

NEW PEOPLES BANKSHARES INC

Form 10-Q

November 13, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2012

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

Commission file number: 000-33411

NEW PEOPLES BANKSHARES, INC.

(Exact name of registrant as specified in its charter)

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Virginia
(State or other jurisdiction of
incorporation or organization)

31-1804543
(I.R.S. Employer
Identification No.)

67 Commerce Drive

Honaker, Virginia
(Address of principal executive offices)

24260
(Zip Code)

(Registrant's telephone number, including area code) (276) 873-7000

n/a

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

| Class | Outstanding at November 9, 2012 |
|--------------------------------|---------------------------------|
| Common Stock, \$2.00 par value | 13,824,697 |

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NEW PEOPLES BANKSHARES, INC.**CONSOLIDATED STATEMENTS OF OPERATIONS****FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011**

(IN THOUSANDS EXCEPT SHARE AND PER SHARE DATA)

(UNAUDITED)

| | 2012 | 2011 |
|--|---------------|---------------|
| INTEREST AND DIVIDEND INCOME | | |
| Loans including fees | \$ 24,784 | \$ 31,357 |
| Federal funds sold | 2 | 9 |
| Interest-earning deposits with banks | 131 | 128 |
| Investments | 653 | 149 |
| Dividends on equity securities (restricted) | 83 | 74 |
| Total Interest and Dividend Income | 25,653 | 31,717 |
| INTEREST EXPENSE | | |
| Deposits | | |
| Demand | 81 | 126 |
| Savings | 177 | 399 |
| Time deposits below \$100,000 | 2,364 | 3,762 |
| Time deposits above \$100,000 | 1,589 | 2,295 |
| FHLB Advances | 403 | 669 |
| Other borrowings | 128 | 150 |
| Trust Preferred Securities | 370 | 315 |
| Total Interest Expense | 5,112 | 7,716 |
| NET INTEREST INCOME | 20,541 | 24,001 |
| PROVISION FOR LOAN LOSSES | 4,093 | 6,258 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 16,448 | 17,743 |
| NONINTEREST INCOME | | |
| Service charges | 1,834 | 1,816 |
| Fees, commissions and other income | 1,742 | 1,515 |
| Insurance and investment fees | 260 | 325 |
| Net realized gains on sale of investment securities | 385 | |
| Life insurance investment income | 235 | 253 |
| Total Noninterest Income | 4,456 | 3,909 |
| NONINTEREST EXPENSES | | |
| Salaries and employee benefits | 10,496 | 11,723 |

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| | | |
|---|-------------------|-------------------|
| Occupancy and equipment expense | 3,231 | 3,276 |
| Advertising and public relations | 325 | 304 |
| Data processing and telecommunications | 1,323 | 1,218 |
| FDIC insurance premiums | 1,244 | 1,571 |
| Other real estate owned and repossessed vehicles, net | 4,387 | 4,476 |
| Other operating expenses | 4,071 | 3,775 |
| Total Noninterest Expenses | 25,077 | 26,343 |
| LOSS BEFORE INCOME TAXES | (4,173) | (4,691) |
| INCOME TAX EXPENSE (BENEFIT) | 2,363 | (1,733) |
| NET LOSS | \$ (6,536) | \$ (2,958) |
| Loss Per Share | | |
| Basic | \$ (0.64) | \$ (0.30) |
| Fully Diluted | \$ (0.64) | \$ (0.30) |
| Average Weighted Shares of Common Stock | | |
| Basic | 10,177,237 | 10,010,178 |
| Fully Diluted | 10,177,237 | 10,010,178 |

The accompanying notes are an integral part of this statement.

Table of Contents**NEW PEOPLES BANKSHARES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011**

(IN THOUSANDS EXCEPT SHARE AND PER SHARE DATA)

(UNAUDITED)

| | 2012 | 2011 |
|--|--------------|---------------|
| INTEREST AND DIVIDEND INCOME | | |
| Loans including fees | \$ 7,989 | \$ 9,955 |
| Federal funds sold | 1 | |
| Interest-earning deposits with banks | 36 | 48 |
| Investments | 212 | 65 |
| Dividends on equity securities (restricted) | 28 | 24 |
| Total Interest and Dividend Income | 8,266 | 10,092 |
| INTEREST EXPENSE | | |
| Deposits | | |
| Demand | 27 | 37 |
| Savings | 57 | 75 |
| Time deposits below \$100,000 | 707 | 1,132 |
| Time deposits above \$100,000 | 477 | 721 |
| FHLB Advances | 72 | 225 |
| Other borrowings | 40 | 45 |
| Trust Preferred Securities | 123 | 115 |
| Total Interest Expense | 1,503 | 2,350 |
| NET INTEREST INCOME | 6,763 | 7,742 |
| PROVISION FOR LOAN LOSSES | 967 | 2,801 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 5,796 | 4,941 |
| NONINTEREST INCOME | | |
| Service charges | 635 | 657 |
| Fees, commissions and other income | 554 | 496 |
| Insurance and investment fees | 28 | 134 |
| Net realized gains on sale of investment securities | 48 | |
| Life insurance investment income | 90 | 77 |
| Total Noninterest Income | 1,355 | 1,364 |
| NONINTEREST EXPENSES | | |
| Salaries and employee benefits | 3,389 | 3,864 |
| Occupancy and equipment expense | 1,047 | 1,132 |
| Advertising and public relations | 114 | 121 |

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| | | |
|---|-------------------|-------------------|
| Data processing and telecommunications | 434 | 420 |
| FDIC insurance premiums | 399 | 475 |
| Other real estate owned and repossessed vehicles, net | 1,140 | 1,986 |
| Other operating expenses | 1,315 | 1,115 |
| Total Noninterest Expenses | 7,838 | 9,113 |
| LOSS BEFORE INCOME TAXES | (687) | (2,808) |
| INCOME TAX EXPENSE (BENEFIT) | 776 | (976) |
| NET LOSS | \$ (1,463) | \$ (1,832) |
| Loss Per Share | | |
| Basic | \$ (0.14) | \$ (0.18) |
| Fully Diluted | \$ (0.14) | \$ (0.18) |
| Average Weighted Shares of Common Stock | | |
| Basic | 10,507,724 | 10,010,178 |
| Fully Diluted | 10,507,724 | 10,010,178 |

The accompanying notes are an integral part of this statement.

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NEW PEOPLES BANKSHARES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

(IN THOUSANDS)

(UNAUDITED)

| | For the three months ended | | For the nine months | |
|--|----------------------------|-------------------|---------------------|-------------------|
| | September 30, | | ended | |
| | 2012 | 2011 | 2012 | 2011 |
| Net Loss | \$ (1,463) | \$ (1,832) | \$ (6,536) | \$ (2,958) |
| Other comprehensive income (loss): | | | | |
| Investment Securities Activity | | | | |
| Unrealized gains arising during the period | 261 | 58 | 475 | 184 |
| Tax related to unrealized gains | (89) | (20) | (162) | (63) |
| Reclassification of realized gains during the period | (48) | | (385) | |
| Tax related to realized gains | 17 | | 131 | |
| Total other comprehensive income | 141 | 38 | 59 | 121 |
| Total comprehensive loss | \$ (1,322) | \$ (1,794) | \$ (6,477) | \$ (2,837) |

The accompanying notes are an integral part of this statement.

Table of Contents**NEW PEOPLES BANKSHARES, INC.****CONSOLIDATED BALANCE SHEETS**

(IN THOUSANDS EXCEPT PER SHARE AND SHARE DATA)

| | September 30, 2012 | December 31, 2011 |
|--|-------------------------------|------------------------------|
| | (Unaudited) | (Audited) |
| ASSETS | | |
| Cash and due from banks | \$ 16,976 | \$ 18,306 |
| Interest-bearing deposits with banks | 50,679 | 72,170 |
| Federal funds sold | 2 | 77 |
| Total Cash and Cash Equivalents | 67,657 | 90,553 |
| Investment securities | | |
| Available-for-sale | 48,559 | 32,434 |
| Loans receivable | 538,992 | 597,816 |
| Allowance for loan losses | (17,588) | (18,380) |
| Net Loans | 521,404 | 579,436 |
| Bank premises and equipment, net | 32,290 | 33,141 |
| Equity securities (restricted) | 2,818 | 3,573 |
| Other real estate owned | 11,368 | 15,092 |
| Accrued interest receivable | 2,516 | 3,067 |
| Life insurance investments | 11,890 | 11,351 |
| Goodwill and other intangibles | 67 | 123 |
| Deferred taxes | 4,789 | 7,220 |
| Other assets | 4,859 | 4,394 |
| Total Assets | \$ 708,217 | \$ 780,384 |
| LIABILITIES | | |
| Deposits: | | |
| Demand deposits: | | |
| Noninterest bearing | \$ 109,057 | \$ 109,629 |
| Interest-bearing | 61,261 | 58,459 |
| Savings deposits | 95,359 | 94,569 |
| Time deposits | 387,540 | 445,658 |
| Total Deposits | 653,217 | 708,315 |
| Federal Home Loan Bank advances | 6,858 | 17,983 |
| Accrued interest payable | 1,793 | 1,796 |
| Accrued expenses and other liabilities | 1,735 | 1,471 |
| Other borrowings | | 5,450 |
| Trust preferred securities | 16,496 | 16,496 |
| Total Liabilities | 680,099 | 751,511 |

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Commitments and contingencies

STOCKHOLDERS EQUITY

| | | |
|--|---------------|---------------|
| Common stock - \$2.00 par value; 50,000,000 shares authorized; 13,824,697 and 10,010,178 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 27,649 | 20,020 |
| Common stock warrants | 663 | |
| Additional paid-in-capital | 19,119 | 21,689 |
| Retained earnings (deficit) | (19,621) | (13,085) |
| Accumulated other comprehensive income | 308 | 249 |
| Total Stockholders Equity | 28,118 | 28,873 |
| | | |
| Total Liabilities and Stockholders Equity | \$ 708,217 | \$ 780,384 |

The accompanying notes are an integral part of this statement.

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NEW PEOPLES BANKSHARES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

(IN THOUSANDS INCLUDING SHARE DATA)

(UNAUDITED)

| | Shares of Common Stock | Common Stock | Common Stock Warrants | Additional Paid in Capital | Retained Earnings (Deficit) | Accumulated Other Comprehensive Income (Loss) | Total Shareholders Equity |
|--|------------------------------|-----------------|-----------------------------|----------------------------------|-----------------------------------|---|---------------------------------|
| Balance, December 31, 2010 | 10,010 | \$ 20,020 | \$ | \$ 21,689 | \$ (4,175) | \$ (11) | \$ 37,523 |
| Net loss | | | | | (2,958) | | (2,958) |
| Unrealized gain on available-for-sale securities, net of \$63 tax | | | | | | 121 | 121 |
| Balance, September 30, 2011 | 10,010 | \$ 20,020 | \$ | \$ 21,689 | \$ (7,133) | \$ 110 | \$ 34,686 |
| Balance, December 31, 2011 | 10,010 | \$ 20,020 | \$ | 21,689 | \$ (13,085) | \$ 249 | \$ 28,873 |
| Net loss | | | | | (6,536) | | (6,536) |
| Conversion of Director Notes plus accrued interest | 3,815 | 7,629 | 663 | (2,570) | | | 5,722 |
| Realized gains on available-for-sale securities, net of \$131 tax | | | | | | (254) | (254) |
| Unrealized gain on available-for-sale securities, net of \$162 tax | | | | | | 313 | 313 |
| Balance, September 30, 2012 | 13,825 | \$ 27,649 | \$ 663 | 19,119 | \$ (19,621) | \$ 308 | \$ 28,118 |

The accompanying notes are an integral part of this statement.

