



2016 Annual Report

Campbell & Lineberry

CERTIFIED PUBLIC ACCOUNTANTS

Independent Auditor's Report

To the Board of Directors
Bank of Botetourt
Buchanan, Virginia

We have audited the accompanying consolidated financial statements of Bank of Botetourt and subsidiary which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Bank of Botetourt and subsidiary as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Campbell & Lineberry, PC

Roanoke, Virginia
February 21, 2017

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Consolidated Balance Sheets

December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Assets		
Cash and due from banks	\$ 5,949,242	\$ 5,454,032
Interest-bearing deposits with banks	9,985,707	9,717,750
Federal funds sold	43,000	103,000
Total cash and cash equivalents	15,977,949	15,274,782
Time deposits with banks	450,000	950,000
Investment securities available for sale	18,177,575	15,950,900
Restricted equity securities	340,501	332,500
Loans held for sale	133,407	211,916
Loans, net of allowance for loan losses of \$2,903,362 in 2016 and \$2,626,142 in 2015	289,416,437	269,774,785
Property and equipment, net	11,946,075	10,966,255
Accrued income	947,836	911,091
Foreclosed assets	3,667,782	2,517,705
Other assets	5,277,297	4,905,685
Total assets	<u>\$ 346,334,859</u>	<u>\$ 321,795,619</u>
Liabilities and Stockholders' Equity		
Liabilities		
Noninterest-bearing deposits	\$ 33,049,496	\$ 30,730,713
Interest-bearing deposits	276,813,210	256,392,341
Total deposits	309,862,706	287,123,054
Accrued interest payable	244,971	205,472
Other liabilities	2,500,464	2,252,753
Total liabilities	<u>312,608,141</u>	<u>289,581,279</u>
Commitments and contingencies	-	-
Stockholders' equity		
Common stock, \$1.50 par value; 2,500,000 shares authorized; 1,425,215 and 1,418,675 shares issued and outstanding in 2016 and 2015, respectively	2,137,822	2,128,012
Additional paid-in capital	3,660,375	3,546,050
Retained earnings	28,397,618	26,835,214
Accumulated other comprehensive loss	(469,097)	(294,936)
Total stockholders' equity	<u>33,726,718</u>	<u>32,214,340</u>
Total liabilities and stockholders' equity	<u>\$ 346,334,859</u>	<u>\$ 321,795,619</u>

Consolidated Statements of Income

Years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Interest income		
Loans and fees on loans	\$ 14,344,685	\$ 13,099,591
Federal funds sold	918	287
Investment securities:		
Taxable	224,155	330,681
Exempt from federal income tax	49,613	98,271
Dividend income	16,036	14,788
Deposits with banks	75,208	34,913
Total interest income	<u>14,710,615</u>	<u>13,578,531</u>
Interest expense		
Deposits	2,155,832	1,902,659
Federal funds purchased	103	27
Other	10	10
Total interest expense	<u>2,155,945</u>	<u>1,902,696</u>
Net interest income	12,554,670	11,675,835
Provision for loan losses	975,000	135,000
Net interest income after provision for loan losses	<u>11,579,670</u>	<u>11,540,835</u>
Noninterest income		
Service charges on deposit accounts	685,314	672,279
ATM and debit card	731,132	575,446
Other service charges and fees	306,401	277,337
Mortgage origination fees	795,488	351,350
Commissions on title services	130,898	88,543
Net gain (loss) on sale of property and equipment	253,996	(29,996)
Net realized gains on sale of AFS securities	-	24,015
Other income	661,589	555,655
Total noninterest income	<u>3,564,818</u>	<u>2,514,629</u>
Noninterest expense		
Salaries and employee benefits	6,117,273	5,306,689
Occupancy	724,859	614,066
Equipment	659,537	531,645
Foreclosed assets, net	126,582	109,246
Outside services	936,735	766,402
FDIC insurance premiums and assessment	274,191	273,370
ATM and debit card	509,612	401,284
Franchise tax	218,464	198,274
Telephone and communication	201,215	180,004
Other professional fees	163,457	142,498
Marketing	307,154	204,737
Other operating expenses	1,555,047	1,382,495
Total noninterest expense	<u>11,794,126</u>	<u>10,110,710</u>
Income before income taxes	3,350,362	3,944,754
Income tax expense	1,105,829	1,287,689
Net income	<u>\$ 2,244,533</u>	<u>\$ 2,657,065</u>
Basic earnings per share	<u>\$ 1.58</u>	<u>\$ 1.88</u>
Diluted earnings per share	<u>\$ 1.58</u>	<u>\$ 1.88</u>
Basic weighted average shares outstanding	<u>1,421,861</u>	<u>1,415,742</u>
Diluted weighted average shares outstanding	<u>1,421,861</u>	<u>1,415,742</u>

Consolidated Statements of Comprehensive Income

Years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Net income	<u>\$ 2,244,533</u>	<u>\$ 2,657,065</u>
Other comprehensive income (loss):		
Unrealized gains (loss) on investment securities available for sale	(104,733)	85,890
Tax benefit (expense) related to unrealized losses on investment securities	35,609	(18,425)
Reclassification of realized gains	-	(24,015)
Tax expense related to reclassification of realized gains	-	8,165
Pension plan adjustment	(205,964)	(64,060)
Tax benefit related to pension plan adjustment	70,028	21,780
Post-retirement health plan adjustment	46,817	29,142
Tax expense related to post-retirement health plan adjustment	<u>(15,918)</u>	<u>(9,908)</u>
Total other comprehensive income (loss)	<u>(174,161)</u>	<u>28,569</u>
Total comprehensive income	<u><u>\$ 2,070,372</u></u>	<u><u>\$ 2,685,634</u></u>

Consolidated Statements of Changes in Stockholders' Equity

Years ended December 31, 2016 and 2015

	Common Stock		Paid-In	Retained	Accumulated Other Comprehensive Income	
	Shares	Amount	Capital	Earnings	(Loss)	Total
Balance, December 31, 2014	1,412,829	\$ 2,119,243	\$ 3,456,277	\$ 24,744,177	\$ (323,505)	\$ 29,996,192
Net income	-	-	-	2,657,065	-	2,657,065
Changes in other comprehensive loss					28,569	28,569
Total comprehensive income						2,685,634
Dividends declared	-	-	-	(566,028)	-	(566,028)
Stock issued under Dividend Reinvest- ment Plan	5,846	8,769	89,773	-	-	98,542
Balance, December 31, 2015	1,418,675	2,128,012	3,546,050	26,835,214	(294,936)	32,214,340
Net income	-	-	-	2,244,533	-	2,244,533
Changes in other comprehensive loss					(174,161)	(174,161)
Total comprehensive income						2,070,372
Dividends declared	-	-	-	(682,129)	-	(682,129)
Stock issued under Dividend Reinvest- ment Plan	6,540	9,810	114,325	-	-	124,135
Balance, December 31, 2016	<u>1,425,215</u>	<u>\$ 2,137,822</u>	<u>\$ 3,660,375</u>	<u>\$ 28,397,618</u>	<u>\$ (469,097)</u>	<u>\$ 33,726,718</u>

Consolidated Statements of Cash Flows

Years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
<i>Cash flows from operating activities</i>		
Net income	\$ 2,244,533	\$ 2,657,065
Adjustments to reconcile net income		
to net cash provided by operations:		
Depreciation and amortization	729,851	579,889
Net amortization of securities premiums	1,200	7,200
Provision for loan losses	975,000	135,000
Deferred income taxes	(219,727)	(530,594)
Net realized gain on sales of assets	(243,641)	(884)
Net write downs of foreclosed assets	68,832	56,500
Increase in cash surrender value of life insurance	(60,792)	(67,707)
Changes in assets and liabilities:		
Loans held for sale	78,509	(211,916)
Accrued income	(36,745)	(37,792)
Other assets	(128,439)	611,915
Accrued interest payable	39,499	(58,870)
Other liabilities	124,172	471,016
Net cash provided by operating activities	<u>3,572,252</u>	<u>3,610,822</u>
<i>Cash flows from investing activities</i>		
Purchases of investment securities – available for sale	(11,500,000)	(8,499,385)
Purchases of restricted equity securities	(8,001)	(6,000)
Maturities of investment securities – available for sale	9,167,391	16,308,695
Sale of investment securities –available for sale	-	454,080
Net decrease in time deposits with banks	500,000	950,000
Net increase in loans	(21,696,766)	(25,580,917)
Purchases of property and equipment	(1,844,967)	(2,867,554)
Proceeds from sales of property and equipment	478,500	-
Capitalized expenditures for foreclosed assets	(306,453)	-
Proceeds from sales of foreclosed assets	159,553	157,795
Net cash used in investing activities	<u>(25,050,743)</u>	<u>(19,083,286)</u>
<i>Cash flows from financing activities</i>		
Net increase (decrease) in noninterest-bearing deposits	2,318,783	(14,207,037)
Net increase in interest-bearing deposits	20,420,869	20,310,037
Proceeds from common stock issued	124,135	98,542
Dividends paid	(682,129)	(566,028)
Net cash provided by financing activities	<u>22,181,658</u>	<u>5,635,514</u>
Net increase (decrease) in cash and cash equivalents	703,167	(9,836,950)
<i>Cash and cash equivalents, beginning</i>	<u>15,274,782</u>	<u>25,111,732</u>
<i>Cash and cash equivalents, ending</i>	<u>\$ 15,977,949</u>	<u>\$ 15,274,782</u>
<i>Supplemental disclosure of cash flow information:</i>		
Interest paid	\$ 2,116,446	\$ 1,961,566
Taxes paid	<u>\$ 1,002,000</u>	<u>\$ 880,000</u>
<i>Supplemental disclosure of noncash activities:</i>		
Foreclosed assets acquired in settlement of loans	<u>\$ 1,140,614</u>	<u>\$ 1,035,500</u>
Loans originated to finance the sale of foreclosed assets	<u>\$ 60,500</u>	<u>\$ 85,680</u>

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies

Organization

Bank of Botetourt (the “Bank”) is a Virginia state-chartered bank subject to regulation by the Virginia Bureau of Financial Institutions and the Federal Deposit Insurance Corporation. The Bank provides full banking services through twelve branch offices in Botetourt, Roanoke, Rockbridge, and Franklin counties and the City of Salem, all in Virginia. In 2016, the Bank began using two “trading as” names registered with the State Corporation Commission for market branding purposes. Virginia Mountain Mortgage is advertised for secondary market mortgage banking activities and Virginia Mountain Financial Services is advertised for non-FDIC insured investment products. The Bank has a wholly-owned subsidiary, Buchanan Service Corporation, which conducts its operations through an interest in an insurance company and two title insurance companies.

