Village Bank & Trust Financial Corp.
Form 10-K
March 30, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2017

Commission file number 0-50765

VILLAGE BANK AND TRUST FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

Virginia	**16-1694602**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

13319 Midlothian Turnpike, Midlothian, Virginia	**23113**
(Address of principal executive offices)	(Zip Code)

Issuer’s telephone number: **804-897-3900**

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, $4.00 par value	The Nasdaq Stock Market

Securities registered under Section 12(g) of the Exchange Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes ¨ No þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 þ 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 þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if smaller reporting company)	Smaller reporting company þ
	Emerging growth company ¨

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

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

Yes ¨ No þ

The aggregate market value of common stock held by non-affiliates of the registrant as of the last business day of the Registrant's most recent completed second fiscal quarter was approximately $21,866,000.

The number of shares of common stock outstanding as of February 28, 2018 was 1,430,627.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be used in conjunction with the 2018 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-K.

Village Bank and Trust Financial Corp.

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Part I

In addition to historical information, the following report contains forward-looking statements that are subject to risks and uncertainties that could cause Village Bank and Trust Financial Corp.'s actual results to differ materially from those anticipated. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis only as of the date of the report. For discussion of factors that may cause our actual future results to differ materially from those anticipated, please see "ITEM 7 – MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS" herein.

ITEM 1. BUSINESS

Village Bank and Trust Financial Corp. ("Company") was incorporated in January 2003 and was organized under the laws of the Commonwealth of Virginia as a bank holding company. The Company has three active wholly owned subsidiaries: Village Bank (the "Bank"), Southern Community Financial Capital Trust I, and Village Financial Statutory Trust II. The Bank has one active wholly owned subsidiary: Village Bank Mortgage Corporation ("the mortgage company"), a full service mortgage banking company. The Company is the holding company of and successor to the Bank. Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction. Unless the context suggest otherwise, the terms "we", "us" and "our" refer collectively to the Company, the Bank, and the mortgage company.

The Bank is the primary operating business of the Company. The Bank offers a wide range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, and commercial, real estate and consumer loans, primarily in the Richmond, Virginia and Williamsburg, Virginia metropolitan areas. The Bank was organized in 1999 as a Virginia chartered bank to engage in a general banking business to serve the communities in and around Richmond, Virginia and expanded its services to Williamsburg, Virginia in 2017. Deposits with the Bank are insured to the maximum amount provided by the Federal Deposit Insurance Corporation ("FDIC"). The Bank offers a comprehensive range of financial services and products and specializes in providing customized financial services to small and medium sized businesses, professionals, and individuals. The Bank provides its customers with personal customized service utilizing the latest technology and delivery channels.

Bank revenues are derived from interest and fees received in connection with loans, deposits, and mortgage services. Administrative and operating expenses are the major expenses, followed by interest paid on deposits and borrowings. Revenues from the mortgage company consist primarily of gains from the sale of loans and loan origination fees and its major expenses consist of personnel, occupancy, data processing, and other operating expenses. In 2017, revenue (after intercompany eliminations) generated by the Bank totaled $19.1 million and the mortgage company generated $6.3 million in revenue.

Segment Reporting

The Company has two reportable segments: traditional commercial banking and mortgage banking. For more financial data and other information about each of the Company's operating segments, refer to Item 7 – "Management's Discussion and Analysis of Financial Condition and Results of Operations" sections, "Segment Information – Commercial Banking Segment" and "Segment Information – Mortgage Banking Segment", and to Note 18 "Segment Reporting" in the "Notes to Consolidated Financial Statements" contained in Item 8 of this Form 10-K.

Business Strategy

We are implementing strategies that we believe will help us achieve our goal of delivering long-term total shareholder returns that rank in the top quartile of a nationwide peer group. To achieve this goal, we believe that we will need to become a top performer in return on equity, produce sustainable earnings growth, achieve best quartile earnings volatility in our industry and deliver best quartile asset quality in the worst part of the economic cycle. Our current business strategies include the following:

- *Build full service banking relationships with high quality local companies by being problem solvers and business builders, not just bankers.* We will continue to build a team of bankers and leaders who are both great bankers and exceptional business people. We will have the capital, capabilities and connections to help business owners achieve their goals and overcome obstacles to their success. We target win-win outcomes. We expect to be disciplined lenders during the good times so that during difficult times we can support our good clients, win high quality relationships and recruit talented bankers while other banks focus on their own challenges. Real estate lending will continue to be an important part of our business. We intend to be diligent in managing overall portfolio concentrations, and we will focus on real estate sectors and sponsors that we expect to perform better during difficult times. We will understand the needs and goals of our business clients and their owners so that we can help them fulfill those needs and achieve those goals. We will target deposit only relationships as actively as we will target full loan and deposit relationships. Wherever possible and prudent, we will purchase products and services from the companies that do business with us to support our clients and thank them for their business.

- *Build long-term, mutually beneficial banking relationships with individuals and families in our market area.* We will offer the basic financial products and services individuals and families in our communities need backed by exceptionally professional and caring service. We offer convenience and flexibility through in person, online, mobile and telephonic options for enrolling in new services, handling transactions and seeking service. We want to help our clients thrive on their journey through life. Through our own team members and business partners, we will help clients develop plans for handling the big moments they will encounter along the way. We will be experts at using technology to understand our clients, serve their needs and growing our business.

- *Grow Village Bank Mortgage Corporation's profitability and positive contribution to our brand.* We intend to add loan officers and production teams, more fully identify and serve the mortgage needs of bank clients, fully leverage available grant programs, introduce portfolio mortgage products, enhance our marketing efforts and streamline our processes. We plan to continue to treat mortgage banking as a specialty line of business. We will continue to differentiate ourselves by treating the homeowners, realtors, builders and financial advisors who work with us to exceptionally professional and caring service.

- *Improve and sustain the economics of our balance sheet, income statement and business model:*

  - Expand our Net Interest Margin by improving the mix of both assets and funding. We will continue to improve the mix of our assets by growing core loans, allowing guaranteed student loans to run off and operating with a loan to earning assets mix at the higher end of industry peers. We will continue to improve our funding mix by developing deposit relationships that produce low cost transaction deposits.
  - Improve asset productivity by increasing the proportion of earning assets to total assets.
  - Build and grow other non-interest income services to leverage our return on assets ("ROA") and return on equity ("ROE").
  - Streamline and rationalize our processes and organization to improve productivity and efficiency.
  - Include a prudent amount of debt in our holding company capital structure to leverage a strong ROA into an even stronger ROE.

- *Achieve excellence in risk management*. We strive to achieve best quartile performance on credit quality metrics in the worst part of the business cycle and sustainable earnings growth over the long term. Risk taking is a fundamental part of banking. Top performing banks are very good at identifying, understanding, measuring, monitoring, managing, mitigating and getting paid for the risks the organization takes. We are committed to building and sustaining the culture, talent, tools, policies, processes and discipline needed to be a top performer in our risk management functions.

- *Be the place where exceptional people want to work.* We are committed to achieving great things and need teammates who share that commitment. We will sustain our fun, fulfilling and rewarding work environment built on trust and teamwork. We know that we will achieve our goals by fielding a team of champions, not by building our business around individual stars. We are a meritocracy where every individual knows he or she can make a difference every day, where their individual contributions are valued, where we invest in our teammates, and where we hold people accountable. We will invest in technology to leverage the talents of our associates and provide the flexibility to allow them to manage their work and life priorities effectively. We will offer benefits and resources intended to help our team members be fit to thrive on their journey through life. When we make difficult business decisions, we will do so with sensitivity to and understanding of the consequences of those decisions.

- *Make a lasting difference in our communities.* We will invest our work, wisdom and wealth to help our communities prepare young people for success in life, help families navigate the complex maze of modern life and support and honor the individuals who serve and protect us. We believe that we can be particularly effective in serving our many stakeholders by being a leader in education and workforce development initiatives in our community because success in these areas will help individuals and families provide for themselves and will provide businesses with the talented employees they need to grow and prosper.

We strongly believe that there is a continuing need for banks like Village with deep community roots and that a well-run community based bank can generate attractive returns for shareholders over the long term.

Market Area

The Company, the Bank, and the mortgage company are headquartered in Chesterfield County and primarily serve the Central Virginia region and the Richmond and Williamsburg Metropolitan Statistical Areas. We currently conduct business from ten full-service branch banking offices, and a mortgage loan production office in Central Virginia in the counties of Chesterfield, Hanover, Henrico, Powhatan and James City. During the fourth quarter of 2017, we expanded into the Williamsburg, Virginia market through the opening of a new Village Bank branch. At the end of the first quarter of 2017, we closed our Manassas, Virginia mortgage production office after the retirement of its long term leader.

Banking Services

Deposit Services. Deposits are a major source of our funding. The Bank offers a full range of deposit services that are typically available in most banks and other financial institutions including checking accounts, savings accounts and other time deposits of various types, ranging from daily money market accounts to longer term certificates of deposit and Individual Retirement Accounts. These deposit accounts are offered at rates competitive with other institutions in our market area. We service our deposit clients in our full-service branches, at drive-up windows, at our ATMs, through our customer care team and through technology such as online banking, mobile banking applications and remote deposit capture for business clients. We have not applied for permission to establish a trust department and offer trust services. The Bank is not a member of the Federal Reserve System. Deposits are insured under the Federal Deposit Insurance Act of 1950 (the “FDI Act”) to the limits provided thereunder.

Lending Services. We offer a full range of short-to-medium term commercial and personal loans. We also provide a wide range of real estate finance services. Our primary focus is on making loans in the Central Virginia and Williamsburg markets where we have branch banking offices. We will periodically offer residential construction-to-permanent financing to clients of the mortgage company.

- *Commercial Business Lending*. We make secured and unsecured loans to small- and medium-sized businesses for purposes such as funding working capital needs (including inventory and receivables), business expansion (including acquisition of real estate and improvements) and purchase of equipment and machinery. We also make loans under Small Business Administration and state sponsored business loan programs. In our underwriting, we evaluate the earnings and cash flows of the business, guarantor support and both the need for and the protection offered by the collateral for the loan.

- *Commercial Real Estate Acquisition, Development, Construction and Mortgage Lending*. We make loans to our clients for the purposes of acquiring, developing, constructing and owning commercial real estate. These properties may be owner-occupied or may be held for investment purposes and repaid from rental income or from the sale of the property.

- *Consumer Lending*. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education and personal investments. We also originate fixed and variable rate mortgage loans and real estate construction and acquisition loans. Residential loans originated by our mortgage company are usually sold in the secondary mortgage market.

- *Loan Participations*. We sell loan participations in the ordinary course of business when a loan originated by us exceeds our legal lending limit or we otherwise deem it prudent to share the risk with another lending institution. Additionally, we purchase loan participations from other banks, usually without recourse against that bank. We underwrite purchased loan participations in accordance with normal underwriting practices.

- *Loan Purchases.* We purchase Federal Rehabilitated Student Loan portfolios when approved by the Board of Directors. These loans are guaranteed by the U.S. Department of Education (“DOE”) which covers approximately 98% of the principal and interest. These loans are serviced by a third party servicer that specializes in handling these types of loans.

We also purchase the guaranteed portion of United State Department of Agriculture Loans (“USDA”) which are guaranteed by the USDA for 100% of the principal and interest. The originating institution holds the unguaranteed portion of the loan and services the loan. These loans are typically purchased at a premium. In the event of a loan default or early prepayment the Bank may need to write off any unamortized premium.

Lending Limit. As of December 31, 2017, our legal lending limit for loans to one borrower was approximately $6,827,000. However, we generally limit credit to any one individual or entity to a maximum of $5,000,000.

Competition

We encounter strong competition from other local commercial banks, credit unions, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market mutual funds and other financial institutions. A number of these competitors are well-established. Competition for loans is keen, and pricing is important. Most of our competitors have substantially greater resources and higher lending limits than ours and offer certain services, such as extensive and established branch networks and trust services, which we do not provide at the present time. Deposit competition also is strong, and we may have to pay higher interest rates to attract deposits. Nationwide banking institutions and their branches have increased competition in our markets, and federal legislation adopted in 1999 allows non-banking companies, such as insurance and investment firms, to establish or acquire banks. We believe that the Company can capitalize on recent merger activity to attract customers from the acquired institutions.

At June 30, 2017, the latest date such information is available from the FDIC, the Bank's deposit market share in Chesterfield County was 4.91%, 4.32% in Hanover County, 8.25% in Powhatan County, 0.40% in the Richmond MSA and 0.08% in Henrico County. Due to the recent opening of the Williamsburg, Virginia branch, our market share in this market is insignificant.

Supervision and Regulation

We are subject to extensive regulation by certain federal and state agencies and receive periodic examinations by those regulatory authorities. As a consequence, our business is affected by state and federal legislation and regulations.

The discussion below is only a summary of the principal laws and regulations that comprise the regulatory framework applicable to us. The descriptions of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, do not purport to be complete and are qualified in their entirety by reference to applicable laws and regulations.

General. The Company is qualified as a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), and is registered as such with the Board of Governors of the Federal Reserve System (the "Federal Reserve"). As a bank holding company, the Company is subject to supervision, regulation and examination by the Federal Reserve and is required to file various reports and additional information with the Federal Reserve. The Company is also registered under the bank holding company laws of Virginia and is subject to supervision, regulation and examination by the Bureau of Financial Institutions of the Virginia State Corporation Commission (the "BFI"). The Bank is a Virginia chartered bank and is not a member of the Federal Reserve System. The Bank is subject to regulation, supervision and examination by the FDIC and the BFI.

The Dodd-Frank Act. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law. The Dodd-Frank Act represents a significant overhaul of many aspects of the regulation of the financial services industry, although many of its provisions (e.g., the interchange and trust preferred capital limitations) apply to companies that are significantly larger than the Company. The Dodd-Frank Act directs applicable regulatory authorities to promulgate regulations implementing its provisions, and its effect on the Company and on the financial services industry as a whole will be clarified as those regulations are issued. Major elements of the Dodd-Frank Act include:

- The Dodd-Frank Act changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less its average tangible equity. In addition, it increased the minimum size of the Deposit

Insurance Fund ("DIF") and eliminated its ceiling, with the burden of the increase in the minimum size on institutions with more than $10 billion of assets.

- The Dodd-Frank Act made permanent the $250,000 limit for federal deposit insurance at all insured depository institutions.

- The Dodd-Frank Act repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

- The Dodd-Frank Act implemented new corporate governance requirements for public companies, such as the Company, requiring additional disclosure relating to executive compensation and proxy access to shareholders.

- The Dodd-Frank Act implemented amendments to the Truth in Lending Act aimed at improving consumer protections with respect to mortgage originations, including originator compensation, minimum repayment standards, and prepayment considerations.

- The Dodd-Frank Act established the Financial Stability Oversight Council, which is responsible for identifying and monitoring systemic risks posed by financial firms, activities, and practices.

- The Dodd-Frank Act amended the Electronic Fund Transfer Act to, among other things, require that debit card interchange fees must be reasonable and proportional to the actual cost incurred by the institution with respect to the transaction. In June 2011, the Federal Reserve adopted regulations applicable to institutions with $10 billion or more of assets that established a maximum permissible interchange fee that an institution may charge. Under the regulations, the maximum permissible interchange fee for such institutions is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction, with an additional adjustment of up to one cent per transaction if the institution implements additional fraud-prevention standards. Although institutions that have assets of less than $10 billion are exempt, these regulations are expected to significantly affect the interchange fees that institutions with less than $10 billion of assets are able to collect.

- The Dodd-Frank Act eliminated (over time) the inclusion of trust preferred securities as a permitted element of Tier 1 capital. However, the Company's currently outstanding trust preferred securities are grandfathered and will continue to qualify as Tier 1 capital.