Table of Contents**NEW PEOPLES BANKSHARES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011**

(IN THOUSANDS)

(UNAUDITED)

| | 2012 | 2011 |
|---|-----------------|-----------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net loss | \$ (6,536) | \$ (2,958) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation | 1,899 | 1,903 |
| Provision for loan losses | 4,093 | 6,258 |
| Income (less expenses) on life insurance | (539) | (253) |
| Gain on sale of securities available-for-sale | (385) | |
| (Gain) loss on sale of fixed assets | (5) | 146 |
| Loss (gain) on sale of foreclosed real estate | 383 | (17) |
| Adjustment of carrying value of foreclosed real estate | 2,983 | 3,508 |
| Accretion of bond premiums/discounts | 397 | 16 |
| Deferred tax expense | 2,401 | (305) |
| Amortization of core deposit intangible | 56 | 79 |
| Net change in: | | |
| Interest receivable | 551 | 532 |
| Other assets | (465) | (2,080) |
| Accrued interest payable | 269 | 176 |
| Accrued expenses and other liabilities | 264 | 80 |
| Net Cash Provided by Operating Activities | 5,366 | 7,085 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Net decrease in loans | 47,066 | 58,201 |
| Purchase of securities available-for-sale | (33,203) | (16,765) |
| Proceeds from sale and maturities of securities available-for-sale | 17,155 | 3,925 |
| Sale of Federal Home Loan Bank stock | 755 | 221 |
| Payments for the purchase of premises and equipment | (1,065) | (1,593) |
| Proceeds from sales of premises and equipment | 22 | 185 |
| Proceeds from sales of other real estate owned | 7,231 | 4,182 |
| Net Cash Provided by Investing Activities | 37,961 | 48,356 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Repayment of line of credit borrowings | | (4,900) |
| Net increase in other borrowings | | 5,200 |
| Repayments to Federal Home Loan Bank | (11,125) | (5,900) |
| Net change in: | | |
| Demand deposits | 2,230 | 17,849 |
| Savings deposits | 790 | (10,617) |
| Time deposits | (58,118) | (41,323) |
| Net Cash Used in Financing Activities | (66,223) | (39,691) |

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| | | |
|--|------------|-----------|
| Net (decrease) increase in cash and cash equivalents | (22,896) | 15,750 |
| Cash and Cash Equivalents, Beginning of Period | 90,553 | 82,529 |
| Cash and Cash Equivalents, End of Period | \$ 67,657 | \$ 98,279 |
| Supplemental Disclosure of Cash Paid During the Period for: | | |
| Interest | \$ 5,115 | \$ 7,892 |
| Taxes | \$ | \$ |
| Supplemental Disclosure of Non Cash Transactions: | | |
| Other real estate acquired in settlement of foreclosed loans | \$ 6,873 | \$ 6,108 |
| Conversion of Director Notes in other borrowings to common stock | \$ (5,450) | \$ |
| Conversion of accrued interest payable on Director Notes to common stock | \$ (272) | \$ |
| Common stock issued as a result of the conversion of Director Notes | \$ 5,722 | \$ |

The accompanying notes are an integral part of this statement.

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NEW PEOPLES BANKSHARES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 NATURE OF OPERATIONS:

New Peoples Bankshares, Inc. (The Company) is a bank holding company whose principal activity is the ownership and management of a community bank. New Peoples Bank, Inc. (Bank) was organized and incorporated under the laws of the Commonwealth of Virginia on December 9, 1997. The Bank commenced operations on October 28, 1998, after receiving regulatory approval. As a state chartered member bank, the Bank is subject to regulation by the Virginia Bureau of Financial Institutions, the Federal Deposit Insurance Corporation and the Federal Reserve Bank. The Bank provides general banking services to individuals, small and medium size businesses and the professional community of southwestern Virginia, southern West Virginia, and eastern Tennessee. On June 9, 2003, the Company formed two wholly owned subsidiaries, NPB Financial Services, Inc. and NPB Web Services, Inc. On July 7, 2004 the Company established NPB Capital Trust I for the purpose of issuing trust preferred securities. On September 27, 2006, the Company established NPB Capital Trust 2 for the purpose of issuing additional trust preferred securities. NPB Financial Services, Inc. was a subsidiary of the Company until January 1, 2009 when it became a subsidiary of the Bank. In June 2012 the name of NPB Financial Services, Inc. was changed to NPB Insurance Services, Inc.

NOTE 2 ACCOUNTING PRINCIPLES:

The financial statements conform to U. S. generally accepted accounting principles and to general industry practices. In the opinion of management, the accompanying unaudited financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position at September 30, 2012, and the results of operations for the three month and nine month periods ended September 30, 2012 and 2011. The notes included herein should be read in conjunction with the notes to financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011. The results of operations for the three month and nine month periods ended September 30, 2012 and 2011 are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions 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. The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions.

NOTE 3 FORMAL WRITTEN AGREEMENT:

Effective July 29, 2010, the Company and the Bank entered into a written agreement with the Federal Reserve Bank of Richmond (Reserve Bank) and the Virginia State Corporation Commission Bureau of Financial Institutions (the Bureau) called (the Written Agreement). At September 30, 2012, we believe we have not yet achieved full compliance with the Written Agreement but we have made progress in our compliance efforts under the Written Agreement and all of the written plans required to date, as discussed in the following paragraphs, have been submitted on a timely basis.

Under the terms of the Written Agreement, the Bank has agreed to develop and submit for approval within specified time periods written plans to: (a) strengthen board oversight of management and the Bank s operation; (b) if appropriate after review, to strengthen the Bank s management and board governance; (c) strengthen credit risk management policies; (d) enhance lending and credit administration; (e) enhance the Bank s management of commercial real estate concentrations; (f) conduct ongoing review and grading of the Bank s loan portfolio; (g) improve the Bank s position with respect to loans, relationships, or other assets in excess of \$1 million which are now or in the future become past due more than 90 days, which are on the Bank s problem loan list, or which are adversely classified in any report of examination of the Bank; (h) review and revise, as appropriate, current policy and maintain sound processes for maintaining an adequate allowance for loan and lease losses; (i) enhance management of the Bank s liquidity position and funds management practices; (j) revise its contingency funding plan; (k) revise its strategic plan; and (l) enhance the Bank s anti-money laundering and related activities.

In addition, the Bank has agreed that it will: (a) not extend, renew, or restructure any credit that has been criticized by the Reserve Bank or the Bureau absent prior board of directors approval in accordance with the restrictions in the Written Agreement; (b) eliminate all assets or portions of assets classified as loss and thereafter charge off all assets classified as loss in a federal or state report of examination, unless otherwise approved by the Reserve Bank.

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Under the terms of the Written Agreement, both the Company and the Bank have agreed to submit capital plans to maintain sufficient capital at the Company, on a consolidated basis, and the Bank, on a stand-alone basis, and to refrain from declaring or paying dividends without prior regulatory approval. The Company has agreed that it will not take any other form of payment representing a reduction in the Bank's capital or make any distributions of interest, principal, or other sums on subordinated debentures or trust preferred securities without prior regulatory approval. The Company may not incur, increase or guarantee any debt without prior regulatory approval and has agreed not to purchase or redeem any shares of its stock without prior regulatory approval.

Under the terms of the Written Agreement, the Company and the Bank have appointed a committee to monitor compliance with the Written Agreement. The directors of the Company and the Bank have recognized and unanimously agree with the common goal of financial soundness represented by the Written Agreement and have confirmed the intent of the directors and executive management to diligently seek to comply with all requirements of the Written Agreement.

NOTE 4 CAPITAL:**Capital Requirements and Ratios**

The Company and the Bank are subject to various capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and, possibly, additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes that, as of September 30, 2012, the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of September 30, 2012 the Bank was well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Company's and Bank's category.

The Company's and the Bank's actual capital amounts and ratios are presented in the table as of September 30, 2012 and December 31, 2011, respectively.

| (Dollars are in thousands) | Actual | | Minimum Capital Requirement | | Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---------------------------------------|-----------|--------|-----------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| September 30, 2012: | | | | | | |
| Total Capital to Risk Weighted Assets | | | | | | |
| The Company | \$ 46,159 | 10.36% | 35,650 | 8% | \$ N/A | N/A |
| The Bank | 48,007 | 10.75% | 35,713 | 8% | 44,641 | 10% |
| Tier 1 Capital Risk Weighted Assets: | | | | | | |
| The Company | 33,688 | 7.56% | 17,825 | 4% | N/A | N/A |
| The Bank | 42,279 | 9.47% | 17,857 | 4% | 26,785 | 6% |
| Tier 1 Capital to Average Assets: | | | | | | |
| The Company | 33,688 | 4.74% | 28,454 | 4% | N/A | N/A |
| The Bank | 42,279 | 5.94% | 28,485 | 4% | 35,607 | 5% |
| December 31, 2011: | | | | | | |
| Total Capital to Risk Weighted Assets | | | | | | |
| The Company | \$ 45,856 | 9.15% | 40,104 | 8% | \$ N/A | N/A |
| The Bank | 53,070 | 10.56% | 40,189 | 8% | 50,236 | 10% |

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| | | | | | | |
|--------------------------------------|--------|-------|--------|----|--------|-----|
| Tier 1 Capital Risk Weighted Assets: | | | | | | |
| The Company | 32,941 | 6.57% | 20,052 | 4% | N/A | N/A |
| The Bank | 46,641 | 9.28% | 20,095 | 4% | 30,142 | 6% |
| Tier 1 Capital to Average Assets: | | | | | | |
| The Company | 33,461 | 4.23% | 31,658 | 4% | N/A | N/A |
| The Bank | 46,641 | 5.99% | 31,160 | 4% | 38,950 | 5% |

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Conversion of Notes to Common Stock and Warrants

In December, 2010, the Company borrowed \$250,000 from Director Scott White for one year. The note bore interest at the variable rate of interest equal to the Wall Street Journal prime rate payable at maturity or conversion, was unsecured and was convertible into the Company's common stock under certain conditions. In January, 2011, the Company received an additional \$250,000 loan from Director Lynn Keene on identical terms. The purpose of these borrowings was to provide cash for operating expenses of the Company. On March 16, 2011 Directors Keene and White loaned the Company an additional \$4.95 million which, after receiving regulatory approval, the Company used to retire its indebtedness to the FDIC as receiver for Silverton Bank. The loans had a stated maturity of December 31, 2011 with the same terms as the previous notes. In each case, the Company was obligated to convert the debt into the Company's common stock if, before the stated maturity, the Company conducted an offering of its common stock at the price per share at which it was offered. If the Company did not conduct an offering prior to the stated maturity, the Company had the option, but not the obligation, to convert the debt into shares of its common stock within 30 days of the stated maturity at a price per share to be established by the Company's Board of Directors. On December 21, 2011, with regulatory approval the Company consolidated the earlier loans into a loan in the principal amount of \$2.8 million from Director White and \$2.65 million from Director Keene on the same terms as the previous loans except that the maturity date of the borrowings was extended to June 30, 2012. Prior to their maturity, the maturity of the loans was extended to December 31, 2012 on the same terms. The Company believes this indebtedness was on more favorable terms to the Company than could be obtained from unrelated parties.

On September 19, 2012, in conjunction with the public offering of its common stock, the Company converted both notes to common stock and Mr. White received 1,959,889 shares and Mr. Keene received 1,854,630 shares. Each director also obtained warrants that are immediately exercisable to purchase common stock over the next five years at a price of \$1.75 per share. Mr. White received 391,977 warrants and Mr. Keene received 370,926 warrants. These conversions were made on the same terms as the public offering as required by the notes. These transactions resulted in Director Keene beneficially owning 16.04% and Director White beneficially owning 19.28% of the Company's common stock.

As a result of this noncash transaction, the Company recorded a \$5.7 million increase to stockholders' equity and reduced other borrowings by \$5.45 million and accrued interest payable by \$272 thousand. The \$5.7 million increase to stockholders' equity was allocated by an increase of \$7.6 million to common stock, \$663 thousand allocated to the common stock warrants, and a decrease of \$2.6 million to additional paid in capital. The value of the common stock warrants was calculated using the Black-Scholes Option Pricing Model.

Table of Contents**NOTE 5 INVESTMENT SECURITIES:**

The amortized cost and estimated fair value of securities (all available-for-sale) are as follows:

| (Dollars are in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Approximate Fair Value |
|-----------------------------|-------------------|------------------------------|-------------------------------|------------------------------|
| September 30, 2012 | | | | |
| U.S. Government Agencies | \$ 25,602 | \$ 258 | \$ 21 | \$ 25,839 |
| Taxable municipals | 853 | 2 | 5 | 850 |
| Tax-exempt municipals | | | | |
| Mortgage backed securities | 21,638 | 233 | 1 | 21,870 |
| Total Securities AFS | \$ 48,093 | \$ 493 | \$ 27 | \$ 48,559 |
| December 31, 2011 | | | | |
| U.S. Government Agencies | \$ 21,405 | \$ 238 | \$ 10 | \$ 21,633 |
| Taxable municipals | 1,465 | 89 | 2 | 1,552 |
| Tax-exempt municipals | 1,043 | 11 | | 1,054 |
| Mortgage backed securities | 8,144 | 67 | 16 | 8,195 |
| Total Securities AFS | \$ 32,057 | \$ 405 | \$ 28 | \$ 32,434 |

The following table details unrealized losses and related fair values in the available-for-sale portfolio. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of September 30, 2012 and December 31, 2011.

| (Dollars are in thousands) | Less than 12 Months | | 12 Months or More | | Total | |
|-----------------------------|---------------------|----------------------|----------------------|----------------------|------------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2012 | | | | | | |
| U.S. Government Agencies | \$ 2,911 | \$ 21 | \$ | \$ | \$ 2,911 | \$ 21 |
| Taxable municipals | 280 | 5 | | | 280 | 5 |
| Mtg. backed securities | 743 | 1 | | | 743 | 1 |
| Total Securities AFS | \$ 3,934 | \$ 27 | \$ | \$ | \$ 3,934 | \$ 27 |
| December 31, 2011 | | | | | | |
| U.S. Government Agencies | \$ 5,592 | \$ 10 | \$ | \$ | \$ 5,592 | \$ 10 |
| Taxable municipals | 572 | 2 | | | 572 | 2 |
| Mtg. backed securities | 4,055 | 16 | | | 4,055 | 16 |
| Total Securities AFS | \$ 10,219 | \$ 28 | \$ | \$ | \$ 10,219 | \$ 28 |

At September 30, 2012, the available-for-sale portfolio included five investments for which the fair market value was less than amortized cost. At December 31, 2011, the available-for-sale portfolio included eleven investments for which the fair market value was less than amortized cost. Management evaluates securities for other than temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial conditions and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. No securities had an other than temporary

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impairment.