The accounting and reporting policies of the Bank and Buchanan Service Corporation follow generally accepted accounting principles (“GAAP”) and general practices of the financial services industry, within the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) structure of authoritative literature. Following is a summary of the more significant policies.

Critical Accounting Policy

Management believes the policy with respect to the methodology for the determination of the allowance for loan losses involves a high degree of complexity. Management must make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. This critical policy and its application are periodically reviewed with the Audit Committee and Board of Directors.

Principles of Consolidation

The consolidated financial statements include the accounts of the Bank and Buchanan Service Corporation. All significant intercompany transactions and balances have been eliminated in consolidation.

Business Segments

The Bank reports its activities as a single business segment. In determining proper segment definition, the Bank considers the materiality of a potential segment and components of the business about which financial information is available and regularly evaluated, relative to resource allocation and performance assessment.

Cash and Cash Equivalents

For the purpose of presentation in the Consolidated Statements of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions “Cash and due from banks”, “Interest-bearing deposits with banks”, and “Federal funds sold”.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions in the application of certain accounting policies that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the valuation of other real estate acquired in connection with foreclosures or in satisfaction of loans, and employee benefit plans. In connection with the determination of the allowance for loan losses and valuation of other real estate owned, management obtains independent appraisals for significant properties.

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Use of Estimates, continued

The majority of the Bank's loan portfolio consists of loans in Botetourt and the adjacent counties of Southwest Virginia. Accordingly, the ultimate collectability of a substantial portion of the Bank's loan portfolio and the recovery of a substantial portion of the carrying amount of foreclosed real estate are susceptible to changes in local market conditions.

While management uses available information to recognize loan losses and losses on foreclosed real estate, future additions to the allowance for loan losses and losses on foreclosed real estate may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as part of their routine examinations process, periodically review the Bank's allowance for loan losses and the valuation of foreclosed real estate. Such agencies may require additions to the allowance for loan losses and foreclosed real estate losses based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowance for loan losses and the valuation of foreclosed real estate may change materially in the near term.

Interest-bearing Deposits with Banks

Interest-bearing deposits with banks are carried at cost.

Trading Securities

The Bank does not hold securities for short-term resale and therefore does not maintain a trading securities portfolio.

Investment Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Realized gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Bank Owned Life Insurance

The cash surrender value of bank owned life insurance is a reasonable estimate of fair value and is included in other assets on the consolidated balance sheet. The cash surrender value of these policies was \$2,150,841 and \$2,090,049 as of December 31, 2016 and 2015, respectively. Any increase in cash surrender value is recorded as other income on the consolidated statement of income. In the event of the death of an insured individual, the Bank would receive the death benefit which would be recorded as other income.

Loans Held for Sale

The carrying amount of loans originated and intended for sale in the secondary market are at fair value.

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, are reported at their outstanding principal amount adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment to the yield on the related loan.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. Management also considers the adequacy of collateral and the state of the collection process. When interest accrual is discontinued, all unpaid accrued interest is reversed. We apply payments received on nonaccrual loans first to outstanding principal, and the residual amount, if any, is applied to interest. When facts, circumstances, and consistent performance indicate the borrower has regained the ability to meet required payments, the loan is returned to accrual status. Past due status of loans is determined based on contractual terms.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio and is based on accounting standards for contingencies and receivables. 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 loan balance is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses consists of specific, general and unallocated components and is evaluated on a regular basis by management.

Property and Equipment

Land is carried at cost. Buildings and furniture and equipment are carried at cost, less accumulated depreciation and amortization computed principally by the straight-line method over the following estimated useful lives or lease terms:

	<u>Years</u>
Buildings and improvements	7-40
Furniture and equipment	3-10

Foreclosed Assets

Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of loan balance or fair value less the cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses during the holding period, gains and losses on sale, and changes in the valuation allowance are included in net expenses from foreclosed assets.

Employee Benefit Plans

A noncontributory cash balance pension plan (the "Plan") has been provided for all employees who met the eligibility requirements of 21 years of age and one year of service. The formulary contribution allocated annually to each participant's hypothetical cash balance account is based on the ages and years of service of the employee participants. Interest credit is indexed to the 10-year Treasury rate and is guaranteed not to be less than 3% on an annual basis. To maintain the Plan's funding adequacy, the Bank contributes an appropriate amount which is deductible for federal income tax purposes. Benefits under the Plan are accrued by periodic charges to income as determined by the Plan's actuaries. To the extent accumulated Plan assets, including current period cash contributions, are less than projected benefit obligations, the Bank accrues such obligations through either a charge to income or other comprehensive

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Employee Benefit Plans, continued

income. To the extent accumulated Plan assets are greater than projected benefit obligations, the Bank records such benefits as a reduction of expense or as other comprehensive income.

The Bank also provides a qualified profit sharing/thrift plan. All full-time employees, age 18 and older, are eligible to participate and are automatically enrolled, unless they choose to opt-out of the plan, after completing their first six months of service. The Bank expenses its matching portion to the employees' contributions each payroll period.

The Bank sponsors a post-retirement health care plan for certain retired employees. Expenses related to benefits under the plan are shared by the Bank and the retirees monthly. The Bank's monthly portion is expensed to income. To the extent accumulated plan assets, including periodic cash contributions from the Bank and the retirees, are less than the benefit obligations, the Bank accounts for such obligations through either a charge to income or other comprehensive income.

Advertising and Public Relations Expense

The Bank expenses advertising and public relations costs as they are incurred.

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, (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.

Income Taxes

Provision for income taxes is based on amounts reported in the consolidated statements of income (after exclusion of non-taxable income such as interest on state and municipal securities and loans) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Deferred income tax liabilities relating to unrealized appreciation (or the deferred tax asset in the case of unrealized depreciation) on investment securities available for sale and the pension plan and post-retirement benefits are recorded in other liabilities (assets). These items are recorded as an adjustment to equity and to other comprehensive income in the financial statements and not included in net income determination until realized. Accordingly, the resulting deferred income tax liabilities or assets are also recorded as an adjustment to equity and to other comprehensive income.

The Bank defers loan fees and costs for financial statement purposes. Current tax regulations suggest that loan fees also be deferred using the effective yield method for income tax purposes. These regulations also suggest that the associated costs, which are primarily employee salaries, be currently deducted. The Bank has chosen to accelerate revenue recognition by including these loan fees in current year income for income tax purposes. As a result of the implementation of disclosure guidance regarding Income Taxes, the Bank has not incurred a tax benefit because the payment of tax on these fees has been accelerated.

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Income Taxes, continued

In the event that the Bank has an unrecognized tax benefit in future accounting periods, the Bank will recognize interest accrued related to the benefit in interest expense and penalties in operating expenses. There were no interest or penalties related to an unrecognized tax benefit for the years ended December 31, 2016 and 2015. Because of the impact of deferred tax accounting, other than interest and penalties, the reversal of the above treatment by taxing authorities would not affect the annual effective tax rate but would defer the payment of cash to the taxing authority to later periods. The Bank's tax filings for years ended 2013 through 2015 are currently open to audit under statutes of limitations of the Internal Revenue Service ("IRS") and the Virginia Department of Taxation. During 2016, the IRS audited the Bank's 2014 federal income tax return. Upon completion of the audit, the IRS concluded there was no change to the amount of tax the Bank reported or paid.

Basic and Diluted Earnings per Share

Basic and diluted earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period. At December 31, 2016 and 2015, the Bank had no potentially dilutive securities outstanding.

Comprehensive Income (Loss)

Comprehensive income (loss) reflects the change in the Bank's equity during the year arising from transactions and events other than investments by, and distributions to, stockholders. It consists of net income plus certain other changes in assets and liabilities that are reported as separate components of stockholders' equity rather than as income or expense.

Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and commercial and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded. Related fees are recorded when they are incurred or received.

Fair Value of Financial Instruments

The Fair Value Measurements and Disclosures topic provides guidance and requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments.

Reclassification

Certain reclassifications have been made to the prior year's financial statements to place them on a comparable basis with the current year. Net income and stockholders' equity previously reported were not affected by these reclassifications.

Note 2. Restrictions on Cash

To comply with banking regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirement was approximately \$1,050,000 for the periods ending December 31, 2016 and 2015.

Notes to Consolidated Financial Statements

Note 3. Investment Securities

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. The carrying amount of securities and their approximate fair values at December 31 follow:

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
2016				
<i>Available for sale:</i>				
Government-sponsored enterprises	\$ 13,500,000	\$ 295	\$ 113,400	\$ 13,386,895
State and municipal securities	3,209,407	88,524	-	3,297,931
Corporate securities	1	92,748	-	92,749
Other	<u>1,400,000</u>	<u>-</u>	<u>-</u>	<u>1,400,000</u>
	<u>\$ 18,109,408</u>	<u>\$ 181,567</u>	<u>\$ 113,400</u>	<u>\$ 18,177,575</u>

2015				
<i>Available for sale:</i>				
Government-sponsored enterprises	\$ 12,164,352	\$ 10,640	\$ 55,800	\$ 12,119,192
State and municipal securities	3,213,647	126,624	-	3,340,271
Corporate securities	1	91,436	-	91,437
Other	<u>400,000</u>	<u>-</u>	<u>-</u>	<u>400,000</u>
	<u>\$ 15,778,000</u>	<u>\$ 228,700</u>	<u>\$ 55,800</u>	<u>\$ 15,950,900</u>

Government-sponsored enterprises, commonly referred to as U.S. Government Agencies, include investments in Federal Farm Credit Banks, Federal Home Loan Banks, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association bonds.