- The Dodd-Frank Act established the Consumer Financial Protection Bureau ("CFPB"), an independent federal agency with broad rule-making, supervisory, and enforcement powers under various federal consumer financial protection laws. The CFPB has examination and primary enforcement authority with respect to depository institutions with $10 billion or more of assets. Smaller institutions, such as the Company, are subject to rules promulgated by the CFPB but are examined and supervised by federal banking regulators for consumer compliance purposes.

- The Dodd-Frank Act enhanced the requirements for certain transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including an expansion of the definition of "covered transactions" and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained.

The Dodd-Frank Act has had, and may in the future have, a material impact on the Company's operations, particularly through increased compliance costs resulting from new and possible future consumer and fair lending regulations.

Reporting Obligations Under Securities Laws. The Company is subject to the periodic reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), including the requirement to file with the Securities and Exchange Commission (the "SEC") annual, quarterly and other reports on the financial condition and performance of the organization. The Company's common stock is listed on the Nasdaq Capital Market and, as a result, the Company is subject to the rules and listing standards adopted by The Nasdaq Stock Market, LLC ("Nasdaq"). The

Company is also affected by the corporate responsibility and accounting reform legislation signed into law on July 30, 2002, known as the Sarbanes-Oxley Act of 2002 (the "SOX Act"), and the related rules and regulations. The SOX Act includes provisions that, among other things, require that periodic reports containing financial statements that are filed with the SEC be accompanied by chief executive officer and chief financial officer certifications as to the accuracy and compliance with law, additional disclosure requirements and corporate governance and other related rules. The Company has expended considerable time and money in complying with the rules and regulations of the SEC and Nasdaq, and with the SOX Act, and expects to continue to incur additional expenses in the future.

Bank Holding Company Act. The Federal Reserve has jurisdiction under the BHC Act to approve any bank or non-bank acquisition, merger or consolidation proposed by a bank holding company. The BHC Act, and other applicable laws and regulations, generally limit the activities of a bank holding company and its subsidiaries to that of banking, managing or controlling banks, or any other activity that is so closely related to banking or to managing or controlling banks as to be a proper incident thereto.

Since September 1995, the BHC Act has permitted bank holding companies from any state to acquire banks and bank holding companies located in any other state, subject to certain conditions, including nationwide and state imposed concentration limits. Banks are also able to branch across state lines, provided certain conditions are met, including that applicable state laws expressly permit such interstate branching. Virginia has adopted legislation that permits branching across state lines, provided there is reciprocity with the state in which the out-of-state bank is based.

Support of Subsidiary Institutions. Under the Dodd-Frank Act, and previously under Federal Reserve policy, the Company is required to act as a source of financial strength for the Bank and to commit resources to support the Bank. This support can be required at times when it would not be in the best interest of the Company’s shareholders or creditors to provide it. In the event of the Company’s bankruptcy, any commitment by us to a federal bank regulatory agency to maintain the capital of the Bank would be assumed by the bankruptcy trustee and entitled to a priority of payment. The Company has periodically raised capital and contributed it to the Bank to support the Bank’s operations.

Privacy Legislation. Several laws, including the Right To Financial Privacy Act and the Gramm-Leach-Bliley Act, provide protections against the transfer and use of customer information by financial institutions. Financial Institutions generally are prohibited from disclosing customer information to non-affiliated third parties, unless the customer has been given the opportunity to object and has not objected to such disclosure. Financial institutions must disclose their specific privacy policies to their customers annually and must conduct an internal risk assessment of their ability to protect customer information.

Mergers and Acquisitions. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, as amended (the "Interstate Banking Act"), generally permits well capitalized and adequately managed bank holding companies to acquire banks in any state, and preempts all state laws restricting the ownership by a bank holding company of banks in more than one state. The Interstate Banking Act also permits a bank to merge with an out-of-state bank and convert any offices into branches of the resulting bank if both states have not opted out of interstate branching; and permits a bank to acquire branches from an out-of-state bank if the law of the state where the branches are located permits the interstate branch acquisition. Under the Dodd-Frank Act, a bank holding company or bank must be well capitalized and well managed to engage in an interstate acquisition. Bank holding companies and banks are required to obtain prior Federal Reserve approval to acquire more than 5% of a class of voting securities, or substantially all of the assets, of a bank holding company, bank or savings association. The Interstate Banking Act and the Dodd-Frank Act permit banks to establish and operate de novo interstate branches to the same extent a bank chartered by the host state may establish branches. Virginia law permits branching across state lines, provided there is reciprocity with the state in which the out-of-state bank is based.

Limits on the Payment of Dividends**.** The Company is a legal entity separate and distinct from the Bank and its other subsidiaries. Virtually all of the Company's cash revenues will result from dividends paid to it by the Bank, which is subject to laws and regulations that limit the amount of dividends that it can pay. Under Virginia law, a bank may not declare a dividend in excess of its accumulated retained earnings without approval by the BFI. As of December 31, 2017, the Bank did not have any accumulated retained earnings. In addition, the Bank may not declare or pay any dividend if, after making the dividend, the Bank would be "undercapitalized," as defined in FDIC regulations.

The FDIC and the state have the general authority to limit the dividends paid by insured banks if the payment is deemed an unsafe and unsound practice. Both the FDIC and the state have indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsound and unsafe banking practice.

In addition, the Company is subject to certain regulatory requirements to maintain capital at or above regulatory minimums. These regulatory requirements regarding capital affect our dividend policies. Regulators have indicated that holding companies should generally pay dividends only if the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends, and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition. In addition, the Federal Reserve has issued guidelines that bank holding companies should inform and consult with the Federal Reserve in advance of declaring or paying a dividend that exceeds earnings for the period (e.g., quarter) for which the dividend is being paid or that could result in a material adverse change to the organization’s capital structure.

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

Insurance of Accounts, Assessments and Regulation by the FDIC. Our deposits are insured by the FDIC up to the limits set forth under applicable law, currently $250,000. We are subject to the deposit insurance assessments of the DIF. The amount of the assessment is a function of the institution’s risk category, of which there are four, and its assessment base. An institution’s risk category is determined according to its supervisory ratings and capital levels and is used to determine the institution’s assessment rate. The assessment base is an institution’s average consolidated total assets less its average tangible equity.

The FDIC is authorized to prohibit any DIF-insured institution from engaging in any activity that the FDIC determines by regulation or order to pose a serious threat to the respective insurance fund. Also, the FDIC may initiate enforcement actions against banks, after first giving the institution’s primary regulatory authority an opportunity to take such action. The FDIC may terminate the deposit insurance of any depository institution if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed in writing by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution has no tangible capital. If deposit insurance is terminated, the deposits at the institution at the time of termination, less subsequent withdrawals, shall continue to be insured for a period from six months to two years, as determined by the FDIC. We are aware of no existing circumstances that could result in termination of our deposit insurance.

Capital Adequacy. Both the Company and the Bank are required to comply with the capital adequacy standards established by the Federal Reserve, in the case of the Company, and the FDIC, in the case of the Bank. In June 2012, the federal bank regulatory agencies jointly issued proposed rules to revise the risk-based and leverage capital requirements and the method for calculating risk-weighted assets to be consistent with the agreements reached by the Basel Committee on Banking Supervision (the "Basel Committee") in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" ("Basel III") and certain provisions of the Dodd-Frank Act. The proposed rules applied to all depository institutions, top-tier bank holding companies with total consolidated assets of $500 million or more, and top-tier savings and loan holding companies. On July 2, 2013, the federal bank regulatory agencies approved certain revisions to the proposed rules and finalized new capital requirements for such banking organizations.

Among other things, the final rules establish a revised definition of regulatory capital, a new common equity Tier 1 minimum capital requirement (“CET1”), a higher minimum Tier 1 capital requirement, and a supplementary leverage ratio that incorporates a broader set of exposures in the denominator. The final rules also establish limits on a banking organization’s capital distributions and certain discretionary bonus payments if the banking organization does not hold a specified amount of CET1 capital in addition to the necessary amount to meet its minimum risk-based capital requirements.

Effective January 1, 2015, the final rules require the Company and the Bank to comply with the following new minimum capital ratios: (i) a new ratio of CET1 to risk-weighted assets of 4.5%; (ii) a ratio of Tier 1 capital to risk-weighted assets of 6.0% (iii) a ratio of total (that is, Tier 1 plus Tier 2) capital to risk-weighted assets of 8.0%; and (iv) a leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (computed as the average for each quarter of the month-end ratios for the quarter). These are the initial capital requirements, which will be phased in over a four-year period that began on January 1, 2015. When fully phased in, Basel III will require the Company and the Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%.

Under new capital guidelines, the Bank must identify high volatility commercial real estate (“HVCRE”) loans, which are defined as a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction of real property, unless the facility finances (1) one to four family residential properties; (2) certain community development projects; (3) the purchase or development of agricultural land; (4) commercial real estate projects that meet the criteria in the rule, including criteria regarding the loan-to-value ratio and capital contributions to the project. Under the new guidelines, HVCRE loans are risk weighted at 150% for capital ratios purposes, rather than 100% as with other loans.

Basel III will also provide for a "countercyclical capital buffer," generally designed to absorb losses during periods of economic stress and to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk. The buffer would be a CET1 add-on to the capital conservation buffer in the range of 0% to 2.5% when fully implemented (potentially resulting in total buffers of between 2.5% and 5%).

The Basel III capital framework is also expected to provide for a number of new deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Implementation of the deductions and other adjustments to CET1 are to be phased-in over a three-year period which began on January 1, 2016.

Additionally, the bank regulatory agencies' final rules revised the "prompt corrective action" regulations pursuant to Section 38 of the FDI Act by (i) introducing a CET1 capital ratio requirement at each level (other than critically undercapitalized), with the required ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum ratio for well-capitalized status being 8.0%; and (iii) eliminating the provision that provides that a bank with a composite supervisory rating of 1 may have a 3.0% Tier 1 leverage ratio and still be well-capitalized. These new thresholds were effective for the Bank as of January 1, 2015. The minimum total capital to risk-weighted assets ratio (10.0%) and minimum leverage ratio (5.0%) for well-capitalized status were unchanged by the final rules. As of December 31, 2017, the Bank met the minimum ratios to be classified as a well capitalized financial institution.

Federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to banks in the three "undercapitalized" categories. The severity of the action depends upon the capital category in which the institution is placed. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category. An institution that is categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. A bank holding company must guarantee that a subsidiary depository institution meets its capital restoration plan, subject to various limitations. The controlling holding company's obligation to fund a capital restoration plan is limited to the lesser of 5% of an undercapitalized subsidiary's assets or the amount required to meet regulatory capital requirements. An undercapitalized institution is also generally prohibited from increasing its average total assets, making acquisitions, establishing any branches or engaging in any new line of business, except under an accepted capital restoration plan or with FDIC approval. The regulations also establish procedures for downgrading an institution and a lower capital category based on supervisory factors other than capital.

In September 2017, the federal bank regulatory agencies proposed to revise and simplify the capital treatment for certain deferred tax assets, mortgage servicing assets, investments in non-consolidated financial entities and minority interests for banking organizations, such as the Bank, that are not subject to the advanced approaches requirements. In November 2017, the regulatory agencies revised the capital rules enacted in 2013 to extend the current transitional treatment of these items for non-advanced approaches banking organizations until the September 2017 proposal is finalized. The September 2017 proposal would also change the capital treatment of certain commercial real estate loans under the standardized approach, which the Bank uses to calculate its capital ratios.

In December 2017, the Basel Committee published standards that it described as the finalization of the Basel III post-crisis regulatory reforms (the standards are commonly referred to as "Basel IV"). Among other things, these standards revise the Basel Committee's standardized approach for credit risk (including by recalibrating risk weights and introducing new capital requirements for certain "unconditionally cancellable commitments," such as unused credit card lines of credit) and provides a new standardized approach for operational risk capital. Under the Basel framework, these standards will generally be effective on January 1, 2022, with an aggregate output floor phasing in through January 1, 2027. Under the current U.S. capital rules, operational risk capital requirements and a capital floor apply only to advanced approaches institutions, and not to the Bank. The impact of Basel IV on us will depend on the manner in which it is implemented by the federal bank regulators.

At December 31, 2017, the Bank's Tier 1 risk-based capital ratio was 11.96%, its total risk-based capital ratio was 12.88% and its leverage ratio was 9.18%. More information concerning our regulatory ratios at December 31, 2017 is included in Note 13 to the "Notes to Consolidated Financial Statements" contained in Item 8 of this Form 10-K.

Restrictions on Transactions with Affiliates. Both the Company and the Bank are subject to the provisions of Section 23A of the Federal Reserve Act. Section 23A places limits on the amount of: (i) a bank's loans or extensions of credit, including purchases of assets subject to an agreement to repurchase, to affiliates; (ii) a bank's investment in affiliates; (iii) assets a bank may purchase from affiliates, except for real and personal property exempted by the Federal Reserve; (iv) the amount of loans or extensions of credit to third parties collateralized by the securities or debt obligations of affiliates; (v) transactions involving the borrowing or lending of securities and any derivative transaction that results in credit exposure to an affiliate; and (vi) a bank's guarantee, acceptance or letter of credit issued on behalf of an affiliate.

The total amount of the above transactions is limited in amount, as to any one affiliate, to 10% of a bank's capital and surplus and, as to all affiliates combined, to 20% of a bank's capital and surplus. In addition to the limitation on the amount of these transactions, each of the above transactions must also meet specified collateral requirements. The Bank must also comply with other provisions designed to avoid acquiring low-quality assets from its affiliates.

The Company and the Bank are also subject to the provisions of Section 23B of the Federal Reserve Act which, among other things, prohibits an institution from engaging in the above transactions with affiliates unless the transactions are on terms substantially the same, or at least as favorable to the institution or its subsidiaries, as those prevailing at the time for comparable transactions with nonaffiliated companies.

The Bank is also subject to restrictions on extensions of credit to its executive officers, directors, principal shareholders and their related interests. These extensions of credit (1) must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third parties, and (2) must not involve more than the normal risk of repayment or present other unfavorable features.

The Dodd-Frank Act also provides that an insured depository institution may not purchase an asset from, or sell an asset to a bank insider (or their related interests) unless (1) the transaction is conducted on market terms between the parties, and (2) if the proposed transaction represents more than 10% of the capital stock and surplus of the insured institution, it has been approved in advance by a majority of the institution's non-interested directors.

Incentive Compensation Policies and Restrictions. In July 2010, the federal banking agencies issued guidance that applies to all banking organizations supervised by the agencies (thereby including both the Company and the Bank). Pursuant to the guidance, to be consistent with safety and soundness principles, a banking organization's incentive compensation arrangements should: (1) provide employees with incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance including active and effective oversight by the banking organization's board of directors. Monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization and its use of incentive compensation. At December 31, 2017, we had not been made aware of any instances of non-compliance with this guidance.

Bank Secrecy Act. The Bank Secrecy Act ("BSA"), which is intended to require financial institutions to develop policies, procedures and practices to prevent and deter money laundering, mandates that every bank have a written, board-approved program that is reasonably designed to assure and monitor compliance with the BSA. The program must, at a minimum: (i) provide for a system of internal controls to assure ongoing compliance; (ii) provide for independent testing for compliance; (iii) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (iv) provide training for appropriate personnel. In addition, a bank is required to adopt a customer identification program as part of its BSA compliance program. Financial institutions are generally required to report cash transactions involving more than $10,000 to the U.S. Department of the Treasury. In addition, financial institutions are required to file suspicious activity reports for transactions that involve more than $5,000 and which the financial institution knows, suspects or has reason to suspect involves illegal funds, is designed to evade the requirements of the BSA or has no lawful purpose. The USA PATRIOT Act of 2001, enacted in response to the September 11, 2001 terrorist attacks, requires bank regulators to consider a financial institution's compliance with the BSA when reviewing applications from a financial institution. In May 2016, the regulations implementing the BSA were amended to explicitly include risk-based procedures for conducting ongoing customer due diligence, to include understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile. In addition, banks must identify and verify the identity of the beneficial owners of all legal entity customers (other than those that are excluded) at the time a new account is opened (other than accounts that are exempted). We must comply with these amendments and new requirements by May 11, 2018.