The amortized cost and fair value of investment securities at September 30, 2012, by contractual maturity, are shown in the following schedule. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars are in thousands)

| Securities Available for Sale | Amortized Cost | Fair Value | Weighted Average Yield |
|--|-------------------|------------------|------------------------------|
| Due in one year or less | \$ | \$ | % |
| Due after one year through five years | 1,503 | 1,510 | 1.01% |
| Due after five years through fifteen years | 12,274 | 12,403 | 1.73% |
| Due after fifteen years | 34,316 | 34,646 | 2.15% |
| Total | \$ 48,093 | \$ 48,559 | 2.01% |

Investment securities with a carrying value of \$18.9 million and \$15.7 million at September 30, 2012 and December 31, 2011, were pledged to secure public deposits, overnight payment processing and for other purposes required by law.

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The Bank, as a member of the Federal Reserve Bank and the Federal Home Loan Bank, is required to hold stock in each. These equity securities are restricted from trading and are recorded at a cost of \$2.8 million and \$3.6 million as of September 30, 2012 and December 31, 2011, respectively.

NOTE 6 LOANS:

Loans receivable outstanding are summarized as follows:

| (Dollars are in thousands) | September 30, 2012 | December 31, 2011 |
|-----------------------------------|--------------------|-------------------|
| Real estate secured: | | |
| Commercial | \$ 155,255 | \$ 170,789 |
| Construction and land development | 25,212 | 32,389 |
| Residential 1-4 family | 243,938 | 255,998 |
| Multifamily | 12,636 | 14,320 |
| Farmland | 35,179 | 40,106 |
| Total real estate loans | 472,220 | 513,602 |
| Commercial | 30,420 | 39,327 |
| Agriculture | 4,965 | 6,147 |
| Consumer installment loans | 31,200 | 38,522 |
| All other loans | 187 | 218 |
| Total loans | \$ 538,992 | \$ 597,816 |

Loans receivable on nonaccrual status are summarized as follows:

| (Dollars are in thousands) | September 30, 2012 | December 31, 2011 |
|--|--------------------|-------------------|
| Real estate secured: | | |
| Commercial | \$ 19,735 | \$ 19,169 |
| Construction and land development | 2,997 | 5,583 |
| Residential 1-4 family | 4,974 | 4,829 |
| Multifamily | 2,076 | 2,101 |
| Farmland | 7,198 | 5,257 |
| Total real estate loans | 36,980 | 36,939 |
| Commercial | 2,556 | 4,522 |
| Agriculture | 494 | 854 |
| Consumer installment loans | 127 | 1 |
| All other loans | | |
| Total loans receivable on nonaccrual status | \$ 40,157 | \$ 42,316 |

Total interest income not recognized on nonaccrual loans for nine months ended September 30, 2012 and 2011 was \$1.1 million and \$1.3 million, respectively.

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The following table presents information concerning the Company's investment in loans considered impaired as of September 30, 2012 and December 31, 2011:

As of September 30, 2012

| | Average Recorded Investment | Interest Income Recognized | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|--|-----------------------------------|----------------------------------|------------------------|--------------------------------|----------------------|
| (Dollars are in thousands) | | | | | |
| With no related allowance recorded: | | | | | |
| Real estate secured: | | | | | |
| Commercial | \$ 28,230 | \$ 628 | \$ 21,704 | \$ 24,215 | \$ |
| Construction and land development | 5,009 | 84 | 4,017 | 8,934 | |
| Residential 1-4 family | 8,203 | 243 | 7,548 | 7,810 | |
| Multifamily | 1,045 | 48 | 1,196 | 1,196 | |
| Farmland | 8,592 | (44) | 9,068 | 9,407 | |
| Commercial | 2,846 | 35 | 2,034 | 2,389 | |
| Agriculture | 551 | 8 | 467 | 467 | |
| Consumer installment loans | 79 | 9 | 112 | 112 | |
| All other loans | | | | | |
| With an allowance recorded: | | | | | |
| Real estate secured: | | | | | |
| Commercial | 15,089 | 241 | 16,139 | 16,510 | 4,225 |
| Construction and land development | 1,962 | (157) | 1,575 | 5,636 | 346 |
| Residential 1-4 family | 5,884 | 165 | 4,714 | 5,257 | 793 |
| Multifamily | 1,479 | 26 | 2,314 | 2,550 | 621 |
| Farmland | 4,790 | 66 | 2,185 | 2,306 | 385 |
| Commercial | 1,641 | 17 | 1,395 | 1,663 | 207 |
| Agriculture | 378 | | | | |
| Consumer installment loans | 79 | 3 | 37 | 37 | 15 |
| All other loans | | | | | |
| Total | \$ 85,857 | \$ 1,372 | \$ 74,505 | \$ 88,489 | \$ 6,592 |

As of December 31, 2011

| | Average Recorded Investment | Interest Income Recognized | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|--|-----------------------------------|----------------------------------|------------------------|--------------------------------|----------------------|
| (Dollars are in thousands) | | | | | |
| With no related allowance recorded: | | | | | |
| Real estate secured: | | | | | |
| Commercial | \$ 32,370 | \$ 1,356 | \$ 31,633 | \$ 33,175 | \$ |
| Construction and land development | 14,288 | 125 | 6,954 | 12,838 | |
| Residential 1-4 family | 6,406 | 315 | 8,221 | 8,296 | |
| Multifamily | 619 | 31 | 613 | 613 | |
| Farmland | 13,005 | 435 | 10,364 | 10,554 | |
| Commercial | 2,958 | 60 | 3,529 | 4,070 | |
| Agriculture | 396 | 1 | 521 | 817 | |
| Consumer installment loans | 4 | 1 | 9 | 9 | |
| All other loans | | | | | |
| With an allowance recorded: | | | | | |
| Real estate secured: | | | | | |
| Commercial | 9,887 | 691 | 14,482 | 14,973 | 2,794 |
| Construction and land development | 2,917 | 87 | 2,289 | 2,310 | 474 |
| Residential 1-4 family | 5,111 | 277 | 6,473 | 6,764 | 1,052 |
| Multifamily | | | | | |
| Farmland | 2,354 | 119 | 4,192 | 4,192 | 605 |

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| | | | | | |
|----------------------------|-----------|----------|-----------|------------|----------|
| Commercial | 1,982 | 75 | 1,857 | 1,857 | 649 |
| Agriculture | 758 | 28 | 641 | 641 | 448 |
| Consumer installment loans | 41 | 3 | 43 | 43 | 24 |
| All other loans | | | | | |
| Total | \$ 93,096 | \$ 3,604 | \$ 91,821 | \$ 101,152 | \$ 6,046 |

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An age analysis of past due loans receivable was as follows:

| | Loans | | | | Total Past Due Loans | Current Loans | Total Loans | Accruing |
|-----------------------------------|------------------|-----------------|------------------|------------------|-------------------------------|-------------------|-----------------|----------|
| | Loans | Loans | 90 or | | | | | Loans |
| | 30-59 | 60-89 | More | | | | | 90 or |
| | Days | Days | Days | | | | | More |
| As of September 30, 2012 | Past | Past | Past | | | | Past | |
| | Due | Due | Due | Loans | Loans | Loans | Due | |
| (Dollars are in thousands) | | | | | | | | |
| Real estate secured: | | | | | | | | |
| Commercial | \$ 4,118 | \$ 884 | \$ 9,586 | \$ 14,588 | \$ 140,667 | \$ 155,255 | \$ | |
| Construction and land development | 2,106 | 84 | 912 | 3,102 | 22,110 | 25,212 | | |
| Residential 1-4 family | 7,586 | 1,858 | 3,692 | 13,136 | 230,802 | 243,938 | 1,074 | |
| Multifamily | | 331 | 2,076 | 2,407 | 10,229 | 12,636 | | |
| Farmland | 704 | 192 | 5,299 | 6,195 | 28,984 | 35,179 | | |
| Total real estate loans | 14,514 | 3,349 | 21,565 | 39,428 | 432,792 | 472,220 | 1,074 | |
| Commercial | 30 | 382 | 1,831 | 2,243 | 28,177 | 30,420 | 3 | |
| Agriculture | 59 | | 343 | 402 | 4,563 | 4,965 | | |
| Consumer installment Loans | 660 | 56 | 187 | 903 | 30,297 | 31,200 | 72 | |
| All other loans | 66 | 14 | 7 | 87 | 100 | 187 | 7 | |
| Total loans | \$ 15,329 | \$ 3,801 | \$ 23,933 | \$ 43,063 | \$ 495,929 | \$ 538,992 | \$ 1,156 | |

| | Loans | | | | Total Past Due Loans | Current Loans | Total Loans | Accruing |
|-----------------------------------|------------------|-----------------|------------------|------------------|-------------------------------|-------------------|-----------------|----------|
| | Loans | Loans | 90 or | | | | | Loans |
| | 30-59 | 60-89 | More | | | | | 90 or |
| | Days | Days | Days | | | | | More |
| As of December 31, 2011 | Past | Past | Past | | | | Past | |
| | Due | Due | Due | Loans | Loans | Loans | Due | |
| (Dollars are in thousands) | | | | | | | | |
| Real estate secured: | | | | | | | | |
| Commercial | \$ 9,754 | \$ 2,294 | \$ 7,771 | \$ 19,819 | \$ 150,970 | \$ 170,789 | \$ | |
| Construction and land development | 595 | 238 | 5,280 | 6,113 | 26,276 | 32,389 | | |
| Residential 1-4 family | 9,471 | 1,412 | 4,101 | 14,984 | 241,014 | 255,998 | 1,129 | |
| Multifamily | | 1,777 | 218 | 1,995 | 12,325 | 14,320 | | |
| Farmland | 2,841 | 624 | 3,800 | 7,265 | 32,841 | 40,106 | | |
| Total real estate loans | 22,661 | 6,345 | 21,170 | 50,176 | 463,426 | 513,602 | 1,129 | |
| Commercial | 551 | 34 | 2,938 | 3,523 | 35,804 | 39,327 | 117 | |
| Agriculture | 268 | 88 | 458 | 814 | 5,333 | 6,147 | 3 | |
| Consumer installment Loans | 822 | 133 | 221 | 1,176 | 37,346 | 38,522 | 222 | |
| All other loans | 26 | 9 | 33 | 68 | 150 | 218 | 33 | |
| Total loans | \$ 24,328 | \$ 6,609 | \$ 24,820 | \$ 55,757 | \$ 542,059 | \$ 597,816 | \$ 1,504 | |

The Company categorizes loans receivable into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans and leases individually by classifying the loans receivable as to credit risk. The Company uses the following definitions for risk ratings:

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Pass - Loans in this category are considered to have a low likelihood of loss based on relevant information analyzed about the ability of the borrowers to service their debt and other factors.

Special Mention - Loans in this category are currently protected but are potentially weak, including adverse trends in borrower's operations, credit quality or financial strength. Those loans constitute an undue and unwarranted credit risk but not to the point of justifying a substandard classification. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances. Special mention loans have potential weaknesses which may, if not checked or corrected, weaken the loan or inadequately protect the Company's credit position at some future date.

Substandard - A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

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Doubtful - Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable.