The Other category represents an investment in a subordinated debt offerings of a 501(c)(3) non-profit, non-stock Community Development Financial Institution ("CDFI") dedicated to revitalizing communities, facilitating the creation of jobs, and increasing the amount of affordable housing throughout Virginia and an investment in a subordinated debt offering of a for-profit commercial financial institution.

No investment securities were pledged at December 31, 2016 and 2015.

There was no sale of investments in 2016. Proceeds from gains on sale of investment amounted to \$24,015 in 2015.

Notes to Consolidated Financial Statements

Note 3. Investment Securities, continued

The scheduled maturities of securities available for sale at December 31, 2016, are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Available for Sale	
	Amortized Cost	Fair Value
Due in one year or less	\$ 1,211,392	\$ 1,210,812
Due after one year through five years	15,353,015	15,327,477
Due after five years through ten years	1,545,000	1,546,537
Due after ten years	1	92,749
	<u>\$ 18,109,408</u>	<u>\$ 18,177,575</u>

The following tables detail unrealized losses and related fair values in the Bank's investment securities portfolio. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2016						
Government-sponsored enterprises	\$11,395,995	\$ 104,005	\$ 990,605	\$ 9,395	\$12,386,600	\$ 113,400
State and municipal securities	-	-	-	-	-	-
Corporate securities	-	-	-	-	-	-
Total temporarily impaired securities	<u>\$11,395,995</u>	<u>\$ 104,005</u>	<u>\$ 990,605</u>	<u>\$ 9,395</u>	<u>\$12,386,600</u>	<u>\$ 113,400</u>
2015						
Government-sponsored enterprises	\$ 6,633,831	\$ 30,520	\$ 2,974,720	\$ 25,280	\$ 9,608,551	\$ 55,800
State and municipal securities	-	-	-	-	-	-
Corporate securities	-	-	-	-	-	-
Total temporarily impaired securities	<u>\$ 6,633,831</u>	<u>\$ 30,520</u>	<u>\$ 2,974,720</u>	<u>\$ 25,280</u>	<u>\$ 9,608,551</u>	<u>\$ 55,800</u>

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security by security basis, in determining if the decline in market value is other than temporary. The Bank does not believe that gross unrealized losses as of December 31, 2016, which is comprised of twenty-five investment securities, represent an other-than-temporary impairment. The gross unrealized losses reported relate to investment securities issued by Government-sponsored enterprises. Total gross unrealized losses, which represent 0.63% of the amortized cost basis of the Bank's total investment securities, were attributable to changes in interest rates due to market conditions and not due to the credit quality of the investment securities. The Bank has both the ability and the intent to hold all of these securities for a period of time necessary to recover amortized cost.

Restricted equity securities, which are carried at cost, consist of investments in stock of the Federal Home Loan Bank of Atlanta ("FHLB"), and CBB Financial Corp., which are upstream correspondents of the Bank. The FHLB requires financial institutions to make equity investments in the FHLB in order to borrow from it. The Bank is required to hold that stock so long as it has borrowing capacity from the FHLB. Both the Bank's stock in CBB Financial Corp. and the FHLB are restricted in the fact that the stock may only be repurchased by the issuer. Management also considers these investments when testing for impairment. On a quarterly basis, management reviews both institutions' capital adequacy to ensure they meet regulatory minimum requirements. Bank management does not believe any unrealized losses associated with investments in these institutions to be anything other than temporary.

Notes to Consolidated Financial Statements

Note 4. Loans Receivable

The Bank segments its loan portfolio to capture the nature of credit risk inherent in its loans receivable. These segments allow management to monitor risk and performance. In reviewing risk, management has determined there to be several different risk categories within the loan portfolio. The allowance for loan losses consists of amounts applicable to portfolios of: (i) Commercial Loans; (ii) Commercial Real Estate Loans; (iii) Consumer Loans; (iv) Residential – Prime Loans; and (v) Agricultural and Raw Land Loans.

The Commercial segment consists of loans made for the purpose of financing the activities of commercial customers. The Commercial Real Estate portfolio includes owner occupied, non-owner occupied, and multi-family dwellings. The Residential – Prime Loan segment consists of fixed rate and adjustable rate single-family amortizing term loans, which are primarily first liens and home equity loans which are generally second liens. The Agricultural and Raw Land category is for farm loans and for undeveloped land. Consumer loans consist of motor vehicle loans, savings account loans, personal lines of credit, overdrafts, other types of secured consumer loans, and unsecured personal loans.

The major segmented components of loans at December 31 are as follows (in thousands):

	2016	2015
Commercial	\$ 27,233	\$ 23,550
Commercial Real Estate	96,559	94,643
Consumer	17,538	15,464
Residential - Prime	130,019	117,615
Agricultural & Raw Land	20,971	21,129
	292,320	272,401
Allowance for loan losses	(2,903)	(2,626)
	<u>\$ 289,417</u>	<u>\$ 269,775</u>

Loans receivable include \$70,000 and \$61,000 in overdraft deposit accounts at December 31, 2016 and 2015, respectively.

The Bank had no subprime residential loans at December 31, 2016 or 2015.

Construction loans are originated in the Commercial Real Estate and Residential – Prime segments of the loan portfolio, as reflected in the components in the table above. Construction lending is generally considered to involve a higher degree of credit risk than long-term permanent financing. If the estimate of construction cost proves to be inaccurate, the Bank may be compelled to advance additional funds to complete the construction with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. If the Bank is forced to foreclose on a project prior to completion, there is no assurance that it will be able to recover all of the unpaid portion of the loan. In addition, the Bank may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. As of December 31, 2016, construction lending represents \$10,143,000, or 3.47% of the overall loan portfolio, compared to \$9,605,000, or 3.52%, the year prior.

Note 5. Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on three basic principles of accounting: (i) guidance for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, (ii) guidance for Receivables, which requires that losses be accrued based on the differences between the present value of future cash flows, value of collateral, or values that are observable in the market, and the loan balance, and (iii) guidance allowing a creditor to use existing methods for recognizing interest income on an impaired loan.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loans identified as losses and deemed uncollectible by management are charged to the allowance. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions and environmental factors. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as additional information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired, for which an allowance is established when the discounted cash flows, collateral value, or observable market price of the loan is lower than its carrying value. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. Historical losses are categorized into risk-similar loan pools and a loss ratio factor is applied to each group's loan balances to determine the allocation. The loss ratio factor is based on average loss history for the current year and two prior years to ensure the most relevant data is being used in the model following the economic recession, anemic recovery, and current economic conditions.

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. Qualitative environmental factors include external risk factors that management believes affect the overall lending environment of the Bank. Environmental factors that management of the Bank routinely analyze include levels and trends in delinquencies and impaired loans, levels and trends in charge-offs and recoveries, trends in volume and terms of loans, effects of changes in risk selection and underwriting practices, experience, ability, and depth of lending management and staff, national and local economic trends and conditions such as unemployment rates, and housing statistics, banking industry conditions, local economic forecasts, and the effect of changes in credit concentrations.

The following table presents activity in the allowance for loan losses for the years-ended December 31, 2016 and 2015 on a portfolio segment basis. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Consumer</u>	<u>Residential- Prime</u>	<u>Agricultural & Raw Land</u>	<u>Total</u>
Allowance for loan losses:						
Balance, January 1, 2016	\$ 362,555	\$ 768,375	\$ 254,828	\$ 1,103,768	\$ 136,616	\$ 2,626,142
Charge-offs	(393,643)	-	(136,928)	(296,559)	-	(827,130)
Recoveries	6,045	-	120,994	2,311	-	129,350
Provisions	793,243	(68,974)	8,865	240,581	1,285	975,000
Balance, December 31, 2016	<u>\$ 768,200</u>	<u>\$ 699,401</u>	<u>\$ 247,759</u>	<u>\$ 1,050,101</u>	<u>\$ 137,901</u>	<u>\$ 2,903,362</u>
Balance, January 1, 2015	\$ 385,777	\$ 1,079,261	\$ 252,265	\$ 1,675,280	\$ 272,265	\$ 3,664,848
Charge-offs	(892,919)	-	(170,420)	(218,705)	-	(1,282,044)
Recoveries	4,453	-	30,579	6,958	66,348	108,338
Provisions	865,244	(310,886)	142,404	(359,765)	(201,997)	135,000
Balance, December 31, 2015	<u>\$ 362,555</u>	<u>\$ 768,375</u>	<u>\$ 254,828</u>	<u>\$ 1,103,768</u>	<u>\$ 136,616</u>	<u>\$ 2,626,142</u>