Reporting Terrorist Activities. The Office of Foreign Assets Control ("OFAC"), which is a division of the Department of the Treasury, is responsible for helping to insure that United States entities do not engage in transactions with "enemies" of the United States, as defined by various Executive Orders and Acts of Congress. OFAC has sent, and will send, our banking regulatory agencies lists of names of persons and organizations suspected of aiding, harboring or engaging in terrorist acts. If the Bank finds a name on any transaction, account or wire transfer that is on an OFAC list, it must freeze such account, file a suspicious activity report and notify the FBI. The Bank has appointed an OFAC compliance officer to oversee the inspection of its accounts and the filing of any notifications. The Bank actively checks high-risk OFAC areas such as new accounts, wire transfers and customer files. The Bank performs these checks utilizing software, which is updated each time a modification is made to the lists provided by OFAC and other agencies of Specially Designated Nationals and Blocked Persons.

Mortgage Banking Regulation. The Bank's mortgage company is subject to the rules and regulations by the Department of Housing and Urban Development, the Federal Housing Administration, the Department of Veteran Affairs and state regulatory authorities with respect to originating, processing, servicing and selling mortgage loans. Those rules and regulations, among other things, establish standards for loan origination, prohibit discrimination, provide for inspections and appraisals of property, require credit reports on prospective borrowers and, in some cases, restrict certain loan features, and fix maximum interest rates and fees. In addition to other federal laws, mortgage origination activities are subject to the Equal Credit Opportunity Act, Truth-in-Lending Act, Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the Home Ownership Equity Protection Act, and the regulations promulgated thereunder. These laws prohibit discrimination, require the disclosure of certain basic information to mortgagors concerning credit and settlement costs, limit payment for settlement services to the reasonable value of the services rendered and require the maintenance and disclosure of information regarding the disposition of mortgage applications based on race, gender, geographical distribution and income level.

Other Safety and Soundness Regulations. There are a number of obligations and restrictions imposed on depository institutions by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insurance funds in the event the depository institution becomes in danger of default or is in default. The Federal banking agencies also have broad powers under current Federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution in question is well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized, as defined by the law. Federal regulatory authorities also have broad enforcement powers over us, including the power to impose fines and other civil and criminal penalties, and to appoint a receiver in order to conserve the assets of any such institution for the benefit of depositors and other creditors. At December 31, 2017, the Bank met the ratio requirements to be classified as a well capitalized financial institution.

Loans-to-One Borrower. Under applicable laws and regulations the amount of loans and extensions of credit which may be extended by a bank to any one borrower, including related entities, generally may not exceed 15% of the sum of the capital, surplus, and loan loss reserve of the institution.

Community Reinvestment. The requirements of the Community Reinvestment Act ("CRA") are applicable to the Company. The CRA imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those institutions. A financial institution's efforts in meeting community credit needs currently are evaluated as part of the examination process pursuant to 12 assessment factors. These factors also are considered in evaluating mergers, acquisitions and applications to open a branch or facility.

Cybersecurity. In March 2015, federal regulators issued two related statements regarding cybersecurity. One statement indicates that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. If the Company fails to observe the regulatory guidance, it could be subject to various regulatory sanctions, including financial penalties. To date, we have not experienced a significant compromise, significant data loss or any material financial losses related to cybersecurity attacks, but our systems and those of our customers and third-party service providers are under constant threat and it is possible that we could experience a significant event in the future. Risks and exposures related to cybersecurity attacks are expected to remain high for the foreseeable future due to the rapidly evolving nature and sophistication of these threats, as well as due to the expanding use of Internet banking, mobile banking and other technology-based products and services by us and our customers.

Tax Reform. On December 22, 2017, the President of the United States signed into law the Tax Cut and Jobs Act of 2017 (the "Tax Reform Act"). The legislation made key changes to the U.S. tax law, including the reduction of the U.S. federal corporate tax rate from 35% to 21%, effective January 1, 2018. As a result of the reduction in the U.S. corporate income tax rate from 35% to 21% under the Tax Reform Act, the Company revalued its deferred tax assets and liabilities at December 31, 2017 and recognized $4,181,000 in tax expense for the year ended December 31, 2017. We are still analyzing certain aspects of the new law and refining our calculations, which could affect the measurement of these assets and liabilities or give rise to new deferred tax amounts. Although the Tax Reform Act had a significant negative impact on the Company's earnings for 2017 as a result of the re-valuation of its deferred tax assets and liabilities, the reduction in the corporate tax rate to 21% is expected to have a significant positive benefit to the Company in 2018 and beyond.

Future Legislation and Regulation. Congress may enact legislation from time to time that affects the regulation of the financial services industry, and state legislatures may enact legislation from time to time affecting the regulation of financial institutions chartered by or operating in those states. Federal and state regulatory agencies also periodically propose and adopt changes to their regulations or change the manner in which existing regulations are applied. The substance or impact of pending or future legislation or regulation, or the application thereof, cannot be predicted, although enactment of the proposed legislation could impact the regulatory structure under which we operate and may significantly increase costs, impede the efficiency of internal business processes, require an increase in regulatory capital, require modifications to business strategy, and limit the ability to pursue business opportunities in an efficient manner.

Employees

As of December 31, 2017, the Company and its subsidiaries had a total of 152 full-time employees and 9 part-time employees. None of the Company's employees are covered by a collective bargaining agreement. The Company considers its relations with its employees to be good.

The Company has a Code of Ethics for directors, officers and all employees of the Company and its subsidiaries, and a Code of Ethics applicable to the Company's Chief Executive Officer, Chief Financial Officer and other principal financial officers. The Code addresses such topics as protection and proper use of Company assets, compliance with applicable laws and regulations, accuracy and preservation of records, accounting and financial reporting and conflicts of interest. A copy of the Code will be provided, without charge, to any shareholder upon written request to the Secretary of the Company, whose address is P.O. Box 330, 13319 Midlothian Turnpike, Midlothian, Virginia 23113.

Additional Information

The Company files annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any reports, statements and other information we file at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operations of the Public Reference Room. Our SEC filings are also available on the SEC's Internet site (http://www.sec.gov).

The Company's common stock trades under the symbol "VBFC" on the Nasdaq Capital Market.

The Company's Internet address is www.villagebank.com. At that address, we make available, free of charge, the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act (see "Investor Relations" section of website), as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

In addition, we will provide, at no cost, paper or electronic copies of our reports and other filings made with the SEC (except for exhibits). Requests should be directed to C. Harril Whitehurst, Jr., Chief Financial Officer, Village Bank and Trust Financial Corp., PO Box 330, Midlothian, VA 23113.

The information on the websites listed above is not and should not be considered to be part of this annual report on Form 10-K and is not incorporated by reference in this document.

ITEM 1A. RISK FACTORS

Not applicable

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable

ITEM 2. PROPERTIES

Our executive and administrative offices are owned by the Bank and are located at 13319 Midlothian Turnpike, Midlothian, Virginia 23113 in Chesterfield County. The current location also houses the principal office of the mortgage company.

In addition to its executive offices, the Bank owns seven full service branch buildings including the land on those buildings and leases an additional four full service branch buildings. Five of our branch offices are located in Chesterfield County, with three branch offices in Hanover County, two in Henrico County, one in Powhatan County and one in James City County.

Our properties are maintained in good operating condition and are suitable and adequate for our operational needs.

ITEM 3. LEGAL PROCEEDINGS

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

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

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

Part Ii

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

On August 8, 2014, we completed a reverse split of our common stock. All financial information and per share amounts in this report are presented as if the reverse split was effective at the beginning of the earliest period presented.

Market Information

Shares of the Company's common stock trade on the Nasdaq Capital Market under the symbol "VBFC". The high and low prices of shares (adjusted for reverse stock split) of the Company's common stock for the periods indicated were as follows:

	High	Low
2016		
1st quarter	$20.36	$18.01
2nd quarter	23.50	18.91
3rd quarter	24.88	22.30
4th quarter	27.45	23.10
2017		
1st quarter	$29.50	$26.70
2nd quarter	32.20	27.30
3rd quarter	33.95	29.00
4th quarter	33.95	28.00

Dividends

The Company has not paid any dividends on its common stock. We intend to retain all of our earnings to finance the Company's operations and we do not anticipate paying cash dividends for the foreseeable future. Any decision made by the board of directors to declare dividends in the future will depend on the Company's future earnings, capital requirements, financial condition and other factors deemed relevant by the board. Banking regulations limit the amount of cash dividends that may be paid without prior approval of the Bank's regulatory agencies. Such dividends are limited to the Bank's accumulated retained earnings. The Federal Reserve has issued guidelines that bank holding companies should inform and consult with the Federal Reserve in advance of declaring or paying a dividend that exceeds earnings for the period (e.g. quarter) for which the dividend is being paid or that could result in a material adverse charge to the organization's capital structure.

The Company was previously prohibited by its Written Agreement with the Reserve Bank from paying dividends on capital stock, including the Series A preferred stock, or interest payments on the trust preferred capital notes without prior regulatory approval. The Written Agreement was terminated by the Reserve Bank as of July 28, 2016. With the termination of the Written Agreement, the Company is not required to defer the quarterly cash dividends on the Series A preferred stock. At December 31, 2016, the aggregate amount of the Company's total accrued but deferred dividend payments on the preferred stock was $2,815,000 and reflected as a reduction of retained earnings.

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

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

At December 31, 2017, the aggregate amount of the Company's total accrued dividend payments on the preferred stock was $54,000 and reflected as a reduction of retained earnings. This amount was accrued for and included in other liabilities on the Balance Sheet in the Consolidated Financial Statements.

Holders

At February 28, 2018, there were approximately 1,006 active holders of common stock; including registered holders and beneficial holders of shares through banks, brokers and other nominees.

For information concerning the Company's Equity Compensation Plans, see "Item 12: Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters".

Purchases of Equity Securities

The Company did not repurchase any of its Common Stock during 2017.

ITEM 6. Selected Financial data

Not applicable

Item 7. 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, consisting of the parent company and its wholly-owned subsidiary, the Bank. This discussion should be read in conjunction with the consolidated financial statements and other financial information contained elsewhere in this report.

Caution About Forward-Looking Statements

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

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

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

underwritten in accordance with the loan program specified by the loan investor;

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

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

General

The Company's primary source of earnings is net interest income, and its principal market risk exposure is interest rate risk. The Company is not able to predict market interest rate fluctuations and its asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on the Company's results of operations and financial condition. Because the Company intentionally decreased assets for the three years prior to 2016 as it was resolving problem assets and attempting to improve capital ratios, as well as declines in yields on earning assets, net interest income declined from $13,018,000 in 2014 to $12,637,000 in 2015. With improved capital ratios and asset quality in 2016, the Company's asset strategy changed to one of growth. Net interest income has increased from $12,637,000 in 2015 to $13,380,000 in 2016 and $14,577,000 in 2017.

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

Results of Operations

The following presents management's discussion and analysis of the financial condition of the Company at December 31, 2017 and 2016, and results of operations for the Company for the years ended December 31, 2017, 2016 and 2015. This discussion should be read in conjunction with the Company's audited Financial Statements and the notes thereto appearing elsewhere in this Annual Report.

The following table sets forth selected financial ratios:

	2017	2016	2015
Performance Ratios			
Return on average assets[(1) (2)]	(0.68)%	3.15 %	0.15 %
Return on average equity[(1)(2)]	(7.08)%	38.81 %	2.30 %
Net interest margin[(3)]	3.56 %	3.53 %	3.40 %
Efficiency[(4)]	93.52 %	90.34 %	105.96%
Loans to deposits	89.64 %	88.12 %	84.27 %
Equity to assets	8.24 %	9.81 %	7.23 %
Asset Quality Ratios			
ALLL to loans at year-end	0.88 %	1.00 %	1.16 %
ALLL to loans at year-end excluding guaranteed student loans[(5)]	1.00 %	1.16 %	1.41 %
ALLL to nonaccrual loans	139.59%	140.41%	95.78 %
Nonperforming assets to total assets	0.86 %	1.20 %	2.37 %
Nonperforming loans to total loans	1.11 %	1.58 %	3.24 %
Net charge-offs to average loans	0.04 %	0.06 %	0.06 %

(1) Return on Average Assets and Return on Average Equity for 2016 were positively impacted by the reversal in the third quarter of 2016 of an $11,997,000 valuation allowance previously recorded against the net deferred tax asset.

(2) Return on Average Assets and Return on Average Equity for 2017 were negatively impacted by the write-off of the net deferred tax asset of approximately $4,181,000 as a result of the reduction in the corporate tax rate.

(3) Net interest margin is computed by dividing net interest income for the period by average interest earning assets.

(4) Efficiency ratio is computed by dividing noninterest expense by the sum of net interest income and noninterest income.

(5) Student loans are guaranteed by the Department of Education for approximately 98% of principal and interest and are evaluated separately for ALLL.

Such ratios are not measurements under accounting principles generally accepted in the United States ("GAAP") and are not intended to be a substitute for our balance sheet or income statement prepared in accordance with GAAP.

Income Statement Analysis

Summary

We recorded a net loss of $3,096,000 and net loss available to common shareholders of $3,594,000 or $(2.55) in 2017 compared to net income of $13,513,000 and net income available to common shareholders of $12,776,000 or $8.99 per fully diluted share in 2016 and a net income of $646,000 and a net income available to common shareholders of $6,591,000, or $5.49 per fully diluted share, in 2015.

The most significant event affecting the Company's results for the fourth quarter of 2017 and the year ended December 31, 2017 was a reduction in the corporate tax rate. On December 22, 2017, the President signed into law the Tax Reform Act. The Tax Reform Act includes a number of changes in existing tax law impacting businesses. One of the most significant changes is a permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction took effect on January 1, 2018. GAAP requires companies to re-value their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment.

As of December 31, 2017, the Company had net deferred tax assets of $11 million. The Company recorded a re-valuation of its deferred tax assets and liabilities as of December 31, 2017, at the new rate of 21%, based upon balances in existence at date of enactment. As a result, the Company's net deferred tax assets were written down by approximately $4,181,000 in the fourth quarter of 2017 with a corresponding increase in tax expense. This write down decreased earnings per share for the fourth quarter by $2.95 and for the year by $2.96. Although the Tax Reform Act had a significant negative impact on the Company's earnings for 2017 as a result of the re-valuation of its deferred tax assets and liabilities, the reduction in the corporate tax rate to 21% is expected to have a significant positive benefit to the Company in 2018 and beyond.

Net income and net income available to common shareholders for the year ended December 31, 2016 were positively impacted by the reversal in the third quarter of 2016 of an $11,997,000 valuation allowance previously recorded against the net deferred tax asset. Netting this reversal against income tax expense for 2016 of $825,000 resulted in an income tax benefit of $11,172,000 for the year ended December 31, 2016. Net income available to common shareholders for the year ended December 31, 2015 was positively impacted by the forgiveness of principal and dividends on preferred stock amounting to $6,619,000 associated with the rights offering to shareholders and concurrent standby offering completed in March 2015.

