                        | 86,641      | 75,000        | (90,276 )      | 2,191,548     |
| Total operating income           | 11,261,095                       | 856,832     | 1,203,474     | (1,217,800 )   | 12,103,601    |
| <b>Expenses</b>                  |                                  |             |               |                |               |
| Interest expense                 | 1,689,787                        | 0           | 3,123         | (3,280 )       | 1,689,630     |
| Provision for loan losses        | 500,000                          | 0           | 0             | 0              | 500,000       |
| Salaries and employee benefits   | 4,232,222                        | 532,719     | 130,625       | 0              | 4,895,566     |
| Other expenses                   | 3,391,473                        | 232,514     | 71,195        | (90,276 )      | 3,604,906     |
| Total operating expenses         | 9,813,482                        | 765,233     | 204,943       | (93,556 )      | 10,690,102    |
| Income before taxes              | 1,447,613                        | 91,599      | 998,531       | (1,124,244 )   | 1,413,499     |
| Income tax expense (benefit)     | 383,825                          | 31,143      | (36,730 )     | 0              | 378,238       |
| Net income                       | \$1,063,788                      | \$60,456    | \$ 1,035,261  | \$(1,124,244 ) | \$1,035,261   |
| Total assets                     | \$828,016,619                    | \$4,893,559 | \$ 84,331,209 | \$(84,815,127) | \$832,426,260 |

|                                  | Three Months Ended June 30, 2010 |          |              |                |              |
|----------------------------------|----------------------------------|----------|--------------|----------------|--------------|
|                                  | Bank                             | Trust    | Parent       | Eliminations   | Consolidated |
| <b>Revenues</b>                  |                                  |          |              |                |              |
| Interest and dividend income     | \$10,205,459                     | \$14,834 | \$ 1,102,756 | \$(1,101,818 ) | \$10,221,231 |
| Income from fiduciary activities | 0                                | 780,963  | 0            | 0              | 780,963      |
| Other income                     | 2,229,996                        | 132,283  | 75,000       | (90,476 )      | 2,346,803    |
| Total operating income           | 12,435,455                       | 928,080  | 1,177,756    | (1,192,294 )   | 13,348,997   |
| <b>Expenses</b>                  |                                  |          |              |                |              |
| Interest expense                 | 2,697,215                        | 0        | 3,089        | (5,242 )       | 2,695,062    |
| Provision for loan losses        | 1,300,000                        | 0        | 0            | 0              | 1,300,000    |
| Salaries and employee benefits   | 3,970,682                        | 524,461  | 126,525      | 0              | 4,621,668    |
| Other expenses                   | 3,104,040                        | 263,267  | 76,966       | (90,476 )      | 3,353,797    |
| Total operating expenses         | 11,071,937                       | 787,728  | 206,580      | (95,718 )      | 11,970,527   |
| Income before taxes              | 1,363,518                        | 140,352  | 971,176      | (1,096,576 )   | 1,378,470    |
| Income tax expense (benefit)     | 359,574                          | 47,720   | (36,920 )    | 0              | 370,374      |
| Net income                       | \$1,003,944                      | \$92,632 | \$ 1,008,096 | \$(1,096,576 ) | \$1,008,096  |

|              |               |             |               |                |               |
|--------------|---------------|-------------|---------------|----------------|---------------|
| Total assets | \$907,795,906 | \$5,051,136 | \$ 82,238,997 | \$(82,716,789) | \$912,369,250 |
|--------------|---------------|-------------|---------------|----------------|---------------|

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Six Months Ended June 30, 2011

|                                  | Unconsolidated |             |               |                |               |
|----------------------------------|----------------|-------------|---------------|----------------|---------------|
|                                  | Bank           | Trust       | Parent        | Eliminations   | Consolidated  |
| <b>Revenues</b>                  |                |             |               |                |               |
| Interest and dividend income     | \$18,495,209   | \$19,980    | \$ 1,544,032  | \$(1,542,177 ) | \$18,517,044  |
| Income from fiduciary activities | 0              | 1,530,896   | 0             | 0              | 1,530,896     |
| Other income                     | 4,068,480      | 187,990     | 150,000       | (180,652 )     | 4,225,818     |
| Total operating income           | 22,563,689     | 1,738,866   | 1,694,032     | (1,722,829 )   | 24,273,758    |
| <b>Expenses</b>                  |                |             |               |                |               |
| Interest expense                 | 3,534,696      | 0           | 6,178         | (6,605 )       | 3,534,269     |
| Provision for loan losses        | 2,300,000      | 0           | 0             | 0              | 2,300,000     |
| Salaries and employee benefits   | 8,248,376      | 1,014,050   | 262,943       | 0              | 9,525,369     |
| Other expenses                   | 6,756,788      | 459,279     | 106,757       | (180,652 )     | 7,142,172     |
| Total operating expenses         | 20,839,860     | 1,473,329   | 375,878       | (187,257 )     | 22,501,810    |
| Income before taxes              | 1,723,829      | 265,537     | 1,318,154     | (1,535,572 )   | 1,771,948     |
| Income tax expense (benefit)     | 363,512        | 90,282      | (61,800 )     | 0              | 391,994       |
| Net income                       | \$1,360,317    | \$175,255   | \$ 1,379,954  | \$(1,535,572 ) | \$1,379,954   |
| Total assets                     | \$828,016,619  | \$4,893,559 | \$ 84,331,209 | \$(84,815,127) | \$832,426,260 |