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Consumer</u>	<u>Residential- Prime</u>	<u>Agricultural & Raw Land</u>	<u>Total</u>
<u>December 31, 2016</u>						
Allowance for loan losses ending balances:						
Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ 25,002	\$ 25,002
Collectively evaluated for impairment	\$ 768,200	\$ 699,401	\$ 247,759	\$ 1,050,101	\$ 112,899	\$ 2,878,360
Loans receivable:						
Ending balance - total	\$ 27,232,786	\$ 96,558,623	\$ 17,538,462	\$ 130,019,451	\$ 20,970,477	\$ 292,319,799
Ending balances:						
Individually evaluated for impairment	\$ 32,443	\$ 631,271	\$ 18,646	\$ 4,112,668	\$ 1,014,269	\$ 5,809,297
Collectively evaluated for impairment	\$ 27,200,343	\$ 95,927,352	\$ 17,519,816	\$ 125,906,783	\$ 19,956,208	\$ 286,510,502
<u>December 31, 2015</u>						
Allowance for loan losses ending balances:						
Individually evaluated for impairment	\$ 419	\$ -	\$ 2	\$ 38,463	\$ 25,002	\$ 63,886
Collectively evaluated for impairment	\$ 362,136	\$ 768,375	\$ 254,826	\$ 1,065,305	\$ 111,614	\$ 2,562,256
Loans receivable:						
Ending balance - total	\$ 23,549,799	\$ 94,642,628	\$ 15,463,926	\$ 117,615,441	\$ 21,129,133	\$ 272,400,927
Ending balances:						
Individually evaluated for impairment	\$ 360,154	\$ 871,080	\$ 26,334	\$ 2,892,046	\$ 1,987,906	\$ 6,137,520
Collectively evaluated for impairment	\$ 23,189,645	\$ 93,771,548	\$ 15,437,592	\$ 114,723,395	\$ 19,141,227	\$ 266,263,407

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Management assesses for possible loan impairment on a quarterly basis. Our impairment review includes examining factors such as the loan balance, payment status, recent payment history, principal curtailment on lines of credit, extensions granted, risk rating, maturity date advancement, and the probability of collecting scheduled principal and interest payments when due. A loan may be considered impaired by management, and still be expected to have full repayment of both principal and interest, but not according to the contractual terms of the loan agreement. 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 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. Large groups of smaller balance homogeneous loans are collectively evaluated for potential loss exposure. Accordingly, the Bank does not generally separately identify individual consumer and residential loans for impairment disclosures.

Cash payments received for individually evaluated impaired loans are recorded according to the accrual status of the loan. If the impaired loan is on nonaccrual status, payments are applied to the principal balance. Otherwise the payment is applied according to its contractual terms.

The recorded investment is defined as the original amount of the loan, net of any deferred costs and fees, less any principal reductions and direct charge-offs. Impaired loans with a balance at the end of the period are reflected in the recorded investment and unpaid principal balance columns. The average recorded investment represents the Bank's average investment in those same loans during the period. The following tables present impaired loans in the segmented portfolio categories as of December 31:

2016:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Commercial	\$ 32,794	\$ 32,443	\$ -	\$ 70,027	\$ 4,131
Commercial Real Estate	632,411	631,271	-	541,978	47,044
Residential - Prime	4,095,739	4,112,668	-	3,608,414	325,295
Consumer	18,684	18,646	-	21,657	4,080
Agricultural & Raw Land	-	-	-	350,081	-
With an allowance recorded:					
Commercial	\$ -	\$ -	\$ -	\$ 175,628	\$ -
Commercial Real Estate	-	-	-	173,653	-
Residential - Prime	-	-	-	697,755	-
Consumer	-	-	-	-	-
Agricultural & Raw Land	1,014,269	1,014,269	25,002	1,010,205	25,779
Total:					
Commercial	\$ 32,794	\$ 32,443	\$ -	\$ 245,655	\$ 4,131
Commercial Real Estate	632,411	631,271	-	715,631	47,044
Residential - Prime	4,095,739	4,112,668	-	4,306,169	325,295
Consumer	18,684	18,646	-	21,657	4,080
Agricultural & Raw Land	1,014,269	1,014,269	25,002	1,360,286	25,779

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

2015:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Commercial	\$ 32,794	\$ 32,443	\$ -	\$ 216,169	\$ 3,959
Commercial Real Estate	871,572	871,080	-	833,910	74,622
Residential - Prime	2,240,370	2,246,165	-	2,881,893	201,813
Consumer	19,709	19,670	-	22,502	4,385
Agricultural & Raw Land	968,704	973,637	-	387,482	87,869
With an allowance recorded:					
Commercial	\$ 328,093	\$ 327,711	\$ 419	\$ 129,931	\$ 46,038
Commercial Real Estate	-	-	-	43,413	-
Residential - Prime	645,936	645,881	38,463	518,413	44,072
Consumer	6,664	6,664	2	1,666	448
Agricultural & Raw Land	1,014,269	1,014,269	25,002	1,014,269	25,709
Total:					
Commercial	\$ 360,887	\$ 360,154	\$ 419	\$ 346,100	\$ 49,997
Commercial Real Estate	871,572	871,080	-	877,323	74,622
Residential - Prime	2,867,226	2,892,046	38,463	3,400,306	245,885
Consumer	26,373	26,334	2	24,168	4,833
Agricultural & Raw Land	1,982,973	1,987,906	25,002	1,401,751	113,578

Loans are considered past due if the required principal and interest payment have not been received as of the due date. The following schedule is an aging of past due loans receivable, including those on nonaccrual status, by portfolio segment as of December 31, 2016.

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater Than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivable</u>	<u>Recorded Investment > 90 Days and Accruing</u>
Commercial	\$ -	\$ 300,729	\$ 37,443	\$ 338,172	\$ 26,894,614	\$ 27,232,786	\$ 37,794
Commercial Real Estate	580,037	1,276,952	631,271	2,488,260	94,070,363	96,558,623	371,932
Consumer	147,436	81,305	100,802	329,543	17,208,919	17,538,462	82,157
Residential - Prime	1,361,962	1,346,088	3,867,976	6,576,026	123,443,425	130,019,451	911,000
Agricultural & Raw Land	1,080,537	-	105,199	1,185,736	19,784,741	20,970,477	105,199
Total	<u>\$ 3,169,972</u>	<u>\$ 3,005,074</u>	<u>\$ 4,742,691</u>	<u>\$ 10,917,737</u>	<u>\$ 281,402,062</u>	<u>\$ 292,319,799</u>	<u>\$ 1,508,082</u>

The following schedule is an aging of past due loans receivable, including those on nonaccrual status, by portfolio segment as of December 31, 2015.

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater Than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivable</u>	<u>Recorded Investment > 90 Days and Accruing</u>
Commercial	\$ 152,062	\$ -	\$ 430,595	\$ 582,657	\$ 22,967,142	\$ 23,549,799	\$ 4,946
Commercial Real Estate	1,220,665	112,495	671,144	2,004,304	92,638,324	94,642,628	671,019
Consumer	136,807	34,576	83,683	255,066	15,208,860	15,463,926	83,683
Residential - Prime	2,128,771	1,743,528	2,683,587	6,555,886	111,059,555	117,615,441	1,548,548
Agricultural & Raw Land	1,055,549	-	1,152,900	2,208,449	18,920,684	21,129,133	1,140,461
Total	<u>\$ 4,693,854</u>	<u>\$ 1,890,599</u>	<u>\$ 5,021,909</u>	<u>\$ 11,606,362</u>	<u>\$ 260,794,565</u>	<u>\$ 272,400,927</u>	<u>\$ 3,448,657</u>

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

Loans are generally placed in nonaccrual status when, in management's opinion, the collection of principal and interest is 90 days or more past due, unless the obligation is both well-secured and in the process of collection. When interest accrual is discontinued, all unpaid accrued interest is reversed. Payments on nonaccrual loans are applied to the principal balance. No interest income was recognized on impaired loans subsequent to the nonaccrual status designation. A loan is returned to accrual status when the borrower makes consistent payments accordingly to contractual terms and future payments are reasonably assured. The following is a schedule of loans receivable, by portfolio segment, on nonaccrual status as of December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Commercial	\$ -	\$ 425,649
Commercial Real Estate	259,862	-
Consumer	18,646	-
Residential - Prime	3,094,946	1,315,812
Agricultural & Raw Land	-	-
	<u>\$ 3,373,454</u>	<u>\$ 1,741,461</u>

The Bank uses several metrics as credit quality indicators of current or potential risks in our loan portfolio. These indicators include, but are not limited to, credit bureau reports, loan-to-value ratios, internal risk ratings, current financial information, historical payment experience, economic conditions, and trends in net charge-offs and nonperforming loans. As part of the ongoing monitoring of the credit quality of the Bank's loan portfolio, every loan is assigned a risk rating grade at the time of loan origination. The risk ratings are formally reviewed for appropriateness over the life of the loan on at least an annual basis. The formal external review occurs during the fourth quarter to correspond to the Bank's fiscal year-end. In addition, quarterly internal reviews occur for specific loans identified by loan administration to ensure loans with potential material impact are captured on an interim basis. These processes historically provide a predictive element to assist management in our efforts to quantify losses. The quarterly review is an important process to accurately identify impaired loans, a critical component in the allowance for loan losses calculation. The credit quality indicators are periodically reviewed and updated on a case-by-case basis.

Listed from the least risk to the highest risk, management uses a nine point internal risk rating system to monitor the credit quality of the non-consumer segments of the loan portfolio.

Excellent: The borrower is typically a long established, well-seasoned company with a significant market position. It possesses unquestioned asset quality, liquidity, and excellent sales and earnings trends. Leverage, if present, is well below industry norms. Borrower appears to have capacity to meet all of its obligations under almost any circumstances. If a business, the borrowing entity's management has extensive experience and depth.

Good: The borrower demonstrates a strong and liquid financial condition based upon current financial information and qualifies to borrow on an unsecured basis under most circumstances. If borrowing is secured, collateral is readily marketable and amply margined. Repayment sources are well defined and more than adequate. Credit checks and prior lending experiences with the company, if any, are fully satisfactory. The borrower's cash flow comfortably exceeds total current obligations.