There were significant changes in income and expense items when comparing the 2017 and 2016 results and 2016 to 2015. These changes are listed in the following table (in thousands):

	2017 Compared to 2016	2016 Compared to 2015
Increase (decrease) in		
Net interest income	$ 1,197	$ 743
(Recovery of) provision for loan losses	-	(2,000)
Gains on loan sales	(1,015)	354
Gain on sale of assets	(504)	504
Gain on sale of investments	(243)	156
Service charges and fees	(51)	(61)
Rental income	(582)	(523)
Other noninterest income	(349)	362
(Increase) decrease in		
Salaries and benefits	(786)	(449)
Commissions	80	(51)
Occupancy expense	337	260
Professional and outside services	5	(69)
Writedown of assets held for sale	(11)	2,429
Loss on branch consolidation	377	(252)
Expenses related to foreclosed real estate	685	(240)
FDIC premium	(5)	624
Other operating expenses	(46)	(78)

Other	41	(14)
	$ (870)	$ 1,695

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Net interest income

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

	Year Ended December 31,		
	2017	2016	Change
	(dollars in thousands)		
Average interest-earning assets	$408,945	$379,163	$29,782
Interest income	$17,298	$15,989	$1,309
Yield on interest-earning assets	4.23 %	4.22 %	0.01 %
Average interest-bearing liabilities	$312,734	$304,458	$8,276
Interest expense	$2,721	$2,609	$112
Cost of interest-bearing liabilities	0.87 %	0.86 %	0.01 %
Net interest income	$14,577	$13,380	$1,197
Net interest margin	3.56 %	3.53 %	0.03 %

The increase in net interest income of $1,197,000 in 2017 was a result of a positive movement in interest income. Interest income increased by $1,309,000, with interest income on loans, investment securities and federal funds sold increasing by $1,035,000, $396,000 and $69,000, respectively. The increase in interest income on loans and investment securities was attributable to increases in average balances outstanding of $20,065,000 and $18,040,000, respectively.

	Year Ended December 31,		
	2016	2015	Change
	(dollars in thousands)		
Average interest-earning assets	$379,163	$371,398	$7,765
Interest income	$15,989	$15,504	$485
Yield on interest-earning assets	4.22 %	4.17 %	0.05 %
Average interest-bearing liabilities	$304,458	$315,823	$(11,365)
Interest expense	$2,609	$2,867	$(258)
Cost of interest-bearing liabilities	0.86 %	0.91 %	(0.05)%

Net interest income	$13,380	$12,637	$743
Net interest margin	3.53 %	3.40 %	0.13 %

The increase in net interest income of $743,000 in 2016 was a result of positive movements in both interest income and interest expense. Interest income increased by $485,000 with interest income on loans increasing by $706,000 offset by a decrease in interest income on investments of $261,000. The increase in interest income on loans was attributable to an increase in average loans outstanding of $27,388,000. The decline in interest income on securities was due to a decline in average investment securities of $10,619,000 as we sold securities to reduce our exposure to interest rate changes. Interest expense declined by $258,000 primarily as a result of a decline in average interest bearing liabilities of $11,365,000.

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

	Year Ended December 31, 2017			Year Ended December 31, 2016			Year Ended December 31, 2015		
	Average Balance	Interest Income/ Expense	Yield Rate	Average Balance	Interest Income/ Expense	Yield Rate	Average Balance	Interest Income/ Expense	Yield Rate
Loans									
Commercial	$ 40,536	$ 1,664	4.11 %	$ 29,989	$ 1,427	4.76 %	$ 21,291	$ 1,096	5.15 %
Real estate - residential	80,863	4,249	5.25 %	82,592	4,397	5.32 %	87,767	4,756	5.42 %
Real estate - commercial	140,809	6,773	4.81 %	128,346	6,108	4.76 %	113,132	5,650	4.99 %
Real estate - construction	34,580	1,742	5.04 %	31,440	1,533	4.88 %	30,828	1,609	5.22 %
Student loans	46,242	1,577	3.41 %	50,742	1,529	3.01 %	42,610	1,204	2.83 %
Consumer	1,846	123	6.66 %	1,702	99	5.82 %	1,795	72	4.01 %
Gross loans	344,876	16,128	4.68 %	324,811	15,093	4.65 %	297,423	14,387	4.84 %
Investment securities	45,667	751	1.64 %	27,627	355	1.28 %	38,246	616	1.61 %
Loans held for sale	6,813	279	4.10 %	12,520	470	3.75 %	11,487	446	3.88 %
Federal funds and other	11,589	140	1.21 %	14,205	71	0.50 %	24,242	55	0.22 %
Total interest earning assets	408,945	17,298	4.23 %	379,163	15,989	4.22 %	371,398	15,504	4.17 %
Allowance for loan losses	(3,308)			(3,513)			(5,678)		
Cash and due from banks	10,210			13,860			9,765		
Premises and equipment, net	12,911			13,187			14,210		
Other assets	25,732			26,703			36,906		
Total assets	$ 454,490			$ 429,400			$ 426,601		
Interest bearing deposits									
Interest checking	45,986	82	0.18 %	42,783	77	0.18 %	43,450	79	0.18 %
Money market	78,492	309	0.39 %	68,817	256	0.37 %	67,796	251	0.37 %
Savings	22,530	39	0.17 %	20,119	36	0.18 %	20,282	37	0.18 %
Certificates	152,341	1,971	1.29 %	158,203	1,998	1.26 %	163,956	2,114	1.29 %
Total deposits	299,349	2,401	0.80 %	289,922	2,367	0.82 %	295,484	2,481	0.84 %
Borrowings									
Long-tern debt - trust preferred securities	8,777	259	2.95 %	9,027	185	2.05 %	9,922	213	2.15 %
FHLB advances	4,221	56	1.33 %	5,161	56	1.09 %	9,027	170	1.88 %
Other borrowings	387	5	1.29 %	348	1	0.29 %	1,390	3	0.22 %
Total interest bearing liabilities	312,734	2,721	0.87 %	304,458	2,609	0.86 %	315,823	2,867	0.91 %

Noninterest bearing deposits	94,618			82,678			75,127		
Other liabilities	3,395			7,445			7,480		
Total liabilities	410,747			394,581			398,430		
Equity capital	43,743			34,819			28,171		
Total liabilities and capital	$ 454,490			$ 429,400			$ 426,601		
Net interest income before provision for loan losses		$ 14,577			$ 13,380			$ 12,637	
Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities			3.36 %			3.36 %			3.27 %
Net interest margin (net interest income expressed as a percentage of average earning assets)			3.56 %			3.53 %			3.40 %

Interest income and interest expense are affected by changes in both average interest rates and average volumes of interest-earning assets and interest-bearing liabilities. The following table analyzes changes in net interest income attributable to changes in the volume of interest-sensitive assets and liabilities compared to changes in interest rates. Nonaccrual loans are included in average loans outstanding. The changes in interest due to both rate and volume have been allocated to changes due to volume and changes due to rate in proportion to the relationship of the absolute dollar amounts of the changes in each (dollars in thousands).

	2017 vs. 2016 Increase (Decrease) Due to Changes in			2016 vs. 2015 Increase (Decrease) Due to Changes in		
	Volume	Rate	Total	Volume	Rate	Total
Interest income						
Loans	$773	$71	$844	$1,128	$(398)	$730
Investment securities	277	119	396	(151)	(110)	(261)
Fed funds sold and other	(10)	79	69	(8)	24	16
Total interest income	1,040	269	1,309	969	(484)	485
Interest expense						
Deposits						
Interest checking	6	(1)	5	(1)	(1)	(2)
Money market accounts	37	16	53	4	1	5
Savings accounts	4	(1)	3	-	(1)	(1)
Certificates of deposit	(79)	52	(27)	(73)	(43)	(116)
Total deposits	(32)	66	34	(70)	(44)	(114)
Borrowings						
Long-term debt	(2)	76	74	3	(31)	(28)
FHLB Advances	(10)	10	-	(57)	(57)	(114)
Other borrowings	4	-	4	(2)	-	(2)
Total interest expense	(40)	152	112	(126)	(132)	(258)
Net interest income	$1,080	$117	$1,197	$1,095	$(352)	$743

Provision for (recovery of) loan losses

The amount of the loan loss provision (recovery) is determined by an evaluation of the level of loans outstanding, the level of nonperforming loans, historical loan loss experience, delinquency trends, underlying collateral values, the amount of actual losses charged to the reserve in a given period and assessment of present and anticipated economic conditions.

Overall the recovery of loan losses recorded for the year ended December 31, 2015 was due primarily to credit quality improvements and an enhanced model for evaluating inherent losses in the Bank's loan portfolio. Improvements in credit quality are provided in the following schedule:

	December 31,		
	2017	2016	2015
Classified assets	$8,313	$10,454	$15,375
Nonaccrual loans	2,320	2,402	3,718
Foreclosed real estate	1,788	2,926	6,249

During the fourth quarter of 2015, we adopted a software solution for the analysis of the allowance for loan losses. While our methodology of evaluating the adequacy of the allowance for loan losses generally did not change, the software is more robust in that it:

- allows us to take a more measurable approach to our evaluation of qualitative factors such as economic conditions that may affect loss experience; and
- is widely used by community banks which provides peer data that can be used as a benchmark for comparison to our analysis.

In addition to the adoption of the software solution for our analysis, we reviewed the last twenty years of historical loss data for peer banks in Virginia to assist us in our evaluation of environmental factors and other conditions that could affect the loan portfolio and the overall adequacy of the allowance for loan losses.

The allowance for loan losses at each of the periods presented includes an amount that could not be identified to individual types of loans referred to as the unallocated portion of the allowance. We recognize the inherent imprecision in estimates of losses due to various uncertainties and variability related to the factors used, and therefore a reasonable range around the estimate of losses is derived and used to ascertain whether the allowance is too high. We concluded that the unallocated portion of the allowance was acceptable given the level of classified assets and was within a reasonable range around the estimate of losses. The allowance for loan losses included an unallocated portion of approximately $347,000, $713,000 and $59,000 at December 31, 2017, 2016 and 2015, respectively.

Discussion of the recovery of loan losses related to specific loan types are provided following:

- The recovery of loan losses totaling $118,000 for the construction and land development portfolio at December 31, 2017 was attributed to a decline in the general component of the allowance for loan losses as a result of a decrease in the historical loss experience from 0.38% as of December 31, 2016 to 0.04% as of December 31, 2017.

- The provision for loan losses totaling $286,000 for the construction and land development portfolio at December 31, 2015 was attributed to a an increase in the historical loss experience from a net recovery of 0.27% at December 31, 2014 to a net charge-off of 0.48% at December 31, 2015.

- The provision for loan losses totaling $316,000 for the commercial and industrial loans (except those secured by real estate) at December 31, 2017 was attributed to an increase of $369,000 in the specific reserve associated with loans evaluated individually for impairment.

- The recovery of loan losses totaling $730,000 and $866,000 for the commercial real estate portfolio at December 31, 2016 and 2015, respectively, was attributed to a decline in the general component of the allowance for loan losses as a result of a decrease in the historical loss experience from 0.96% in 2014 to 0.57% in 2015 and to 0.20% in 2016. In addition, net charge-offs on this portfolio decreased from $1,220,000 in 2014 to $90,000 in 2015 and to a net recovery of $111,000 in 2016.

- The recovery of loan losses totaling $146,000 and $1,143,000 for the consumer real estate portfolio at December 31, 2016 and 2015, respectively, was attributed to a decline in the general component of the allowance for loan losses as a result of a decrease in the historical loss experience from 1.36% in 2014 to 0.24% in 2015 and to .0022% in 2016. In addition, net charge-offs on this portfolio decreased from $562,000 in 2014 to a recovery of $215,000 in 2015.

For more financial data and other information about the provision for (recovery of) loan losses refer to section, “Balance Sheet Analysis” under this Item 7 – “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, and Note 4 “Allowance for Loan Losses” in the “Notes to Consolidated Financial Statements” contained in Item 8 of this Form 10-K.

Noninterest income

Noninterest income includes service charges and fees on deposit accounts, fee income related to loan origination, gains and losses on sale of mortgage loans and securities held for sale, and, in 2016 and 2015, rental income primarily on our previous headquarters building. The most significant noninterest income item has been gain on loan sales generated by the mortgage company, representing 67% in 2017, 59% in 2016, and 60% in 2015 of total noninterest income. Noninterest income amounted to $8,106,000 in 2017, $10,850,000 in 2016, and $10,058,000 in 2015.

	For the Year Ended December 31,		Change	
	2017	2016	$	%
	(dollars in thousands)			
Service charges and fees	$2,408	$2,459	$(51)	(2.1)%
Gain on sale of loans	5,415	6,430	(1,015)	(15.8)%
Gain on sale of assets	-	504	(504)	100.0 %
Gain (loss) on sale of investment securities	(81)	162	(243)	(150.0)%
Rental income	-	582	(582)	(100.0)%
Other	364	713	(349)	(48.9)%
Total noninterest income	$8,106	$10,850	$(2,744)	(25.3)%

- The decrease in gain on sale of loans was due to decreased activity by our mortgage banking segment during the latter part of 2017. At the end of the first quarter of 2017, we closed our Manassas, VA mortgage production office after the retirement of its long term leader. Additionally, the President of the mortgage banking segment retired in the first quarter of 2017. Both of these events had a negative impact on the mortgage banking segments' loan production. The gain on sale is recognized at the date of sale to the investor and mortgage loans sales decreased from $218,627,000 in 2016 to $170,539,000 in 2017.
- The gain on sale of assets in 2016 was related to the sale of our previous headquarters building and was a onetime event.
- The Company sold approximately $10 million and $22 million in investments securities resulting in a loss of $81,000 and a gain of $162,000 during the years ended 2017 and 2016, respectively. These sales resulted from management's efforts to reduce interest rate risk in our investment portfolio.
- The decline in rental income was a result of the sale of our previous headquarters building in June 2016 that generated rental income from nonrelated entities.
- The decrease in other income was primarily due to a gain of $266,000 from a bank owned life insurance claim in 2016.

	For the Year Ended December 31,		Change	

	2016	2015	$	%
	(dollars in thousands)			
Service charges and fees	$2,459	$2,520	$(61)	(2.4)%
Gain on sale of loans	6,430	6,076	354	5.8 %
Gain on sale of assets	504	-	504	100.0 %
Gain on sale of investment securities	162	6	156	2600.0%
Rental income	582	1,105	(523)	(47.3)%
Other	713	351	362	103.1 %
Total noninterest income	$10,850	$10,058	$792	7.9 %

- The increase in gain on sale of loans was due to increased activity by our mortgage banking segment as the mortgage market was more favorable in the latter half of 2016. The gain on sale is recognized at the date of sale to the investor and mortgage loan sales increased from $208,479,000 in 2015 to $218,627,000 in 2016.
- The gain on sale of assets in 2016 related to the sale of our previous headquarters building and was a onetime event.
- The gain on investment securities resulted from management's efforts to reduce interest rate risk in our investment portfolio by selling longer duration securities.
- The decline in rental income was a result of the sale of our previous headquarters building in June 2016 that generated rental income from nonrelated entities.
- The increase in other income was primarily due to a gain of $266,000 from a bank owned life insurance claim.

Noninterest expense

Noninterest expense includes all expenses of the Company with the exception of interest expense on deposits and borrowings, provision for loan losses and income taxes. Some of the primary components of noninterest expense are salaries and benefits, occupancy and equipment costs and professional and outside services. Over the last three years, the most significant noninterest expense item has been salaries and benefits including commissions, representing 64%, 59%, and 52% of noninterest expense in 2017, 2016 and 2015, respectively. Noninterest expense decreased from $24,049,000 in 2015 to $21,889,000 in 2016, and decreased to $21,212,000 in 2017.

	For the Year Ended December 31,		Change	
	2017	2016	$	%
	(dollars in thousands)			
Salaries and benefits	$12,081	$11,295	$786	7.0 %
Commissions	1,526	1,606	(80)	(5.0)%
Occupancy	1,133	1,470	(337)	(22.9)%
Equipment	757	762	(5)	(0.7)%
Write down of assets held for sale	231	220	11	5.0 %
Cease use lease obligation	(125)	252	(377)	(149.6)%
Supplies	244	265	(21)	(7.9)%
Professional and outside services	2,994	2,999	(5)	(0.2)%
Advertising and marketing	340	355	(15)	(4.2)%
Foreclosed assets, net	(292)	393	(685)	(174.3)%
FDIC insurance premium	297	292	5	1.7 %
Other operating expense	2,026	1,980	46	2.3 %
Total noninterest income	$21,212	$21,889	$(677)	(3.1)%

- The increase in salaries and benefits was due to staffing changes in key management positions as well as retention and severance payments made to mortgage lending personnel.