Six Months Ended June 30, 2010

|                                  | Unconsolidated |             |               |                |               |
|----------------------------------|----------------|-------------|---------------|----------------|---------------|
|                                  | Bank           | Trust       | Parent        | Eliminations   | Consolidated  |
| <b>Revenues</b>                  |                |             |               |                |               |
| Interest and dividend income     | \$20,607,919   | \$27,942    | \$ 227,087    | \$(226,230 )   | \$20,636,718  |
| Income from fiduciary activities | 0              | 1,601,848   | 0             | 0              | 1,601,848     |
| Other income                     | 4,600,780      | 249,800     | 153,038       | (179,852 )     | 4,823,766     |
| Total operating income           | 25,208,699     | 1,879,590   | 380,125       | (406,082 )     | 27,062,332    |
| <b>Expenses</b>                  |                |             |               |                |               |
| Interest expense                 | 5,664,277      | 0           | 6,144         | (11,503 )      | 5,658,918     |
| Provision for loan losses        | 6,000,000      | 0           | 0             | 0              | 6,000,000     |
| Salaries and employee benefits   | 7,864,760      | 1,026,909   | 261,081       | 0              | 9,152,750     |
| Other expenses                   | 6,139,612      | 485,997     | 111,571       | (179,852 )     | 6,557,328     |
| Total operating expenses         | 25,668,649     | 1,512,906   | 378,796       | (191,355 )     | 27,368,996    |
| Income (loss) before taxes       | (459,950 )     | 366,684     | 1,329         | (214,727 )     | (306,664 )    |
| Income tax expense (benefit)     | (432,666 )     | 124,673     | (61,140 )     | 0              | (369,133 )    |
| Net income (loss)                | \$(27,284 )    | \$242,011   | \$ 62,469     | \$(214,727 )   | \$62,469      |
| Total assets                     | \$907,795,906  | \$5,051,136 | \$ 82,238,997 | \$(82,716,789) | \$912,369,250 |



The accounting policies of the segments are the same as those described in the summary of significant accounting policies reported in the Company's 2010 annual report on Form 10-K. The Company evaluates performance based on profit or loss from operations before income taxes, not including nonrecurring gains or losses.

The Bank extends a line of credit to the Parent. This line of credit may be used, from time to time and among other purposes, to repurchase the Parent's publicly traded stock. As of June 30, 2011, \$244 thousand was drawn under the line of credit and \$6 thousand remained available. Interest is charged at the Wall Street Journal Prime Rate minus 0.5%, with a floor of 5.0%. This loan is secured by a held-to-maturity security with a book value of \$282 thousand and a market value of \$289 thousand at June 30, 2011. Both the Parent and the Trust companies maintain deposit accounts with the Bank, on terms substantially similar to those available to other customers. These transactions are eliminated to reach consolidated totals.

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

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

**Caution About Forward-Looking Statements**

In addition to historical information, this report may contain forward-looking statements. For this purpose, any statement that is not a statement of historical fact may be a forward-looking statement. These forward-looking statements may include, but are not limited to, statements regarding profitability, liquidity, the loan portfolio, allowance for loan losses, the security portfolio, interest rate sensitivity, asset quality, levels of net loan charge-offs, noninterest expense (and components of noninterest expense), income taxes, expected impact of efforts to restructure the balance sheet, market risk, growth strategy, investment strategy and financial and other goals. Forward-looking statements often use words such as “believes,” “expects,” “plans,” “may,” “will,” “should,” “projects,” “contemplates,” “aforecasts,” “intends” or other words of similar meaning. Forward-looking statements can also be identified by the fact that they do not relate strictly to historical or current facts. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, and actual results could differ materially from historical results or those anticipated by such statements.

There are many factors that could have a material adverse effect on the operations and future prospects of the Company including, but not limited to, changes in interest rates, general economic and business conditions, the quality or composition of the loan or investment portfolios, the size of the provision for loan losses, the adequacy of the allowance for loan losses, the level of nonperforming assets, impaired loans and charge-offs, the local real estate market, results of internal assessments and external bank regulatory examinations, the value of collateral securing loans, the value of and the Company's ability to sell foreclosed assets, the Company's ability to enter into an agreement with a general contractor to expand a current branch office on acceptable terms, volatility and disruption in national and international financial markets, government intervention in the U.S. financial system, Federal Deposit Insurance Corporation (FDIC) premiums and/or assessments, demand for loan and other products, deposit flows, competition, and accounting principles, policies and guidelines. Monetary and fiscal policies of the U.S. Government could also adversely affect the Company; such policies include the impact of any regulations or programs implemented pursuant to the Emergency Economic Stabilization Act of 2008 (EESA), the American Recovery and Reinvestment Act of 2009 (ARRA), the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and other policies of the Office of the Comptroller of the Currency (OCC), U.S. Treasury and the Federal Reserve Board.

The Company has experienced reduced earnings due to the current economic climate. Dramatic declines in the residential and commercial real estate markets in recent years have resulted in increases in nonperforming assets and significant write-downs of asset values by the Company as well as by other financial institutions in the U.S. Concerns about future economic conditions and financial markets generally have reduced the availability of funding to certain financial institutions, leading to a tightening of credit and reduction of business activity.

In July 2010, the President signed into law the Dodd-Frank Act, which implements far-reaching changes across the financial regulatory landscape. It is not clear what other impacts the Dodd-Frank Act, regulations promulgated thereunder and other regulatory initiatives of the U.S. Treasury and other bank regulatory agencies will have on the financial markets and the financial services industry. The limited credit availability currently being experienced could continue to affect the U.S. banking industry and the broader U.S. and global economies, which would have an effect on all financial institutions, including the Company.

These risks and uncertainties, in addition to the risks and uncertainties identified in the Company's annual report on Form 10-K for the year ended December 31, 2010, should be considered in evaluating the forward-looking statements contained herein, and readers are cautioned not to place undue reliance on such statements. Any forward-looking statement speaks only as of the date on which it is made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which it is made. In addition, past results of operations are not necessarily indicative of future results.

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### General

The Company is the parent company of the Bank and Trust. The Bank is a locally managed community bank serving the Hampton Roads localities of Hampton, Newport News, Norfolk, Virginia Beach, Chesapeake, Williamsburg/James City County, York County and Isle of Wight County. The Bank currently has 21 branch offices. Trust is a wealth management services provider.

### Critical Accounting Policies and Estimates

As of June 30, 2011, there have been no significant changes with regard to the critical accounting policies and estimates disclosed in the Company's 2010 annual report on Form 10-K. That disclosure included a discussion of the accounting policy that requires management's most difficult, subjective or complex judgments: the allowance for loan losses. For a discussion of the Company's policies for calculating the allowance for loan losses, see Note 3 to the Consolidated Financial Statements.

### Earnings Summary

Net income for the second quarter of 2011 was \$1.0 million, up \$27 thousand or 2.69% from the second quarter of 2010. For the six months ending June 30, 2011, net income was \$1.4 million, as compared to net income of \$62 thousand in the first two quarters of 2010. Lower provisions for loan losses in both the three and six months ended June 30, 2011, compared to the same periods in 2010, accounted for the majority of the improvement in net income. The provision for loan losses of \$2.3 million for the first half of 2011 was \$3.7 million lower than the equivalent period in 2010. Basic and diluted earnings per share for the three and six months ended June 30, 2011 were \$0.21 and \$0.28, respectively. Basic and diluted earnings per share were \$0.01 for the six months ended June 30, 2010 and \$0.21 and \$0.20, respectively, for the second quarter of 2010.