Satisfactory: The borrower provides current financial information reflecting a satisfactory financial condition and reasonable debt service capacity. If borrowing is secured, collateral is marketable, adequately margined at the present time, and expected to afford coverage to maturity. Repayment understandings are documented, sources are considered adequate, and repayment terms are appropriate. Credit checks and prior experience, if any, are satisfactory. The borrower is usually established and is attractive to other financial institutions. If a business, the borrower's balance sheet is stable and sales and earnings are steady and predictable.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

Acceptable: While an acceptable credit risk to the Bank, the borrower will generally demonstrate a higher leveraged, less liquid balance sheet and capacity to service debt, while steady, may be less well-defined. Repayment terms may not be appropriate for individual transactions. Borrower is generally acceptable to other financial institutions; however, secured borrowing is the norm. Collateral marketability and margin are acceptable at the present time but may not continue to be so. Credit checks or prior experience, if any, reveals some, but not serious, slowness in paying. If a business, its management experience may be limited or have less depth than a Satisfactory borrower. Sensitivity to economic or credit cycles exists, and staying power could be a problem.

Pass/Watch: Loan coverage is somewhat erratic, future coverage is uncertain, liquidity is strained and leverage capacity is considered minimal. Indicators of potential deterioration of repayment sources have resulted in uncertainty or unknown factors concerning the status of the credit. This risk rating is considered transitory in nature. When factors causing the uncertainty have been clearly defined, a risk rating will be assigned commensurate with the risk characteristics and circumstances that exist.

Special Mention: While loans to a borrower in this rating category are currently protected (no loss of principal or interest envisioned), they may pose undue or unwarranted credit risks if weaknesses are not checked or corrected. Weaknesses may be limited to one or several trends or developments. Weaknesses may include one or more of the following: a potentially over-extended financial condition, a questionable repayment program, an uncertain level of continuing employment or income, inadequate or deteriorating collateral, inadequate or untimely financial information, management competence or succession issues, and a high degree of vulnerability to outside forces.

Substandard: Assets in this category are inadequately protected by the current creditworthiness and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Nonaccrual loans, reduced-earnings loans, and loans to borrowers engaged in bankruptcy proceedings are automatically rated Substandard or lower.

Doubtful: A loan rated Doubtful has all of the weaknesses inherent in one rated Substandard with the added characteristic that the weakness may make collection or liquidation in full, on the basis of currently existing facts, highly improbable. A Doubtful rating generally is used when the amount of loss can be projected and that projection exceeds one-third of the balance of outstanding debt but does not exceed two-thirds of that balance. A Doubtful rating is generally applied when the likelihood of significant loss is high.

Loss: A Loss rating should be applied when the borrower's outstanding debt is considered uncollectible or of such little value that its continuance as a bankable asset is not warranted. This rating does not suggest that there is absolutely no recovery or salvage value, but that it is not practical or desirable to defer writing off the debt even though a partial recovery may be affected in the future.

For the consumer segment of the loan portfolio, the Bank uses the following definitions:

Nonperforming: Loans on nonaccrual status plus loans greater than ninety days past due and still accruing interest.

Performing: All current loans plus loans less than ninety days past due.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

The following is a schedule of the credit quality of loans receivable, by portfolio segment, as of December 31, 2016:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential- Prime</u>	<u>Agricultural & Raw Land</u>
Internal Risk Rating Grades:				
Satisfactory or better	\$ 13,413,962	\$ 48,290,250	\$ 73,488,228	\$ 5,294,980
Acceptable	12,919,121	43,046,222	40,261,891	13,350,843
Pass/Watch	-	572,816	3,026,477	-
Special Mention	566,530	2,657,295	5,682,430	1,105,523
Substandard	333,173	1,992,040	7,560,425	1,219,131
Doubtful	-	-	-	-
Total	<u>\$ 27,232,786</u>	<u>\$ 96,558,623</u>	<u>\$ 130,019,451</u>	<u>\$ 20,970,477</u>
				<u>Consumer</u>
Internal Risk Rating Grades:				
Performing				\$ 17,437,660
Nonperforming				100,802
Total				<u>\$ 17,538,462</u>

The following is a schedule of the credit quality of loans receivable, by portfolio segment, as of December 31, 2015:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential- Prime</u>	<u>Agricultural & Raw Land</u>
Internal Risk Rating Grades:				
Satisfactory or better	\$ 13,247,703	\$ 54,203,286	\$ 64,790,024	\$ 5,744,720
Acceptable	8,996,715	34,562,473	35,733,676	12,300,840
Pass/Watch	504,946	546,962	2,147,287	831,936
Special Mention	138,638	4,052,066	9,878,896	50,565
Substandard	661,797	1,277,841	5,065,558	2,201,072
Doubtful	-	-	-	-
Total	<u>\$ 23,549,799</u>	<u>\$ 94,642,628</u>	<u>\$ 117,615,441</u>	<u>\$ 21,129,133</u>
				<u>Consumer</u>
Internal Risk Rating Grades:				
Performing				\$ 15,387,274
Nonperforming				76,652
Total				<u>\$ 15,463,926</u>

The Bank evaluated all loan restructurings to determine whether they are troubled debt restructurings (“TDRs”) under the guidance of ASU 2011-02. Upon identifying these loans as TDRs, the Bank identified and prospectively measured them as impaired under the guidance in ASC 310-10-35.

During 2016, the Bank identified one TDR due to an informal agreement that changed the payment structure from monthly principal and interest payments to interest only payments. The loan was past due at December 31, 2016.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses, continued

The following is a schedule of loans that were restructured during the year-ended December 31, 2016:

	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Commercial Real Estate	<u>1</u>	<u>\$ 371,408</u>	<u>\$ 371,932</u>
Total	<u>1</u>	<u>\$ 371,408</u>	<u>\$ 371,932</u>

During 2015, the Bank modified one loan that was considered to be a troubled debt restructuring and entered into a forbearance agreement with respect to this loan.

The following is a schedule of loans that were restructured during the year-ended December 31, 2015:

	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Residential - Prime	<u>1</u>	<u>\$ 185,532</u>	<u>\$ 185,753</u>
Total	<u>1</u>	<u>\$ 185,532</u>	<u>\$ 185,753</u>

During 2015, no loans that had been previously restructured were in default at December 31, 2016.

In the determination of the allowance for loan losses, management considers troubled debt restructurings and subsequent defaults in these restructurings. All troubled debt restructurings are considered impaired loans. Loss exposure related to these loans are determined by management on a quarterly basis.

Note 6. Property, Equipment and Foreclosed Assets

Components of property and equipment and total accumulated depreciation at December 31 are as follows:

	2016	2015
Land	\$ 3,388,953	\$ 3,307,853
Construction in process	4,951	2,610,778
Buildings and improvements	9,990,466	7,163,529
Furniture and equipment	<u>3,922,419</u>	<u>3,038,923</u>
	17,306,789	16,121,083
Less accumulated depreciation	<u>5,360,714</u>	<u>5,154,828</u>
	<u>\$ 11,946,075</u>	<u>\$ 10,966,255</u>

Depreciation expense for 2016 and 2015 was \$640,644 and \$476,401, respectively.

Lessee Activities

The Bank leased out a portion of its loan administration facility under an annually renewable lease and received rental income of \$9,000 in both 2016 and 2015.

The Bank leased out a portion of two branch facilities under a lease and received rental income of \$24,200 in 2016. The Bank leased out a portion of one branch facility under a lease and received rental income of \$24,050 in 2015.

Notes to Consolidated Financial Statements

Note 6. Property, Equipment and Foreclosed Assets, continued

Lessee Activities, Continued

The Bank leases office space to Mountain Valley Title Insurance Agency, LLC and to Rockbridge Title Services, LLC each for an annual amount of \$6,200, totaling \$12,400 in rental income. Both of these companies are related party interests as subsidiaries of the Bank.

In 2016, the Bank subleased one of its rental properties, resulting in \$2,690 in rental income.

Aggregate rental income for 2016 and 2015 was \$49,377 and \$52,250, respectively.

Lessor Activities

The Bank leases locations for automated teller machines, equipment, and office space under various operating leases that call for annual payments as follows:

2017	\$	51,387
2018		8,555
2019		1,080
2020		1,080
2021		360
Thereafter		-
	\$	<u>62,462</u>

Aggregate rental expense for 2016 and 2015 was \$52,666 and \$21,268, respectively.

Foreclosed Assets

The following table summarizes the activity in foreclosed assets:

	<u>2016</u>	<u>2015</u>
Balance, beginning of year	\$ 2,517,705	\$ 1,777,065
Additions	1,140,614	1,035,500
Sales	(159,553)	(157,795)
Loans originated to finance the sale of foreclosed assets	(60,500)	(85,680)
Net write-downs	(68,832)	(56,500)
Capitalized expenditures	306,453	-
Net gain (loss) on sale	(8,105)	5,115
Balance, end of year	<u>\$ 3,667,782</u>	<u>\$ 2,517,705</u>

At December 31, 2016 and 2015, the Bank held foreclosed residential properties at a carrying value of \$336,534 and \$216,300 respectively.

Notes to Consolidated Financial Statements

Note 7. Deposits

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2016 and 2015 was \$19,498,712 and \$16,421,721, respectively.

At December 31, 2016, the scheduled maturities of time deposits are as follows:

2017	\$ 43,244,154
2018	59,633,016
2019	9,051,816
2020	20,320,706
2021	15,716,878
Thereafter	<u>50,756</u>
	<u>\$ 148,017,326</u>

Note 8. Short-Term Debt

The Bank has established various credit facilities to provide additional liquidity if and as needed. At December 31, 2016 and 2015, these facilities from correspondent banks included unsecured lines of credit, a secured line of credit and a repurchase agreement line of credit totaling \$24,000,000. At December 31, 2016 and 2015, the Bank had no outstanding balance against these lines.

In addition, the Bank has a secured line of credit of approximately \$20,843,000 with the Federal Home Loan Bank of Atlanta as of December 31, 2016. Any borrowings from the Federal Home Loan Bank are secured by a blanket collateral agreement on a pledged portion of the Bank's 1-to-4 family residential real estate loans, multifamily mortgage loans, and commercial mortgage collateral. At December 31, 2016, a \$4,000,000 letter of credit in favor of the Commonwealth of Virginia-Treasury Board, to secure public deposits, was utilized from this line of credit, reducing the available credit for secondary liquidity needs to \$16,843,000. No balance was outstanding on this line at December 31, 2016 or December 31, 2015.