- Occupancy declined due to the sale of our previous headquarters building in June 2016.
- During the fourth quarter of 2016, the Company recorded a loss from branch consolidation of $252,000 related to a future lease obligation, which was settled for a lower amount late in the first quarter of 2017 resulting in a partial recovery of $125,000.
- The decrease in expense related to foreclosed real estate was due to the recognition of gains on the sale of foreclosed assets of $380,000 during 2017 as well as lower expenses and write downs due to declines in foreclosed real estate.

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	For the Year Ended December 31, 2016	2015	Change $	%
	(dollars in thousands)			
Salaries and benefits	$11,295	$10,846	$449	4.1 %
Commissions	1,606	1,555	51	3.3 %
Occupancy	1,470	1,730	(260)	(15.0)%
Equipment	762	765	(3)	(0.4)%
Write down of assets held for sale	220	2,649	(2,429)	(91.7)%
Cease use lease obligation	252	-	252	
Supplies	265	278	(13)	(4.7)%
Professional and outside services	2,999	2,930	69	2.4 %
Advertising and marketing	355	325	30	9.2 %
Foreclosed assets, net	393	153	240	156.9%
FDIC insurance premium	292	916	(624)	(68.1)%
Other operating expense	1,980	1,902	78	4.1 %
Total noninterest income	$21,889	$24,049	$(2,160)	(9.0)%

- The increase in salaries and benefits was due to staffing changes in key management positions.
- Occupancy declined due to the sale of our previous headquarters building in June 2016.
- Write down of assets held for sale decreased due to write downs in 2015 associated with the headquarters building. The building was sold in June 2016 for a gain of $504,000.
- Cease use lease obligation is due to recording a loss related to consolidating two branches.
- Costs associated with foreclosed assets increased due to gains on sale in 2015 as we disposed of these assets. We did not have similar gains in 2016.
- The decrease in the FDIC insurance premium was due to the improvement in the Bank's risk rating with the FDIC based on the removal of the Consent Order in December 2015.

Income taxes

The Company has a net deferred tax asset which is included in other assets on the balance sheet. For more financial data and other information about income taxes refer to Note 1 "Summary of Significant Accounting Policies" and Note 9 "Income Taxes" in the "Notes to Consolidated Financial Statements" contained in Item 8 of this Form 10-K.

Balance Sheet Analysis

Investment securities

At December 31, 2017 and 2016, all of our investment securities were classified as available for sale. The following table presents the composition of our investment portfolio at the dates indicated (dollars in thousands).

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	Par Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Average Yield
December 31, 2017						
US Government Agencies						
One to five years	$21,400	$ 21,561	$ -	$ (276)	$ 21,285	1.44 %
More than ten years	2,411	2,415	-	(17)	2,398	1.74 %
	23,811	23,976	-	(293)	23,683	1.47 %
Mortgage-backed securities						
Five to ten years	3,400	3,472	-	(43)	3,429	1.72 %
More than ten years	18,518	18,655	1	(145)	18,511	2.39 %
	21,918	22,127	1	(188)	21,940	2.28 %
Subordinated debt						
Five to ten years	4,050	4,103	11	(26)	4,088	3.08 %
Total investment securities	$49,779	$ 50,206	$ 12	$ (507)	$ 49,711	1.96 %
December 31, 2016						
US Government Agencies						
One to five years	$29,400	$ 29,607	$ -	$ (213)	$ 29,394	1.25 %
More than ten years	2,862	2,868	-	(16)	2,852	1.08 %
	32,262	32,475	-	(229)	32,246	1.24 %
Mortgage-backed securities						
One to five years	3,457	3,524	-	(33)	3,491	1.78 %
More than ten years	8,253	8,170	1	(14)	8,157	2.16 %
	11,710	11,694	1	(47)	11,648	2.05 %
Total investment securities	$43,972	$ 44,169	$ 1	$ (276)	$ 43,894	1.45 %

For more financial data and other information about investment securities refer to Note 1 “Summary of Significant Accounting Policies” and Note 2 “Investment Securities Available for Sale” in the “Notes to Consolidated Financial Statements” contained in Item 8 of this Form 10-K.

Loans

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

Approximately 77% of all loans are secured by mortgages on real property located principally in the Commonwealth of Virginia. We are much less reliant on real estate secured lending than was the case in 2012 when 90% of our loan portfolio consisted of this type of lending. Approximately 12% of the loan portfolio consists of rehabilitated student loans purchased by the Bank in 2017, 2016, 2015 and 2014 (see discussion following). Commercial and industrial loans represented $37 million, or 10%, of the portfolio at December 31, 2017. Loans in this category are typically made to individuals, small and medium-sized businesses and range between $250,000 and $2.5 million. Based on underwriting standards, these loans may be secured in whole or in part by collateral such as liquid assets, accounts receivable, equipment, inventory, and real property. The collateral securing any loan may depend on the type of loan and may vary in value based on market conditions. The remainder of our loan portfolio is in consumer loans which represent 1% of the total.

The following tables present the composition of our loan portfolio at the dates indicated (in thousands).

	December 31, 2017	2016	2015	2014	2013
Construction and land development					
Residential	$5,361	$6,770	$5,202	$4,315	$2,931
Commercial	25,456	27,092	25,948	25,152	28,179
Total construction and land development	30,817	33,862	31,150	29,467	31,110
Commercial real estate					
Owner occupied	85,004	66,021	69,256	58,804	73,585
Non-owner occupied	70,845	57,944	38,037	38,892	43,868
Multifamily	9,386	8,824	8,537	11,438	11,560
Farmland	270	310	388	434	1,463
Total commercial real estate	165,505	133,099	116,218	109,568	130,476
Consumer real estate					
Home equity lines	22,849	20,691	20,333	20,082	21,246
Secured by 1-4 family residential					
First deeds of trust	57,919	54,791	56,776	61,837	66,872
Second deeds of trust	7,460	5,768	6,485	7,854	8,675
Total consumer real estate	88,228	81,250	83,594	89,773	96,793
Commercial and industrial loans (except those secured by real estate)	36,506	39,390	20,086	22,165	26,254
Guaranteed student loans	45,805	47,398	53,989	33,562	-
Consumer and other	1,848	2,101	1,734	1,611	1,930
Total Loans	368,709	337,100	306,771	286,146	286,563
Deferred loan cost, net	699	660	670	722	683
Less: Allowance for loan losses	(3,239)	(3,373)	(3,562)	(5,729)	(7,239)
Total loans, net	$366,169	$334,387	$303,879	$281,139	$280,007

Maturities by loan type at December 31, 2017 were as follows (in thousands):

		Fixed Rate			Variable Rate			
	Within 1 Year	1 to 5 Years	After 5 Years	Total	1 to 5 Years	After 5 Years	Total	Total Maturities
Construction and land development								
Residential	$5,229	$132	$-	$132	$-	$-	$-	$5,361
Commercial	22,417	2,876	-	2,876	112	51	163	25,456
	27,646	3,008	-	3,008	112	51	163	30,817

Total construction and land development								
Commercial real estate								
Owner occupied	19,411	27,931	29,429	57,360	6,269	1,964	8,233	85,004
Non-owner occupied	17,098	30,588	18,483	49,071	4,676	-	4,676	70,845
Multifamily	2,757	6,164	465	6,629	-	-	-	9,386
Farmland	140	40	-	40	-	90	90	270
Total commercial real estate	39,406	64,723	48,377	113,100	10,945	2,054	12,999	165,505
Consumer real estate								
Home equity lines	19,153	128	3,568	3,696	-	-	-	22,849
Secured by 1-4 family residential								
First deeds of trust	21,151	23,220	4,414	27,634	9,109	25	9,134	57,919
Second deeds of trust	1,918	1,278	1,438	2,716	2,814	12	2,826	7,460
Total consumer real estate	42,222	24,626	9,420	34,046	11,923	37	11,960	88,228
Commercial and industrial loans (except those secured by real estate)	19,123	8,357	8,493	16,850	533	-	533	36,506
Guaranteed student loans	-	-	-	-	45,805	-	45,805	45,805
Consumer and other	582	1,266		1,266	-	-	-	1,848
	$128,979	$101,980	$66,290	$168,270	$69,318	$2,142	$71,460	$368,709

For more financial data and other information about loans refer to Note 1 “Summary of Significant Accounting Policies” and Note 3 “Loans” in the “Notes to Consolidated Financial Statements” contained in Item 8 of this Form 10-K.

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Allowance for loan losses

We monitor and maintain an allowance for loan losses to absorb an estimate of probable losses inherent in the loan portfolio. For more financial data and other information about loans refer to Note 1 “Summary of Significant Accounting Policies” and Note 4 “Allowance for Loan Losses” in the “Notes to Consolidated Financial Statements” contained in Item 8 of this Form 10-K.

The following table presents an analysis of the changes in the allowance for loan losses for the periods indicated (dollars in thousands).

	Year Ended December 31,				
	2017	2016	2015	2014	2013
Beginning balance	$3,373	$3,562	$5,729	$7,239	$10,808
(Recovery of), provision for loan losses	-	-	(2,000)	100	1,173
Charge-offs					
Construction and land development					
Commercial	(31)	(10)	(252)	(100)	(279)
Commercial real estate					
Owner occupied	-	(66)	(127)	(631)	(454)
Non-owner occupied	-	(1)	-	(518)	(619)
Multifamily					-
Farmland	-	-	-	(96)	(896)
Consumer real estate					
Home equity lines	-	(53)	(62)	(476)	(266)
Secured by 1-4 family residential					
First deed of trust	(107)	(140)	(103)	(277)	(1,953)
Second deed of trust	-	(25)	(55)	(86)	(367)
Commercial and industrial (except those secured by real estate)	-	(15)	(162)	(172)	(760)
Guaranteed student loans	(146)	(221)		-	-
Consumer and other	(2)	(13)	(55)	(25)	(64)
	(286)	(544)	(816)	(2,381)	(5,658)
Recoveries					
Construction and land development					
Residential	1	1	2	2	102
Commercial	4	10	49	44	424
Commercial real estate					
Owner occupied	13	-	33	-	43
Non-owner occupied	-	53	4	25	20
Farmland	-	125	-	-	-

Consumer real estate					
Home equity lines	2	3	5	15	9
Secured by 1-4 family residential					
First deed of trust	64	25	380	72	94
Second deed of trust	34	29	50	190	38
Commercial and industrial (except those secured by real estate)	17	100	100	401	177
Guranteed student loans					
Consumer and other	17	9	26	22	9
	152	355	649	771	916
Net charge-offs	(134)	(189)	(167)	(1,610)	(4,742)
Ending balance	$3,239	$3,373	$3,562	$5,729	$7,239
Loans outstanding at end of period(1)	$369,408	$337,760	$307,441	$286,868	$287,246
Ratio of allowance for loan losses as a percent of loans outstanding at end of period	0.88 %	1.00 %	1.16 %	2.00 %	2.52 %
Average loans outstanding for the period(1)	$344,876	$324,811	$297,423	$274,429	$315,642
Ratio of net charge-offs to average loans outstanding for the period	0.04 %	0.06 %	0.06 %	0.59 %	1.50 %

(1) Loans are net of unearned income.

Asset quality

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

	December 31, 2017	2016	2015	2014	2013
Nonaccrual loans	$2,320	$2,402	$3,718	$7,478	$18,647
Foreclosed properties	1,788	2,926	6,249	12,638	16,742
Total nonperforming assets	$4,108	$5,328	$9,967	$20,116	$35,389
Restructured loans (not included in nonaccrual loans above)	$8,313	$10,154	$14,260	$24,812	$28,236
Loans past due 90 days and still accruing *(1)*	$7,229	$8,174	$8,590	$719	$60
Nonperforming assets to loans *(2)*	1.11 %	1.58 %	3.25 %	7.03 %	12.35 %
Nonperforming assets to total assets	0.9 %	1.2 %	2.4 %	4.6 %	8.0 %
Allowance for loan losses to nonaccrual loans	139.6%	140.4 %	95.8 %	76.6 %	38.8 %

(1) All loans 90 days past due and still accruing are rehabilitated student loans which have a 98% guarantee by the DOE.
(2) Loans are net of unearned income and deferred cost.

The following table presents an analysis of the changes in nonperforming assets for 2017 (in thousands).

	Nonaccrual Loans	OREO	Total
Balance December 31, 2016	$ 2,402	$2,926	$5,328
Additions	1,289	-	1,289
Loans placed back on accrual	(384)	-	(384)
Transfers to OREO	(285)	285	-
Repayments	(490)	-	(490)
Charge-offs	(212)	(20)	(232)
Sales	-	(1,403)	(1,403)

Balance December 31, 2017	$ 2,320	$1,788	$4,108

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

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

Of the total nonaccrual loans of $2,320,000 at December 31, 2017 that were considered impaired, 13 loans totaling $1,053,000 had specific allowances for loan losses totaling $454,000. This compares to $2,402,000 in nonaccrual loans at December 31, 2016 of which 8 loans totaling $660,000 had specific allowances for loan losses of $97,000.

Cumulative interest income that would have been recorded had nonaccrual loans been performing would have been $159,000, $119,000 and $146,000 for 2017, 2016 and 2015, respectively. Student loans totaling $7,229,000 and $8,174,000 at December 31, 2017 and 2016, respectively, were past due 90 days or more and interest was still being accrued as principal and interest on such loans have a 98% guarantee by the DOE. The 2% not covered by the DOE guarantee is provided for in the allowance for loan losses.

Other real estate owned consists of assets acquired through or in lieu of foreclosure. $1,503,000 of the $1,788,000 other real estate owned at December 31, 2017, or 84%, relates to loans previously classified as construction loans.

Deposits

The following table gives the composition of our deposits at the dates indicated (dollars in thousands).

	December 31, 2017			December 31, 2016			December 31, 2015		
	Amount	%		Amount	%		Amount	%	
Checking accounts									
Noninterest bearing demand	$ 104,138	25.3	%	$ 92,574	24.2	%	$ 78,282	21.5	%
Interest bearing	48,042	11.7	%	44,390	11.6	%	44,256	12.1	%
Money market accounts	82,523	20.1	%	71,290	18.6	%	64,841	17.8	%
Savings accounts	27,596	6.7	%	26,598	6.9	%	19,403	5.3	%
Time deposits of $250,000 and over	21,592	5.2	%	13,372	3.5	%	9,717	2.7	%

Other time deposits	127,733	31.0 %	135,053	35.2 %	148,349	40.6 %
Total	$ 411,624	100.0 %	$ 383,277	100.0 %	$ 364,848	100.0 %

Total deposits have increased steadily over the last three years by 7.4%, 5.1% and 3.7% in 2017, 2016 and 2015, respectively. All of this growth occurred in low cost relationship deposits (checking, money market and savings) which increased by $27.4 million, or 11.7%, from 2016 to 2017, and by $28.1 million, or 13.6%, from 2015 to 2016. This growth is a result of our focus on building customer relationships that provide lower cost deposits. The cost of deposits declined from .084% for 2015 to .082% for 2016 and to 0.80% for 2017. Higher cost time deposits declined as a percentage of total deposits from 43.3% at December 31, 2015 to 38.7% at December 31, 2016 and to 36.2% at December 31, 2017.

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

The following table is a schedule of average balances and average rates paid for each deposit category for the periods presented (dollars in thousands).

