Village Bank & Trust Financial Corp.
Form 10-K
March 30, 2012

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

FORM 10-K
ANNUAL REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2011

Commission file number 0-50765

VILLAGE BANK AND TRUST FINANCIAL CORP.
(Exact name of registrant as specified in its charter)

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

15521 Midlothian Turnpike, Suite 200, Midlothian, Virginia	23113
(Address of principal executive offices)	(Zip Code)

Issuer’s telephone number 804-897-3900

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

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

Securities registered under Section 12(g) of the Exchange Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o Noþ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. [ ]

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yesþ Noo

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yesþ Noo

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

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

Large Accelerated Filer o	Accelerated Filer o
Non-Accelerated Filer o (Do not check if smaller reporting company)	Smaller Reporting Company þ

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

The aggregate market value of common stock held by non-affiliates of the registrant as of the last business day of the Registrant's most recent completed second fiscal quarter was approximately $9,760,000.

The number of shares of common stock outstanding as of March 9, 2012 was 4,251,795.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be used in conjunction with the 2012 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-K.

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PART I

ITEM 1. BUSINESS

The disclosures set forth in this item are qualified by ITEM 1A. RISK FACTORS and the section captioned "Caution About Forward-Looking Statements" and other cautionary statements set forth elsewhere in this report.

General

Village Bank and Trust Financial Corp. (the "Company") was incorporated in January 2003 and was organized under the laws of the Commonwealth of Virginia as a bank holding company whose activities consist of investment in its wholly-owned subsidiary, Village Bank (the "Bank"). The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Company acquired or formed three wholly owned subsidiaries of the Bank, Village Bank Mortgage Corporation ("Village Bank Mortgage"), a full service mortgage banking company, Village Insurance Agency, Inc. ("Village Insurance"), a full service property and casualty insurance agency, and Village Financial Services Corporation ("Village Financial Services"), a financial services company. Currently, Village Insurance and Village Financial Services have no ongoing operations. In addition we provide investment services through a separate division of the Bank, Village Investment Services.

The Company is the holding company of and successor to the Bank. Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction. In the transaction, the shares of the Bank's common stock were exchanged for shares of the Company's common stock, par value $4.00 per share ("Common Stock"), on a one-for-one basis. As a result, the Bank became a wholly-owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company.

We offer a wide range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, and commercial, real estate and consumer loans. In addition we provide investment services through a separate division of the Bank, Village Investment Services. We are a community-oriented and locally managed financial institution focusing on providing a high level of responsive and personalized services to our customers, delivered in the context of a strong direct relationship with our customers. We conduct our operations from our main office/corporate headquarters location in Chesterfield County, and we have fourteen branch offices.

On October 14, 2008, Village Bank and Trust Financial Corp. and Village Bank completed a merger with River City Bank from which the Company acquired approximately $154 million in assets and three branch offices.

Business Strategy

Our current business strategies include the following:

- To be a full service financial services provider enabling us to establish and maintain relationships with our customers.

- To reduce the level of our nonperforming assets. Nonperforming assets, consisting of nonaccrual loans and real estate acquired through foreclosure, reached record highs in 2011 and continue to have a negative effect on profitability. We have committed significant resources to reduce the level of nonperforming assets.

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To comply with the requirements agreed to with our Regulatory Authorities. The Bank has entered into an agreement with the Federal Deposit Insurance Corporation and the Virginia Bureau of Financial Institutions, agreeing among other matters to: (1) improve its credit risk exposure; (2) comply with regulatory capital requirements of 8% Tier 1 leverage capital and 11% total risk-based capital ratios; and (3) not grow its assets more than 10% per year. This agreement is more fully discussed later in this Annual Report.

- In addition, the Company also entered into a Memorandum of Understanding with the Federal Reserve Bank of Richmond (the "Reserve Bank"). Pursuant to this Memorandum of Understanding, the Company must submit to the Reserve Bank acceptable policies and procedures to ensure that the Company does not violate Sections 23A and 23B of the Federal Reserve Act and Regulation W of the Federal Reserve, which governs transactions between the Company and the Bank. In addition, the Company will not, without prior written approval of the Reserve Bank:

  - o declare or pay any dividends on its common stock or preferred stock;
  - o take dividends or any other form of payment representing a reduction in capital from the Bank;
  - o make any payments on trust preferred securities;
  - o incur, increase, repay, refinance or guarantee any debt; or
  - o purchase or redeem any shares of its stock.

- To reduce our total assets and liabilities. Due to a continued depressed economy as well as capital limitations, we will be making efforts to decrease our loans, deposits and borrowings in 2012. These efforts may include reducing our lending efforts, repricing of higher cost certificates of deposit to encourage these customers to withdraw their deposits, and not replacing maturing Federal Home Loan Bank advances as they mature.

- To attract commercial and retail customers by providing the breadth of products offered by larger banks while maintaining the quick response and personal service of a community bank. We will continue to look for opportunities to expand our products and services. We have established a diverse product line, including commercial, mortgage and consumer loans as well as a full array of deposit products and services.

Our officers, employees and the directors live and work in our market area. We believe that the existing and future banking market in our community represents an opportunity for locally owned and locally managed community banks. In view of the continuing trend in the financial services industry toward consolidation into larger, statewide, regional and national institutions, the market exists for the personal and customized financial services that an independent, locally owned bank with local decision making can offer. With the flexibility of our smaller size and through an emphasis on relationship banking, including personal attention and service, we can be more responsive to the individual needs of our customers than our larger competitors. As a community oriented and locally managed institution, we make most of our loans in our community and can tailor our services to meet the banking and financial needs of our customers who live and do business in our market.

Location and Market Area

Our overall strategy is to become the premier financial institution serving the Richmond metropolitan area. We recognized early on that to be successful with this strategy, we needed to grow aggressively, expanding our branch network to reach the most people possible. Initially, we focused our operations in Chesterfield County, Virginia, which, despite its potential for business development and population growth, has been underserved by community banks. Chesterfield's resources are very favorable for businesses seeking a profitable and stable environment. The county offers superb commercial and industrial sites, an educated work force, well-designed and developed infrastructure

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and a competitive tax structure. Chesterfield has been awarded the U.S. Senate Gold Medallion for Productivity and Quality. The county has the highest bond rating from three rating agencies - Standard and Poors, Moody's and Fitch.

Once we established a strong banking presence in Chesterfield County market with eight branches, we continued the implementation of our strategy by expanding our franchise into other counties in the Richmond Metropolitan area. In addition to Chesterfield County, we have now opened three branches in both Hanover and Henrico Counties and one in Powhatan County; all three along with Chesterfield have seen strong population growth in recent years. Our mortgage company has experienced a significant increase in loan production as a result of the addition of a loan production office in Northern Virginia.

At December 31, 2011, we had fourteen full service banking offices, which were staffed by 54 full-time employees. Our senior staff averages more than 25 years of professional or banking experience. Our principal office, which houses our executive officers and loan department, was opened in August 2008 and is located at 15521 Midlothian Turnpike, Midlothian, Virginia 23113. Our main telephone number is (804) 897-3900.