The Bank has established a Discount Window facility at the Federal Reserve Bank of Richmond as part of its Contingency Liquidity Plan. Collateral would have to be pledged in order to borrow from the facility. No balance was outstanding on this line at December 31, 2016 or 2015.

Note 9. Fair Values of Financial Instruments

Financial Instruments Measured at Fair Value

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

The fair value of net loans is based on estimated cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. This does not include consideration of liquidity that market participants would use to value such loans. The estimated fair values of deposits are based on estimated cash flows discounted at market interest rates.

The fair value of off-balance sheet financial instruments is considered immaterial. These off-balance sheet financial instruments are commitments to extend credit and are either short-term in nature or subject to immediate repricing.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Bank's financial instruments as of December 31, 2016 and 2015. These tables exclude financial instruments for which the carrying amount approximates fair value and which would be classified as Level 1. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization.

Notes to Consolidated Financial Statements

Note 9. Fair Values of Financial Instruments, continued

Financial Instruments Measured at Fair Value, continued

	Carrying Amount	Fair Value	Fair Value Measurements	
			Significant Other Observable Inputs Level 2	Significant Other Unobservable Inputs Level 3
(In Thousands)				
December 31, 2016				
Financial assets				
Loans, net	\$ 289,417	\$ 294,724	\$ -	\$ 294,724
Financial liabilities				
Deposits	\$ 309,863	\$ 309,663	\$ 309,663	\$ -
(In Thousands)				
December 31, 2015				
Financial assets				
Loans, net	\$ 269,775	\$ 275,454	\$ 487	\$ 274,967
Financial liabilities				
Deposits	\$ 287,123	\$ 285,906	\$ 285,906	\$ -

GAAP provides a framework for measuring and disclosing fair value which requires disclosures about the fair value of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis (for example, available for sale investment securities) or on a nonrecurring basis (for example, impaired loans).

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Bank utilizes fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Bank may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Fair Value Hierarchy

The Bank groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

Notes to Consolidated Financial Statements

Note 9. Fair Values of Financial Instruments, continued

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active or over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Foreclosed Assets

Foreclosed assets are recorded at the lower of investment in the loan or fair value at acquisition. During the holding phase, foreclosed assets are carried at the lower of the carrying value or fair value. Fair value is based on independent observable market prices or appraised values of the collateral, which the Bank considers to be level 2 inputs. When the appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Bank records the foreclosed asset as nonrecurring Level 3.

Loans, net

Other than the loans held for sale portfolio, the Bank does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2016 and 2015, substantially all impaired loans were evaluated based upon the fair value of collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Bank records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Bank records the loan as nonrecurring Level 3. When management performs an in-house appraisal using data such as comparable sales analysis, analysis on tax assessments, and physical inspection to determine the fair value, the Bank records the loans as nonrecurring Level 3.

Deposits

Deposits without a stated maturity, including demand, interest-bearing demand, and savings accounts, are reported at their carrying value in accordance with authoritative accounting guidance. No value has been assigned to the franchise value of these deposits. For other types of deposits with fixed maturities, fair value has been estimated by discounting future cash flows based on interest rates currently being offered on deposits with similar characteristics and maturities.

Notes to Consolidated Financial Statements

Note 9. Fair Values of Financial Instruments, continued

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

December 31, 2016 (In Thousands)	Total	Level 1	Level 2	Level 3
Investment securities available for sale:				
Government-sponsored enterprises	\$ 13,387	\$ -	\$ 13,387	\$ -
State and municipal securities	3,298	-	3,298	-
Other investments	1,400	-	-	1,400
Corporate securities	93	93	-	-
Total assets at fair value	<u>\$ 18,178</u>	<u>\$ 93</u>	<u>\$ 16,685</u>	<u>\$ 1,400</u>

December 31, 2015 (In Thousands)				
Investment securities available for sale:				
Government-sponsored enterprises	\$ 12,119	\$ -	\$ 12,119	\$ -
State and municipal securities	3,340	-	3,340	-
Other investments	400	-	-	400
Corporate securities	92	92	-	-
Total assets at fair value	<u>\$ 15,951</u>	<u>\$ 92</u>	<u>\$ 15,459</u>	<u>\$ 400</u>

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

The Bank may be required from time to time, to measure certain assets at fair value on a nonrecurring basis. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Balances are net of specific reserves. Assets measured at fair value on a nonrecurring basis are included in the table below.

December 31, 2016 (In Thousands)	Total	Level 1	Level 2	Level 3
Impaired loans:				
Commercial	\$ -	\$ -	\$ -	\$ -
Agricultural & Raw Land	989	-	-	989
Consumer	-	-	-	-
Residential - Prime	-	-	-	-
Total Impaired Loans	989	-	-	989
Foreclosed assets	3,668	-	3,668	-
Total assets at fair value	<u>\$ 4,657</u>	<u>\$ -</u>	<u>\$ 3,668</u>	<u>\$ 989</u>

December 31, 2015 (In Thousands)	Total	Level 1	Level 2	Level 3
Commercial	\$ 327	\$ -	\$ 327	\$ -
Agricultural & Raw Land	989	-	-	989
Consumer	7	-	7	-
Residential - Prime	608	-	153	455
Total Impaired Loans	1,931	-	487	1,444
Foreclosed assets	2,518	-	2,518	-
Total assets at fair value	<u>\$ 4,449</u>	<u>\$ -</u>	<u>\$ 3,005</u>	<u>\$ 1,444</u>

Notes to Consolidated Financial Statements

Note 9. Fair Values of Financial Instruments, continued

During 2016, one loan transferred out of Level 3 due to an updated present value of cash flows valuation. No transfers into or out of Level 3 occurred during 2015. For the years ended December 31, 2016 and 2015, the changes in Level 3 assets measured at fair value on a nonrecurring basis are summarized as follows (dollars in thousands):

	Year Ended December 31,	
	2016	2015
	Impaired Loans	Impaired Loans
Balance, January 1	\$ 1,444	\$ 1,445
Included in earnings	1	4
Transfers into Level 3	-	-
Transfers out of Level 3	(449)	-
Principal reductions	(7)	(5)
Balance, December 31	<u>\$ 989</u>	<u>\$ 1,444</u>

The Bank has no liabilities carried at fair value or measured at fair value on a recurring or nonrecurring basis.

Level 3 Valuation Techniques

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis, as of December 31, 2016, the valuation technique and the significant unobservable inputs used in the fair value measurements were as follows:

(In Thousands) December 31, 2016	Fair Value	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Value
Impaired loans	\$ 989	Management estimate	Appraisals and/or sales of compare- able properties	n/a

Note 10. Benefit Plans

Pension Plan

For the years ended December 31, 2016 and 2015, the Bank had a noncontributory cash balance pension plan ("Plan"). The Plan is sponsored by the Virginia Bankers Association and covers all eligible employees with at least one year of service who have attained the age of twenty-one. The Bank is permitted to make annual contributions to the Plan. Contribution credits are based on a tier for age and years of service. Interest is credit annually based on a rate tied to the 10-year Treasury rate and is guaranteed to meet the minimum threshold established by the IRS and not to be less than 3% on an annual basis. Upon retirement, the Plan permits lump sum, periodic installments, and monthly benefit payment options.

Notes to Consolidated Financial Statements

Note 10. Benefit Plans, continued

Pension Plan, continued

The Plan was underfunded at December 31, 2016 and 2015. The underfunded status at December 31, 2016 is primarily due to benefits paid exceeding employer contributions and an adverse change in the discount rate assumption, partially offset by a positive return on plan assets. The following table is a summary of the plan's funded status for each year ended December 31:

	<u>2016</u>	<u>2015</u>
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year	\$ 3,756,952	\$ 3,892,641
Service cost	200,607	183,964
Interest cost	160,607	152,276
Actuarial (gain) loss	206,082	(207,287)
Benefits paid	<u>(232,233)</u>	<u>(264,642)</u>
Benefit obligation at end of year	<u>4,092,015</u>	<u>3,756,952</u>
<i>Change in plan assets</i>		
Fair value of plan assets at beginning of year	3,391,995	3,536,551
Actual return on plan assets	252,938	(9,914)
Employer contributions	200,000	130,000
Benefits paid	<u>(232,233)</u>	<u>(264,642)</u>
Fair value of plan assets at end of year	<u>3,612,700</u>	<u>3,391,995</u>
Funded status, over (under) at end of year	<u>\$ (479,315)</u>	<u>\$ (364,957)</u>
<i>Amounts recognized on the balance sheet</i>		
Other assets	\$ 250,745	\$ 180,717
Other liabilities	<u>(479,315)</u>	<u>(364,957)</u>
Net assets (liabilities)	<u>\$ (228,570)</u>	<u>\$ (184,240)</u>
<i>Amounts recognized in accumulated other comprehensive income:</i>		
Actuarial (gain) loss, net of tax	<u>\$ 486,740</u>	<u>\$ 350,804</u>
<i>Components of net periodic benefit cost and other amounts recognized in accumulated other comprehensive income:</i>		
<i>Net periodic benefit cost</i>		
Service cost	\$ 200,607	\$ 183,964
Interest cost	160,607	152,276
Expected return on plan assets	(266,351)	(265,830)
Amortization of prior service cost	4,397	4,397
Recognized net actuarial (gain) loss	<u>9,134</u>	<u>-</u>
Net periodic benefit cost (credit)	<u>108,394</u>	<u>74,807</u>
<i>Other changes in plan assets and benefit obligations recognized in other comprehensive income</i>		
Net actuarial (gain) loss	205,964	64,060
Tax expense (benefit) on actuarial (gain) loss	<u>(70,028)</u>	<u>(21,780)</u>
Total recognized in other comprehensive (income) loss	<u>135,936</u>	<u>42,280</u>
Total recognized in net periodic benefit cost (credit) and other comprehensive (income) loss	<u>\$ 244,330</u>	<u>\$ 117,087</u>