	Year Ended December 31,					
	2017		2016		2015	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing demand accounts	$94,618		$82,678		$75,127	
Interest-bearing deposits						
Interest checking accounts	45,986	0.18%	42,783	0.18%	43,450	0.18%
Money market accounts	78,492	0.39%	68,817	0.37%	67,796	0.37%
Savings accounts	22,530	0.17%	20,119	0.18%	20,282	1.80%
Other time deposits	152,341	1.29%	158,203	1.26%	163,956	1.29%
Total interest-bearing deposits	299,349	0.80%	289,922	0.82%	295,484	0.84%
Total average deposits	$393,967		$372,600		$370,611	

With short-term interest rates remaining at historic lows throughout the last few years, we were able to significantly reduce the interest rates paid on deposits, particularly on longer term certificates of deposit, as higher rate certificates of deposit matured in 2017, 2016 and 2015.

The following table is a schedule of maturities for time deposits of $100,000 or more at December 31, 2017 (in thousands).

Due within three months	$8,318
Due after three months through six months	9,386
Due after six months through twelve months	22,616
Over twelve months	40,405
	$80,725

The Dodd-Frank Act permanently raises the current standard maximum deposit insurance amount to $250,000. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category.

Borrowings

We utilize borrowings to supplement deposits to address funding or liability duration needs. For more financial data and other information about borrowings refer to Note 8 “Borrowings” in the “Notes to Consolidated Financial Statements” contained in Item 8 of this Form 10-K.

Off-balance sheet arrangements

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. For more financial data and other information about loans refer to Note 12 “Commitments and Contingencies” in the “Notes to Consolidated Financial Statements” contained in Item 8 of this Form 10-K.

Capital resources

Shareholders’ equity at December 31, 2017 was $39,334,000, compared to $43,614,000 at December 31, 2016 and $30,359,000 at December 31, 2015. The $4,280,000 decrease in shareholders’ equity in 2017 is primarily due to the reduction in the corporate tax rate. On December 22, 2017, the President signed into law the Tax Reform Act. The Tax Reform Act includes a number of changes in existing tax law impacting businesses. One of the most significant changes is a permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction took effect on January 1, 2018. GAAP requires companies to re-value their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment.

The $13,254,000 increase in shareholders' equity in 2016 is primarily due to net income for the year of $13,513,000, which includes the reversal of the $11,977,000 valuation allowance previously recorded against the net deferred tax asset, offset by dividends on preferred stock of $737,000.

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

	December 31, 2017	2016
Tier 1 capital		
Total bank equity capital	$44,748	$50,231
Net unrealized loss on available-for-sale securities	401	181
Defined benefit postretirement plan	51	60
Dissallowed deferred tax asset	(2,935)	(4,619)
Disallowed intangible assets	-	(1)
Total Tier 1 capital	42,265	45,852
Tier 2 capital		
Allowance for loan losses	3,239	3,373
Total Tier 2 capital	3,239	3,373
Total risk-based capital	45,504	49,225
Risk-weighted assets	$353,349	$321,166
Average assets	$460,556	$438,069
Capital ratios		
Leverage ratio (Tier 1 capital to average assets)	9.18 %	10.47 %
Common equity tier 1 capital ratio (CET 1)	11.96 %	14.28 %
Tier 1 capital to risk-weighted assets	11.96 %	14.28 %
Total capital to risk-weighted assets	12.88 %	15.33 %
Equity to total assets	9.42 %	11.37 %

For more financial data and other information about capital resources refer to Note 13 "Shareholders' Equity and Regulatory Matters" and Note 15 "Trust Preferred Securities" in the "Notes to Consolidated Financial Statements" contained in Item 8 of this Form 10-K.

Liquidity

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At December 31, 2017 and 2016, our liquid assets, consisting of cash, cash equivalents and investment securities available for sale, totaled $67,521,000 and $55,690,000, or 14.2% and 12.5% of total assets, respectively. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. There were no securities pledged as collateral on borrowings as of December 31, 2017.

Our holdings of liquid assets plus the ability to maintain and expand our deposit base and borrowing capabilities serve as our principal sources of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain two federal funds lines of credit with correspondent banks totaling $15 million for which there were no borrowings against the lines at December 31, 2017.

We are also a member of the FHLB, from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the Bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at December 31, 2017 was $8.5 million, based on the Bank's qualifying collateral available to secure any future borrowings. However, we are able to pledge additional collateral to the FHLB in order to increase our available borrowing capacity up to 25% of assets. Liquidity provides us with the ability to meet normal deposit withdrawals, while also providing for the credit needs of customers. We are committed to maintaining liquidity at a level sufficient to protect depositors, provide for reasonable growth, and fully comply with all regulatory requirements.

At December 31, 2017, we had commitments to originate $83,998,000 of loans. Fixed commitments to incur capital expenditures were approximately $275,000 at December 31, 2017. Certificates of deposit scheduled to mature or reprice in the 12-month period ending December 31, 2017 total $74,225,000. We believe that a significant portion of such deposits will remain with us. We further believe that deposit growth, loan repayments and other sources of funds will be adequate to meet our foreseeable short-term and long-term liquidity needs.

Interest Rate Sensitivity

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

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

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

Critical Accounting Policies and Estimates

General

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

The more critical accounting and reporting policies include the Company's accounting for the allowance for loan losses, real estate acquired in settlement of loans, and income taxes. The Company's accounting policies are fundamental to understanding the Company's consolidated financial position and consolidated results of operations. Accordingly, the Company's significant accounting policies are discussed in detail in Note 1 "Summary of Significant Accounting Policies" in the "Notes to Consolidated Financial Statements" contained in Item 8 of this Form 10-K.

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

Allowance for loan losses

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

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

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

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

Troubled debt restructurings

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

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

Real estate acquired in settlement of loans

Real estate acquired in settlement of loans represents properties acquired through foreclosure or physical possession. Write-downs to fair value of foreclosed assets less estimate costs to sell at the time of transfer are charged to allowance for loan losses. Subsequent to foreclosure, the Company periodically evaluates the value of foreclosed assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. If fair value declines subsequent to foreclosure a valuation allowance is recorded through expense. Operating costs after acquisition are expensed as incurred. The valuation allowance was $281,000 and $612,000 at December 31, 2017 and 2016, respectively. Fair value is based on an assessment of information available at the end of a reporting period and depends upon a number of factors, including historical experience, economic conditions, and issues specific to individual properties. The evaluation of these factors involves subjective estimates and judgments that may change.

Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established. Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if management projects lower levels of future taxable income. Management determined that as of December 31, 2015, the objective negative evidence represented by the Company's recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance for all of the net deferred tax asset that is dependent on future earnings of the Company of approximately $11,807,000.

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

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

There was an $11,172,000 income tax benefit recorded for the year ended December 31, 2016 compared to no tax expense for the year ended December 31 2015. The income tax benefit in 2016 was primarily due to the reversal of an $11,997,000 valuation allowance previously recorded against the net deferred tax asset. This valuation allowance was first recorded in the fourth quarter of 2011 due to the uncertainty of whether or not the Company would be able to realize the asset.

New accounting standards

For information regarding recent accounting pronouncements and their effect on us, see “New Accounting Pronouncements” in Note 1 “Summary of Significant Accounting Policies” in the “Notes to Consolidated Financial Statements” contained in Item 8 of this Form 10-K.

Impact of inflation and changing prices

The Company’s financial statements included herein have been prepared in accordance with GAAP, which require the Company to measure financial position and operating results primarily in terms of historical dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Company is reflected in increased operating costs. In management’s opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Company, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements and related footnotes of the Company are presented following.

Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors

Village Bank and Trust Financial Corp.

Midlothian, Virginia

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Village Bank and Trust Financial Corp. (the "Company") and Subsidiary as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2017, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company and subsidiaries at December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2017**,** in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP

We have served as the Company's auditor since 1999.

Richmond, Virginia

March 30, 2018

Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Balance Sheets
December 31, 2017 and 2016
(in thousands, except share data)

	2017	2016
Assets		
Cash and due from banks	$17,810	$10,848
Federal funds sold	-	948
Total cash and cash equivalents	17,810	11,796
Investment securities available for sale	49,711	43,894
Loans held for sale	8,047	14,784
Loans		
Outstandings	368,709	337,100
Allowance for loan losses	(3,239)	(3,373)
Deferred fees and costs, net	699	660
Total loans, net	366,169	334,387
Other real estate owned, net of valuation allowance	1,788	2,926
Assets held for sale	610	841
Premises and equipment, net	12,982	12,758
Bank owned life insurance	7,268	7,093
Accrued interest receivable	2,600	2,274
Other assets	9,989	14,049
	$476,974	$444,802
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing demand	$104,138	$92,574
Interest bearing	307,486	290,703
Total deposits	411,624	383,277
Federal Home Loan Bank advances	12,300	2,400
Long-term debt - trust preferred securities	8,764	8,764
Other borrowings	1,584	81
Accrued interest payable	93	70
Other liabilities	3,275	6,596
Total liabilities	437,640	401,188
Shareholders' equity		
Preferred stock, $4 par value, $1,000 liquidation preference, 1,000,000 shares authorized; 5,027 shares issued and outstanding at December 31, 2017 and 5,715 shares issued and outstanding at December 31, 2016	20	23
Common stock, $4 par value - 10,000,000 shares authorized; 1,430,751 shares issued and outstanding at December 31, 2017 and 1,428,261 shares issued and outstanding at December 31, 2016	5,672	5,629

Additional paid-in capital	58,055	58,643
Accumulated deficit	(24,693)	(21,172)
Common stock warrant	732	732
Stock in directors rabbi trust	(1,010)	(1,034)
Directors deferred fees obligation	1,010	1,034
Accumulated other comprehensive loss	(452)	(241)
Total shareholders' equity	39,334	43,614
	$476,974	$444,802

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Operations
Years Ended December 31, 2017, 2016 and 2015
(in thousands, except per share data)

	2017	2016	2015
Interest income			
Loans	$16,407	$15,563	$14,833
Investment securities	751	355	616
Federal funds sold	140	71	55
Total interest income	17,298	15,989	15,504
Interest expense			
Deposits	2,401	2,367	2,481
Borrowed funds	320	242	386
Total interest expense	2,721	2,609	2,867
Net interest income	14,577	13,380	12,637
Provision for (recovery of) loan losses	-	-	(2,000)
Net interest income after provision for (recovery of) loan losses	14,577	13,380	14,637
Noninterest income			
Service charges and fees	2,408	2,459	2,520
Gain on sale of loans	5,415	6,430	6,076
Gain on sale of asset held for sale	-	504	-
Gain (loss) on sale of investment securities	(81)	162	6
Rental income	-	582	1,105
Other	364	713	351
Total noninterest income	8,106	10,850	10,058
Noninterest expense			
Salaries and benefits	12,081	11,295	10,846
Commissions	1,526	1,606	1,555
Occupancy	1,133	1,470	1,730
Equipment	757	762	765
Write down of assets held for sale	231	220	2,649
Cease use lease obligation	(125)	252	-
Supplies	244	265	278
Professional and outside services	2,994	2,999	2,930
Advertising and marketing	340	355	325
Foreclosed assets, net	(292)	393	153
FDIC insurance premium	297	292	916
Other operating expense	2,026	1,980	1,902
Total noninterest expense	21,212	21,889	24,049
Income before income tax expense (benefit)	1,471	2,341	646

Income tax expense (benefit)	4,567	(11,172)	-
Net income (loss)	(3,096)	13,513	646
Preferred stock dividends and amortization of discount	(498)	(737)	(674)
Preferred stock principal forgiveness	-	-	4,404
Preferred stock dividend forgiveness	-	-	2,215
Net income (loss) available to common shareholders	$(3,594)	$12,776	$6,591
Earnings (loss) per share, basic	$(2.55)	$8.99	$5.65
Earnings (loss) per share, diluted	$(2.55)	$8.99	$5.49

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Comprehensive Income (Loss)
Years Ended December 31, 2017, 2016 and 2015
(in thousands)

	2017	2016	2015
Net income (loss)	$(3,096)	$13,513	$646
Other comprehensive income (loss)			
Unrealized holding gains (losses) arising during the period	(266)	552	317
Tax effect	(55)	188	108
Net change in unrealized holding gains (losses) on securities available for sale, net of tax	(211)	364	209
Reclassification adjustment			
Reclassification adjustment for (gains) losses realized in net income (loss)	81	(162)	(6)
Tax effect	17	(55)	(2)
Reclassification for (gains) losses included in net income (loss), net of tax	64	(107)	(4)
Minimum pension adjustment	14	14	14
Tax effect	5	5	5
Minimum pension adjustment, net of tax	9	9	9
Total other comprehensive income (loss)	(138)	266	214
Total comprehensive income (loss)	$(3,234)	$13,779	$860

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Shareholders' Equity
Years Ended December 31, 2017, 2016 and 2015
(in thousands)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Warrant	Stock in Directors Rabbi Trust	Directors Deferred Fees Obligation	Accumulated Other Comprehensive Income (loss)	Total
Balance, December 31, 2014	$ 59	$ 1,339	$ 58,188	$ (40,539)	$ 732	$ (878)	$ 878	$ (721)	$ 19,058
Preferred stock dividend	-	-	-	(674)	-			-	(674)
Restricted stock issuance	-	16	(95)	-	-	(156)	156	-	(79)
Issuance of common stock, net of offering expense of $1,200	-	2,875	5,842	-	-	-	-	-	8,717
Preferred stock exchanged for common stock	(18)	1,332	(1,314)	-	-	-	-	-	-
Preferred stock principal forgiveness	(18)	-	(4,386)	4,404	-	-	-	-	-
Preferred stock dividend forgiveness	-	-	-	2,215	-	-	-	-	2,215
Stock based compensation	-	-	262	-	-			-	262
Minimum pension adjustment (net of income taxes of $5)	-	-	-	-	-			9	9
Net income	-	-	-	646	-			-	646
Change in unrealized gain on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	-	205	205
Balance, December 31, 2015	23	5,562	58,497	(33,948)	732	(1,034)	1,034	(507)	30,359
Preferred stock dividend	-	-	-	(737)	-				(737)
Restricted stock issuance		67	(67)	-	-	-	-		-
Stock based compensation	-	-	213	-	-	-	-	-	213
Minimum pension adjustment (net of	-	-	-	-	-	-	-	9	9

income taxes of $5)									
Net income	-	-	-	13,513	-	-	-	-	13,513
Change in unrealized gain on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	-	257	257
Balance, December 31, 2016	$ 23	$ 5,629	$ 58,643	$ (21,172)	$ 732	$ (1,034)	$ 1,034	$ (241)	$ 43,614
Preferred stock redemption	(3)	-	(685)	-	-	-	-	-	(688)
Preferred stock dividend	-	-	-	(498)	-	-	-	-	(498)
Ristricted stock redemption	-	-	-	-	-	24	(24)	-	-
Issuance of common stock	-	43	(43)	-	-	-	-	-	-
Stock based compensation	-	-	140	-	-	-	-	-	140
Minimum pension adjustment (net of income taxes of $5)	-	-	-	-	-	-	-	9	9
Net loss	-	-	-	(3,096)	-	-	-	-	(3,096)
Reclassification due to the adoption of ASU 2018-02	-	-	-	73	-	-	-	(73)	-
Change in unrealized loss on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	-	(147)	(147)
Balance, December 31, 2017	$ 20	$ 5,672	$ 58,055	$ (24,693)	$ 732	$ (1,010)	$ 1,010	$ (452)	$ 39,334

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Cash Flows
Years Ended December 31, 2017, 2016 and 2015
(in thousands)