Historically the Richmond Metropolitan area has been a favorable market for us to provide banking services. However, with the depressed economy that started in late 2008 and was prevalent throughout 2009, 2010 and 2011, this market area was negatively impacted by the decline in the housing market, especially in Chesterfield County where residential housing has been an economic driver in the past. Because a substantial part of our loan portfolio is collateralized by residential real estate primarily in Chesterfield County, this decline in the housing market has had a negative impact on our asset quality. The result has been a substantial increase in nonperforming assets, and in turn, a negative impact on profitability. See further discussion of nonperforming assets under Asset Quality in Management's Discussion and Analysis of Financial Condition and Results of Operations following.

Banking Services

We receive deposits, make consumer and commercial loans, and provide other services customarily offered by a commercial banking institution, such as business and personal checking and savings accounts, drive-up windows, and 24-hour automated teller machines. We have not applied for permission to establish a trust department and offer trust services. We are not a member of the Federal Reserve System. Our deposits are insured under the Federal Deposit Insurance Act to the limits provided thereunder.

We offer a full range of short-to-medium term commercial and personal loans. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements) and purchase of equipment and machinery. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education and personal investments. We also originate fixed and variable rate mortgage loans and real estate construction and acquisition loans. Residential loans originated by our mortgage company are usually sold in the secondary mortgage market.

Our lending activities are subject to a variety of lending limits imposed by federal and state law. While differing limits apply in certain circumstances based on the type of loan or the nature of the borrower (including the borrower's relationship to the bank), in general, for loans that are not secured by readily marketable or other permissible collateral, we are subject to a loans-to-one borrower limit of an amount equal to 15% of our capital and surplus. We may voluntarily choose to impose a policy limit on loans to a single borrower that is less than the legal lending limit. We are a member of the Community Bankers' Bank and may participate out portions of loans when loan amounts exceed our legal lending limits or internal lending policies.

Lending Activities

Our primary focus is on making loans to small businesses and consumers in our local market area.

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In addition, we also provide a select range of real estate finance services. Our primary lending activities are principally directed to our market area.

Loan Portfolio. The net loan portfolio was $412,567,000 at December 31, 2011, which compares to $446,555,000 at December 31, 2010. The Company continued to see a decline in loan levels in 2011, with a decline of 7.6% compared to a decline of 2.3% in 2010. The declines in loans in 2011 and 2010 were a direct result of the prolonged economic downturn and our decision to increase capital ratios to meet regulator requirements. We intend to allow our loan level to continue to decline in 2012 in order to assist us in meeting the capital ratios required by our regulators. Our loan customers are generally located in the Richmond metropolitan area.

Commercial Real Estate Lending. We finance commercial real estate for our clients and commercial real estate loans represent the largest segment of our loan portfolio. This segment of our loan portfolio has been the largest segment since 2004 due to the significant real estate opportunities in our market area. We generally will finance owner-occupied commercial real estate at an 80% loan-to-value ratio or less. In many cases our loan-to-value ratio is less than 80%, which provides us with a higher level of collateral security. Our underwriting policies and procedures focus on the borrower's ability to repay the loan as well as assessment of the underlying real estate. Risks inherent in managing a commercial real estate loan portfolio relate to sudden or gradual drops in property values as well as changes in the economic climate. We attempt to mitigate those risks by carefully underwriting loans of this type as well as following appropriate loan-to-value standards. Commercial real estate loans (generally owner occupied) at December 31, 2011 were $168,796,000, or 39.5% of the total loan portfolio.

Residential Mortgage Lending. We make permanent residential mortgage loans for inclusion in the loan portfolio. We seek to retain in our portfolio variable rate loans secured by one-to-four-family residences. However, the majority of permanent residential loans are made by the Bank's subsidiary, Village Bank Mortgage, which sells them to investors in the secondary mortgage market on a pre-sold basis. Given the low fixed rate residential loan market in recent years, this allows us to offer this service to our customers without retaining a significant low rate residential loan portfolio which would be detrimental to earnings as interest rates increase. We originate both conforming and non-conforming single-family loans.

Before we make a loan we evaluate both the borrower's ability to make principal and interest payments and the value of the property that will secure the loan. We make first mortgage loans in amounts up to 90% of the appraised value of the underlying real estate. We retain some second mortgage loans secured by property in our market area, as long as the loan-to-value ratio combined with the first mortgage does not exceed 90%. For conventional loans in excess of 80% loan-to-value, private mortgage insurance is required.

Our current one-to-four-family residential adjustable rate mortgage loans have interest rates that adjust annually after a fixed period of 1, 3 and 5 years, generally in accordance with the rates on comparable U.S. Treasury bills plus a margin. Our adjustable rate mortgage loans generally limit interest rate increases to 2% each rate adjustment period and have an established ceiling rate at the time the loans are made of up to 6% over the original interest rate. There are risks resulting from increased costs to a borrower as a result of the periodic repricing mechanisms of these loans. Despite the benefits of adjustable rate mortgage loans to our asset/liability management, they pose additional risks, primarily because as interest rates rise; the underlying payments by the borrowers rise, increasing the potential for default. At the same time, the marketability of the underlying property may be adversely affected by higher interest rates. At December 31, 2011, $135,948,000, or 31.8% of our loan portfolio, consisted of residential mortgage loans.

Real Estate Construction Lending. This segment of our loan portfolio is predominantly residential in nature and comprised of loans with short duration, meaning maturities of twelve months or less. Residential houses under construction and the underlying land for which the loan was obtained secure the construction loans. Construction lending entails significant risks compared with residential mortgage lending. These risks involve larger loan balances concentrated with single borrowers with funds advanced upon the security of the land and home under construction, which is

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estimated prior to the completion of the home. Thus it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate these risks we generally limit loan amounts to 80% of appraised values on pre-sold homes and 75% on speculative homes, and obtain first lien positions on the property taken as security. Additionally, we offer real estate construction financing to individuals who have demonstrated the ability to obtain a permanent loan. At December 31, 2011, construction loans totaled $80,527,000, or 18.8% of the total loan portfolio.

Commercial Business Lending. Our commercial business lending consists of lines of credit, revolving credit facilities, term loans, equipment loans, stand-by letters of credit and unsecured loans. Commercial loans are written for any business purpose including the financing of plant and equipment, carrying accounts receivable, general working capital, contract administration and acquisition activities. Our client base is diverse, and we do not have a concentration of loans in any specific industry segment. Commercial business loans are generally secured by accounts receivable, equipment, inventory and other collateral such as marketable securities, cash value of life insurance, and time deposits. Commercial business loans have a higher degree of risk than residential mortgage loans, but have higher yields. To manage these risks, we generally obtain appropriate collateral and personal guarantees from the borrower's principal owners and monitor the financial condition of business borrowers. The availability of funds for the repayment of commercial business loans may substantially depend on the success of the business itself. Further, the collateral for commercial business loans may depreciate over time and cannot be appraised with as much precision as residential real estate. All commercial loans we make have recourse under the terms of a promissory note. At December 31, 2011, commercial loans totaled $37,735,000, or 8.8% of the total loan portfolio.