Based on the most recent analysis performed, the risk category of loans receivable was as follows:

As of September 30, 2012

| (Dollars are in thousands) | Pass | Special Mention | Substandard | Doubtful | Total |
|-----------------------------------|-------------------|--------------------|------------------|-----------------|-------------------|
| Real estate secured: | | | | | |
| Commercial | \$ 109,113 | \$ 11,913 | \$ 34,084 | \$ 145 | \$ 155,255 |
| Construction and land development | 18,148 | 1,260 | 5,804 | | 25,212 |
| Residential 1-4 family | 198,672 | 16,245 | 27,834 | 1,187 | 243,938 |
| Multifamily | 9,220 | 179 | 3,237 | | 12,636 |
| Farmland | 21,904 | 2,405 | 10,870 | | 35,179 |
| Total real estate loans | 357,057 | 32,002 | 81,829 | 1,332 | 472,220 |
| Commercial | 23,013 | 3,748 | 3,618 | 41 | 30,420 |
| Agriculture | 4,191 | 229 | 543 | 2 | 4,965 |
| Consumer installment loans | 29,622 | 501 | 1,027 | 50 | 31,200 |
| All other loans | 187 | | | | 187 |
| Total | \$ 414,070 | \$ 36,480 | \$ 87,017 | \$ 1,425 | \$ 538,992 |

As of December 31, 2011

| (Dollars are in thousands) | Pass | Special Mention | Substandard | Doubtful | Total |
|-----------------------------------|-------------------|--------------------|------------------|-----------------|-------------------|
| Real estate secured: | | | | | |
| Commercial | \$ 112,694 | \$ 18,377 | \$ 39,573 | \$ 145 | \$ 170,789 |
| Construction and land development | 23,203 | 1,224 | 7,962 | | 32,389 |
| Residential 1-4 family | 209,863 | 17,137 | 27,730 | 1,268 | 255,998 |
| Multifamily | 11,727 | 1,909 | 684 | | 14,320 |
| Farmland | 21,715 | 4,957 | 13,022 | 412 | 40,106 |
| Total real estate loans | 379,202 | 43,604 | 88,971 | 1,825 | 513,602 |
| Commercial | 32,018 | 2,045 | 4,227 | 1,037 | 39,327 |
| Agriculture | 4,743 | 678 | 726 | | 6,147 |
| Consumer installment loans | 36,107 | 900 | 1,484 | 31 | 38,522 |
| All other loans | 218 | | | | 218 |
| Total | \$ 452,288 | \$ 47,227 | \$ 95,408 | \$ 2,893 | \$ 597,816 |

Table of Contents**NOTE 7 ALLOWANCE FOR LOAN LOSSES:**

The following table details activity in the allowance for loan losses by portfolio segment for the period ended September 30, 2012. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

As of September 30, 2012

| (Dollars are in thousands) | Beginning Balance | Charge Offs | Recoveries | Advances | Provisions | Ending Balance |
|-----------------------------------|-------------------|-------------------|---------------|-----------|-----------------|------------------|
| Real estate secured: | | | | | | |
| Commercial | \$ 5,671 | \$ (1,989) | \$ 38 | \$ | \$ 3,852 | \$ 7,572 |
| Construction and land development | 3,848 | (339) | 71 | | (1,240) | 2,340 |
| Residential 1-4 family | 3,759 | (1,289) | 84 | | 726 | 3,280 |
| Multifamily | 148 | | | | 541 | 689 |
| Farmland | 951 | (577) | | | 483 | 857 |
| Total real estate loans | 14,377 | (4,194) | 193 | | 4,362 | 14,738 |
| Commercial | 1,883 | (736) | 67 | | 311 | 1,525 |
| Agriculture | 486 | (2) | 11 | | (171) | 324 |
| Consumer installment loans | 781 | (267) | 43 | | (128) | 429 |
| All other loans | 2 | | | | (1) | 1 |
| Unallocated | 851 | | | | (280) | 571 |
| Total | \$ 18,380 | \$ (5,199) | \$ 314 | \$ | \$ 4,093 | \$ 17,588 |

| As of September 30, 2012 | Allowance for Loan Losses | | | Recorded Investment in Loans | | |
|-----------------------------------|---------------------------|--------------------------|------------------|------------------------------|--------------------------|-------------------|
| | Individually | Collectively | Total | Individually | Collectively | Total |
| | Evaluated for Impairment | Evaluated for Impairment | | Evaluated for Impairment | Evaluated for Impairment | |
| (Dollars are in thousands) | | | | | | |
| Real estate secured: | | | | | | |
| Commercial | \$ 4,225 | \$ 3,347 | \$ 7,572 | \$ 37,843 | \$ 117,412 | \$ 155,255 |
| Construction and land development | 346 | 1,994 | 2,340 | 5,592 | 19,620 | 25,212 |
| Residential 1-4 family | 793 | 2,487 | 3,280 | 12,262 | 231,676 | 243,938 |
| Multifamily | 621 | 68 | 689 | 3,510 | 9,126 | 12,636 |
| Farmland | 385 | 472 | 857 | 11,253 | 23,926 | 35,179 |
| Total real estate loans | 6,370 | 8,368 | 14,738 | 70,460 | 401,760 | 472,220 |
| Commercial | 207 | 1,318 | 1,525 | 3,429 | 26,991 | 30,420 |
| Agriculture | | 324 | 324 | 467 | 4,498 | 4,965 |
| Consumer installment loans | 15 | 414 | 429 | 149 | 31,051 | 31,200 |
| All other loans | | 1 | 1 | | 187 | 187 |
| Unallocated | | 571 | 571 | | | |
| Total | \$ 6,592 | \$ 10,996 | \$ 17,588 | \$ 74,505 | \$ 464,487 | \$ 538,992 |

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The following table details activity in the allowance for loan losses by portfolio segment for the period ended December 31, 2011. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

As of December 31, 2011

| (Dollars are in thousands) | Beginning Balance | Charge Offs | Recoveries | Advances | Provisions | Ending Balance |
|-----------------------------------|-------------------|--------------------|-----------------|---------------|-----------------|------------------|
| Real estate secured: | | | | | | |
| Commercial | \$ 5,141 | \$ (4,147) | \$ 877 | \$ | \$ 3,800 | \$ 5,671 |
| Construction and land development | 4,913 | (7,245) | 1,296 | 153 | 4,731 | 3,848 |
| Residential 1-4 family | 1,699 | (1,299) | 141 | | 3,218 | 3,759 |
| Multifamily | 42 | | | | 106 | 148 |
| Farmland | 922 | (511) | 66 | | 474 | 951 |
| Total real estate loans | 12,717 | (13,202) | 2,380 | 153 | 12,329 | 14,377 |
| Commercial | 3,281 | (2,480) | 140 | | 942 | 1,883 |
| Agriculture | 1,120 | (1,031) | 18 | | 379 | 486 |
| Consumer installment loans | 1,733 | (694) | 123 | | (381) | 781 |
| All other loans | | | | | 2 | 2 |
| Unallocated | 6,163 | | | | (5,312) | 851 |
| Total | \$ 25,014 | \$ (17,407) | \$ 2,661 | \$ 153 | \$ 7,959 | \$ 18,380 |

| As of December 31, 2011 | Allowance for Loan Losses | | | Recorded Investment in Loans | | |
|-----------------------------------|---------------------------|--------------------------|------------------|------------------------------|--------------------------|-------------------|
| | Individually | Collectively | Total | Individually | Collectively | Total |
| | Evaluated for Impairment | Evaluated for Impairment | | Evaluated for Impairment | Evaluated for Impairment | |
| Real estate secured: | | | | | | |
| Commercial | \$ 2,794 | \$ 2,877 | \$ 5,671 | \$ 46,115 | \$ 124,674 | \$ 170,789 |
| Construction and land development | 474 | 3,374 | 3,848 | 9,243 | 23,146 | 32,389 |
| Residential 1-4 family | 1,052 | 2,707 | 3,759 | 14,694 | 241,304 | 255,998 |
| Multifamily | | 148 | 148 | 613 | 13,707 | 14,320 |
| Farmland | 605 | 346 | 951 | 14,556 | 25,550 | 40,106 |
| Total real estate loans | 4,925 | 9,452 | 14,377 | 85,221 | 428,381 | 513,602 |
| Commercial | 649 | 1,234 | 1,883 | 5,386 | 33,941 | 39,327 |
| Agriculture | 448 | 38 | 486 | 1,162 | 4,985 | 6,147 |
| Consumer installment loans | 24 | 757 | 781 | 52 | 38,470 | 38,522 |
| All other loans | | 2 | 2 | | 218 | 218 |
| Unallocated | | 851 | 851 | | | |
| Total | \$ 6,046 | \$ 12,334 | \$ 18,380 | \$ 91,821 | \$ 505,995 | \$ 597,816 |

In determining the amount of our allowance, we rely on an analysis of our loan portfolio, our experience and our evaluation of general economic conditions, as well as the requirements of the written agreement and other regulatory input. If our assumptions prove to be incorrect, our current allowance may not be sufficient to cover future loan losses and we may experience significant increases to our provision.

Table of Contents**NOTE 8 TROUBLED DEBT RESTRUCTURINGS:**

The following table presents information related to loans modified as troubled debt restructurings during the nine and three months ended September 30, 2012 and 2011.

| Troubled Debt Restructurings | For the nine months ended September 30, 2012 | | | For the nine months ended September 30, 2011 | | |
|-----------------------------------|---|------------------------------------|-------------------------------------|---|------------------------------------|-------------------------------------|
| | # of Loans | Pre-Mod. Recorded Investment | Post-Mod. Recorded Investment | # of Loans | Pre-Mod. Recorded Investment | Post-Mod. Recorded Investment |
| (Dollars are in thousands) | | | | | | |
| Real estate secured: | | | | | | |
| Commercial | 7 | \$ 991 | \$ 791 | 8 | \$ 6,956 | \$ 6,928 |
| Construction and land Development | | | | 1 | 29 | 28 |
| Residential 1-4 family | 35 | 2,052 | 1,964 | 8 | 641 | 626 |
| Multifamily | | | | 1 | 342 | 342 |
| Farmland | | | | | | |
| Total real estate loans | 42 | 3,043 | 2,755 | 18 | 7,968 | 7,924 |
| Commercial | | | | 6 | 1,111 | 1,096 |
| Agriculture | | | | 2 | 390 | 390 |
| Consumer installment loans | 3 | 25 | 19 | 8 | 159 | 152 |
| All other loans | | | | | | |
| Total | 45 | \$ 3,068 | \$ 2,774 | 34 | \$ 9,628 | \$ 9,562 |

| Troubled Debt Restructurings | For the three months ended September 30, 2012 | | | For the three months ended September 30, 2011 | | |
|-----------------------------------|--|------------------------------------|-------------------------------------|--|------------------------------------|-------------------------------------|
| | # of Loans | Pre-Mod. Recorded Investment | Post-Mod. Recorded Investment | # of Loans | Pre-Mod. Recorded Investment | Post-Mod. Recorded Investment |
| (Dollars are in thousands) | | | | | | |
| Real estate secured: | | | | | | |
| Commercial | | \$ | \$ | 4 | \$ 3,585 | \$ 3,577 |
| Construction and land Development | | | | | | |
| Residential 1-4 family | | | | 4 | 312 | 298 |
| Multifamily | | | | 1 | 342 | 342 |
| Farmland | | | | | | |
| Total real estate loans | | | | 9 | 4,239 | 4,217 |
| Commercial | | | | 5 | 1,074 | 1,063 |
| Agriculture | | | | 1 | 90 | 90 |
| Consumer installment loans | | | | 4 | 92 | 91 |
| All other loans | | | | | | |
| Total | | \$ | \$ | 19 | \$ 5,495 | \$ 5,461 |

During the nine months ended September 30, 2012, the Company modified 45 loans that were considered to be troubled debt restructurings. We extended the terms for 6 of these loans and the interest rate was lowered for 35 of these loans. During the nine months ended September 30, 2011, the Company modified 34 loans that were considered to be troubled debt restructurings. We extended the terms for 17 of these loans and the interest rate was lowered for 15 of these loans.

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The following table presents information related to loans to modified as a troubled debt restructurings that defaulted during the nine and three months ended September 30, 2012 and 2011, and within twelve months of their modification date. A troubled debt restructuring is considered to be in default once it becomes 90 days or more past due following a modification.

| Troubled Debt Restructurings That Subsequently Defaulted During the Period | For the nine months ended September 30, 2012 | | For the nine months ended September 30, 2011 | |
|--|---|------------------------|---|------------------------|
| | # of Loans | Recorded Investment | # of Loans | Recorded Investment |
| (Dollars are in thousands) | | | | |
| Real estate secured: | | | | |
| Commercial | 4 | \$ 1,859 | | \$ |
| Construction and land development | | | | |
| Residential 1-4 family | 2 | 633 | | |
| Multifamily | 1 | 163 | | |
| Farmland | | | | |
| Total real estate loans | 7 | 2,655 | | |
| Commercial | | | | |
| Agriculture | 1 | 300 | | |
| Consumer installment loans | | | | |
| All other loans | | | | |
| Total | 8 | \$ 2,955 | | \$ |

| Troubled Debt Restructurings That Subsequently Defaulted During the Period | For the three months ended September 30, 2012 | | For the three months ended September 30, 2011 | |
|--|--|------------------------|--|------------------------|
| | # of Loans | Recorded Investment | # of Loans | Recorded Investment |
| (Dollars are in thousands) | | | | |
| Real estate secured: | | | | |
| Commercial | | \$ | | \$ |
| Construction and land development | | | | |
| Residential 1-4 family | 1 | 522 | | |
| Multifamily | 1 | 163 | | |
| Farmland | | | | |
| Total real estate loans | 2 | 685 | | |
| Commercial | | | | |
| Agriculture | | | | |
| Consumer installment loans | | | | |
| All other loans | | | | |
| Total | 2 | \$ 685 | | \$ |

In determination of the allowance for loan losses, management considers troubled debt restructurings and subsequent defaults in these restructurings in its estimate. The Company evaluates all troubled debt restructurings for possible further impairment. As a result, the allowance may be increased, adjustments may be made in the allocation of the allowance, or charge-offs may be taken to further writedown the carrying value of the loan. At September 30, 2012 there were \$21.8 million in loans that are classified as troubled debt restructurings compared to \$29.1 million at December 31, 2011.