	2017	**2016**	**2015**
Cash Flows from Operating Activities			
Net income (loss)	$(3,096)	$13,513	$646
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	742	765	843
Deferred income taxes	385	813	277
Valuation allowance (recovery) on net deferred tax asset	-	(11,997)	(277)
Write-off of deferred tax assets	4,181		
Provision for (recovery of) loan losses	-	-	(2,000)
Write-down of other real estate owned	20	624	690
Valuation allowance other real estate owned	162	(393)	(35)
Write-down of assets held for sale	20	220	2,649
(Gain) loss on securities sold	81	(162)	(6)
Gain on loans sold	(5,415)	(6,430)	(6,076)
Gain on sale of assets held for sale	-	(504)	-
Loss on sale and disposal of premises and equipment	-	2	12
Gain on sale of other real estate owned	(380)	(15)	(862)
Stock compensation expense	140	213	262
Proceeds from sale of mortgage loans	170,539	218,627	208,479
Origination of mortgage loans for sale	(158,387)	(212,608)	(206,862)
Amortization of premiums and accretion of discounts on securities, net	95	142	287
Increase in interest receivable	(326)	(214)	(688)
Increase in bank owned life insurance	(175)	(185)	(183)
Income recognized from death benefit on bank owned life insurance	-	(226)	-
Decrease (increase) in other assets	(213)	2,660	(190)
Increase (decrease) in interest payable	23	(1,276)	179
(Decrease) increase in other liabilities	(562)	(2,257)	505
Net cash provided by (used in) operating activities	7,834	1,312	(2,350)
Cash Flows from Investing Activities			
Purchases of available for sale securities	(18,366)	(27,822)	(6,748)
Proceeds from the sale of available for sale securities	9,949	21,041	7,566
Proceeds from maturities, calls and paydowns of available for sale securities	2,204	1,216	836
Proceeds from the sale of assets held for sale	-	7,338	-
Net increase in loans	(32,067)	(26,169)	(21,181)
Proceeds from bank owned life insurance death benefit	-	448	-
Proceeds from sale of other real estate owned	1,621	3,680	7,037
Purchases of premises and equipment	(966)	(912)	(1,080)
Net cash used in investing activities	(37,625)	(21,180)	(13,570)

Cash Flows from Financing Activities			
Issuance of common stock	-	-	(79)
Net proceeds from sale of common stock	-	-	8,965
Redemption of preferred stock	(688)	-	-
Payment of preferred dividends	(3,257)	-	-
Net increase (decrease) in deposits	28,347	18,429	(14,012)
Net increase (decrease) in Federal Home Loan Bank advances	9,900	(3,600)	(8,000)
Net increase (decrease) in other borrowings	1,503	(427)	(2,794)
Net cash provided by (used in) financing activities	35,805	14,402	(15,920)
Net increase (decrease) in cash and cash equivalents	6,014	(5,466)	(31,840)
Cash and cash equivalents, beginning of period	11,796	17,262	49,103
Cash and cash equivalents, end of period	$17,810	$11,796	$17,263
Supplemental Disclosure of Cash Flow Information			
Cash payments for interest	$2,698	$3,233	$2,688
Supplemental Schedule of Non Cash Activities			
Real estate owned assets acquired in settlement of loans	$285	$268	$461
Assets moved to held for sale	$-	$-	$831
Accrual of additions on held for sale	$-	$-	$547
Bank financed sale of asset held for sale	$-	$4,912	$-
Dividends on preferred stock accrued	$57	$737	$674
Non-Cash conversion of preferred shares	$-	$-	$4,619
Forgiveness of principal and accrued dividends	$-	$-	$6,619

See accompanying notes to consolidated financial statements.

Village Bank and Trust Financial Corp. and Subsidiary

Notes to Consolidated Financial Statements

Years Ended December 31, 2017, 2016 and 2015

Note 1. Summary of Significant Accounting Policies

The accounting and reporting policies of Village Bank and Trust Financial Corp. and subsidiary (the “Company”) conform to accounting principles generally accepted in the United States of America (“GAAP”) and to general practice within the banking industry. The following is a description of the more significant of those policies:

Business

The Company is the holding company of Village Bank (the “Bank”). The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. In 2017, the Bank entered a new market by opening a branch in Williamsburg, Virginia. Village Bank Mortgage Corporation (“Village Mortgage”) is a full service mortgage banking company wholly-owned by the Bank.

The Bank is subject to regulations of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities. As a consequence of the extensive regulation of commercial banking activities, the Bank’s business is susceptible to being affected by state and federal legislation and regulations.

The majority of the Company’s real estate loans are collateralized by properties in the Richmond, Virginia metropolitan area. Accordingly, the ultimate collectability of those loans collateralized by real estate is particularly susceptible to changes in market conditions in the Richmond area.

Basis of presentation and consolidation

The consolidated financial statements include the accounts of the Company, the Bank and Village Mortgage. All material intercompany balances and transactions have been eliminated in consolidation.

Use of estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the balance sheets dates and revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change include the determination of the allowance for loan losses and its related provision, and the estimate of the fair value of assets held for sale.

Investment securities

At the time of purchase, debt securities are classified into the following categories: held to maturity, available for sale or trading. Debt securities that the Company has both the positive intent and ability to hold to maturity are classified as held to maturity. Held to maturity securities are stated at amortized cost adjusted for amortization of premiums and accretion of discounts on purchase using a method that approximates the effective interest method. Investments classified as trading or available for sale are stated at fair value. Changes in fair value of trading investments are included in current earnings while changes in fair value of available for sale investments are excluded from current earnings and reported, net of taxes, as a separate component of other comprehensive income. Presently, the Company does not maintain a portfolio of trading securities or held to maturity.

The fair value of investment securities held to maturity and available for sale is estimated based on quoted prices for similar assets determined by bid quotations received from independent pricing services. Declines in the fair value of securities below their amortized cost that are other than temporary are reflected in earnings or other comprehensive income, as appropriate. For those debt securities whose fair value is less than their amortized cost basis, we consider our intent to sell the security, whether it is more likely than not that we will be required to sell the security before recovery and if we do not expect to recover the entire amortized cost basis of the security. In analyzing an issuer's financial condition, we may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred and the results of reviews of the issuer's financial condition.

Interest income is recognized when earned. Realized gains and losses for securities classified as available-for-sale and held-to-maturity are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Loans held for sale

The Company, through the Bank's mortgage banking subsidiary, Village Mortgage, originates residential mortgage loans for sale in the secondary market. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an aggregate basis as determined by outstanding commitments from investors. Upon entering into a commitment to originate a loan, the Company locks in the loan and rate with an investor and commits to deliver the loan if settlement occurs on a best efforts basis, thus limiting interest rate risk. Certain additional risks exist that the investor fails to meet its purchase obligation; however, based on historical performance and the size and nature of the investors the Company does not expect them to fail to meet their obligation. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Residential mortgage loans held for sale are sold to the permanent investor with the mortgage servicing rights released. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold. Gains on the sale of loans totaling approximately $5,415,000, $6,430,000 and $6,076,000 were realized during the years ended December 31, 2017, 2016 and 2015, respectively.

Once a residential mortgage loan is sold to a permanent investor, the Company has no further involvement or retained interest in the loan. There are limited circumstances in which the permanent investor can contractually require the Company to repurchase the loan. The Company makes no provision for any such recourse related to loans sold as history has shown repurchase of loans under these circumstances has been remote.

The Company, through Village Mortgage, enters into commitments to originate residential mortgage loans in which the interest rate on the loan is determined prior to funding, termed rate lock commitments. Such rate lock commitments on mortgage loans to be sold in the secondary market are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 30 to 45 days. The Company protects itself from changes in interest rates during this period by requiring a firm purchase agreement from a permanent investor before a loan can be closed. As a result, the Company is not exposed to losses nor will it realize gains or losses related to its rate lock commitments due to changes in interest rates.

The fair value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The Company determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the value of the underlying asset while taking into consideration the probability that the rate lock commitments will close. Due to high correlation between rate lock commitments and best efforts contracts, no significant gains or losses have occurred on the rate lock commitments.

At December 31, 2017, Village Mortgage had rate lock commitments to originate mortgage loans aggregating approximately $13,888,000 and loans held for sale of approximately $8,047,000. Village Mortgage has entered into corresponding commitments with third party investors to sell loans of approximately $21,935,000. Under the best efforts contractual relationship with these investors, Village Mortgage is obligated to sell the loans, and the investor is obligated to purchase the loans, only if the loans close. No other obligation exists. As a result of these best efforts contractual relationships with these investors Village Mortgage is not exposed to losses, nor will it realize gains, related to its rate lock commitments due to changes in interest rates.

Transfers of financial assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Bank and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets. Our transfers of financial assets are limited to commercial loan participations sold, which were insignificant for 2017, 2016 and 2015, and the sale of residential mortgage loans in the secondary market; the extent of which are disclosed in the Consolidated Statements of Cash Flows.

Loans

Loans are stated at the principal amount outstanding, net of unearned income. Loan origination fees and certain direct loan origination costs are deferred and amortized to interest income over the life of the loan as an adjustment to the loan’s yield over the term of the loan.

Interest is accrued on outstanding principal balances, unless the Company considers collection to be doubtful. Commercial and unsecured consumer loans are designated as nonaccrual when payment is delinquent 90 days or at the point which the Company considers collection doubtful, if earlier. Mortgage loans and most other types of consumer loans past due 90 days or more may remain on accrual status if management determines that such amounts are collectible. When loans are placed in nonaccrual status, previously accrued and unpaid interest is reversed against interest income in the current period and interest is subsequently recognized only to the extent cash is received as long as the remaining recorded investment in the loan is deemed fully collectible. Loans may be placed back on accrual status when, in the opinion of management, the circumstances warrant such action such as a history of timely payments subsequent to being placed on nonaccrual status, additional collateral is obtained or the borrowers cash flows improve.

Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The total contractual amount of standby letters of credit, whose contract amounts represent credit risk was approximately $4,615,000 at December 31, 2017 and approximately $4,397,000 at December 31, 2016.

Allowance for loan losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is probable. Subsequent recoveries, if any, are credited to the allowance.

The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as changes in the nature and volume of the loan portfolio, current economic conditions which may affect a borrower's ability to repay, overall portfolio quality, and review of specific potential losses. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of general and specific components. The general component covers non-classified loans and is based on historical loss experience and risk characteristics (i.e. trends in delinquencies and other nonperforming loans, changes in economic conditions on both a local and national level, and changes in the categories of loans comprising the loan portfolio) adjusted for qualitative factors. The specific component relates to loans that we have concluded, based on the value of collateral, guarantees and any other pertinent factors, have known losses. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Troubled debt restructurings

A loan or lease is accounted for as a troubled debt restructuring ("TDR") if we, for economic or legal reasons related to the borrower's financial condition, grant a significant concession to the borrower that we would not otherwise consider. A TDR may involve the receipt of assets from the debtor in partial or full satisfaction of the loan or lease, or a modification of terms such as a reduction of the stated interest rate or balance of the loan or lease, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. TDRs generally remain categorized as nonperforming loans and leases until a six-month payment history has been maintained.

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

Real estate acquired in settlement of loans

Real estate acquired through or in lieu of foreclosure is initially recorded at estimated fair value less estimated selling costs. Subsequent to the date of acquisition, it is carried at the lower of cost or fair value, adjusted for net selling costs. If fair value declines subsequent to foreclosure a valuation allowance is recorded through expense. Operating costs after acquisition are expensed as incurred. The valuation allowance was $281,000 and $612,000 at December 31, 2017 and 2016, respectively. Costs relating to the development and improvement of such property are capitalized when appropriate, whereas those costs relating to holding the property are expensed.

Assets held for sale

Assets held for sale at December 31, 2017 and December 31, 2016 included a branch building we previously closed. The Company periodically evaluates the value of assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs.

Premises and equipment

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation of buildings and improvements is computed using the straight-line method over the estimated useful lives of the assets of 39 years. Depreciation of equipment is computed using the straight-line method over the estimated useful lives of the assets ranging from 3 to 7 years. Amortization of premises (leasehold improvements) is computed using the straight-line method over the term of the lease or estimated lives of the improvements, whichever is shorter.

Income taxes

Deferred income taxes are recognized for the tax consequences of “temporary differences” by applying enacted tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The primary temporary differences are the allowance for loan losses and depreciation and amortization. The effect on recorded deferred income taxes of a change in tax laws or rates is recognized in income in the period that includes the enactment date. To the extent that available evidence about the future raises doubt about the realization of a deferred income tax asset, a valuation allowance is established. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. Interest and penalties associated with unrecognized tax benefits are classified as taxes other than income in the statement of income. The Company has no uncertain tax positions.

Consolidated statements of cash flows

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, due from banks (including cash items in process of collection), interest-bearing deposits with banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods. Cash flows from loans originated by the Bank for investment and deposits are reported net. The Company did not pay income taxes in 2017, 2016 and 2015.

Comprehensive income

Comprehensive income is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. Total comprehensive income consists of net income (loss) and other comprehensive income. The Company's other comprehensive income and accumulated other comprehensive income are comprised of unrealized gains and losses on investment securities available for sale and amortization of the unfunded pension liability. At December 31, 2017 and 2016 the accumulated other comprehensive income was comprised of unrealized losses on securities available for sale of $391,000 and $181,000 and unfunded pension liability of $61,000 and $60,000 net of tax, respectively.

Earnings per common share

Basic earnings (loss) per common share represent net income available to common shareholders, which represents net income (loss) less dividends paid or payable to preferred stock shareholders, divided by the weighted-average number of common shares outstanding during the period. For diluted earnings per common share, net income available to common shareholders is divided by the weighted average number of common shares issued and outstanding for each period plus amounts representing the dilutive effect of stock options, restricted stock, and warrants, as well as any adjustment to income that would result from the assumed issuance. The effects of stock options, restricted stock, and warrants are excluded from the computation of diluted earnings per common share in periods in which the effect would be antidilutive. Stock options, restricted stock, and warrants are antidilutive if the underlying average market price of the stock that can be purchased for the period is less than the exercise price of the option or warrant. Potential common shares that may be issued by the Company relate solely to outstanding stock options, restricted stock, and warrants and are determined using the treasury stock method.

Stock incentive plan

On May 26, 2015, the Company's shareholders approved the adoption of the Village Bank and Trust Financial Corp. 2015 Stock Incentive Plan (the "2015 Plan") authorizing the issuance of up to 60,000 shares of common stock. The 2015 Plan was adopted to replace the Company's 2006 stock incentive plan (the "2006 Plan") and any new awards will be made pursuant to the 2015 Plan. The prior awards made under the 2006 Plan were unchanged by the adoption of the 2015 Plan and continue to be governed by the terms of the 2006 Plan. See Note 14 for more information on the stock incentive plans.

Fair values of financial instruments

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are independent, knowledgeable, able to transact and willing to transact. See Note 17 for the methods and assumptions the Bank uses in estimating fair values of financial instruments.

Insurance of accounts, assessments and regulation by the FDIC

Our deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to the limits set forth under applicable law, currently $250,000. We are subject to the deposit insurance assessments of the Deposit Insurance Fund ("DIF"). The amount of the assessment is a function of the institution's risk category, of which there are four, and its assessment base. An institution's risk category is determined according to its supervisory ratings and capital levels and is used to determine the institution's assessment rate. The assessment base is an institution's average consolidated total assets less its average tangible equity.

The FDIC is authorized to prohibit any DIF-insured institution from engaging in any activity that the FDIC determines by regulation or order to pose a serious threat to the respective insurance fund. Also, the FDIC may initiate enforcement actions against banks, after first giving the institution's primary regulatory authority an opportunity to take such action. The FDIC may terminate the deposit insurance of any depository institution if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed in writing by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution has no tangible capital. If deposit insurance is terminated, the deposits at the institution at the time of termination, less subsequent withdrawals, shall continue to be insured for a period from six months to two years, as determined by the FDIC. We are aware of no existing circumstances that could result in termination of our deposit insurance.