### 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 yield is calculated by dividing tax-equivalent net interest income by average earning assets. Total interest and dividend income and total interest expense both decreased during the three and six months ended June 30, 2011 from the same periods in 2010, resulting in net interest income in 2011 that was roughly unchanged from 2010 levels.

Net interest income, on a fully tax equivalent basis, was \$7.5 million in the second quarter of 2011, a decrease of \$81 thousand from the second quarter of 2010. The net interest yield was 3.87% in the second quarter of 2011, 42 basis points higher than the 3.45% net interest yield in the equivalent period in 2010. The higher net interest yield in the second quarter of 2011 as compared to the second quarter of 2010 was the result of two factors. First, a reduction in average nonaccrual loans accounted for a 6 basis point increase in the loan portfolio yield, out of a total yield increase of 7 basis points. Second, net interest yield was also affected by the rate on interest-bearing liabilities decreasing 38 basis points, as the rate paid on and volume of higher-priced deposits decreased.

Tax-equivalent interest income decreased by \$1.1 million, or 10.58%, in the second quarter of 2011 compared to the same period of 2010. Average earning assets for the second quarter of 2011 decreased \$104.7 million, or 11.90%, compared to the second quarter of 2010. Interest expense decreased \$1.0 million, or 37.33%, and average interest-bearing liabilities decreased by \$114.9 million, or 15.84% in the second quarter of 2011 compared to the same period of 2010. The decrease in interest expense is a result of the decrease in average interest-bearing liabilities and the 38 basis-point decrease in the average rate on interest-bearing liabilities in the second quarter of 2011 compared to the second quarter of 2010.

For the six months ended June 30, 2011, tax-equivalent net interest income was \$15.1 million, down 0.26% from the first six months of 2010. The net interest yield of 3.81% in the first half of 2011 was 33 basis points higher than the yield for the same period of 2010, due to the rate on interest-bearing liabilities decreasing faster than the yield on earning assets. Tax-equivalent interest income for the six months ended June 30, 2011 decreased \$2.2 million, or 10.43%, from the first six months of 2010, while interest expense fell \$2.1 million, or 37.55% between the same periods. Although average earning assets decreased 9.04% between June 30, 2011 and June 30, 2010, average interest-bearing liabilities decreased at a higher rate during that period at 12.54%.

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The yield on average earning assets and cost of average interest-bearing liabilities both decreased due to the Federal Open Market Committee (FOMC) lowering the Federal Funds Target Rate during 2008 from 4.25% to a range of 0.00% to 0.25%. The FOMC has kept the Federal Funds Target Rate unchanged during 2009, 2010 and the first six months of 2011. As higher-yielding earning assets and higher-cost interest-bearing liabilities that were booked prior to 2008 mature, they are being replaced with lower-yielding earning assets and lower-cost interest-bearing liabilities. Assuming that the FOMC keeps interest rates at current levels, management believes that the decrease of the average rate on interest-bearing liabilities will slow as a high percentage of the Company's interest-bearing liabilities have already re-priced.

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

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

For the quarter ended June 30,

|   | Average<br>Balance | 2011<br>Interest<br>Income/<br>Expense | Yield/<br>Rate** |   | Average<br>Balance | 2010<br>Interest<br>Income/<br>Expense | Yield/<br>Rate** |   |
|---|--------------------|--|------------------|---|--------------------|--|------------------|---|
| (in thousands)  |                    |  |                  |   |                    |  |                  |   |
| <b>ASSETS</b>   |                    |  |                  |   |                    |  |                  |   |
| Loans*  | \$551,918          | \$8,208                                | 5.95             | % | \$631,202          | \$9,274                                | 5.88             | % |
| Investment securities:  |                    |  |                  |   |                    |  |                  |   |
| Taxable   | 199,280            | 896                                    | 1.80             | % | 182,401            | 849                                    | 1.86             | % |
| Tax-exempt*   | 3,059              | 57                                     | 7.45             | % | 5,912              | 113                                    | 7.65             | % |
| Total investment securities   | 202,339            | 953                                    | 1.88             | % | 188,313            | 962                                    | 2.04             | % |
| Federal funds sold  | 14,972             | 6                                      | 0.16             | % | 54,423             | 28                                     | 0.21             | % |
| Other investments   | 5,904              | 21                                     | 1.42             | % | 5,926              | 11                                     | 0.74             | % |
| Total earning assets  | 775,133            | \$9,188                                | 4.74             | % | 879,864            | \$10,275                               | 4.67             | % |
| Allowance for loan losses   | (10,437 )          |  |                  |   | (11,468 )          |  |                  |   |
| Other nonearning assets   | 85,597             |  |                  |   | 79,733             |  |                  |   |
| Total assets  | \$850,293          |  |                  |   | \$948,129          |  |                  |   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                         |                    |  |                  |   |                    |  |                  |   |
| Time and savings deposits:  |                    |  |                  |   |                    |  |                  |   |
| Interest-bearing transaction  |                    |  |                  |   |                    |  |                  |   |
| accounts  | \$11,468           | \$2                                    | 0.07             | % | \$11,571           | \$2                                    | 0.07             | % |
| Money market deposit accounts                                       | 170,221            | 88                                     | 0.21             | % | 155,714            | 86                                     | 0.22             | % |
| Savings accounts  | 48,250             | 13                                     | 0.11             | % | 45,682             | 11                                     | 0.10             | % |
| Time deposits, \$100,000 or more                                    | 131,232            | 469                                    | 1.43             | % | 147,982            | 716                                    | 1.94             | % |
| Other time deposits   | 178,904            | 675                                    | 1.51             | % | 204,761            | 987                                    | 1.93             | % |
| Total time and savings deposits                                     | 540,075            | 1,247                                  | 0.92             | % | 565,710            | 1,802                                  | 1.27             | % |
| Federal funds purchased, repurchase agreements and other borrowings |                    |  |                  |   |                    |  |                  |   |
|   | 35,440             | 18                                     | 0.20             | % | 104,196            | 183                                    | 0.70             | % |
| Federal Home Loan Bank advances                                     | 35,000             | 424                                    | 4.85             | % | 55,480             | 710                                    | 5.12             | % |