Notes to Consolidated Financial Statements

Note 10. Benefit Plans, continued

Pension Plan, continued

	<u>2016</u>	<u>2015</u>
Assumptions		
<i>Weighted-average assumptions at December 31</i>		
Discount rate used for net periodic pension cost	4.25%	4.00%
Discount rate used for disclosure	4.00%	4.25%
Expected return on plan assets	7.50%	7.50%
Rate of compensation increase	3.00%	3.00%
Rate of compensation increase for net periodic pension cost	3.00%	3.00%

Using the same fair value hierarchy described in Note 9, the fair values of the Bank's pension plan assets, by asset category, are as follows:

<u>December 31, 2016</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash equivalents and short term investments	\$ -	\$ -	\$ -	\$ -
Mutual funds – equities	2,212,950	2,212,950	-	-
Mutual funds – fixed income	1,399,750	1,399,750	-	-
Total assets at fair value	<u>\$ 3,612,700</u>	<u>\$ 3,612,700</u>	<u>\$ -</u>	<u>\$ -</u>
<u>December 31, 2015</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash equivalents and short term investments	\$ 413	\$ 413	\$ -	\$ -
Mutual funds – equities	2,028,508	2,028,508	-	-
Mutual funds – fixed income	1,363,074	1,363,074	-	-
Total assets at fair value	<u>\$ 3,391,995</u>	<u>\$ 3,391,995</u>	<u>\$ -</u>	<u>\$ -</u>

A contribution of \$285,000 was made during 2017.

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows:

2017	\$ 660,060
2018	89,636
2019	229,434
2020	46,726
2021	398,057
2022-2026	2,364,987

Long-term rate of return

The plan sponsor selects the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed – especially with respect to real rates of return (net of inflation) – for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience – that may not continue over the measurement period – with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further – solely for this purpose – the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

Notes to Consolidated Financial Statements

Note 10. Benefit Plans, continued

Pension Plan assumptions, continued

Discount Rate

The process used to select the discount rate assumption under ASC 715 takes into account the benefit cash flow and the segmented yields on high quality corporate bonds that would be available to provide for the payment of the benefit cash flow. A single effective discount rate, rounded to the nearest 0.25%, is then established that produces an equivalent discounted present value.

Asset allocation and investment strategies

The pension plan's weighted-average asset allocations, by asset category, are as follows for the year-ended December 31:

Asset Category	2016	2015
Mutual funds – fixed income	39%	40%
Mutual funds – equity	61%	60%
Total	100%	100%

Bank management elects an asset allocation for the plan annually. The election is based on management's assessment of the fixed income and equities markets and the economic outlook when matching potential risk and return for employee participants. The trust fund is diversified to maintain a reasonable level of risk without imprudently sacrificing return. The targeted asset allocation was 40% fixed income and 60% equities in 2016 and 2015. The Investment Manager selects fund managers with demonstrated experience and expertise and funds with demonstrated historical performance for the implementation of the Plan's investment strategy. The Investment Manager considers both actively and passively managed investment strategies and allocates funds across the asset classes to develop an efficient investment structure.

It is the responsibility of the Trustee to administer the investments of the Trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administration costs chargeable to the Trust.

Concentration of risk

No concentration of risk was identified in the plan.

Notes to Consolidated Financial Statements

Note 10. Benefit Plans, continued

Post-Retirement Health Insurance

The Bank sponsors a post-retirement health care plan for certain retired employees. The health plan has an annual limitation (a “cap”) on the dollar amount of the employer’s share of the cost of covered benefits incurred by a plan participant. The retiree is responsible, therefore, for the amount by which the cost of the benefit coverage under the plan incurred during a year exceeds that cap. No health care cost increases have been factored into the health plan’s actuarial calculations due to this cap. The plan remains frozen with coverage continuing for four existing retiree participants. The following tables summarize the Bank’s post retirement plan obligations, assets, funded status, and the assumptions and components of net periodic benefit costs using a measurement date of December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year	\$ 141,370	\$ 162,894
Interest cost	4,835	5,296
Actuarial gain	(32,094)	(14,420)
Benefits paid	<u>(9,600)</u>	<u>(12,400)</u>
Benefit obligation at end of year	<u>104,511</u>	<u>141,370</u>
<i>Change in plan assets</i>		
Fair value of plan assets at beginning of year	-	-
Employer contribution	9,600	12,400
Benefits paid	<u>(9,600)</u>	<u>(12,400)</u>
Fair value of plan assets at end of year	-	-
Funded status, over (under) at end of year	<u>\$ (104,511)</u>	<u>\$ (141,370)</u>
<i>Amounts recognized on the balance sheet</i>		
Other assets (deferred tax)	\$ 14,089	\$ 30,006
Other liabilities	<u>(104,511)</u>	<u>(141,370)</u>
Net liabilities	<u>\$ (90,422)</u>	<u>\$ (111,364)</u>
<i>Amounts recognized in accumulated other comprehensive income:</i>		
Actuarial gain	\$ (32,167)	\$ (73)
Prior service cost	73,604	88,326
Deferred tax benefit	<u>(14,089)</u>	<u>(30,006)</u>
Net accumulated other comprehensive loss	<u>\$ 27,348</u>	<u>\$ 58,247</u>
<i>Components of net periodic postretirement cost and other amounts recognized in accumulated other comprehensive income:</i>		
<i>Net periodic benefit cost</i>		
Interest cost	\$ 4,835	\$ 5,296
Amortization of prior service cost	<u>14,722</u>	<u>14,722</u>
Net periodic postretirement cost	<u>19,557</u>	<u>20,018</u>
<i>Other changes in plan assets and benefit obligations recognized in other comprehensive income</i>		
Actuarial gain	(32,094)	(14,420)
Amortization of prior service cost	(14,722)	(14,722)
Tax benefit on comprehensive income	<u>15,917</u>	<u>9,908</u>
Total recognized in other comprehensive loss	<u>(30,899)</u>	<u>(19,234)</u>
Total recognized in net periodic postretirement cost and other comprehensive (income) loss	<u>\$ (11,342)</u>	<u>\$ 784</u>

Notes to Consolidated Financial Statements

Note 10. Benefit Plans, continued

Post-Retirement Health Insurance, continued

The Bank expects to recognize amortization of transition obligation of \$14,722 in 2017.

The discount rate assumption in determining the benefit relating to the untrended post-retirement health care plan at December 31, 2016, was 3.39%. Since the post-retirement health insurance benefit plan is untrended, increases and decreases in health care cost trend rates, expected rate of return on plan assets, and the rate of compensation increase is not applicable.

Employer contributions are expected to be \$9,600 in 2017.

Estimated future benefit payments by the plan are as follows:

2017	\$	9,600
2018		9,371
2019		9,125
2020		8,863
2021		8,581
2022-2026		37,989

Deferred Compensation Plan

Funded deferred compensation plans have been adopted for certain members of the Board of Directors and executive employees. The corresponding assets and liabilities of the plans are held by a third party through the Virginia Bankers Association and totaled \$629,342 and \$587,767 for the Director Plan at December 31, 2016 and 2015, respectively. The Executive Plan had no active participants and a zero balance at December 31, 2016 and 2015.

Profit Sharing/Thrift Plan

The Bank provides a profit sharing/thrift plan for its employees to which contributions are made at the discretion of the Board of Directors. All full-time employees, age 18 and older, are eligible to participate and are automatically enrolled, unless they choose to opt-out of the plan, after completing their first six months of service. The plan allows for pretax employee contributions of up to the maximum allowed by the IRS. In 2016 and 2015, the first 1% of employee contributions was matched 100% by the Bank. The next 5% of employee contributions was matched 50% by the Bank. Employer contributions to the plan amounted to \$131,846 and \$189,082 in 2016 and 2015, respectively.

Note 11. Income Taxes

Current and Deferred Income Tax Components

The components of income tax expense (benefit) are as follows:

	<u>2016</u>	<u>2015</u>
<i>Current</i>		
Federal	\$ 876,432	\$ 749,503
State	<u>9,670</u>	<u>7,592</u>
	<u>886,102</u>	<u>757,095</u>
<i>Deferred</i>		
Federal	218,795	530,527
State	<u>932</u>	<u>67</u>
	<u>219,727</u>	<u>530,594</u>
<i>Income Tax Expense</i>	<u>\$ 1,105,829</u>	<u>\$ 1,287,689</u>

Notes to Consolidated Financial Statements

Note 11. Income Taxes, continued

Rate Reconciliation

A reconciliation of income tax expense computed at the statutory federal income tax rate to income tax expense included in the consolidated statements of income is as follows:

	<u>2016</u>	<u>2015</u>
Tax at statutory federal rate	\$ 1,139,123	\$ 1,341,216
Tax exempt interest income	(44,744)	(60,078)
Other	11,450	6,551
Income Tax Expense	<u>\$ 1,105,829</u>	<u>\$ 1,287,689</u>

Deferred Income Tax Analysis

The significant components of net deferred tax assets at December 31 are summarized as follows:

	<u>2016</u>	<u>2015</u>
Deferred tax assets		
Allowance for loan losses	\$ 220,842	\$ 34,511
Deferred compensation	174,041	157,706
Pension plan	250,745	180,717
Post-retirement health benefits	14,089	30,006
Investment in pass-through entities	63,003	68,900
Foreclosed assets	156,208	131,683
Interest on nonaccrual loans	11,169	8,164
Accrued unpaid compensation	69,670	64,510
Other	98,041	102,702
Deferred tax assets	<u>1,057,808</u>	<u>778,899</u>
Deferred tax liabilities		
Net unrealized appreciation		
on securities available for sale	(23,177)	(58,787)
Depreciation	(775,340)	(411,562)
Accretion of discount on investment securities	(242)	(207)
Accrued pension costs	(184,678)	(124,632)
Other	(51,286)	(30,617)
Deferred tax liabilities	<u>(1,034,723)</u>	<u>(625,805)</u>
Net deferred tax asset	<u>\$ 23,085</u>	<u>\$ 153,094</u>

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with accounting guidance on Income Taxes.