Consumer Installment Lending. We offer various types of secured and unsecured consumer loans. We make consumer loans primarily for personal, family or household purposes as a convenience to our customer base since these loans are not the primary focus of our lending activities. Our general guideline is that a consumer's total debt service should not exceed 40% of the consumer's gross income. Our underwriting standards for consumer loans include making a determination of the applicant's payment history on other debts and an assessment of his or her ability to meet existing obligations and payments on the proposed loan. The stability of an applicant's monthly income may be determined by verification of gross monthly income from primary employment and additionally from any verifiable secondary income. Consumer loans totaled $4,866,000 at December 31, 2011, which was 1.1% of the total loan portfolio.

Loan Commitments and Contingent Liabilities. In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities which are disclosed in the footnotes of our annual financial statements, including commitments to extend credit. At December 31, 2011, undisbursed credit lines, standby letters of credit and commitments to extend credit totaled $62,594,000.

Credit Policies and Administration. We have a comprehensive lending policy, which includes stringent underwriting standards for all types of loans. Our lending staff follows pricing guidelines established periodically by our management team. In an effort to manage risk, all credit decisions in excess of the officers' lending authority must be approved prior to funding by a management loan committee and/or a board of directors-level loan committee. Any loans above $5,000,000 require full board of directors' approval. Management believes that it employs experienced lending officers, secures appropriate collateral and carefully monitors the financial conditions of our borrowers and the concentration of such loans in the portfolio.

In addition to the normal repayment risks, all loans in our portfolio are subject to the state of the economy and the related effects on the borrower and/or the real estate market. Generally, longer-term loans have periodic interest rate adjustments and/or call provisions. Our senior management monitors the loan portfolio closely to ensure that past due loans are minimized and that potential problem loans are swiftly dealt with. In addition to the internal business processes employed in the credit administration area, the Company utilizes an outside consulting firm to review the loan portfolio. Results of the report are used to validate our internal loan ratings and to provide

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independent commentary on specific loans and loan administration activities.

Lending Limit. As of December 31, 2011, our legal lending limit for loans to one borrower was approximately $6,880,000. However, we generally will not extend credit to any one individual or entity in excess of $5,000,000, and, as noted above, any amount over that must be approved by the full Board of Directors.

Investments and Funding

We balance our liquidity needs based on loan and deposit growth via the investment portfolio, purchased federal funds, and Federal Home Loan Bank advances. It is our goal to provide adequate liquidity to support our loan growth. Should we have excess liquidity, investments are used to generate earnings. In the event deposit growth does not fully support our loan growth, a combination of investment sales, federal funds and Federal Home Loan Bank advances will be used to augment our funding position. However, we believe that due to a continued depressed economy as well as capital limitations, we will be making efforts to decrease our loans, deposits and borrowings in 2012. These efforts will include reducing our lending efforts, repricing of higher cost certificates of deposit to encourage these customers to withdraw their deposits, and not replacing maturing Federal Home Loan Bank advances as they mature.

Our investment portfolio is actively monitored and is classified as "available for sale." Under such a classification, investment instruments may be sold as deemed appropriate by management. On a monthly basis, the investment portfolio is marked to market via equity as required by generally accepted accounting principles. Additionally, we use the investment portfolio to balance our asset and liability position. We will invest in fixed rate or floating rate instruments as necessary to reduce our interest rate risk exposure.

For securities classified as available-for-sale securities, we evaluate whether a decline in fair value below the amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings. There were no securities at December 31, 2011 where a decline in market value was considered other than temporary.

Asset and Liability Management

Our Asset Liability Management Committee (ALCO), composed of senior managers of the Bank, manages the Bank's assets and liabilities and strives to provide a stable, optimized net interest income and margin, adequate liquidity and ultimately a suitable after-tax return on assets and return on equity. ALCO conducts these management functions within the framework of written policies that the Bank's board of directors has adopted. ALCO works to maintain an acceptable position between rate sensitive assets and rate sensitive liabilities. The board of directors oversees the ALCO function on an ongoing basis.

Competition

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

The greater Richmond metropolitan market has experienced several significant mergers or

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acquisitions involving all four regional banks formerly headquartered in central Virginia over the past fifteen years. Additionally, other larger banks from outside Virginia have acquired local banks. We believe that the Company can capitalize on the such merger activity and attract customers from those who are dissatisfied with the acquired banks.

At June 30, 2011, the latest date such information is available from the FDIC, the Bank's deposit market share in Chesterfield County was 8.37% and 0.75% in the Richmond MSA.

Regulation

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

General. The discussion below is only a summary of the principal laws and regulations that comprise the regulatory framework applicable to us. The descriptions of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, do not purport to be complete and are qualified in their entirety by reference to applicable laws and regulations. In recent years, regulatory compliance by financial institutions such as ours has placed a significant burden on us both in costs and employee time commitment.

Bank Holding Company. The Company is a bank holding company under the federal Bank Holding Company Act of 1956, as amended, and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and Virginia Bureau of Financial Institutions (the "BFI"). As a bank holding company, the Company is required to furnish to the Federal Reserve annual and quarterly reports of its operations and such additional information as the Federal Reserve may require. The Federal Reserve, Federal Deposit Insurance Corporation (the "FDIC") and BFI also may conduct examinations of the Company and/or its subsidiary bank.

Bank Regulation. As a Virginia-chartered bank that is not a member of the Federal Reserve System, the Bank is subject to regulation, supervision and examination by the BFI and the FDIC. Federal and state law also specify the activities in which we may engage, the investments we may make and the aggregate amount of loans that may be granted to one borrower. Various consumer and compliance laws and regulations also affect our operations. Earnings are affected by general economic conditions, management policies and the legislative and governmental actions of various regulatory authorities, including those referred to above. The following description summarizes some of the laws to which we are subject. The BFI and the FDIC conduct regular examinations, reviewing such matters as the overall safety and soundness of the institution, the adequacy of loan loss reserves, quality of loans and investments, management practices, compliance with laws, and other aspects of our operations. In addition to these regular examinations, we must furnish the FDIC and BFI with periodic reports containing a full and accurate statement of our affairs. Supervision, regulation and examination of banks by these agencies are intended primarily for the protection of depositors rather than shareholders.

Consent Order. In February 2012, the Bank entered into a Stipulation and Consent to the Issuance of a Consent Order ("Consent Agreement") with the FDIC and the BFI (the "Supervisory Authorities"), and the Supervisory Authorities have issued the related Consent Order (the "Order") effective February 3, 2012. The description of the Consent Agreement and the Order set forth below:

Management. The Order requires that the Bank have and retain qualified management, including at a minimum a chief executive officer, senior lending officer and chief operating officer, with qualifications and experience commensurate with their assigned duties and responsibilities within 90 days from the effective date of the order. Within 30 days of the effective date of the Order, the Bank must retain a bank consultant to develop a written analysis and assessment of the Bank’s management and staffing needs for the purpose of providing qualified management for the Bank. Within 30 days from receipt of the consultant’s management report, the Bank must formulate a written management plan that incorporates the findings of the management report, a

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plan of action in response to each recommendation contained in the management report, and a timeframe for completing each action.

Capital Requirements. Within 90 days from the effective date of the Order and during the life of the Order, the Bank must have Tier 1 capital equal to or greater than 8 percent of its total assets, and total risk-based capital equal to or greater than 11 percent of the Bank's total risk-weighted assets. Within 90 days from the effective date of the Order, the Bank must submit a written capital plan to the Supervisory Authorities. The capital plan must include a contingency plan in the event that the Bank fails to maintain the minimum capital ratios required in the Order, submit a capital plan that is acceptable to the Supervisory Authorities, or implement or adhere to the capital plan.