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|  |           |         |      |   |           |         |      |   |
|--|-----------|---------|------|---|-----------|---------|------|---|
| Total interest-bearing liabilities         | 610,515   | 1,689   | 1.11 | % | 725,386   | 2,695   | 1.49 | % |
| Demand deposits                            | 137,431   |         |      |   | 122,835   |         |      |   |
| Noninterest-bearing repurchase agreements  | 18,294    |         |      |   | 16,198    |         |      |   |
| Other liabilities                          | 1,548     |         |      |   | 2,363     |         |      |   |
| Stockholders' equity                       | 82,505    |         |      |   | 81,347    |         |      |   |
| Total liabilities and stockholders' equity | \$850,293 |         |      |   | \$948,129 |         |      |   |
| Net interest income/yield                  |           | \$7,499 | 3.87 | % |           | \$7,580 | 3.45 | % |

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For the six months ended June 30,

|   | Average<br>Balance | 2011<br>Interest<br>Income/<br>Expense | Yield/<br>Rate** |   | Average<br>Balance | 2010<br>Interest<br>Income/<br>Expense | Yield/<br>Rate** |   |
|---|--------------------|--|------------------|---|--------------------|--|------------------|---|
| (in thousands)  |                    |  |                  |   |                    |  |                  |   |
| <b>ASSETS</b>   |                    |  |                  |   |                    |  |                  |   |
| Loans*  | \$562,316          | \$16,626                               | 5.91             | % | \$631,898          | \$18,776                               | 5.94             | % |
| Investment securities:  |                    |  |                  |   |                    |  |                  |   |
| Taxable   | 202,163            | 1,799                                  | 1.78             | % | 176,755            | 1,653                                  | 1.87             | % |
| Tax-exempt*   | 3,205              | 117                                    | 7.30             | % | 6,907              | 255                                    | 7.38             | % |
| Total investment securities   | 205,368            | 1,916                                  | 1.87             | % | 183,662            | 1,908                                  | 2.08             | % |
| Federal funds sold  | 16,325             | 14                                     | 0.17             | % | 46,587             | 48                                     | 0.21             | % |
| Other investments   | 5,826              | 33                                     | 1.13             | % | 6,146              | 22                                     | 0.72             | % |
| Total earning assets  | 789,835            | \$18,589                               | 4.71             | % | 868,293            | \$20,754                               | 4.78             | % |
| Allowance for loan losses   | (11,160 )          |  |                  |   | (9,776 )           |  |                  |   |
| Other nonearning assets   | 84,907             |  |                  |   | 78,607             |  |                  |   |
| Total assets  | \$863,582          |  |                  |   | \$937,124          |  |                  |   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                         |                    |  |                  |   |                    |  |                  |   |
| Time and savings deposits:  |                    |  |                  |   |                    |  |                  |   |
| Interest-bearing transaction  |                    |  |                  |   |                    |  |                  |   |
| accounts  | \$11,841           | \$4                                    | 0.07             | % | \$11,092           | \$4                                    | 0.07             | % |
| Money market deposit accounts                                       | 169,540            | 180                                    | 0.21             | % | 153,078            | 167                                    | 0.22             | % |
| Savings accounts  | 47,392             | 24                                     | 0.10             | % | 44,492             | 23                                     | 0.10             | % |
| Time deposits, \$100,000 or more                                    | 132,907            | 1,003                                  | 1.51             | % | 173,283            | 1,427                                  | 1.65             | % |
| Other time deposits   | 181,641            | 1,407                                  | 1.55             | % | 176,283            | 2,137                                  | 2.42             | % |
| Total time and savings deposits                                     | 543,321            | 2,618                                  | 0.96             | % | 558,228            | 3,758                                  | 1.35             | % |
| Federal funds purchased, repurchase agreements and other borrowings |                    |  |                  |   |                    |  |                  |   |
|   | 47,428             | 71                                     | 0.30             | % | 96,981             | 361                                    | 0.74             | % |
| Federal Home Loan Bank advances                                     |                    |  |                  |   |                    |  |                  |   |
|   | 35,000             | 845                                    | 4.83             | % | 60,240             | 1,540                                  | 5.11             | % |
| Total interest-bearing liabilities                                  | 625,749            | 3,534                                  | 1.13             | % | 715,449            | 5,659                                  | 1.58             | % |
| Demand deposits   | 136,144            |  |                  |   | 121,050            |  |                  |   |
| Noninterest-bearing repurchase agreements                           |                    |  |                  |   |                    |  |                  |   |
|   | 18,397             |  |                  |   | 16,213             |  |                  |   |
| Other liabilities   | 1,585              |  |                  |   | 2,542              |  |                  |   |
| Stockholders' equity  | 81,707             |  |                  |   | 81,870             |  |                  |   |
| Total liabilities and stockholders' equity                          | \$863,582          |  |                  |   | \$937,124          |  |                  |   |
| Net interest income/yield   |                    | \$15,055                               | 3.81             | % |                    | \$15,095                               | 3.48             | % |

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

\*\*Annualized



#### Provision for Loan Losses

The provision for loan losses is a charge against earnings necessary to maintain the allowance for loan losses at a level consistent with management's evaluation of the portfolio. This expense is based on management's estimate of credit losses that may be sustained in the loan portfolio. Management's evaluation included credit quality trends, collateral values, the findings of internal credit quality assessments and results from external bank regulatory examinations. These factors, as well as identified impaired loans, historical losses and current economic and business conditions, were used in developing estimated loss factors for determining the loan loss provision.

The provision for loan losses was \$500 thousand in the second quarter of 2011, as compared to \$1.3 million in the second quarter of 2010 and was \$2.3 million for the first half of 2011, as compared to \$6.0 million in the first half of 2010. The Company was able to reduce the provision in 2011 due to a decrease of nonperforming loans and improvement in loan risk ratings as shown in Note 3 of the Consolidated Financial Statements contained in this quarterly report on Form 10-Q. In addition, management concluded that the lower provision was appropriate based on its analysis of the adequacy of the allowance for loan losses.

Net loans charged off were \$810 thousand for the second quarter of 2011 as compared to \$737 thousand for the second quarter of 2010. For the first six months of 2011 and 2010, net loans charged off were \$5.6 million and \$2.2 million, respectively. Of the \$5.6 million of net loans charged off in 2011, \$4.9 million was due to four loans. More than half of the net loans charged off in 2011 were previously provided for in the 2010 provision for loan losses.