Segments

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

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

New accounting pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers: Topic 606." This ASU revised guidance for the recognition, measurement, and disclosure of revenue from contracts with customers. The original guidance has been amended through subsequent accounting standard updates that resulted in technical corrections, improvements, and a one-year deferral of the effective date to January 1, 2018. The guidance, as amended, is applicable to all entities and will replace significant portions of existing industry and transaction-specific revenue recognition rules with a more principles-based recognition model. Most revenue associated with financial instruments, including interest income, loan origination fees, and credit card fees, is outside the scope of the guidance. Gains and losses on investment securities, derivatives, and sales of financial instruments are similarly excluded from the scope. Entities can elect to adopt the guidance either on a full or modified retrospective basis. Full retrospective adoption will require a cumulative effect adjustment to retained earnings as of the beginning of the earliest comparative period presented. Modified retrospective adoption will require a cumulative effect adjustment to retained earnings as of the beginning of the reporting period in which the entity first applies the new guidance. The Company has adopted this guidance as of the effective date, January 1, 2018, via the modified retrospective approach. The Company has completed its assessment of the adoption of this ASU, noting the standard will result in expanded disclosures related to non-interest income and enhance the qualitative disclosures on the revenues within the scope of the new guidance. The Company has concluded the adoption of this accounting guidance will not have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." This ASU requires an entity to: (i) measure equity investments at fair value through net income, with certain exceptions; (ii) present in Other Comprehensive Income the changes in instrument-specific credit risk for financial liabilities measured using the fair value option; (iii) present financial assets and financial liabilities by measurement category and form of financial asset; (iv) calculate the fair value of financial instruments for disclosure purposes based on an exit price and; (v) assess a valuation allowance on deferred tax assets related to unrealized losses of AFS debt securities in combination with other deferred tax assets. The ASU provides an election to subsequently measure certain nonmarketable equity investments at cost less any impairment and adjusted for certain observable price changes. The ASU also requires a qualitative impairment assessment of such equity investments and amends certain fair value disclosure requirements. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is only permitted for the provision related to instrument-specific credit risk. The Company does not expect ASU 2016-01 to have a material impact on the Company's financial position, results of operations, or cash flows.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842)”. This ASU requires lessees to recognize assets and liabilities arising from most operating leases on the statement of financial position. ASU 2016-02 will be effective for the Company for the fiscal years beginning after December 15, 2018 with early adoption permitted. The Company has determined that the provisions of ASU-2016-02 may result in an increase in assets to recognize the present value of the lease obligations with a corresponding increase in liabilities, however, the Company does not expect this to have a material impact on the Company’s financial position, results of operations or cash flows.

In March 2016, the FASB issued ASU No. 2016-09, "Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." This ASU simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The Company has concluded the adoption of ASU No. 2016-09 has not had a material impact on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." This ASU amends guidance on reporting credit losses for assets held at amortized cost basis and available-for-sale debt securities by eliminating the probable initial recognition threshold (incurred loss methodology) and requiring entities to reflect its current estimate of all expected credit losses. The amendments in the ASU are effective beginning after December 15, 2019 and for interim periods within that year. Early adoption is permitted beginning after December 15, 2018. Entities will apply the amendments in this ASU through a cumulative-effect adjustment to retained earnings in the first period effective. While the Company is currently evaluating the provisions of ASU No. 2016-13 to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements, it has taken steps to prepare for the implementation when it becomes effective, such as forming an internal task force, gathering pertinent data, consulting with outside professionals, and evaluating its current IT systems. This guidance may result in material changes in the Company's accounting for credit losses on financial instruments

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Payments (a consensus of Merging Issues Task Force)." This ASU attempts to clarify how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The purpose of this update is to reduce existing diversity in practice in eight areas addressed by the update. The amendment will be effective for the Company for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company has concluded the adoption of ASU No. 2016-15 will not have a material impact on its consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-08, "Receivables – Nonrefundable Fees and Other Cost (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities." These amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company does have exposure and is assessing the impact of ASU 2017-08, and may choose early adoption. Overall, the Company does not expect it to have a material impact on its accounting.

In May 2017, the FASB issued ASU No. 2017-09, "Scope of Modification Accounting." The amendment clarifies Topic 718, *Compensation – Stock Compensation*, such that an entity must apply modification accounting to changes in the terms or conditions of a share-based payment award unless all of the following criteria are met: (1) the fair value of the modified award is the same as the fair value of the original award immediately before the modification, provided that the ASU indicates that if the modification does not affect any of the inputs to the valuation technique used to value the award, the entity is not required to estimate the value immediately before and after the modification; (2) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the modification; and (3) the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the modification. The ASU is effective for all entities for fiscal years beginning after December 15, 2017, including interim periods within those years. The Company has concluded the adoption of ASU No. 2017-09 will not have a material impact on its consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, “Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income”, to address a narrow-scope financial reporting issue that arose as a consequence of the change in the tax law. On December 22, 2017 the U.S. federal government enacted the Tax Cuts and Jobs Act of 2017 (“Tax Act”). ASU No. 2018-02 permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the new federal corporate income tax rate under the Tax Act. The amount of the reclassification would be the difference between the historical corporate income tax rate of 35% and the newly enacted 21% corporate income tax rate. This ASU is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years with early adoption permitted, including adoption in any interim period, for (i) public business entities for reporting periods for which financial statements have not yet been issued and (ii) all other entities for reporting periods for which financial statements have not yet been made available for issuance. The changes are required to be applied retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Act is recognized. The Corporation's early adoption of ASU No. 2018-02 resulted in the reclassification from accumulated other comprehensive income (loss) to retained earnings of $73,000, reflected in the Consolidated Statements of Changes in Shareholders' Equity.

Note 2. Investment Securities Available for Sale

The amortized cost and estimated fair value of investment securities available for sale as of December 31, 2017 and 2016 are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2017				
U.S. Government agencies	$ 23,976	$ -	$ (293)	$ 23,683
Mortgage-backed securities	22,127	1	(188)	21,940
Corporate debt	4,103	11	(26)	4,088
	$ 50,206	$ 12	$ (507)	$ 49,711
December 31, 2016				
U.S. Government agencies	$ 32,475	$ -	$ (229)	$ 32,246
Mortgage-backed securities	11,694	1	(47)	11,648
	$ 44,169	$ 1	$ (276)	$ 43,894

There were no investment securities pledged to secure deposit repurchase agreements at December 31, 2017 and approximately $1,050,000 at December 31, 2016.

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Gross realized gains and losses pertaining to available for sale securities are detailed as follows for the years ending December 31, 2017, 2016 and 2015 (in thousands):

	December 31,		
	2017	2016	2015
Gross realized gains	$-	$162	$ 13
Gross realized losses	(81)	-	(7)
	$(81)	$162	$ 6

The Company sold approximately $10 million, $22 million and $8 million of investment securities available for sale at a loss of $81,000 in 2017 and a gain of $162,000 and $6,000 in 2016 and 2015, respectively. The sale of these securities, which had fixed interest rates, allowed the Company to decrease its exposure to the anticipated upward movement in interest rates that would result in unrealized losses being recognized in shareholders' equity.

Investment securities available for sale that have an unrealized loss position at December 31, 2017 and December 31, 2016 are detailed below (in thousands):

	Securities in a loss position for less than 12 Months		Securities in a loss position for more than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2017						
US Government Agencies	$ 6,153	$ (76)	$ 17,530	$ (217)	$23,683	$ (293)
Mortgage-backed securities	20,227	(160)	1,651	(28)	21,878	(188)
Corporate debt	1,021	(26)	-	-	1,021	(26)
	$ 27,401	$ (262)	$ 19,181	$ (245)	$46,582	$ (507)
December 31, 2016						
US Government Agencies	$ 27,291	$ (213)	$ 2,852	$ (16)	$33,143	$ (229)
Mortgage-backed securities	9,450	(47)	-	-	9,450	(47)
	$ 36,741	$ (260)	$ 2,852	$ (16)	$42,593	$ (276)

All of the unrealized losses are attributable to increases in interest rates and not to credit deterioration. Currently, the Company believes that it is probable that the Company will be able to collect all amounts due according to the contractual terms of the investments. Because the decline in market value is attributable to changes in interest rates and not to credit quality, and because it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other than temporarily impaired at December 31, 2017.

The amortized cost and estimated fair value of investment securities available for sale as of December 31, 2017, by contractual maturity, are as follows (in thousands):

	Amortized Cost	Estimated Fair Value
One to five years	$ 21,561	$ 21,285
Five to ten years	7,575	7,517
More than ten years	21,070	20,909
Total	$ 50,206	$ 49,711

Note 3. Loans

Loans classified by type as of December 31, 2017 and 2016 are as follows (in thousands):

	2017	2016
Construction and land development		
Residential	$5,361	$6,770
Commercial	25,456	27,092
	30,817	33,862
Commercial real estate		
Owner occupied	85,004	66,021
Non-owner occupied	70,845	57,944
Multifamily	9,386	8,824
Farmland	270	310
	165,505	133,099
Consumer real estate		
Home equity lines	22,849	20,691
Secured by 1-4 family residential,		
First deed of trust	57,919	54,791
Second deed of trust	7,460	5,768
	88,228	81,250
Commercial and industrial loans (except those secured by real estate)	36,506	39,390
Guaranteed student loans	45,805	47,398
Consumer and other	1,848	2,101
Total loans	368,709	337,100
Deferred loan cost, net	699	660
Less: allowance for loan losses	(3,239)	(3,373)

	$366,169	$334,387

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

Loans pledged as collateral with the Federal Home Loan Bank of Atlanta ("FHLB") as part of their lending arrangements with the Company totaled $29,615,000 and $27,073,000 as of December 31, 2017 and 2016, respectively.

The following is a summary of loans directly or indirectly with executive officers or directors of the Company for the years ended December 31, 2017 and 2016 (in thousands):

	2017	2016
Beginning balance	$7,711	$8,073
Additions	5,793	2,703
Reductions	(4,547)	(3,065)
Ending balance	$8,957	$7,711

Executive officers and directors also had unused credit lines totaling $2,590,000 and $3,219,000 at December 31, 2017 and 2016, respectively. All loans and credit lines to executive officers and directors were made in the ordinary course of business at the Company's normal credit terms, including interest rate and collateralization prevailing at the time for comparable transactions with other persons.

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

Year-end nonaccrual loans segregated by type as of December 31, 2017 and 2016 were as follows (in thousands):

	2017	2016
Construction and land development		
Commercial	$43	$102
	43	102
Commercial real estate		
Owner occupied	183	225
	183	225
Consumer real estate		
Home equity lines	135	163
Secured by 1-4 family residential,		
First deed of trust	1,000	1,404

Second deed of trust	67	72
	1,202	1,639
Commercial and industrial loans (except those secured by real estate)	870	430
Consumer and other	22	6
Total loans	$2,320	$2,402

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

- Risk rated 1 to 4 loans are considered of sufficient quality to preclude an adverse rating. These assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
- Risk rated 5 loans are defined as having potential weaknesses that deserve management's close attention;
- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any; and
- Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

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

	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	Total Loans
December 31, 2017					
Construction and land development					
Residential	$ 5,361	$ -	$ -	$ -	$ 5,361
Commercial	24,305	1,108	43	-	25,456
	29,666	1,108	43	-	30,817
Commercial real estate					
Owner occupied	78,791	2,716	3,497	-	85,004
Non-owner occupied	70,845	-	-	-	70,845
Multifamily	9,210	176	-	-	9,386
Farmland	270	-	-	-	270
	159,116	2,892	3,497	-	165,505
Consumer real estate					
Home equity lines	21,777	932	140	-	22,849
Secured by 1-4 family residential					
First deed of trust	53,591	2,637	1,691	-	57,919
Second deed of trust	7,140	181	139	-	7,460
	82,508	3,750	1,970	-	88,228
Commercial and industrial loans (except those secured by real estate)	35,143	139	529	695	36,506
Guaranteed student loans	45,805	-	-	-	45,805
Consumer and other	1,826	4	18	-	1,848
Total loans	$ 354,064	$ 7,893	$ 6,057	$ 695	$ 368,709

	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	Total Loans
December 31, 2016					
Construction and land development					
Residential	$ 6,770	$ -	$ -	$ -	$ 6,770
Commercial	25,342	1,648	102	-	27,092
	32,112	1,648	102	-	33,862
Commercial real estate					
Owner occupied	58,788	3,565	3,668	-	66,021
Non-owner occupied	57,944	-	-	-	57,944
Multifamily	8,634	190	-	-	8,824
Farmland	310	-	-	-	310
	125,676	3,755	3,668	-	133,099
Consumer real estate					

Home equity lines	19,501	487	703	-	20,691
Secured by 1-4 family residential					
First deed of trust	49,648	2,847	2,296	-	54,791
Second deed of trust	5,399	125	244	-	5,768
	74,548	3,459	3,243	-	81,250
Commercial and industrial loans (except those secured by real estate)	39,390			-	39,390
Guaranteed student loans	46,009	739	650	-	47,398
Consumer and other	2,043	52	6	-	2,101
Total loans	$ 319,778	$ 9,653	$ 7,669	$ -	$ 337,100

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The following tables present the aging of the recorded investment in past due loans as of the dates indicated (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
December 31, 2017							
Construction and land development							
Residential	$ -	$ -	$ -	$ -	$5,361	$5,361	$ -
Commercial	-	-	-	-	25,456	25,456	-
	-	-	-	-	30,817	30,817	-
Commercial real estate							
Owner occupied	-	-	-	-	85,004	85,004	-
Non-owner occupied	-	-	-	-	70,845	70,845	-
Multifamily	-	-	-	-	9,386	9,386	-
Farmland	-	-	-	-	270	270	-
	-	-	-	-	165,505	165,505	-
Consumer real estate							
Home equity lines	18	-	-	18	22,831	22,849	-
Secured by 1-4 family residential							
First deed of trust	457	-	-	457	57,462	57,919	-
Second deed of trust	91	-	-	91	7,369	7,460	-
	566	-	-	566	87,662	88,228	-
Commercial and industrial loans (except those secured by real estate)	-	3	-	3	36,503	36,506	-
Guaranteed student loans	2,891	1,300	7,229	11,420	34,385	45,805	7,229
Consumer and other	2	-	-	2	1,846	1,848	-
Total loans	$ 3,459	$ 1,303	$ 7,229	$ 11,991	$356,718	$368,709	$ 7,229

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
December 31, 2016							
Construction and land development							

Residential	$ -	$ -	$ -	$ -	$6,770	$6,770	$ -
Commercial	-	-	-	-	27,092	27,092	-
	-	-	-	-	33,862	33,862	-
Commercial real estate							
Owner occupied	-	-	-	-	66,021	66,021	-
Non-owner occupied	-	-	-	-	57,944	57,944	-
Multifamily	190	-	-	190	8,634	8,824	-
Farmland	-	-	-	-	310	310	-
	190	-	-	190	132,909	133,099	-
Consumer real estate							
Home equity lines	-	-	-	-	20,691	20,691	-
Secured by 1-4 family residential							
First deed of trust	414	63	-	477	54,314	54,791	-
Second deed of trust	128	-	-	128	5,640	5,768	-
	542	63	-	605	80,645	81,250	-
Commercial and industrial							
loans (except those secured by real estate)	15	62	-	77	39,313	39,390	-
Guaranteed student loans	2,743	1,923	8,174	12,840	34,558	47,398	8,174
Consumer and other	11	-	-	11	2,090	2,101	-
Total loans	$ 3,501	$ 2,048	$ 8,174	$ 13,723	$323,377	$337,100	$ 8,174

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

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

	December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded			
Construction and land development			
Commercial	$ 502	$ 600	$ -
	502	600	-
Commercial real estate			
Owner occupied	3,879	3,879	-
Non-owner occupied	2,153	2,153	-
	6,032	6,032	-
Consumer real estate			
Home equity			