Charge-offs. The Order requires the Bank to eliminate from its books, by charge-off or collection, all assets or portions of assets classified "Loss" and 50 percent of those classified "Doubtful". If an asset is classified "Doubtful", the Bank may, in the alternative, charge off the amount that is considered uncollectible in accordance with the Bank's written analysis of loan or lease impairment. The Order also prevents the Bank from extending, directly or indirectly, any additional credit to, or for the benefit of, any borrower who has a loan or other extension of credit from the Bank that has been charged off or classified, on whole or in part, "loss" or "doubtful" and is uncollected. The Bank may not extend, directly or indirectly, any additional credit to any borrower who has a loan or other extension of credit from the Bank that has been classified "substandard." These limitations do not apply if the Bank's failure to extend further credit to a particular borrower would be detrimental to the best interests of the Bank.

Asset Growth. While the Order is in effect, the Bank must notify the Supervisory Authorities at least 60 days prior to undertaking asset growth that exceeds 10% or more per year or initiating material changes in asset or liability composition. The Bank's asset growth cannot result in noncompliance with the capital maintenance provisions of the Order unless the Bank receives prior written approval from the Supervisory Authorities.

Restriction on Dividends and Other Payments. While the Order is in effect, the Bank cannot declare or pay dividends, pay bonuses, or pay any form of payment outside the ordinary course of business resulting in a reduction of capital without the prior written approval of the Supervisory Authorities. In addition, the Bank cannot make any distributions of interest, principal, or other sums on subordinated debentures without prior written approval of the Supervisory Authorities.

Brokered Deposits. The Order provides that the Bank may not accept, renew, or roll over any brokered deposits unless it is in compliance with the requirements of the FDIC regulations governing brokered deposits. These regulations prohibit undercapitalized institutions from accepting, renewing, or rolling over any brokered deposits and also prohibit undercapitalized institutions from soliciting deposits by offering an effective yield that exceeds by more than 75 basis points the prevailing effective yields on insured deposits of comparable maturity in the institution's market area. An "adequately capitalized" institution may not accept, renew, or roll over brokered deposits unless it has applied for and been granted a waiver by the FDIC.

Written Plans and Other Material Terms. Under the terms of the Order, the Bank is required to prepare and submit the following written plans or reports to the FDIC and the Commissioner:

- Plan to improve liquidity, contingency funding, interest rate risk, and asset liability management
- Plan to reduce assets of $250,000 or greater classified "doubtful" and "substandard"
- Revised lending and collection policy to provide effective guidance and control over the Bank's lending and credit administration functions

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·Effective internal loan review and grading system

·Policy for managing the Bank's other real estate

·Business/strategic plan covering the overall operation of the Bank

·Plan and comprehensive budget for all categories of income and expense for the year 2011

·Policy and procedures for managing interest rate risk

·Assessment of the Bank's information technology function

Under the Order, the Bank's board of directors has agreed to increase its participation in the affairs of the Bank, including assuming full responsibility for the approval of policies and objectives for the supervision of all of the Bank's activities. The Bank must also establish a board committee to monitor and coordinate compliance with the Order.

The Bank has already taken many actions to comply with the Order including establishing a board committee to monitor and coordinate compliance with the Order, hiring a consultant to assist the Bank with compliance, hiring a consultant to perform a review of management, charging off all assets or portions of assets classified "Loss" and 50 percent of those classified "Doubtful", and rewritten our loan policy to address issues identified in the Order.

The Order will remain in effect until modified or terminated by the Supervisory Authorities.

Memorandum of Understanding. In addition, the Company also entered into a Memorandum of Understanding with the Federal Reserve Bank of Richmond (the "Reserve Bank"). Pursuant to this Memorandum of Understanding, the Company must submit to the Reserve Bank acceptable policies and procedures to ensure that the Company does not violate Sections 23A and 23B of the Federal Reserve Act and Regulation W of the Federal Reserve, which governs transactions between the Company and the Bank. In addition, the Company will not, without prior written approval of the Reserve Bank:

- declare or pay any dividends on its common stock or preferred stock;
- take dividends or any other form of payment representing a reduction in capital from the Bank;
- make any payments on trust preferred securities;
- incur, increase, repay, refinance or guarantee any debt; or
- purchase or redeem any shares of its stock.

The Dodd-Frank Wall Street Reform and Consumer Protection Act. In July 2010, the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law, incorporating numerous financial institution regulatory reforms. Many of these reforms are yet to be implemented through regulations to be adopted by various federal banking and securities regulatory agencies. The following discussion describes the material elements of the regulatory framework that currently apply. The Dodd-Frank Act implements far-reaching reforms of major elements of the financial landscape, particularly for larger financial institutions. Many of its provisions do not directly impact community-based institutions like the Bank. For instance, provisions that regulate derivative transactions and limit derivatives trading activity of federally-insured institutions, enhance supervision of "systemically significant" institutions, impose new regulatory authority over hedge funds, limit proprietary trading by banks, and phase-out the eligibility of trust preferred securities for Tier 1 capital are among the provisions that do not directly impact the Bank either because of exemptions for institutions below a certain asset size or because of the nature of the Bank's operations. Provisions that do impact the Bank include the following:

- FDIC Assessments. The Dodd-Frank Act changes the assessment base for federal deposit insurance from the amount of insured deposits to average consolidated total assets less its average tangible equity. In addition, it increases the minimum size of the Deposit Insurance Fund (“DIF”) and eliminates its ceiling, with the burden of the increase in the minimum size

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on institutions with more than $10 billion in assets.

- Deposit Insurance. The Dodd-Frank Act makes permanent the $250,000 limit for federal deposit insurance and provides unlimited federal deposit insurance until December 31, 2012 for non-interest-bearing demand transaction accounts at all insured depository institutions.
- Interest on Demand Deposits. The Dodd- Frank Act also provides that, effective one year after the date of enactment, depository institutions may pay interest on demand deposits, including business transaction and other accounts.
- Consumer Financial Protection Bureau. The Dodd-Frank Act centralizes responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau, responsible for implementing federal consumer protection laws, although banks below $10 billion in assets will continue to be examined and supervised for compliance with these laws by their federal bank regulator.
- Mortgage Lending. New requirements are imposed on mortgage lending, including new minimum underwriting standards, prohibitions on certain yield-spread compensation to mortgage originators, special consumer protections for mortgage loans that do not meet certain provision qualifications, prohibitions and limitations on certain mortgage terms and various new mandated disclosures to mortgage borrowers.
- Holding Company Capital Levels. Bank regulators are required to establish minimum capital levels for holding companies that are at least as stringent as those currently applicable to banks. In addition, all trust preferred securities issued after May 19, 2010 will be counted as Tier 2 capital, but the Company's currently outstanding trust preferred securities will continue to qualify as Tier 1 capital.
- De Novo Interstate Branching. National and state banks are permitted to establish de novo interstate branches outside of their home state, and bank holding companies and banks must be well-capitalized and well managed in order to acquire banks located outside their home state.
- Transactions with Affiliates. The Dodd-Frank Act enhances the requirements for certain transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including an expansion of the definition of "covered transactions" and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained.
- Transactions with Insiders. Insider transaction limitations are expanded through the strengthening of loan restrictions to insiders and the expansion of the types of transactions subject to the various limits, including derivative transactions, repurchase agreements, reverse repurchase agreements and securities lending or borrowing transactions. Restrictions are also placed on certain asset sales to and from an insider to an institution, including requirements that such sales be on market terms and, in certain circumstances, approved by the institution's board of directors.
- Corporate Governance. The Dodd-Frank Act includes corporate governance revisions that apply to all public companies, not just financial institutions, including with regard to executive compensation and proxy access to shareholders.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, and their impact on the Company or the financial industry is difficult to predict before such regulations are adopted. Provisions in the legislation that affect deposit insurance assessments, payment of interest on demand deposits and interchange fees could increase the costs associated with deposits as well as place limitations on certain revenues those deposits may generate.