The Bank has evaluated the need for a deferred tax valuation allowance for the years ended December 31, 2016 and 2015 in accordance with ASC 740, Income Taxes. Based on a three year taxable income projection and tax strategies which would result in recognition of potential securities gains and the effects of off-setting deferred tax liabilities, the Bank believes that it is more likely than not that the deferred tax assets are realizable. Therefore, no allowance is required.

With few exceptions, the Bank is no longer subject to federal or state income tax examinations by tax authorities for years before 2013.

Notes to Consolidated Financial Statements

Note 12. Low Income Housing Tax Credits

The Bank is an investor in a housing equity fund. The general purpose of this fund is to encourage and assist participants in investing in low-income residential rental properties located in the Commonwealth of Virginia, develop and implement strategies to maintain projects as low-income housing, deliver Federal Low Income Housing Credits to investors, allocate tax losses and other possible tax benefits to investors, and to preserve and protect project assets. The Bank accounts for this investment under the proportional amortization method and at December 31, 2016, the investment in this fund, recorded in other assets on the consolidated balance sheet, was \$496,293. Total projected tax credits to be received for 2016 are \$4,453 which is based on the most recent estimates received from the fund. Amortization expense for 2016 was \$2,650. Additional capital calls expected for the fund totals \$499,500 at December 31, 2016 and is included in other liabilities on the consolidated balance sheets.

Note 13. Commitments and Contingencies

Litigation

In the normal course of business the Bank is involved in various legal proceedings. After consultation with legal counsel, management believes that any liability resulting from such proceedings will not be material to the consolidated financial statements.

Financial Instruments with Off-Balance-Sheet Risk

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amounts recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments. A summary of commitments at December 31 is as follows:

	<u>2016</u>	<u>2015</u>
Commitments to extend credit	\$ 45,373,000	\$ 45,013,000
Standby letters of credit	<u>2,021,000</u>	<u>1,775,000</u>
	<u>\$ 47,394,000</u>	<u>\$ 46,788,000</u>

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

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

Notes to Consolidated Financial Statements

Note 13. Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk, continued

In the normal course of business, the Bank extends commitment letters to fund loans at a future date. The Bank had issued approximately \$11,400,000 in such commitments at December 31, 2016. However, there is no assurance that the loans will be originated and funded due to uncertainty of customer acceptance of the terms and conditions of the agreement.

Concentrations of Credit Risk

Substantially all of the Bank's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Standby letters of credit are granted primarily to commercial borrowers. Although the Bank has a reasonably diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent upon economic conditions in and around the counties of Botetourt, Roanoke, Rockbridge and Franklin and the City of Salem, Virginia. At December 31, 2016 the Bank had an approximate \$29,000,000 in secured loan concentration balances in 1-4 family residential construction, other construction, land and development, and lots. This amount represents 78.13% of total risk based capital, complying with the Federal Deposit Insurance Corporation's ("FDIC") suggested guideline of less than 100%.

The Bank also monitors loan concentrations for non-owner occupied commercial real estate, construction, and lot loans. Combined with the categories above, the Bank had approximately \$68,400,000 in concentration balances or 184.32% of total risk based capital, below the FDIC's suggested guideline of less than 300%. Large individual credit relationships are also monitored to mitigate risk and ensure compliance with applicable laws.

Certain cash deposits maintained by the Bank with other financial institutions are secured by federal depository insurance. At times during the year these accounts are in excess of the FDIC insured limit of \$250,000. The Bank has not experienced losses in such accounts and believes it is not exposed to significant credit risk on cash and cash equivalents.

Note 14. Regulatory Restrictions

Investments in state and municipal securities involve governmental entities within and outside the Bank's market area.

The Bank from time to time has cash and cash equivalents on deposit with financial institutions which exceed federally-insured limits.

Dividends

As a Virginia banking corporation, the Bank may pay dividends only out of its retained earnings. However, regulatory authorities may limit or prevent payment of dividends by any bank when it is determined that such a limitation is in the public interest and is necessary to ensure financial soundness of the bank.

Capital Requirements

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

Notes to Consolidated Financial Statements

Note 14. Regulatory Restrictions, continued

Capital Requirements, continued

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total Capital, Tier 1 Capital and Tier 1 Common Equity Capital to risk-weighted assets, and of Tier 1 Leverage Capital to average assets, as all those terms are defined in the regulations. Management believes, as of December 31, 2016, that the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2016 and 2015, the Bank was categorized as “well capitalized” as defined by applicable regulations. To be categorized as “well capitalized”, the Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 Common Equity, and Tier 1 Leverage ratios as set forth in the table below. BASEL III regulatory capital guidance established the capital conservation buffer phase-in beginning January 1, 2016. The capital conservation buffer requirement will be gradually phased in starting with 0.625% in 2016 and increased each year until it is fully implemented at 2.5% in 2019. The Bank must maintain the required capital conservation buffer to avoid restrictions on payments of dividends, discretionary bonuses, and capital repurchases. At December 31, 2016, the Bank met the capital conservation buffer requirement.

There are no conditions or events since that date that management believes have changed the Bank’s category. The Bank’s actual capital amounts and ratios are presented in the table below (in thousands except for percentages):

	<u>Actual</u>		<u>Regulatory Minimum With Capital Conservation Buffer</u>		<u>Capital Required To Be Considered Well Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
December 31, 2016:						
Total Capital (to Risk-Weighted Assets)	\$ 37,099	12.9%	\$ 24,746	8.625%	\$ 28,691	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 34,196	11.9%	\$ 19,008	6.625%	\$ 22,953	8.0%
Tier 1 Common Equity Capital (to Risk-Weighted Assets)	\$ 34,196	11.9%	\$ 14,704	5.125%	\$ 18,649	6.5%
Tier 1 Capital - Leverage (to Average Assets)	\$ 34,196	9.8%	\$ 13,955	4.000%	\$ 17,444	5.0%
December 31, 2015:						
Total Capital (to Risk-Weighted Assets)	\$ 35,135	12.9%	\$ 21,784	8.0%	\$ 27,230	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 32,509	11.9%	\$ 16,338	6.0%	\$ 21,784	8.0%
Tier 1 Common Equity Capital (to Risk-Weighted Assets)	\$ 32,509	11.9%	\$ 12,254	4.5%	\$ 17,700	6.5%
Tier 1 Capital - Leverage (to Average Assets)	\$ 32,509	10.1%	\$ 12,844	4.0%	\$ 16,055	5.0%

Note 15. Transactions with Related Parties

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Notes to Consolidated Financial Statements

Note 15. Transactions with Related Parties, continued

Aggregate loan transactions with related parties were as follows for the year-ended December 31:

	<u>2016</u>	<u>2015</u>
<i>Balance, beginning</i>	\$ 4,057,202	\$ 3,131,668
New loans or credit line advances	4,036,449	5,654,601
Repayments	<u>(4,250,048)</u>	<u>(4,729,067)</u>
<i>Balance, ending</i>	<u>\$ 3,843,603</u>	<u>\$ 4,057,202</u>

Deposit transactions with related parties at December 31, 2016 and 2015 were insignificant.

As discussed in Note 6 Property, Equipment and Foreclosed Assets, the Bank had lessee activities with companies of related party interests in both 2016 and 2015.

Note 16. Dividend Reinvestment and Stock Purchase Plan

The Bank's Dividend Reinvestment and Stock Purchase Plan ("DRIP") provides for the issuance of up to 200,000 shares of common stock. Common shares may be acquired on a quarterly basis via full or partial dividend reinvestment, systematic quarterly purchases, or a one-time purchase. The purchase price of shares acquired through the DRIP is recommended by the Dividend Reinvestment Plan Committee ("Committee") of the Bank and approved by the Board of Directors. In determining the purchase price per share, the Committee considers book value of the common stock, the relationship between traded price and book value, known recent trades, bid price, and any additional information the Committee deems appropriate.

The following is a summary of the shares of common stock issued from dividends reinvested and optional cash purchases in 2016 and 2015.

	<u>2016</u>	
	<u>Shares</u>	<u>Purchase Price</u>
First Quarter	1,590	\$ 18.50
Second Quarter	1,563	18.75
Third Quarter	1,807	19.15
Fourth Quarter	<u>1,580</u>	<u>19.50</u>
Total Shares Issued	<u>6,540</u>	

	<u>2015</u>	
	<u>Shares</u>	<u>Purchase Price</u>
First Quarter	1,501	\$ 16.25
Second Quarter	1,510	16.50
Third Quarter	1,448	17.00
Fourth Quarter	<u>1,387</u>	<u>17.75</u>
Total Shares Issued	<u>5,846</u>	

Notes to Consolidated Financial Statements

Note 17. Subsequent Events

Defined Contribution Plan

Effective January 1, 2017 part-time employees became eligible to participate in the Bank's defined contribution plan following a Plan amendment approved by the Board of Directors on November 16, 2016.

Declaration of Cash Dividend

On January 25, 2017, the Bank declared a first quarter \$0.14 dividend per common share paid on February 17, 2016 to shareholders of record on February 10, 2017.

Short-Term Debt

On February 1, 2017, the Bank increased its letter of credit in favor of the Commonwealth of Virginia-Treasury Board, to secure public deposits, from \$4,000,000 to \$8,000,000 thereby reducing the available credit for secondary liquidity needs to \$12,843,000.

These financial statements have not been updated for subsequent events occurring after February 21, 2017 which is the date these financial statements were available to be issued.

NOTES

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