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On an annualized basis, net loan charge-offs were 2.06% of total loans for the first six months of 2011 compared with 0.69% for the same period in 2010. While net loans charged off remain high compared to historic levels and reflect ongoing difficulties in the commercial and consumer real estate sectors, management does not anticipate the significantly elevated level of charge-offs that occurred in the first six months of 2011 to continue during the remainder of the year. On a quarter-to-quarter basis, the Company's net charge-offs for the first quarter of 2011 were elevated, at \$4.7 million, while second quarter net charge-offs were \$810 thousand. Management believes that net loans charged off will remain relatively high until the economic recovery becomes more pronounced.

Nonperforming assets consist of nonaccrual loans, loans past due 90 days or more and accruing interest, restructured loans, and foreclosed assets. Restructured loans are loans with terms that were modified in a troubled debt restructuring for borrowers experiencing financial difficulties. As of June 30, 2011, the Company had three restructured loans; these restructured loans are performing in accordance with the new terms. Foreclosed assets consist of real estate from foreclosures on loan collateral. The majority of the loans 90 days past due but still accruing interest are classified as substandard. As noted below, substandard loans are a component of the allowance for loan losses. When a loan changes from "past due 90 days or more and accruing interest" status to "nonaccrual" status, the loan is reviewed for impairment. If the loan is considered impaired, then the difference between the value of the collateral and the principal amount outstanding on the loan is charged off. If the Company is waiting on an appraisal to determine the collateral's value or is in negotiations with the borrower or other parties that may affect the value of the collateral, management allocates funds to cover the deficiency to the allowance for loan losses based on information available to management at that time.

The following table presents information on nonperforming assets:

|  | June 30,<br>2011 | December<br>31,<br>2010 | Increase<br>(Decrease) |
|--|------------------|-------------------------|------------------------|
|  | (in thousands)   |                         |                        |
| Nonaccrual loans   |                  |                         |                        |
| Commercial   | \$ 120           | \$ 178                  | \$(58 )                |
| Real estate-construction                                     | 0                | 37                      | (37 )                  |
| Real estate-mortgage (1)                                     | 8,824            | 20,550                  | (11,726 )              |
| Consumer loans   | 15               | 116                     | (101 )                 |
| Total nonaccrual loans                                       | \$8,959          | \$20,881                | \$(11,922 )            |
| Loans past due 90 days or more and accruing interest         |                  |                         |                        |
| Commercial   | \$ 13            | \$ 0                    | \$ 13                  |
| Real estate-construction                                     | 0                | 16                      | (16 )                  |
| Real estate-mortgage (1)                                     | 252              | 33                      | 219                    |
| Consumer loans   | 1                | 23                      | (22 )                  |
| Other  | 0                | 1                       | (1 )                   |
| Total loans past due 90 days or more and accruing interest   | \$266            | \$73                    | \$193                  |
| Restructured loans (in compliance with modified terms)       |                  |                         |                        |
| Real estate-mortgage (1)                                     | \$ 1,853         | \$ 1,639                | \$ 214                 |
| Total restructured loans (in compliance with modified terms) | \$ 1,853         | \$ 1,639                | \$ 214                 |
| Foreclosed assets  |                  |                         |                        |
| Real estate-construction                                     | \$4,070          | \$4,074                 | \$(4 )                 |
| Real estate-mortgage (1)                                     | 6,727            | 7,374                   | (647 )                 |
| Total foreclosed assets                                      | \$10,797         | \$11,448                | \$(651 )               |
| Total nonperforming assets                                   | \$21,875         | \$34,041                | \$(12,166 )            |

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

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Nonperforming assets as of June 30, 2011 were \$12.2 million, or 35.74% lower than nonperforming assets as of December 31, 2010. The largest decrease in nonperforming assets was in the category of nonaccrual loans, which decreased by \$11.9 million. Nonaccrual loans totaling \$12.3 million were sold without recourse in the second quarter of 2011; \$581 thousand of the second quarter 2011 charge-offs were related to these loans. In future periods, the Company will evaluate opportunities to further improve asset quality and reduce nonaccrual loans through non-recourse sales of these loans.

The majority of the balance of nonaccrual loans at June 30, 2011 was related to a few large credit relationships. Of the \$9.0 million of nonaccrual loans at June 30, 2011, \$7.1 million or 78.94% was comprised of four credit relationships: \$3.5 million, \$1.5 million, \$1.1 million, and \$972 thousand. The loans that make up the nonaccrual balance have been written down to their net realizable value. As shown in the table above, the majority of the nonaccrual loans were collateralized by real estate at June 30, 2011 and December 31, 2010.

Management believes the Company has excellent credit quality review processes in place to identify problem loans quickly. As seen by the reduction in nonperforming assets during the first half of 2011, the quality of the Company's loan portfolio has improved with nonperforming assets stabilizing due to prior charge-offs and non-recourse sales of nonaccrual loans. Management believes that the elevated levels of nonperforming assets in prior quarters was primarily due to economic conditions, depressed commercial and residential real estate markets and the effects of unemployment on borrowers. However, management remains cautious about the future and is well aware that if the economy does not continue to improve, nonperforming assets could increase in future periods. As was seen in recent financial periods, the effect of a sustained increase in nonperforming assets would be lower earnings caused by larger contributions to the loan loss provision, which in turn would be driven by larger impairments in the loan portfolio and higher levels of loan charge-offs.

As of June 30, 2011, the allowance for loan losses was 45.60% of nonperforming assets and 90.03% of nonperforming loans. The definition of nonperforming loans is nonperforming assets less foreclosed assets. The allowance for loan losses was 1.85% of total loans on June 30, 2011 and 2.25% of total loans on December 31, 2010.