Table of Contents**NOTE 9 EARNINGS PER SHARE:**

Basic earnings per share computations are based on the weighted average number of shares outstanding during each year. Dilutive earnings per share reflect the additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued relate to outstanding options and are determined by the Treasury method. For the three and nine months ended September 30, 2012 and 2011, potential common shares were anti-dilutive and were not included in the calculation. Basic and diluted net loss per common share calculations follows:

(Amounts in Thousands, Except

| Share and Per Share Data) | For the three months ended September 30, | | For the nine months ended September 30, | |
|--|---|------------|--|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net loss | \$ (1,463) | \$ (1,832) | \$ (6,536) | \$ (2,958) |
| Weighted average shares outstanding | 10,507,724 | 10,010,178 | 10,177,237 | 10,010,178 |
| Dilutive shares for stock options | | | | |
| Weighted average dilutive shares outstanding | 10,507,724 | 10,010,178 | 10,177,237 | 10,010,178 |
| Basic loss per share | \$ (0.14) | \$ (0.18) | \$ (0.64) | \$ (0.30) |
| Diluted loss per share | \$ (0.14) | \$ (0.18) | \$ (0.64) | \$ (0.30) |

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NOTE 10 FAIR VALUES:

Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures provides a framework for measuring fair value under generally accepted accounting principles and requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, 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 and other real estate acquired through foreclosure).

Fair value is 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. Fair Value Measurements and Disclosures also establishes 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 standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an exchange market, as well as U. S. Treasury, other U. S. Government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2: Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes certain derivative contracts and impaired loans.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. For example, this category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, and highly structured or long-term derivative contracts.

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. The Company's available for sale securities, totaling \$48.6 million and \$32.4 million at September 30, 2012 and December 31, 2011, respectively, are the only assets whose fair values are measured on a recurring basis using Level 2 inputs from an independent pricing service.

Loans - The Company does not record loans at fair value on a recurring basis. The Company is predominantly an asset based lender with real estate serving as collateral on a substantial majority of loans. From time to time a loan is considered impaired and an allowance for loan losses is established. Loans which are deemed to be impaired and require a reserve are primarily valued on a non-recurring basis at the fair values of the underlying real estate collateral. Such fair values are obtained using independent appraisals, which management evaluates and determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, or an appraised value does not include estimated costs of disposition and management must make an estimate, the Company records the impaired loan as nonrecurring Level 3. The aggregate carrying amount of impaired loans carried at fair value were \$67.9 million and \$85.8 million at September 30, 2012 and December 31, 2011, respectively.

Foreclosed Assets Foreclosed assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Foreclosed assets are carried at the lower of the carrying value or fair value. Fair value is based upon independent observable market prices or appraised values of the collateral with a third party estimate of disposition costs, which the Company considers to be level 2 inputs. When the appraised value is not available, management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, or an appraised value does not include estimated costs of disposition and management must make an estimate, the Company records the foreclosed asset as nonrecurring Level 3. The aggregate carrying amounts of foreclosed assets were \$11.4 million and \$15.1 million at September 30, 2012 and December 31, 2011, respectively.

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Assets and liabilities measured at fair value are as follows as of September 30, 2012 (for purpose of this table the impaired loans are shown net of the related allowance):

| | Quoted market price in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|-----------------------------------|---|--|--|
| (Dollars are in thousands) | | | |
| (On a recurring basis) | | | |
| Available for sale investments | | | |
| U.S. Government Agencies | \$ | \$ 25,839 | \$ |
| Taxable municipals | | 850 | |
| Mortgage backed securities | | 21,870 | |
| (On a non-recurring basis) | | | |
| Other real estate owned | | | 11,368 |
| Impaired loans: | | | |
| Real estate secured: | | | |
| Commercial | | | 33,618 |
| Construction and land development | | | 5,246 |
| Residential 1-4 family | | | 11,469 |
| Multifamily | | | 2,889 |
| Farmland | | | 10,868 |
| Commercial | | | 3,222 |
| Agriculture | | | 467 |
| Consumer installment loans | | | 134 |
| All other loans | | | |
| Total | \$ | \$ 48,559 | \$ 79,281 |

Assets and liabilities measured at fair value are as follows as of December 31, 2011 (for purpose of this table the impaired loans are shown net of the related allowance):

| | Quoted market price in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|-----------------------------------|--|--|--|
| (Dollars are in thousands) | | | |
| (On a recurring basis) | | | |
| Available for sale investments | | | |
| U.S. Government Agencies | \$ | \$ 21,633 | \$ |
| Taxable municipals | | 1,552 | |
| Tax-exempt municipals | | 1,054 | |
| Mortgage backed securities | | 8,195 | |
| (On a non-recurring basis) | | | |
| Other real estate owned | | | 15,092 |
| Impaired loans: | | | |
| Real estate secured: | | | |
| Commercial | | | 43,321 |
| Construction and land development | | | 8,769 |
| Residential 1-4 family | | | 13,642 |
| Multifamily | | | 613 |
| Farmland | | | 13,951 |
| Commercial | | | 4,737 |
| Agriculture | | | 714 |

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| | | | | |
|----------------------------|----|----|--------|------------|
| Consumer installment loans | | | | 28 |
| All other loans | | | | |
| Total | \$ | \$ | 32,434 | \$ 100,867 |

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For Level 3 assets measured at fair value on a recurring or non-recurring basis as of September 30, 2012, the significant unobservable inputs used in the fair value measurements were as follows:

| (Dollars in thousands) | Fair Value at September 30, 2012 | Valuation Technique | Significant Unobservable Inputs | Significant Unobservable Input Value |
|-------------------------|--|--|--|--|
| Impaired Loans | \$ 67,913 | Appraised Value/Discounted Cash Flows/Market Value of Note | Appraisals and/or sales of comparable properties/Independent quotes | n/a |
| Other Real Estate Owned | \$ 11,368 | Appraised Value/Comparable Sales/Other Estimates from Independent Sources | Appraisal and/or sales of comparable properties/Independent quotes/bids | n/a |

Fair Value of Financial Instruments

Fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practical to estimate the value is based upon the characteristics of the instruments and relevant market information. Financial instruments include cash, evidence of ownership in an entity, or contracts that convey or impose on an entity that contractual right or obligation to either receive or deliver cash for another financial instrument.

The following summary presents the methodologies and assumptions used to estimate the fair value of the Company's financial instruments presented below. The information used to determine fair value is highly subjective and judgmental in nature and, therefore, the results may not be precise. Subjective factors include, among other things, estimates of cash flows, risk characteristics, credit quality, and interest rates, all of which are subject to change. Since the fair value is estimated as of the balance sheet date, the amounts that will actually be realized or paid upon settlement or maturity on these various instruments could be significantly different.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of September 30, 2012 and December 31, 2011. This table excludes financial instruments for which the carrying amount approximates fair value. The carrying value of cash and due from banks, federal funds sold, interest-bearing deposits, deposits with no stated maturities, trust preferred securities and accrued interest approximates fair value. The remaining financial instruments were valued based on the present value of estimated future cash flows, discounted at various rates in effect for similar instruments during the months of September 2012 and December 2011.

| (Dollars are in thousands) | Carrying Amount | Fair Value | Fair Value Measurements | | |
|-----------------------------------|--------------------|---------------|---|---|--|
| | | | Quoted market price in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| September 30, 2012 | | | | | |
| Financial Instruments Assets | | | | | |
| Net Loans | \$ 521,404 | \$ 522,445 | \$ | \$ 454,532 | \$ 67,913 |
| Financial Instruments Liabilities | | | | | |

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| | | | | | |
|-----------------------------------|--|------------|------------|----|----------------------|
| Time Deposits | | 387,540 | 391,266 | | 391,266 |
| FHLB Advances | | 6,858 | 6,858 | | 6,858 |
| December 31, 2011 | | | | | |
| Financial Instruments Assets | | | | | |
| Net Loans | | \$ 579,436 | \$ 588,888 | \$ | \$ 493,661 \$ 85,775 |
| Financial Instruments Liabilities | | | | | |
| Time Deposits | | 445,658 | 451,312 | | 451,312 |
| FHLB Advances | | 17,983 | 17,756 | | 17,756 |

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NOTE 11 RECENT ACCOUNTING DEVELOPMENTS:

The following is a summary of recent authoritative announcements:

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the Accounting Standards Codification (ASC) was amended by Accounting Standards Update (ASU) 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments are effective for the Company on January 1, 2012 and had no effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Company beginning January 1, 2012 and had no effect on the financial statements except for expanded disclosures.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company on January 1, 2012 and have been applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while FASB redeliberates future requirements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

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

Caution About Forward Looking Statements

We make forward looking statements in this quarterly report that are subject to risks and uncertainties. These forward looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, business strategy, and financial and other goals. The words believes, expects, may, will, should, projects, contemplates, anticipates, forecasts, intends, or other terms are intended to identify forward looking statements.

Certain information contained in this discussion may include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements contain the Company's expectations, plans, future financial performance, and other statements that are not historical facts. These forward-looking statements are generally identified by phrases such as the Company expects, the Company believes or words of similar importance. Such forward-looking statements involve known and unknown risks including, but not limited to, changes in general economic and business conditions, interest rate fluctuations, competition within and from outside the banking industry, new products and services in the banking industry, risk inherent in making loans such as repayment risks and fluctuating collateral values, problems with technology utilized by the Company, changing trends in customer profiles and changes in laws and regulations applicable to the Company. Although the Company believes that its expectations with respect to the forward-looking statements are based upon reasonable assumptions within the bounds of its knowledge of its business and operations, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements.

Because of these uncertainties, our actual future results may be materially different from the results indicated by these forward looking statements. In addition, our past results of operations do not necessarily indicate our future results.

Written Agreement

The Company and the Bank entered into a written agreement with the Federal Reserve Bank of Richmond and the Virginia Bureau of Financial Institutions. Under this Agreement, the Bank has agreed to develop and submit for approval within specified time periods written plans to: (a) strengthen board oversight of management and the Bank's operation; (b) if appropriate after review, to strengthen the Bank's management and board governance; (c) strengthen credit risk management policies; (d) enhance lending and credit administration; (e) enhance the Bank's management of commercial real estate concentrations; (f) conduct ongoing review and grading of the Bank's loan portfolio; (g) improve the Bank's position with respect to loans, relationships, or other assets in excess of \$1 million which are now or in the future become past due more than 90 days, which are on the Bank's problem loan list, or which are adversely classified in any report of examination of the Bank; (h) review and revise, as appropriate, current policy and maintain sound processes for maintaining an adequate allowance for loan and lease losses; (i) enhance management of the Bank's liquidity position and funds management practices; (j) revise its contingency funding plan; (k) revise its strategic plan; and (l) enhance the Bank's anti-money laundering and related activities.

In addition, the Bank has agreed that it will: (a) not extend, renew, or restructure any credit that has been criticized by the Reserve Bank or the Bureau absent prior board of directors approval in accordance with the restrictions in the Agreement; (b) eliminate all assets or portions of assets classified as loss and thereafter charge off all assets classified as loss in a federal or state report of examination, which has been done.

The Company and the Bank have agreed to submit capital plans to maintain sufficient capital at the Company, on a consolidated basis, and the Bank, on a stand-alone basis, and to refrain from declaring or paying dividends without prior regulatory approval. The Company has agreed that it will not take any other form of payment representing a reduction in the Bank's capital or make any distributions of interest, principal, or other sums on subordinated debentures or trust preferred securities without prior regulatory approval. The Company may not incur, increase or guarantee any debt without prior regulatory approval and has agreed not to purchase or redeem any shares of its stock without prior regulatory approval.

Under the terms of the Agreement, the Company and the Bank have appointed a committee to monitor compliance. The directors of the Company and the Bank have recognized and unanimously agree with the common goal of financial soundness represented by the Agreement and have confirmed the intent of the directors and executive management to diligently seek to comply with all requirements of the Written Agreement.