Insurance of Accounts, Assessments and Regulation by the FDIC. Our deposits are insured by the FDIC up to the limits set forth under applicable law, currently $250,000. We are subject to the deposit insurance assessments of the DIF. The amount of the assessment is a function of the institution's risk category, of which there are four, and its assessment base. An institution's risk category is determined according to its supervisory ratings and capital levels and is used to determine the institution's assessment rate. Beginning April 1, 2011, the assessment base is an institution's average consolidated total assets less its average tangible equity.

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

Payment of Dividends. We are a legal entity separate and distinct from the Bank and our other subsidiaries. Virtually all of our cash revenues will result from dividends paid to us by the Bank, which is subject to laws and regulations that limit the amount of dividends that it can pay. Under Virginia law, a bank may not declare a dividend in excess of its accumulated retained earnings without BFI approval. As of December 31, 2011, the Bank did not have any accumulated retained earnings. In addition, the Bank may not declare or pay any dividend if, after making the dividend, the bank would be "undercapitalized," as defined in FDIC regulations.

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

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

The Company is currently subject to a Memorandum of Understanding with the Reserve Bank pursuant to which the Company must obtain the prior written approval of the Reserve Bank to declare or pay any dividends on its common stock or preferred stock, take dividends or any other form of payment representing a reduction in capital from the Bank or make any payments on its trust preferred securities.

The Bank is currently subject to a Consent Order with the FDIC and the BFI pursuant to which also requires the Bank to obtain prior written regulatory approval to declare or pay any dividends, pay bonuses or make any other form of payment outside the ordinary course of business resulting in a reduction of capital.

Capital Adequacy. Both the Company and the Bank are required to comply with the capital adequacy standards established by the Federal Reserve, in the case of the Company, and the FDIC, in the case of the Bank. The Federal Reserve has established a risk-based and a leverage measure of capital adequacy for bank holding companies. The Bank is also subject to risk-based and leverage capital requirements adopted by the FDIC, which are substantially similar to those adopted by the Federal Reserve for bank holding companies. Under the risk-based capital requirements, we and our bank subsidiary are each generally required to maintain a minimum ratio of total capital to risk-weighted assets (including specific off-balance sheet activities, such as standby letters of credit) of 8%. At least half of the total capital must be composed of “Tier 1 Capital,” which is defined as common equity, retained earnings, qualifying perpetual preferred stock and minority interests in common equity accounts of consolidated subsidiaries, less certain intangibles. The remainder may consist of “Tier 2 Capital”, which is defined as specific subordinated debt, some hybrid capital

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instruments and other qualifying preferred stock and a limited amount of the loan loss allowance and pretax net unrealized holding gains on certain equity securities. In addition, each of the federal banking regulatory agencies has established minimum leverage capital requirements for banking organizations. Under these requirements, banking organizations must maintain a minimum ratio of Tier 1 capital to adjusted average quarterly assets equal to 3% to 5%, subject to federal bank regulatory evaluation of an organization's overall safety and soundness. In summary, the capital measures used by the federal banking regulators are:

- Total Risk-Based Capital ratio, which is the total of Tier 1 Risk-Based Capital (which includes common shareholders' equity, trust preferred securities, minority interests and qualifying preferred stock, less goodwill and other adjustments) and Tier 2 Capital (which includes preferred stock not qualifying as Tier 1 capital, mandatory convertible debt, limited amounts of subordinated debt, other qualifying term debt and the allowance for loan losses up to 1.25 percent of risk-weighted assets and other adjustments) as a percentage of total risk-weighted assets,
- Tier 1 Risk-Based Capital ratio (Tier 1 capital divided by total risk-weighted assets), and
- the Leverage ratio (Tier 1 capital divided by adjusted average total assets).

Under these regulations, a bank will be:

- "well capitalized" if it has a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 6% or greater, a leverage ratio of 5% or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure,
- "adequately capitalized" if it has a Total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital ratio of 4% or greater, and a leverage ratio of 4% or greater (or 3% in certain circumstances) and is not well capitalized,
- "undercapitalized" if it has a Total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 4% (or 3% in certain circumstances), or a leverage ratio of less than 4% (or 3% in certain circumstances),
- "significantly undercapitalized" if it has a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 3%, or a leverage ratio of less than 3%, or
- "critically undercapitalized" if its tangible equity is equal to or less than 2% of tangible assets.

In addition, the FDIC may require banks to maintain capital at levels higher than those required by general regulatory requirements.

In late 2010, the Basel Committee on Banking Supervision issued Basel III, a new capital framework for banks and bank holding companies that will impose a stricter definition of capital, with more focus on common equity. If Basel III is implemented in the United States and becomes applicable to us, the Company and the Bank would likely be subject to higher minimum capital ratios than those to which we are currently subject.

Failure to meet statutorily mandated capital guidelines or more restrictive ratios separately established for a financial institution (like those contained in the Bank's Consent Order with the FDIC and BFI) could subject a bank or bank holding company to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting or renewing brokered deposits, limitations on the rates of interest that the institution may pay on its deposits and other restrictions on its business. As described above, significant additional restrictions can be imposed on FDIC-insured depository institutions that fail to meet applicable capital requirements.

Additionally, the Federal Deposit Insurance Corporation Improvement Act of 1991 establishes a system of prompt corrective action to resolve the problems of undercapitalized banks. Federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to banks in the three “undercapitalized” categories. The

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severity of the action depends upon the capital category in which the institution is placed. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category.

An institution that is categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. A bank holding company must guarantee that a subsidiary depository institution meets its capital restoration plan, subject to various limitations. The controlling holding company's obligation to fund a capital restoration plan is limited to the lesser of 5% of an undercapitalized subsidiary's assets or the amount required to meet regulatory capital requirements. An undercapitalized institution is also generally prohibited from increasing its average total assets, making acquisitions, establishing any branches or engaging in any new line of business, except under an accepted capital restoration plan or with FDIC approval. The regulations also establish procedures for downgrading an institution and a lower capital category based on supervisory factors other than capital. As of December 31, 2011, the Bank was considered "well capitalized" by the FDIC.