### Allowance for Loan Losses

The allowance for loan losses is based on several components. In evaluating the adequacy of the allowance, each segment of the loan portfolio is divided into several pools of loans:

1. Doubtful-specific identification
2. Substandard-specific identification
3. Pool-substandard
4. Pool-other assets especially mentioned (rated just above substandard)
5. Pool-pass loans (all other loans)

Historical loss rates, adjusted for the current economic environment, are applied to the above five pools of loans for each segment of the loan portfolio, except for doubtful and certain substandard loans which have losses specifically calculated on an individual loan basis. Historical loss is one of the components of the allowance. Historical loss is based on the Company's loss experience during the past eight quarters, which management believes reflects the risk related to each segment of loans in the current economic environment. The historical loss component of the allowance amounted to \$5.6 million and \$5.1 million as of June 30, 2011 and December 31, 2010, respectively. This increase is due to higher charge-offs in the most recent two quarters as compared to the level of charge-offs in certain quarters included in past historical loss periods. The Company uses a rolling eight-quarter average to calculate the historical loss component of the allowance, so lower charge-offs in the first two quarters of 2009 are no longer included in the calculation as of June 30, 2011, which has caused the historical loss component to increase.

In addition, nonperforming loans are analyzed for impairment under U.S. GAAP and are allocated based on this analysis. Increases in nonperforming loans affect this portion of the adequacy review. The Company's nonperforming loans fall into the following pools of loans: doubtful-specific identification, substandard-specific identification and the pool-substandard. Therefore, changes in nonperforming loans affect the dollar amount of the allowance. Unless the nonperforming loan is not impaired (i.e. the collateral value is considered sufficient), increases in nonperforming loans are reflected as an increase in the allowance for loan losses.

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The majority of the Company's nonperforming loans are collateralized by real estate. When reviewing loans for impairment, the Company obtains current appraisals when applicable. Any loan balance that is in excess of the appraised value is allocated in the allowance. In the current real estate market, appraisers may have difficulty finding comparable sales, which is causing some appraisals to be very low. As a result, the Company is being conservative in its valuation of collateral which results in higher than normal charged off loans and higher than normal increases to the Company's allowance for loan losses. As of June 30, 2011 and December 31, 2010, the impaired loan component of the allowance for loan losses amounted to \$1.0 million and \$3.0 million, respectively, and for each quarter is reflected as a valuation allowance related to impaired loans in Note 3 of the Notes to the Consolidated Financial Statements included in this Form 10-Q. As shown in the impaired loan tables in Note 3, the unpaid principal balance on impaired loans at June 30, 2011 was \$11.2 million lower than at December 31, 2010.

The final component of the allowance consists of qualitative factors and includes items such as the economy, growth trends, loan concentrations, and legal and regulatory changes. The qualitative component of the allowance amounted to \$3.4 million and \$5.1 million as of June 30, 2011 and December 31, 2010, respectively. The majority of the reduction in this component is due to the \$47.5 million reduction in total loans and the \$11.5 million reduction in nonperforming loans from December 31, 2010 levels.

As a result of these changes and management's belief that nonperforming assets have stabilized, the Company added, through the provision, \$500 thousand and \$2.3 million to the allowance for loan losses in the three and six months ended June 30, 2011. Management believes that the allowance has been appropriately funded for additional losses on existing loans, based on currently available information. The Company will continue to monitor the loan portfolio and levels of nonperforming loans closely and make changes to the allowance for loan losses when management concludes such changes are necessary.

### Noninterest Income

For the second quarter of 2011, noninterest income decreased \$176 thousand, or 5.64%, as compared to the same period in 2010. This majority of this decrease is located in the service charges on deposit accounts category and the other operating income category.

In the service charges on deposit accounts category, there was a decrease in overdraft fees of \$245 thousand between the second quarter of 2011 and the second quarter of 2010. The majority of this decrease in overdraft fees is attributed to the changes in Regulation E requiring a customer to authorize in advance overdrafts caused by debit card and ATM transactions. The Company expects continued uncertainty regarding overdraft fee income and is compensating for this uncertainty by pursuing new product offerings, such as remote deposit capture and lockbox services, to help drive future noninterest income.

The other operating income category decreased \$41 thousand, or 39.68% during the second quarter of 2011 as compared to the same quarter in 2010. This decline is principally due to reduced income from the Company's joint venture, Old Point Mortgage LLC.

The noninterest income category other service charges, commissions and fees increased \$67 thousand when comparing the three months and \$114 thousand when comparing the six months ended June 30, 2011 to the same periods in 2010. This increase is related to increased usage of on-line banking, lockbox services, debit card and remote deposit capture.

For the six months ended June 30, 2011, noninterest income decreased by \$669 thousand as compared to the six months ended June 30, 2010. The majority of this decrease is in the categories of service charges on deposit accounts, income from bank owned life insurance and other operating income. The reasons for the reduction in the categories of service charges on deposit accounts and other operating income are explained in the prior paragraph. The decline in

noninterest income from bank owned life insurance is principally due to life insurance proceeds received by the Company during 2010 that were not received in 2011.

Noninterest Expense

For the second quarter of 2011, noninterest expense increased \$525 thousand, or 6.58% over the second quarter of 2010. Significant increases occurred in the following categories; salaries and employee benefits, data processing, other outside service fees, employee professional development and loss (gain) on write-down/sale of foreclosed assets.

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The two largest increases between the second quarters of 2011 and 2010 were in salaries and benefits expense and loss on write-down/sale of foreclosed assets, which increased \$274 thousand and \$273 thousand, respectively. During 2011 the Company added nine full-time equivalent employees. Many of these newly hired employees are in the Company's private banking and corporate lending areas and were hired to increase small business lending, treasury services and lending in areas other than commercial real estate as part of management's focus on increasing loans and noninterest income. The noninterest expense category of loss on write-down/sale of foreclosed assets increased as the Company managed problem loans created by the economic downturn. As seen by the reduction in the Company's nonperforming loans, these efforts are working. However, these expenses will likely continue to be elevated for the foreseeable future.

The increase in the second quarter of 2011 over the second quarter of 2010 in the category of data processing is related to increased usage of on-line banking, lockbox services, debit card and remote deposit capture. This expense is more than offset by the increase in the noninterest income category of other service charges, commissions and fees due to the revenue generated by these services.

Other outside service fees increased \$49 thousand for the three months ended and \$101 thousand for the six months ended June 30, 2011 as compared to the same periods in 2010. The majority of the increase in other outside service fees was related to the use of independent contractors to provide coverage for open positions and to provide coverage in areas experiencing a temporary increase in workload associated with the economic downturn.

Employee professional development expense also increased in the second quarter 2011 as compared to the second quarter of 2010. In 2010 when earnings were depressed, management cut expenses in personnel education and recruitment, as a temporary measure to reduce noninterest expenses. As the Company's financial results have improved in recent periods, management has begun reinstating certain personnel education and recruitment efforts to maintain a highly qualified workforce to support the Company's operations.