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Written Agreement Progress Report

At September 30, 2012, we believe we have not yet achieved full compliance with the Agreement but we have made progress in our compliance efforts under the Agreement. We are aggressively working to comply with the Agreement and have timely submitted each required plan by its respective deadline. We have hired an independent consultant to assist us in these efforts and the following actions have taken place:

1. With regard to corporate governance, we have established a weekly Director's Loan Committee to oversee all loan approvals and all loan renewals, extensions and approvals for loans risk rated Special Mention or worse, as well as, exposures exceeding the Chief Credit Officer's lending authority. This has enabled the Board to increase its oversight of the Bank's largest credit exposures and problem credits, and enhanced the monitoring and compliance with all loan policies and procedures. Secondly, we have enhanced our reporting of credit quality to the board. Furthermore, we have adopted formal charters for our Nominating, Compliance, Compensation, and Loan Committees. A corporate governance policy was adopted by the Board of Directors on April 23, 2012.
2. The requirement to assess the Board and management has been completed by an independent party. A report has been issued to the Board and recommendations are being followed. In September 2010, our President and CEO was added as a member of the Board and in November 2010, Eugene Hearl was added as a member of the Board. Mr. Hearl has over 40 years banking experience as President and CEO for two community banks and Regional President of a large regional financial institution.

In addition, training is a key initiative of both the Board of Directors and employees. Further training of the Board and employees has been implemented and will be ongoing.

A formal management succession plan has been developed and approved by the Board of Directors.

3. In the month of September 2010, a newly revised strategic plan and a capital plan were completed and submitted to our regulators. The 2011 Budget was submitted to our regulators in the fourth quarter of 2010. The 2012 Budget was submitted to our regulators also in the fourth quarter of 2011.

A newly revised strategic plan for the years 2012 through 2014 was completed and submitted to the regulators in November 2011.

In accordance with our capital plan, we have begun a common stock offering in July 2012 to existing shareholders followed by an offering to the public during the third and fourth quarters of 2012. We anticipate the closing of the offering to be on November 30, 2012 although it may be extended to no later than December 31, 2012.

In September 2012, we converted notes payable to two of our directors totaling \$5.5 million plus accrued interest of \$272 thousand to common stock. As a result of the conversion, the Company returned to well capitalized status at September 30, 2012.

4. Loan policies have been revised; an online approval and underwriting system for loans has been implemented; underwriting, monitoring and management of credits and collections have been enhanced; frequency of external loan reviews increased; and the focus on problem loans intensified at all levels in the organization. As a result, we are more timely in identifying problem loans. In the future, continuing these procedures should strengthen asset quality substantially. Further training of lending personnel is ongoing regarding proper risk grading of credits and identification of problem credits.
5. Enhanced loan concentration identification and new procedures for monitoring and managing concentrations have been implemented. Loan concentration targets have been established and efforts continue to reduce higher risk concentrations. In particular, construction and development loans and commercial real estate loans have been reduced and continue to decrease toward acceptable levels as determined by the new policies.

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6. To strengthen management of credit quality and loan production, we added a new Chief Credit Officer, Stephen Trescot, in the first quarter of 2011 who brings vast credit administration experience to our management team. Sharon Borich, our former Chief Credit Officer, assumed the role of Senior Lending Officer with oversight of loan production and business development which is her area of expertise. In addition to new lending policies and procedures, the management of all real estate development projects and draws has been centralized. We have segregated the duties of lenders for greater specialization of commercial and retail lending responsibilities. As a result we have formed a Commercial Loan division that is supervised by the Senior Vice President and Senior Lending Officer. The retail loans are primarily the responsibility of branch personnel who report to branch managers and respective area managers.

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The credit analysis function has been restructured and is a part of credit administration. The credit analysis function is led by a Vice President/Senior Analyst, who supervises three analysts, of which, two analysts are CPAs, the third has an MBA. The function reports directly to the Chief Credit Officer and is responsible for analyzing new and renewed loan relationships of \$250 thousand or more prior to approval and conducting annual financial reviews of loan relationships of \$500 thousand or more.

The appraisal review function, consisting of two Vice Presidents, one of which is an experienced licensed appraiser, and one administrative assistant, also reports directly to the Chief Credit Officer. The appraisal review function reviews the quality of appraisals on behalf of the Bank by reviewing the methods, assumptions, and value conclusions of internal and external appraisals. In addition, this data is used to determine whether an external appraiser should be utilized for future work.

7. We have retained an independent third party to perform loan reviews on a quarterly basis in 2010 and 2011 and have engaged them to perform this function in June 2012 and December 2012. The third party loan review company has also conducted two loan portfolio stress tests for the Bank to obtain a better understanding of potential loan losses over a two year period.
8. To support the focus on problem credit management the Bank further developed, in March, 2011, a Special Assets department which reports to the Chief Credit Officer. Presently, the department has two workout specialists/Vice Presidents, one Vice President managing other real estate owned properties, an analyst, and two support personnel. Substantially all the relationships in the Bank with total commitments in excess of \$500,000 which are risk rated Special Mention or worse are assigned to this department. This department is organizationally structured to manage workout situations, collections, other real estate owned, nonperforming assets, watch list credits, and the Bank's legal department. New reporting and monitoring is conducted monthly by this division. Material changes to Special Asset credits are reported to the Board at the time of occurrence and, quarterly, the Board receives written action plans and status updates of the Bank's twenty largest problem credits. A quarterly management watch list committee has been established to actively manage and monitor these credits.
9. A new allowance for loan loss model was implemented and reviewed independently during 2010. The Board has approved a new allowance for loan loss policy. We have shifted duties for maintaining the allowance for loan loss model and credit reporting to a more experienced employee. The allowance for loan loss and the methodology supporting the results are approved quarterly by the Audit Committee of the Board of Directors, and ratified by the Board.
10. We have significantly increased our asset based liquidity sources throughout 2010, 2011 and 2012 to meet financial obligations. A new liquidity risk management policy has been adopted and a revised contingency funding plan has been created. We have lost all of our federal funds lines of credit, but we have added an internet certificate of deposit funding source to increase contingent funding sources. We believe that we have adequate liquidity in normal and stressed situations. We are further developing an investment portfolio, as well. The investment portfolio has grown to \$48.6 million at September 30, 2012 from \$4.7 million at December 31, 2010.
11. In the fourth quarter of 2009, we ceased the declaration of dividends from the Bank to the Company. We also deferred interest payments on our trust preferred securities issuances.
12. Anti-money laundering and bank secrecy act programs and training have been enhanced.

Overview

The Company had a net loss for the quarter ended September 30, 2012 of \$1.5 million as compared to a net loss of \$1.8 million for the quarter ended September 30, 2011. Year-to-date September 30, 2012, the Company had a net loss of \$6.5 million as compared to a net loss of \$3.0 million for the same period in 2011. Basic net loss per share was \$0.14 for the quarter ended September 30, 2012 as compared to basic net loss of \$0.18 for the quarter ended September 30, 2011. Basic net loss per share was \$0.64 for the nine months ended September 30, 2012 as compared to net loss per share of \$0.30 for the nine months ended September 30, 2011. The net loss year-to-date is primarily the result of other

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real estate owned expenses of \$4.4 million, of which \$3.0 million is the result of other real estate owned properties writedowns, \$4.1 million in loan loss provision, and a deferred tax valuation allowance of \$4.1 million.

Total assets decreased to \$708.2 million, or 9.25%, from \$780.4 million at December 31, 2011. We intentionally are reducing our asset size in an attempt to improve our capital position and manage our net interest margin by reducing higher cost funding. We foresee total assets to continue shrinking in the near future as we manage to maintain a well-capitalized status under regulatory guidelines at the Bank and Company level. Depending upon the success of the common stock offering being conducted in the fourth quarter 2012, we may not shrink the Bank at the rate as in the recent past.

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At September 30, 2012, the Company returned to regulatory well-capitalized status as a result of the Tier 1 leverage ratio increasing to 4.74%, which was above the minimum requirement of 4.00%. This was the result of the conversion of \$5.5 million in notes payable to two Board members plus accrued interest of \$272 thousand to common stock on September 19, 2012 after receipt of regulatory approval. At December 31, 2011, the Tier 1 leverage ratio was 4.23%. The Tier 1 risk based ratio was 7.56% at September 30, 2012, compared to 6.57% at December 31, 2011. The Total risked based capital ratio was 10.36% at September 30, 2012, compared to 9.15% at December 31, 2011.

At September 30, 2012 the Bank remains well capitalized under the regulatory framework for prompt corrective action. The following ratios existed at September 30, 2012 for the Bank: Tier 1 leverage ratio of 5.94%, Tier 1 risk based capital ratio of 9.47%, and Total risk based capital ratio of 10.75%. The ratios were as follows at December 31, 2011: Tier 1 leverage ratio of 5.99%, Tier 1 risk based capital ratio of 9.28%, and Total risk based capital ratio of 10.56%.

In the third quarter of 2012, our net interest margin was 4.20%, as compared to 4.18% for the same period in 2011. We had a \$979 thousand decrease in net interest income during the third quarter of 2012 as compared to the same period in 2011 primarily related to the decreased loan portfolio.

Total loans decreased to \$539.0 million at September 30, 2012 from \$597.8 million at year end 2011. This is the result of charge offs of \$5.2 million for the first nine months of 2012, resolution of problem loans, decreased loan demand, tighter underwriting guidelines, and the intentional shrinking of the loan portfolio to increase regulatory capital ratios. We continue to serve our customers, and although the total loan portfolio has shrunk, we have renewed existing credits and have made new loans to qualified borrowers as well. We anticipate continued decreases in the loan portfolio in the near future as we reduce our exposure to certain credit and market risks and decrease nonperforming loans. Increased focus is being made by the lending personnel to further develop new and existing lending relationships and will help slow the pace of total loans declining. Total deposits decreased \$55.1 million from \$708.3 million at December 31, 2011 to \$653.2 million at September 30, 2012 as we have experienced shrinkage in time deposits due to the interest rate environment.

The deterioration of the residential and commercial real estate markets, as well as the extended recessionary period, have resulted in high levels of nonperforming assets; however, during 2012 nonperforming assets have begun to decrease. Nonperforming assets, which include nonaccrual loans, other real estate owned and past due loans greater than 90 days still accruing interest, decreased to \$52.7 million at September 30, 2012 from \$58.9 million at December 31, 2011. The majority of these assets are real estate development projects and commercial real estate secured loans. We are working aggressively to reduce these totals primarily by working with the customer for additional collateral, or restructuring the debt. However, we also may have to foreclose, repossess collateral or take other prudent measures. We are uncertain how long these processes will take. We believe we are making good progress and the level of nonperforming assets decreased in the third quarter. The ratio of nonperforming assets to total assets increased to 8.28% at September 30, 2012 from 7.55% at December 31, 2011 as a result of total assets shrinking at a faster pace than nonperforming assets. In the first nine months of 2012, net charge offs were \$4.9 million as compared to \$15.6 million in the same period of 2011. The majority of the charge offs in the first nine months of 2012 were related to real estate construction loans and commercial loans with collateral values that are dependent upon current market and economic conditions when these are ascertainable.

The provision for loan losses decreased \$1.8 million, or 65.48%, to \$967 thousand for the third quarter of 2012 as compared to \$2.8 million in the same period for 2011. At September 30, 2012 our allowance for loan losses totaled \$17.6 million, or 3.26% of total loans, as compared to \$18.4 million, or 3.07% of total loans as of December 31, 2011. At September 30, 2011 our allowance for loan losses totaled \$17.4 million, or 2.76% of total loans. The allowance for loan losses is being maintained at a level that management deems appropriate to absorb any potential future losses and known impairments within the loan portfolio whether or not the losses are actually ever realized. We continue to modify the allowance for loan loss model to best reflect the risks in the portfolio and the improvements made in our internal policies and procedures.

Critical Accounting Policies

For discussion of our significant accounting policies see our Annual Report on Form 10-K for the year ended December 31, 2011. Certain critical accounting policies affect the more significant judgments and estimates used in the preparation of our financial statements. Our most critical accounting policies relate to our provision for loan losses and the calculation of our deferred tax asset and valuation allowance.

The provision for loan losses reflects the estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our borrowers were to further deteriorate, resulting in an impairment of their ability to make payments, our estimates would be updated, and additional provisions could be required. For further discussion of the estimates used in determining the allowance for loan losses, we refer you to the section on [Provision for Loan Losses](#) below.

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Our deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. If all or a portion of the net deferred tax asset is determined to be unlikely to be realized, a valuation allowance is established to reduce the net deferred tax asset to the amount that is more likely than not to be realized. For further discussion of the deferred tax asset and valuation allowance, we refer you to the section on Deferred Tax Asset and Income Taxes below.

Balance Sheet Changes

At September 30, 2012, total assets were \$708.2 million, a decrease of \$72.2 million, or 9.25%, over December 31, 2011. Total deposits decreased \$55.1 million, or 7.78%, for the first nine months of 2012 to \$653.2 million from \$708.3 million at December 31, 2011. Total loans decreased \$58.8 million, or 9.84%, to \$539.0 million at September 30, 2012 from \$597.8 million at December 31, 2011.