The Dodd-Frank Act contains a number of provisions dealing with capital adequacy of insured depository institutions and their holding companies, which may result in more stringent capital requirements for insured depository institutions and their holding companies. Under the Collins Amendment to the Dodd-Frank Act, federal regulators were directed to establish minimum leverage and risk-based capital requirements for, among other entities, banks and bank holding companies on a consolidated basis. These minimum requirements can't be less than the generally applicable leverage and risk-based capital requirements established for insured depository institutions nor quantitatively lower than the leverage and risk-based capital requirements established for insured depository institutions that were in effect as of the date that the Dodd-Frank Act was enacted. These requirements in effect create capital level floors for bank holding companies similar to those in place currently for insured depository institutions. The Collins Amendment also excludes trust preferred securities issued after May 19, 2010 from being included in Tier 1 capital unless the issuing company is a bank holding company with less than $500 million in total assets. Trust preferred securities issued prior to that date will continue to count as Tier 1 capital for bank holding companies with less than $15 billion in total assets, and such securities will be phased out of Tier 1 capital treatment for bank holding companies with over $15 billion in total assets over a three-year period beginning in 2013. The Collins Amendment did not exclude preferred stock issued to the U.S. Treasury through the TARP Capital Purchase Program from Tier 1 capital treatment. Accordingly, the Company's trust preferred securities and preferred stock issued to the U.S. Treasury through the TARP Capital Purchase Program will continue to qualify as Tier 1 capital as should any preferred stock issued to the U.S. Treasury under the Small Business Lending Fund, if any.

In February 2012, the Bank entered into the Consent Order with the Supervisory Authorities which provided that, within 90 days from the date of the order and during the life of the order, the Bank must have a leverage ratio equal to or greater than 8% of its total assets, and total risk-based capital equal to or greater than 11% of the Bank's total risk-weighted assets. At December 31, 2011, the Bank's Tier 1 risk-based capital ratio was 8.98%, its total risk-based capital ratio was 10.26% and its leverage ratio was 6.46%, compared to 10.85%, 12.11% and 8.76% at December 31, 2010, respectively. More information concerning our regulatory ratios at December 31, 2011 is included in Note 14 to the "Notes to Consolidated Financial Statements" included elsewhere in this Annual Report on Form 10-K.

Restrictions on Transactions with Affiliates. Both the Company and the Bank are subject to the provisions of Section 23A of the Federal Reserve Act. Section 23A places limits on the amount of:

- A bank's loans or extensions of credit, including purchases of assets subject to an agreement to repurchase, to affiliates;
- A bank's investment in affiliates;

- Assets a bank may purchase from affiliates, except for real and personal property exempted by the Federal Reserve;

- The amount of loans or extensions of credit to third parties collateralized by the securities or debt obligations of affiliates;
- Transactions involving the borrowing or lending of securities and any derivative transaction that results in credit exposure to an affiliate; and
- A bank's guarantee, acceptance or letter of credit issued on behalf of an affiliate.

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

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

On September 30, 2010, the Company sold its headquarters building at the Watkins Centre to the Bank. This transaction allowed us to repay the outstanding mortgage loan on the building resulting in a reduction of our interest expense and improvement in earnings on a consolidated basis. The Federal Reserve Bank has determined that the sale of the headquarters building from the Company to the Bank was not permitted under Section 23A of the Federal Reserve Act as the amount of the transaction exceeded 10% of the Bank's capital stock and surplus. As a result, the Federal Reserve Bank has directed the Company to take corrective action. The Company has taken and continues to take active steps to correct this violation including offering the building for sale. However, the Company has not been successful in these efforts and continues to update the Federal Reserve Bank on such efforts.

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

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

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

Incentive Compensation Policies and Restrictions. In July 2010, the federal banking agencies issued guidance which applies to all banking organizations supervised by the agencies (thereby including both the Company and the Bank). Pursuant to the guidance, to be consistent with safety and soundness principles, a banking organization's incentive compensation arrangements should: (1) provide employees with incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance including active and effective oversight by the banking organization's board of directors. Monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization and its use of incentive compensation.

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Emergency Economic Stabilization Act of 2008. In response to unprecedented market turmoil during the third quarter of 2008, the Emergency Economic Stabilization Act of 2008 ("EESA") was enacted on October 3, 2008. EESA authorized the U.S. Treasury to provide up to $700 billion to support the financial services industry. Pursuant to the EESA, the U.S. Treasury was initially authorized to use $350 billion for the Troubled Asset Relief Program ("TARP"), of which the U.S. Treasury allocated $250 billion to the TARP Capital Purchase Program.

On May 1, 2009, the Company issued preferred stock and a warrant to purchase its common stock to the U.S. Treasury pursuant to the TARP Capital Purchase Program. The amount of capital raised in that transaction was $14.7 million, approximately three percent of the Company's risk-weighted assets. Prior to May 1, 2012, unless the Company has redeemed all such preferred stock or the U.S. Treasury has transferred all such preferred stock to a third party, the consent of the U.S. Treasury will be required for us to, among other things, pay a dividend on the Company's common stock or repurchase our common stock or outstanding preferred stock except in limited circumstances. No dividends may be paid on common stock unless dividends have been paid on the preferred stock. The preferred stock does not have voting rights other than the right to vote as a class on the issuance of any preferred stock ranking senior, any change in its terms or any merger, exchange or similar transaction that would adversely affect its rights. The U.S. Treasury's preferred stock will also have the right to elect two directors if dividends have not been paid for six periods. The Company filed a registration statement on Form S-3 covering the warrant as required under the terms of the TARP investment, on May 29, 2009. The registration statement was declared effective by the SEC on June 16, 2009.

In addition, as long as any obligation remains outstanding to the U.S. Treasury under the TARP Capital Purchase Program, the Company and the Bank must comply in all respects with the executive compensation and corporate governance standards under EESA and the rules and regulations thereunder. In compliance with such requirements, each of our senior executive officers agreed in writing to accept the compensation standards under the TARP Capital Purchase Program and thereby cap or eliminate some of their contractual or legal rights.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 implemented a broad range of corporate governance, accounting and reporting measures for companies, like the Company, that have securities registered under the Securities Exchange Act of 1934. Specifically, the Sarbanes-Oxley Act and the various regulations promulgated under the Act, established, among other things: (i) new requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) new standards for auditors and regulation of audits, including independence provisions that restrict non-audit services that accountants may provide to their audit clients; (iv) increased disclosure and reporting obligations for the reporting company and their directors and executive officers, including accelerated reporting of stock transactions and a prohibition on trading during pension blackout periods; and (v) a range of new and increased civil and criminal penalties for fraud and other violations of the securities laws. In addition, Sarbanes-Oxley required stock exchanges, such as NASDAQ, to institute additional requirements relating to corporate governance in their listing rules.

Section 404 of the Sarbanes-Oxley Act requires the Company to include in its Annual Report on Form 10-K a report by management. Management's internal control report must, among other things, set forth management's assessment of the effectiveness of the Company's internal control over financial reporting.

Gramm-Leach-Bliley Act. On November 12, 1999, the Gramm-Leach-Bliley Act was signed into law. Gramm-Leach-Bliley permits commercial banks to affiliate with investment banks. It also permits bank holding companies which elect financial holding company status to engage in any type of financial activity, including securities, insurance, merchant banking/equity investment and other activities that are financial in nature. The merchant banking provisions allow a financial holding company to make a controlling investment in any kind of company, financial or commercial. These new powers allow a bank to engage in virtually every type of activity currently recognized as financial or incidental or complementary to a financial activity. A commercial bank that wishes to engage in

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these activities is required to be well capitalized, well managed and have a satisfactory or better Community Reinvestment Act rating. Gramm-Leach-Bliley also allows subsidiaries of banks to engage in a broad range of financial activities that are not permitted for banks themselves.