For the second quarter of 2011 over the second quarter of 2010, decreases were seen in the noninterest expense categories of FDIC insurance and loan expenses. The reduction in FDIC insurance expense was due to changes effective April 1, 2011 in the method for calculating this expense. Management believes that these changes will continue to have a positive impact on the Company's FDIC insurance expense. Loan expenses were \$12 thousand lower when comparing the second quarter of 2011 to the same quarter in 2010. Whether this trend continues is dependent on many factors, particularly the local economy and unemployment rate.

For the six months ended June 30, 2011, noninterest expense increased \$957 thousand over the comparable period in 2010. The noninterest expense categories that increased in the second quarter of 2011 also increased in the six months ended June 30, 2011, for the reasons listed above. In addition, FDIC insurance expense and loan expenses were higher for the six months ended June 30, 2011 than the equivalent period in 2010. The reason for the increase in the six months ended June 30, 2011, as compared to the three months ended June 30, 2011, was elevated expenses in the first quarter of 2011.

The following categories of noninterest expense experienced decreases for both the three months and six months ended June 30, 2011 as compared to the same periods in 2010: occupancy and equipment, advertising and postage and courier expense. These reductions are the result of the Company's focus on improving operating efficiency and monitoring noninterest expense items.

## Balance Sheet Review

At June 30, 2011, the Company had total assets of \$832.4 million, a decrease of 6.14% from \$886.8 million at December 31, 2010. This decrease is largely due to the current economic environment as loan demand has fallen and the Company's loan portfolio has decreased during 2011. Net loans as of June 30, 2011 were \$529.2 million, a



decrease of 7.71% from \$573.4 million at December 31, 2010. Loan balances have declined for several reasons, including: higher than normal amortization of residential loans due to an attractive refinance market; closer management of revolving credits; purposeful exiting of troubled credits; partial charge-offs of some larger troubled loans to properly account for reasonable collateral value; regularly scheduled payoffs exceeding loan demand from qualified borrowers and reduced quality loan demand in the Company's market.

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, 2011.

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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, as of June 30, 2011, the Company’s loans with subprime characteristics that were secured by 1-4 family first mortgages, 1-4 family open-end and 1-4 family junior lien loans for which the Company has recorded a credit score in its system.

Loans Secured by 1 - 4 Family First Mortgages,  
1 - 4 Family Open-end and 1 - 4 Family Junior Liens  
(in thousands)

|   | Amount            | Percent |
|---|-------------------|---------|
| Subprime  | \$ 23,572         | 21.2 %  |
| Non-subprime  | 87,744            | 78.8 %  |
|   | \$ 111,316        | 100.0 % |
| <b>Total loans</b>  | <b>\$ 539,131</b> |         |
| Percentage of Real<br>Estate-Secured Subprime<br>Loans to Total Loans |                   | 4.37 %  |

In addition to the subprime loans secured by real estate discussed above, as of June 30, 2011, the Company had an additional \$2.2 million in subprime consumer loans that were either unsecured or secured by collateral other than real estate. Together with the subprime loans secured by real estate, the Company’s total subprime loans as of June 30, 2011 were \$25.8 million, amounting to 4.78% of the Company’s total loans at June 30, 2011.

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

Average assets for the first six months of 2011 were \$863.6 million compared to \$937.1 million for the first six months of 2010. The reduction in average assets as of June 30, 2011 as compared to average assets as of June 30, 2010 was due mainly to the decline in average loans of \$69.6 million, due to the factors impacting the loan portfolio identified above.

Total available-for-sale and held-to-maturity securities at June 30, 2011 was \$196.4 million, a decrease of 5.58% from \$208.0 million at December 31, 2010. Since loan demand continues to be slow and yields on investment securities are low, the Company has allowed higher cost time deposits and term repurchase agreements to mature without renewal. As a result of these balance sheet decisions on how to allocate excess liquidity, management has improved the Company’s net interest margin by reducing higher-cost funding. The Company’s goal is to provide maximum return on the investment portfolio within the framework of its asset/liability objectives. The objectives include managing interest sensitivity, liquidity and pledging requirements.

At June 30, 2011, noninterest-bearing and savings deposits were \$22.6 million higher than comparable deposits at December 31, 2010. In addition to improving the Company's net interest margin, the Company has focused on relationship building. A portion of the growth in noninterest-bearing and savings deposits was due to the sale of high-quality treasury services. Customers pay for these services either with compensating balances or with fees which flow to noninterest income. As seen by both the balance sheets and the income statement, these efforts are working. The liability side of the balance sheet has shifted from higher cost non-relationship funds to lower cost, service providing accounts. The Company reduced its higher cost time deposits and repurchase agreement balances by \$80.5 million since December 31, 2010.

During the first six months of 2011, \$18.5 million of the reduction in repurchase agreements was for a customer which preferred to maintain compensating balances with the Bank instead of paying service fees. These balances were transferred from a noninterest-bearing repurchase agreement to noninterest-bearing deposits. Because the FDIC recently modified how deposit insurance premiums are calculated and noninterest-bearing deposits are now fully insured, the Company was able to make this change and free up the securities that were used as collateral for the repurchase agreement.

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## Capital Resources

Total stockholders' equity as of June 30, 2011 was \$84.1 million, up 3.87% from \$81.0 million at December 31, 2010. Under applicable banking regulations, Total Capital is comprised of core capital (Tier 1) and supplemental capital (Tier 2). Tier 1 capital consists of common stockholders' equity and retained earnings less goodwill. Tier 2 capital consists of certain qualifying debt and a qualifying portion of the allowance for loan losses. The following is a summary of the Company's capital ratios at June 30, 2011. As shown below, these ratios were all well above the regulatory minimum levels, and demonstrate that the Company's capital position remains strong.

|                    | 2011       |                  |
|--------------------|------------|------------------|
|                    | Regulatory | June 30,<br>2011 |
|                    | Minimums   |                  |
| Tier 1             | 4.00%      | 13.89%           |
| Total Capital      | 8.00%      | 15.14%           |
| Tier 1<br>Leverage | 4.00%      | 9.96%            |

Book value per share was \$16.97 at June 30, 2011 up from \$16.65 at June 30, 2010. Cash dividends were \$248 thousand or \$0.05 per share in the second quarter of 2011 and \$246 thousand or \$0.05 per share in the second quarter of 2010. The common stock of the Company has not been extensively traded.