Core deposits remained substantially at the same level as noninterest bearing deposits slightly decreased 0.52%, or \$572 thousand, from \$109.6 million at December 31, 2011 to \$109.1 million at September 30, 2012. Overall, we continue to maintain core deposits through attractive consumer and commercial deposit products and strong ties with our customer base and communities. We experienced an increase of \$2.8 million in interest bearing demand deposits and a \$790 thousand increase in savings deposits during the first nine months of 2012.

We experienced a decrease in time deposits of \$58.2 million. This is the result of decreased interest rates offered in this very low interest rate environment. During 2012, interest rate sensitive deposits have withdrawn to seek other investment opportunities. We expect to continue to lose higher cost and rate sensitive deposits in the near future, but at a decreased pace than in the past. However, we monitor deposits to ensure that we maintain adequate liquidity levels. We believe despite the deposit decrease, we have adequate liquidity.

Total loans decreased to \$539.0 million at September 30, 2012 from \$597.8 million at year end 2011. This is the result of charge offs of \$5.2 million for the first nine months of 2012, lower loan demand, tighter underwriting criteria, and resolution of problem loans. We plan to decrease the loan portfolio as we manage our capital levels to maintain the Bank's and the Company's well-capitalized status, reduce certain risks to various industry sectors that have posed higher risks in recent times and resolve nonperforming loans. Even as we decrease our loan portfolio, we still are committed to serving our customers. We have hired commercial lending personnel, continue to train our loan officers to meet the needs of our customers, and are developing new business with qualified borrowers that will ensure a stronger loan portfolio in the future.

Other real estate owned decreased \$3.7 million, or 24.68%, to \$11.4 million at September 30, 2012 from \$15.1 million at December 31, 2011. During the first nine months of 2012, we acquired \$6.9 million in other real estate owned as a result of settlement of foreclosed loans, which was offset by sales of \$7.2 million of our properties with losses of \$383 thousand realized as a result of the sales. We also had to record writedowns on other real estate owned properties in the amount of \$3.0 million for the first nine months of 2012. Future sales of these properties are contingent upon an economic recovery; consequently, it is difficult to estimate the duration of our ownership of these assets. As we continue to resolve problem loans, we may experience an increase in other real estate owned properties in the short term. We have designated employees to monitor other real estate owned properties to ensure proper fair market values of these assets and to ensure that maintenance and improvements are made to make these properties more marketable.

Net Interest Income and Net Interest Margin

Net interest income decreased \$979 thousand, or 12.65%, to \$6.8 million for the third quarter of 2012 from \$7.7 million for the same period in 2011. This is the result of the level of nonaccrual loans of \$40.2 million at September 30, 2012 which negatively affects the net interest margin as these loans are nonearning assets. It is also affected by the decreased volume of loans, which are typically higher earning assets. Our net interest margin was 4.20% in the third quarter of 2012 as compared to 4.18% for the same period in 2011.

With regard to recognition of interest income on impaired loans, interest income and cash receipts on impaired loans are handled differently depending on whether or not the loan is on nonaccrual status. If the impaired loan is not on nonaccrual status, then the interest income on the loan is computed using the effective interest method. If there is serious doubt about the collectability of an impaired loan, it is the Bank's policy to stop accruing interest on a loan and classify that loan as nonaccrual under the following circumstances: (a) whenever we are advised by the borrower that scheduled payment or

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interest payments cannot be met, (b) when our best judgment indicates that payment in full of principal and interest can no longer be expected, or (c) when any such loan or obligation becomes delinquent for 90 days unless it is both well secured and in the process of collection. All interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is accounted for on the cash basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and prospects for future contractual payments are reasonably assured. In addition, funds generated from a shrinking loan portfolio are reinvested at lower interest rates in both overnight deposits for liquidity purposes and in investment securities. If nonaccruing loans increase, it may reduce our net interest margin further. We continue to manage our yields on assets and our costs of funds to attempt to improve the net interest margin.

As mentioned earlier, our loan portfolio has decreased and as a result the interest income generated by these higher earning assets has been redeployed into investment securities, a lower yielding asset. The overall effect is a decrease in the interest income of the Bank.

Although our cost of funds has decreased due to deposits repricing at lower interest rates, the rate of this decrease in interest costs is not consistent with the rate of decrease in interest income; consequently, this is causing net interest income to decrease overall.

As the total assets decrease, we anticipate, however, that the net interest margin will still remain above 4%; accordingly, we are managing this critical source of earnings.

Noninterest Income

Noninterest income was \$1.4 million in the third quarter of 2012 which was comparable to the \$1.4 million for the same period in 2011. During the third quarter we had \$48 thousand in realized gain on the sale of investment. We expect noninterest income to remain flat throughout 2012 as a result of regulatory changes; however, we continue to seek opportunities to improve noninterest income. The annualized ratio of noninterest income as percentage of average assets was 0.80% at September 30, 2012 as compared to 0.62% for the same period in 2011.

Noninterest Expense

Noninterest expense totaled \$7.8 million for the third quarter of 2012 as compared to \$9.1 million for the third quarter of 2011. The primary contributor to the decrease in noninterest expenses for the quarter is the decrease in other real estate owned expenses of \$846 thousand.

Salaries and benefits decreased \$475 thousand in the quarter-to-quarter comparison from \$3.9 million at September 30, 2011 to \$3.4 million for the same period in 2012. We decreased staffing during 2011 and are now starting to realize the reduced expenses. Total full time equivalent employees have decreased to 289 at September 30, 2012 from 323 at September 30, 2011, a reduction of 34, or 10.53%. In addition, we have frozen salaries for the year 2012 in order to control this expense. In the year 2012, we also lowered the 401-k matching contribution from matching dollar for dollar on the 5% employee contribution to 3%. On May 31, 2012 we merged eight existing offices together to form four offices which reduced our total number of branches to 23. We anticipate annual pre-tax savings from these consolidations to be approximately \$1.0 million. In the future, we are continuing to focus on reducing salary and benefits expenses.

Our efficiency ratio, which is defined as noninterest expense divided by the sum of net interest income plus noninterest income, was 96.55% for the third quarter of 2012 as compared to 100.08% for the same period in 2011. Included in this calculation are the other real estate owned write-downs which significantly and negatively impact the ratio. We anticipate this ratio to improve in the future as we realize cost savings from staff reductions and the branch mergers that occurred in the second quarter of 2012. We believe that other real estate owned write-downs may reduce from the past as these have been primarily related to construction and development type properties that have been significantly impacted due to recent market valuation trends. Our level of these properties is much lower and reflect current market values.

Provision for Loan Losses

The calculation of the allowance for loan losses is considered a critical accounting policy. The adequacy of the allowance for loan losses is based upon management's judgment and analysis. The following factors are included in our evaluation of determining the adequacy of the allowance: risk characteristics of the loan portfolio, current and historical loss experience, concentrations and internal and external factors such as general economic conditions.

The allowance for loan losses decreased to \$17.6 million at September 30, 2012 as compared to \$18.4 million at December 31, 2011. Even so, the allowance for loan losses at September 30, 2012 was approximately 3.26% of total loans as compared to 3.07% at December 31, 2011 and 2.76% at September 30, 2011. Net loans charged off for the first nine

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months of 2012 were \$4.9 million, or 1.15% of average loans, and \$14.0 million, or 2.77% of average loans, for the first nine months of 2011. The provision for loan losses was \$967 thousand for the third quarter of 2012 as compared with \$2.8 million in the same period for 2011.

Loans delinquent greater than 90 days still accruing interest and loans in non-accrual status present higher risks of default and loan losses. At September 30, 2012, there were 150 loans in non-accrual status totaling \$40.2 million, or 7.45% of total loans. At December 31, 2011, there were 170 loans in non-accrual status totaling \$42.3 million, or 7.08% of total loans. The amounts of interest that would have been recognized on these loans were \$1.1 million and \$1.3 million for the nine months ended September 30, 2012 and 2011, respectively. There were 26 loans past due 90 days or greater and still accruing interest totaling \$1.2 million, or 0.21% of total loans at September 30, 2012. There were 47 loans past due 90 days or greater and still accruing interest totaling \$1.5 million at year end 2011. It is our policy to stop accruing interest on a loan, and to classify that loan as non-accrual, under the following circumstances: (a) whenever we are advised by the borrower that scheduled payment or interest payments cannot be met, (b) when our best judgment indicates that payment in full of principal and interest can no longer be expected, or (c) when any such loan or obligation becomes delinquent for 90 days unless it is both well secured and in the process of collection. There were \$21.8 million in loans classified as troubled debt restructurings as of September 30, 2012 as compared to \$29.1 million in loans classified as troubled debt restructurings as of December 31, 2011. Of the loans classified as troubled debt restructurings at September 30, 2012, \$7.8 million were in non-accrual status, compared to \$8.2 million at December 31, 2011. We do not have any commitments to lend additional funds to non-performing debtors.

Certain risks exist in the Bank's loan portfolio. Historically, we had experienced significant annual loan growth until the past couple of years. Consequently there might be loans that have single pay maturities or demand loans that may be too new to have exhibited signs of weakness. A majority of our loans are collateralized by real estate located in our market area. It is our policy to sufficiently collateralize loans to help minimize loss exposures in case of default. With the exception of real estate development type properties which have experienced more deterioration in market values, the local residential and commercial real estate market values have shown some deterioration but remain relatively stable. It is uncertain as to when or if local real estate values will be more significantly impacted. We do not believe that there will be a severely negative effect in our market area, but because of the uncertainty we deem it prudent to assign more of the allowance to these types of loans. Our market area is somewhat diverse, but certain areas are more reliant upon agriculture, coal mining and natural gas. As a result, increased risk of loan impairments is possible if these industries experience a significant downturn although we do not believe this to be likely at least in the near future. We consider these factors to be the primary higher risk characteristics of the loan portfolio.

Loans are initially risk rated by the originating loan officer. If deteriorations in the financial condition of the borrower and the capacity to repay the debt occur, along with other factors, the loan may be downgraded. This is to be determined by the loan officer. Guidance for the evaluation is established by the regulatory authorities who periodically review the Bank's loan portfolio for compliance. Classifications used by the Bank are exceptional, very good, standard, acceptable, transitory risk, other assets especially mentioned, substandard, doubtful and loss. For the year 2011, we engaged a third party loan review firm to conduct quarterly loan reviews and have engaged them to perform this function in 2012 on a semiannual basis. Upon their review, loans risk ratings may change from the rating assigned by the respective lender. We have experienced fewer rating changes in more recent reviews indicating better risk identification for the loan portfolio in light of the experience from the severe recession.

All loans classified as special mention, substandard, doubtful and loss are individually reviewed for impairment. In determining impairment, collateral for loans classified as substandard, doubtful and loss is reviewed to determine if the collateral is sufficient for each of these credits, generally through the review of the appraisal. If the appraisal is current, less than twelve months old, and has been reviewed, then if no negative information regarding the appraised value is obtained, the value is accepted, and impairment, if required is made. If the appraisal is not current, the lender would proceed to validate the appraised value through current tax values, recent comparable sales and/or the use of an outside appraisal review firm. The outside firm would review the appraisal given current economics and recommend whether or not the existing appraisal is valid. If it is not, in most cases, the bank will order a new appraisal upon which to base any impairment. In determining the ASC 450 component of our allowance, we do not directly consider the potential for outdated appraisals since that portion of our allowance is based on the analysis of the performance of loans with similar characteristics, external and internal risk factors. We consider the overall quality of our underwriting process in our internal risk factors, but the need to update appraisals is associated with loans identified as impaired under ASC 310. If an appraisal is older than one year, a new external certified appraisal may be obtained and used to determine impairment. If an exposure exists, a specific allowance is directly made for the amount of the potential loss in addition to estimated liquidation and disposal costs. The evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Impaired loans decreased to \$74.5 million with \$34.0 million requiring a valuation allowance of \$6.6 million at September 30, 2012 as compared to \$91.8 million with \$30.0 million requiring a valuation allowance of \$6.0 million at December 31, 2011. Of the \$74.5 million recorded as impaired loans, \$38.4 million were nonperforming loans, which includes nonaccrual loans and past due 90 days or more. Management is aggressively working to reduce the impaired credits at minimal loss.