USA Patriot Act. The USA Patriot Act became effective on October 26, 2001 and provides for the facilitation of information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering. Among other provisions, the USA Patriot Act permits financial institutions, upon providing notice to the United States Treasury, to share information with one another in order to better identify and report to the federal government activities that may involve money laundering or terrorists' activities. The USA Patriot Act is considered a significant banking law in terms of information disclosure regarding certain customer transactions. Certain provisions of the USA Patriot Act impose the obligation to establish anti-money laundering programs, including the development of a customer identification program, and the screening of all customers against any government lists of known or suspected terrorists. Although it does create a reporting obligation and compliance costs, the USA Patriot Act has not materially affected the Bank's products, services or other business activities.

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

Other Safety and Soundness Regulations. There are a number of obligations and restrictions imposed on depository institutions by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insurance funds in the event the depository institution becomes in danger of default or is in default. The Federal banking agencies also have broad powers under current Federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution in question is well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized, as defined by the law. Federal regulatory authorities also have broad enforcement powers over us, including the power to impose fines and other civil and criminal penalties, and to appoint a receiver in order to conserve the assets of any such institution for the benefit of depositors and other creditors. At December 31, 2011, Village Bank met the requirements to be classified as a well capitalized financial institution. However, as a result of the Order, Village Bank currently is classified as adequately capitalized.

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

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

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Economic and Monetary Policies. Our operations are affected not only by general economic conditions, but also by the economic and monetary policies of various regulatory authorities. In particular, the Federal Reserve regulates money, credit and interest rates in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits and affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

Employees

As of December 31, 2011, the Company and its subsidiaries had a total of 182 full-time employees and 21 part-time employees. None of the Company's employees are covered by a collective bargaining agreement. The Company considers its relations with its employees to be good.

Control by Certain Shareholders

The Company has one shareholder who owns 8.34% of its outstanding Common Stock. As a group, the Board of Directors and the Company's Executive Officers control 16.50% of the outstanding Common Stock of the Company as of March 9, 2012. Accordingly, such persons, if they were to act in concert, would not have majority control of the Bank and would not have the ability to approve certain fundamental corporate transactions or the election of the Board of Directors.

Additional Information

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

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

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

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

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

ITEM 1A. RISK FACTORS

An investment in the Company's common stock is subject to risks inherent to the Company's business, including the material risks and uncertainties that are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing the Company. Additional risks and uncertainties that management is not aware of or focused on, or that management currently deems immaterial, may also impair the Company's business operations. This report is qualified in its entirety by these risk factors. If any of the following risks adversely affect the Company's business,

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financial condition or results of operations, the value of the Company's common stock could decline significantly and you could lose all or part of your investment.

We are subject to agreements with our regulators, which will require us to dedicate a significant amount of resources and which could otherwise adversely affect us.

In February 2012, the Bank entered into a Consent Order with the FDIC and the BFI. Among other things, the Consent Order requires us to develop and submit plans to reduce improve our loan portfolio, reducing our commercial real estate concentration, maintain an appropriate allowance for loan losses, review our management performance, and correct certain violations of law. In addition, the Consent Order requires us to limit asset growth to no more than 10% per year and maintain certain capital ratios higher than those required to be considered "well capitalized." The Company has also agreed not to declare or pay any dividends, pay bonuses or make any other form of payment outside the ordinary course of business resulting in a reduction of capital without prior regulatory approval.

In addition, we are subject to a Memorandum of Understanding with the Reserve Bank. Among other things, the Memorandum of Understanding requires us to submit to the Reserve Bank acceptable policies and procedures and to take corrective action to ensure that the Company does not violate Sections 23A and 23B of the Federal Reserve Act and Regulation W of the Board of Governors. In particular, the Reserve Bank has determined that the Company's sale of its headquarters building at the Watkins Centre to the Bank was not permitted under Section 23A of the Federal Reserve Act. This transaction had allowed the Company to repay the outstanding mortgage loan on the building, thereby reducing interest expense and increasing earnings on a consolidated basis; as a result, any corrective action could have an adverse impact on the Company's results of operations. The Company has taken and continues to take active steps to correct this violation including offering the building for sale, but cannot know at this time what corrective measure will be taken or what the impact will be. The Company has also agreed not to declare or pay and dividends on common stock or preferred stock, including the TARP preferred, or make any payments on its trust preferred securities without prior regulatory approval.

While subject to these agreements, we expect that our management and board of directors will be required to focus considerable time and attention on taking corrective actions to comply with the terms. In addition, certain provisions of these agreements described above could adversely impact the Company's businesses and results of operations.

There also is no guarantee that we will successfully address our regulators' concerns in the agreements or that we will be able to comply with them. If we do not comply with these regulatory agreements, we could be subject to the assessment of civil monetary penalties, further regulatory sanctions and/or other regulatory enforcement actions.

The Company's business may be adversely affected by conditions in the financial markets and economic conditions generally.

From December 2007 through June 2009, the U.S. economy was in recession. Business activity across a wide range of industries and regions in the U.S. was greatly reduced. Although economic conditions have begun to improve, certain sectors, such as real estate, remain weak and unemployment remains high. Local governments and many businesses are still in serious difficulty due to lower consumer spending and the lack of liquidity in the credit markets. Market conditions also led to the failure or merger of several prominent financial institutions and numerous regional and community-based financial institutions. These failures, as well as projected future failures, have had a significant negative impact on the capitalization level of the Deposit Insurance Fund of the FDIC, which, in turn, has led to a significant increase in deposit insurance premiums paid by financial institutions. Such conditions have adversely affected the credit quality of the Company's loans, and the Company's results of operations and financial condition. The Company's financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services the Company offers, is highly dependent upon on the business environment in the markets where the Company operates.

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Improvements in economic indicators disproportionately affecting the financial services industry may lag improvements in the general economy.

Should the stabilization of the U.S. economy lead to a general economic recovery, the improvement of certain economic indicators, such as unemployment and real estate asset values and rents, may nevertheless continue to lag behind the overall economy. These economic indicators typically affect certain industries, such as real estate and financial services, more significantly. For example, improvements in commercial real estate fundamentals typically lag broad economic recovery by 12 to 18 months. The Company's clients include entities active in these industries. Furthermore, financial services companies with a substantial lending business are dependent upon the ability of their borrowers to make debt service payments on loans. Should unemployment or real estate asset values fail to recover for an extended period of time, the Company could be adversely affected.

Our results of operations are significantly affected by the ability of our borrowers to repay their loans.

A significant source of risk is the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loan agreements. Most of the Company's loans are secured but some loans are unsecured. With respect to the secured loans, the collateral securing the repayment of these loans may be insufficient to cover the obligations owed under such loans. Collateral values may be adversely affected by changes in economic, environmental and other conditions, including declines in the value of real estate, changes in interest rates, changes in monetary and fiscal policies of the federal government, widespread disease, terrorist activity, environmental contamination and other external events. In addition, collateral appraisals that are out of date or that do not meet industry recognized standards may create the impression that a loan is adequately collateralized when it is not. The Company has adopted underwriting and credit monitoring procedures and policies, including regular reviews of appraisals and borrower financial statements, that management believes are appropriate to mitigate the risk of loss.