## Liquidity

Liquidity is the ability of the Company to meet present and future financial obligations through either the sale or maturity of existing assets or the acquisition of additional funds through liability management. Liquid assets include cash, interest-bearing deposits with banks, federal funds sold, investments in securities and loans maturing within one year.

A major source of the Company's liquidity is its large stable deposit base. In addition, secondary liquidity sources are available through the use of borrowed funds if the need should arise, including secured advances from the FHLB. As of the end of the second quarter of 2011, the Company had \$213.4 million in FHLB borrowing availability. The Company has available short-term unsecured borrowed funds in the form of federal funds lines with correspondent banks. As of the end of the second quarter of 2011, the Company had \$25.0 million available in federal funds lines to handle any short-term borrowing needs.

In the current economic climate, the Company's available sources of additional liquidity have tightened. Although the Company remains very liquid, two secondary sources of liquidity have become more limited. Available federal funds lines of credit decreased during 2010 as a result of more stringent requirements from correspondent banks. The Company could have maintained these lines if it was willing to pledge collateral, such as investment securities. Since the Company rarely utilizes these lines, management chose to keep a reserve of unpledged securities and allow the lines to be reduced. In the first quarter of 2011, a federal funds line was reinstated which increased the Company's total federal funds line of credit to \$25 million from \$15 million as of December 31, 2010. In July 2011, a second federal funds line was reinstated which increased the Company's total federal funds line of credit to \$33 million. Management anticipates that as the economy improves, the requirements will continue to be relaxed and the remaining federal funds lines that were reduced will be readily available once again.

Similarly in 2010, the FHLB instituted more stringent requirements for securing advances. The FHLB is applying a discount rate to loans used as collateral to simulate the falling value of the properties securing those loans. Even with

these additional collateral requirements, the Company still has more than sufficient collateral to pledge against outstanding FHLB advances.

Other than the decrease in federal funds lines of credit from pre-recession levels and the more stringent requirements for the FHLB advances, management is not aware of any market or institutional trends, events or uncertainties that are expected to have a material effect on the liquidity, capital resources or operations of the Company. Nor is management aware of any current recommendations by regulatory authorities that would have a material affect on liquidity, capital resources or operations. The Company's internal sources of such liquidity are deposits, loan and investment repayments and securities available-for-sale. The Company's primary external source of liquidity is advances from the FHLB.

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

### Contractual Obligations

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

The Company has plans to expand the building of a current branch office. On January 25, 2011 the Company signed a contract with a general contractor for construction of the building. The contract entitles the contractor to the cost of construction plus a fee of 2.50%. The Company anticipates that the project will likely cost between \$8.0 million and \$10.0 million over the next two to three years. \$84 thousand has been disbursed as of June 30, 2011.

As of June 30, 2011, other than those disclosed above, there have been no material changes outside the ordinary course of business in the Company's contractual obligations disclosed in the Company's 2010 annual report on Form 10-K.

### Off-Balance Sheet Arrangements

As of June 30, 2011, there were no material changes in the Company's off-balance sheet arrangements disclosed in the Company's 2010 annual report on Form 10-K.

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

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

The Company determines the overall magnitude of interest sensitivity risk and then formulates policies governing asset generation and pricing, funding sources and pricing, and off-balance sheet commitments. These decisions are based on management's expectations regarding future interest rate movements, the state of the national and regional economy, and other financial and business risk factors. The Company uses computer simulations to measure the effect of various interest rate scenarios on net interest income. This modeling reflects interest rate changes and the related impact on net interest income and net income over specified time horizons.

Based on scheduled maturities only, the Company was liability sensitive as of June 30, 2011. It should be noted, however, that non-maturing deposit liabilities, which consist of interest checking, money market, and savings accounts, are less interest sensitive than other market driven deposits. At June 30, 2011, non-maturing deposit liabilities totaled \$377.0 million or 55.40% of total deposit liabilities.

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

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

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

Under the rate environment forecasted by management, rate shocks in 50 to 100 basis point increments are applied to assess the impact on the Company’s earnings at June 30, 2011. The rate shock model reveals that a 50 basis point decrease in rates would cause an approximate 0.83% annual decrease in net interest income. The rate shock model reveals that a 50 basis point rise in rates would cause an approximate 0.72% annual increase in net interest income and that a 100 basis point rise in rates would cause an approximate 1.54% increase in net interest income.

Item 4. Controls and Procedures.

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

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

Internal Control over Financial Reporting. Management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). No changes in the Company’s internal control over financial reporting occurred during the fiscal quarter ended June 30, 2011 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 2010 annual report on Form 10-K.

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

Pursuant to the Company's stock option plans, participants may exercise stock options by surrendering shares of the Company's common stock that the participants already own. Shares surrendered by participants of these plans are repurchased at current market value pursuant to the terms of the applicable stock options. During the quarter ended June 30, 2011, the Company did not repurchase any shares related to the exercise of stock options.

During the quarter ended June 30, 2011, the Company did not repurchase any shares pursuant to the Company's stock repurchase program.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. [Removed and Reserved].

Item 5. Other Information.

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

Item 6. Exhibits.

| Exhibit No. | Description   |
|-------------|---|
| 3.1         | Articles of Incorporation of Old Point Financial Corporation, as amended effective June 22, 2000 (incorporated by reference to Exhibit 3.1 to Form 10-K filed March 12, 2009)   |
| 3.2         | Bylaws of Old Point Financial Corporation, as amended and restated March 8, 2011 (incorporated by reference to Exhibit 3.2 to Form 8-K filed March 10, 2011)  |
| <u>31.1</u> | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| <u>31.2</u> | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| <u>32.1</u> | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101         | The following materials from Old Point Financial Corporation's quarterly report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Balance Sheets (unaudited), (ii) Consolidated Statements of Income (unaudited), (iii) Consolidated Statements of Changes in Stockholders' Equity (unaudited), (iv) Consolidated Statements of Cash Flows (unaudited), and (v) Notes to Consolidated Financial Statements (unaudited) |

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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 15, 2011

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

August 15, 2011

/s/Laurie D. Grabow  
Laurie D. Grabow  
Chief Financial Officer & Senior Vice President/Finance  
(Principal Financial & Accounting Officer)