Table of Contents**Deferred Tax Asset and Income Taxes**

Due to timing differences between book and tax treatment of several income and expense items, a deferred tax asset of \$4.8 million existed at September 30, 2012 as compared to a deferred tax asset of \$7.2 million at December 31, 2011. During the first nine months of 2012 a \$4.1 million deferred tax asset valuation allowance was recorded, which increased the total valuation allowance to \$6.8 million at September 30, 2012, compared to \$2.7 million at December 31, 2011. Management reviewed the September 30, 2012 deferred tax calculation to determine the need for a valuation allowance. Based on the trend of reduced levels of earning assets and net interest income, we modified the projections of taxable income over the next three years and determined that an additional deferred tax asset valuation allowance was required. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. In management's opinion, based on a three year taxable income projection, tax strategies which would result in potential securities gains and the effects of off-setting deferred tax liabilities, it is more likely than not that all the deferred tax assets, net of the \$6.8 million allowance, would be realizable. Included in deferred tax assets are the tax benefits derived from net operating loss carryforwards totaling \$4.2 million. Management expects to utilize all of these carryforwards prior to expiration. Direct charge-offs contributed to a reduction of the tax asset and are permitted as tax deductions. In addition, writedowns on other real estate owned property are expensed for book purposes but are not deductible for tax purposes until disposition of the property. Goodwill expense also was realized for book purposes in 2011 but continues to only be tax deductible based on the statutory requirements; thus, creating a deferred tax asset. When, and if, taxable income increases in the future and during the net operating loss carryforward period, this valuation allowance may be reversed and used to decrease tax obligations in the future. Our income tax expense was computed at the normal corporate income tax rate of 34% of taxable income included in net income. We do not have significant nontaxable income or nondeductible expenses.

Liquidity

We closely monitor our liquidity and our liquid assets in the form of cash, due from banks, federal funds sold, and unpledged available for sale investments were \$97.3 million at September 30, 2012 down from \$107.3 million at December 31, 2011. We plan to maintain surplus short-term assets at levels adequate to meet potential liquidity needs during 2012.

At September 30, 2012, all of our investments are classified as available-for-sale, providing an additional source of liquidity in the amount of \$29.7 million, which is net of those securities pledged as collateral. This will primarily serve as a source of liquidity while yielding a higher return than other short term investment options, such as federal funds sold and overnight deposits with the Federal Reserve Bank. We have increased our investment portfolio from \$32.4 million at December 31, 2011 to \$48.6 million at September 30, 2012. Our strategy is to further develop the investment portfolio for the Bank. We foresee purchasing additional securities in the near future as opportunities arise.

Our loan to deposit ratio decreased to 82.51% at September 30, 2012 from 84.40% at year end 2011. We anticipate this ratio to remain below 90% as we continue to decrease our loan portfolio throughout 2012. We can further lower the ratio as management deems appropriate by managing the rate of growth in our loan portfolio and by offering special promotions to entice new deposits. This can be done by changing interest rates charged or limiting the amount of new loans approved.

Available third party sources of liquidity remain intact at September 30, 2012 which includes the following: our line of credit with the Federal Home Loan Bank of Atlanta, the brokered certificates of deposit markets, internet certificates of deposit, and the discount window at the Federal Reserve Bank of Richmond.

At September 30, 2012, we had borrowings from the Federal Home Loan Bank totaling \$6.9 million as compared to \$18.0 million at December 31, 2011. None is overnight and subject to daily interest rate changes. The borrowings have a maturity date in the year 2018, but reduce in principal amounts monthly. The decrease of \$11.1 million was due to regularly scheduled principal payments and the early payoff of the term notes of \$10.2 million during the second quarter of 2012 that were to mature in the third quarter 2012. We incurred \$90 thousand in prepayment penalties during the second quarter as a result of this early payoff; however, with securities gains realized on the sales of some investment securities with future interest expense reductions related to the term borrowing with the FHLB, we anticipate approximately a \$125 thousand increase in earnings by year end 2012. We also used our line of credit with the Federal Home Loan Bank to issue a letter of credit for \$7.0 million in 2008 and \$3.0 million in 2010 to the Treasury Board of Virginia for collateral on public funds. An additional \$40.9 million was available on September 30, 2012 on the \$57.8 million line of credit which is secured by a blanket lien on our residential real estate loans.

We have access to the brokered deposits market. Currently we have \$2.7 million in 10 year term time deposits comprised of \$3 thousand incremental deposits which yield an interest rate of 4.10%. With the exception of CDARS time deposits, we have no other brokered deposits. Though this has not been a strategy in the past, we may utilize this source in the future as a lower cost source of funds.

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We are a member of an internet certificate of deposit network whereby we may obtain funds from other financial institutions at auction. We may invest funds through this network as well. Currently, we only intend to use this source of liquidity in a liquidity crisis event.

The Bank has access to additional liquidity through the Federal Reserve Bank discount window for overnight funding needs. We may collateralize this line with investment securities and loans at our discretion, however, we do not anticipate using this funding source except as a last resort.

Additional liquidity is expected to be provided by loan repayments and core deposit growth that will result from an increase in market share in our targeted trade area.

With the increased asset liquidity and other external sources of funding, we believe at the Bank level we have adequate liquidity and capital resources to meet our requirements and needs for the foreseeable future. However, liquidity can be further affected by a number of factors such as counterparty willingness or ability to extend credit, regulatory actions and customer preferences, some of which are beyond our control.

Liquidity levels at the holding company level have tightened during 2012 as stock offering expenses have been paid prior to the offering's completion. We anticipate improvements in liquidity if we are able to complete the stock offering in the fourth quarter of 2012 enabling us to meet future liquidity needs. Additional contingent funding sources will be explored as available.

Capital Resources

Total capital at the end of the third quarter of 2012 was \$28.1 million as compared to \$28.9 million at the end of December 31, 2011. During the third quarter 2012 we converted the notes payable to two Board members of \$5.5 million plus accrued interest of \$272 thousand to common stock, which resulted in an increase to capital of \$5.7 million. This increase was offset by the net loss of \$6.5 million for the nine months of 2012, which was primarily the result of other real estate owned expenses and writedowns, loan loss provisions and the deferred tax asset valuation allowance expense. The Bank and the Company were both well capitalized as of September 30, 2012, as defined by the regulatory capital guidelines. The Company's capital as a percentage of total assets was 3.97% at September 30, 2012 compared to 3.70% at December 31, 2011.

Total assets decreased during the first nine months of 2012 and we anticipate further decreasing assets to be the trend in 2012. We developed a new strategic plan and capital plan in 2011. Under current economic conditions, we believe it is prudent to increase capital to absorb potential losses that may occur if asset quality deteriorates further. We are aware that capital needs and requirements are affected by the level of problem assets, growth, earnings and other factors. Retained earnings are not alone sufficient to provide for this economic cycle and we believe other measures to increase our capital ratios are needed.

As part of our initiative to improve regulatory capital ratios, we are further reducing our higher risk assets, which results in a shrinking loan portfolio. Deposit growth is primarily focused on growing core deposits, which are mainly transaction accounts, commercial relationships and savings products. We are focused on improving earnings by maintaining a strong net interest margin and decreasing overhead expenses. We are fully implementing this strategy to increase capital. However, these efforts alone may not provide us adequate capital if further loan losses are realized. Therefore, we commenced an offering of our common stock pursuant to a registration on Form S-1 with the U.S. Securities and Exchange Commission which became effective on July 6, 2012. We are conducting a rights offering and an offering of common stock to the public on a best efforts basis at a price of \$1.50 per share. We mailed the offering prospectus to our shareholders on July 16, 2012 to initiate the rights offering. The rights offering ended on August 31, 2012. The public offering commenced in September 2012 and is scheduled to close on November 30, 2012, but may be extended to (but not beyond) December 31, 2012. The maximum offered is \$25.0 million and we must reach a minimum of \$10.0 million in order to complete the offering. The offering provides for the issuance of one warrant to acquire one share of our common stock for each five shares purchased in the offering. The warrants are immediately exercisable and valid for five years. The rights offering and the public offering are being conducted to raise sufficient capital to comply with our capital plan, as approved by federal and state bank regulatory agencies. For more information please refer to our Prospectus dated July 6, 2012.

No cash dividends have been paid historically and none are anticipated in the foreseeable future.

Off Balance Sheet Items and Contractual Obligations

There have been no material changes during the quarter ended September 30, 2012 to the off-balance sheet items and the contractual obligations disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2011.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not Applicable.

Item 4. Controls and Procedures

We have carried out an evaluation, under the supervision and with the participation of our management, including our President and Chief Executive Officer (our CEO) and our Executive Vice President and Chief Financial Officer (our CFO), of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were operating effectively in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (b) such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended September 30, 2012 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

Part II Other Information

Item 1. Legal Proceedings

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

The Bank is a co-defendant in a case brought by VFI Associates LLC, Burke LPI and Nicewonder, LPI in the Circuit Court of Russell County, Virginia on March 2, 2010. The main claim is that the Bank's former President and a former Senior Vice President imputed liability to the Bank through their conduct in a personal business venture and that an unrecordable ground lease entered into after the Bank's deed of trust was recorded is superior in right. The relief sought is principally equitable in nature and not for money damages. The Bank believes it will prevail in the litigation.

Item 1A. Risk Factors

Not Applicable.

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

Not Applicable

Item 3. Defaults Upon Senior Securities

Not Applicable

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

Not Applicable

Item 6. Exhibits

See Index of Exhibits.

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SIGNATURES

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

**NEW PEOPLES BANKSHARES, INC.
(Registrant)**

By: /s/ JONATHAN H. MULLINS
Jonathan H. Mullins
President and Chief Executive Officer

Date: November 13, 2012

By: /s/ C. TODD ASBURY
C. Todd Asbury
Executive Vice President and Chief Financial
Officer

Date: November 13, 2012

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Index of Exhibits

| No. | Description |
|-------|---|
| 2.1 | Agreement and Plan of Share Exchange dated August 15, 2011 (incorporated by reference to Exhibit 2 to Form 8-K filed December 17, 2011). |
| 3.1 | Amended Articles of Incorporation of New Peoples Bankshares, Inc. (incorporated by reference to Exhibit 3.1 to Form 10-Q for the quarterly period ended June 30, 2008 filed on August 11, 2008). |
| 3.2 | Bylaws of New Peoples Bankshares, Inc. (incorporated by reference to Exhibit 3.1 to Form 8-K filed on April 15, 2004). |
| 4.1 | Specimen Common Stock Certificate of New Peoples Bankshares, Inc. (incorporated by reference to Exhibit 4.1 to Form 10-Q for the quarterly period ended June 30, 2012 filed on August 14, 2012). |
| 4.2 | Form of Warrant to Purchase Shares of Common Stock (incorporated by reference to Exhibit 4.2 to Form 10-Q for the quarterly period ended June 30, 2012 filed on August 14, 2012). |
| 4.3 | Form of Rights Certificate (incorporated by reference to Exhibit 4.3 to Form 10-Q for the quarterly period ended June 30, 2012 filed on August 14, 2012). |
| 10.1* | New Peoples Bank, Inc. 2001 Stock Option Plan (incorporated by reference to Exhibit 10.1 to Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001). |
| 10.2* | Form of Non-Employee Director Non-Qualified Stock Option Agreement (incorporated by reference to Exhibit 10.2 to Form 8-K filed November 30, 2004). |
| 10.3* | Form of Incentive Stock Option Agreement (incorporated by reference to Exhibit 10.3 to Form 8-K filed November 30, 2004). |
| 10.4* | Salary Continuation Agreement dated December 18, 2002 between New Peoples Bank, Inc. and Frank Sexton, Jr. (incorporated by reference to Exhibit 10.6 to Annual Report on Form 10-K for the fiscal year ended December 31, 2004). |
| 10.5* | First Amendment dated June 30, 2003 to Salary Continuation Agreement between New Peoples Bank, Inc. and Frank Sexton, Jr. (incorporated by reference to Exhibit 10.7 to Annual Report on Form 10-K for the fiscal year ended December 31, 2004). |
| 10.6* | Letter Agreement, dated as of June 29, 2009, between the Company and Kenneth D. Hart (incorporated by reference to Exhibit 10.1 to Quarterly Report on Form 10-Q for the quarter ended June 30, 2009). |
| 10.7 | Written Agreement, effective August 4, 2010, by and among New Peoples Bankshares, Inc., New Peoples Bank, Inc., the Federal Reserve Bank of Richmond and the State Corporation Commission Bureau of Financial Institutions (incorporated by reference to Exhibit 10.1 to Form 8-K filed August 6, 2010). |
| 10.8 | Engagement Letters of Scott & Stringfellow, LLC (incorporated by reference to Exhibit 10.8 to Form 10-Q for the quarterly period ended June 30, 2012 filed on August 14, 2012). |
| 10.9 | Convertible Note Payable, B. Scott White, dated June 27, 2012 (incorporated by reference to Exhibit 10.1 to Form 8-K filed June 29, 2012). |
| 10.10 | Convertible Note Payable, Harold Lynn Keene, dated June 27, 2012 (incorporated by reference to Exhibit 10.2 to Form 8-K filed June 29, 2012). |
| 31.1 | Certification by Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act. |
| 31.2 | Certification by Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act. |
| 32 | Certification by Chief Executive Officer and Chief Financial Officer, as required by Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | The following materials for the Company's 10-Q Report for the quarterly period ended September 30, 2012, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to the Consolidated Financial Statements, tagged as blocks of text. ⁽¹⁾ |

- * Denotes management contract.
- (1) Furnished, not filed.