As of December 31, 2011, approximately 67% of the Company's loan portfolio consisted of commercial and industrial, construction and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Company's loan portfolio contains a significant number of commercial and industrial, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in nonperforming loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Company's financial condition and results of operations. Further, if repurchase and indemnity demands with respect to the Company's loan portfolio increase, its liquidity, results of operations and financial condition will be adversely affected.

The Company's allowance for loan losses may be insufficient.

The Company maintains an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio.

The level of the allowance reflects management's continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires the Company to make significant estimates of current credit risks

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and future trends, all of which may undergo material changes. Continuing deterioration of economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside the Company's control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review the Company's allowance for loan losses and have required an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. Further, if charge-offs in future periods exceed the allowance for loan losses, the Company will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on the Company's financial condition and results of operations.

Changes in interest rates may have an adverse effect on the Company's profitability.

The operations of financial institutions such as the Company are dependent to a large degree on net interest income, which is the difference between interest income from loans and investments and interest expense on deposits and borrowings. An institution's net interest income is significantly affected by market rates of interest that in turn are affected by prevailing economic conditions, by the fiscal and monetary policies of the federal government and by the policies of various regulatory agencies. The Federal Reserve Board (FRB) regulates the national money supply in order to manage recessionary and inflationary pressures. In doing so, the FRB may use techniques such as engaging in open market transactions of U.S. Government securities, changing the discount rate and changing reserve requirements against bank deposits. The use of these techniques may also affect interest rates charged on loans and paid on deposits. The interest rate environment, which includes both the level of interest rates and the shape of the U.S. Treasury yield curve, has a significant impact on net interest income. Like all financial institutions, the Company's balance sheet is affected by fluctuations in interest rates. Volatility in interest rates can also result in disintermediation, which is the flow of deposits away from financial institutions into direct investments, such as US Government and corporate securities and other investment vehicles, including mutual funds, which, because of the absence of federal insurance premiums and reserve requirements, generally pay higher rates of return than bank deposit products. See "Item 7: Management's Discussion of Financial Condition and Results of Operations" and "Item 7A: Quantitative and Qualitative Disclosure about Market Risk".

An inability to improve our regulatory capital position could adversely affect our operations.

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. As of December 31, 2011 the Bank exceeded applicable thresholds to be considered well capitalized; however, as a result of our Consent Order with the FDIC and BFI, the Bank currently is considered adequately capitalized. Until we are no longer subject to the capital directives contained in the Consent Order and become well capitalized for regulatory capital purposes, we cannot renew or accept brokered deposits without prior regulatory approval and we may not offer interest rates on our deposit accounts that are significantly higher than the average rates in our market area. As a result, it may be more difficult for us to attract new deposits as our existing brokered deposits mature and do not rollover and to retain or increase non-brokered deposits. If we are not able to attract new deposits, our ability to fund our loan portfolio may be adversely affected. As a result of being adequately capitalized, we also could be subject to more frequent examinations by FDIC, restrictions on new branches and other potential limitations. In addition, we will pay higher insurance premiums to the FDIC, which will reduce our earnings.

In addition, federal law establishes mandatory and discretionary restrictions on insured depository institutions that fail to remain at least adequately capitalized, which could include: submissions and implementations of capital plans, restrictions on payment of dividends and certain management fees, increased supervisory monitoring, restrictions as to asset growth, and branching and new business lines without regulatory approval.

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Declines in value may adversely impact the investment portfolio.

We have not realized any non-cash, other-than-temporary impairment charges during 2011 as a result of reductions in fair value below original cost of any investments in our investment portfolio. However, we could be required to record future impairment charges on our investment securities if they suffer any declines in value that are considered other-than-temporary. Considerations used to determine other-than-temporary impairment status to individual holdings include the length of time the stock has remained in an unrealized loss position, and the percentage of unrealized loss compared to the carrying cost of the stock, dividend reduction or suspension, market analyst reviews and expectations, and other pertinent news that would affect expectations for recovery or further decline.

The Company may not be able to meet the cash flow requirements of its depositors and borrowers or meet its operating cash needs.

Liquidity is the ability to meet cash flow needs on a timely basis at a reasonable cost. The liquidity of the Company is used to service its debt. The liquidity of the Bank is used to make loans and leases and to repay deposit liabilities as they become due or are demanded by customers. Liquidity policies and limits are established by the board of directors. The overall liquidity position of the Company and the Bank are regularly monitored to ensure that various alternative strategies exist to cover unanticipated events that could affect liquidity. Funding sources include Federal funds purchased, securities sold under repurchase agreements and non-core deposits. The Bank is a member of the Federal Home Loan Bank of Atlanta, which provides funding through advances to members that are collateralized with mortgage-related assets.

If the Company is unable to access any of these funding sources when needed, we might be unable to meet customers' needs, which could adversely impact our financial condition, results of operations, cash flows, and level of regulatory-qualifying capital

Negative perceptions associated with the Company's continued participation in the U.S. Treasury's Capital Purchase Program may adversely affect its ability to retain customers, attract investors and compete for new business opportunities.

Several financial institutions which participated in the TARP Capital Purchase Program ("CPP") have received approval from the U.S. Treasury to exit the program. These institutions have, or are in the process of, repurchasing the preferred stock and repurchasing or auctioning the warrant issued to the U.S. Treasury as part of the program. The Company has not yet requested regulatory approval to repurchase the preferred stock and warrant from the U.S. Treasury. In order to repurchase one or both securities, in whole or in part, the Company must establish that it has satisfied all of the conditions to repurchase and must obtain the approval of the U.S. Treasury and the consent of the FDIC. There can be no assurance that the Company will be able to repurchase these securities from the U.S. Treasury. The Company's customers, employees and counterparties in its current and future business relationships may draw negative implications regarding the strength of the Company as a financial institution based on its continued participation in the program following the exit of one or more of its competitors or other financial institutions. Any such negative perceptions may impair the Company's ability to effectively compete with other financial institutions for business or to retain high performing employees. If this were to occur, the Company's business, financial condition and results of operations may be adversely affected, perhaps materially.

Government measures to regulate the financial industry, including the recently enacted Dodd-Frank Act, subject us to increased regulation and could aversely affect us.

As a financial institution, we are heavily regulated at the state and federal levels. As a result of the financial crisis and related global economic downturn that began in 2007, we have faced, and expect to continue to face, increased public and legislative scrutiny as well as stricter and more comprehensive regulation of our financial services practices. In July 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act includes significant changes in the financial regulatory landscape and will impact all financial institutions, including the Company and the Bank. Many of

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the provisions of the Dodd-Frank Act have begun to be or will be implemented over the next several months or years and will be subject both to further rulemaking and the discretion of applicable regulatory bodies. Because the ultimate impact of the Dodd-Frank Act will depend on future regulatory rulemaking and interpretation, we cannot predict the full effect of this legislation on our businesses, financial condition or results of operations. Among other things, the Dodd-Frank Act and the regulations implemented thereunder could limit debit card interchange fees, increase FDIC assessments, impose new requirements on mortgage lending, and establish more stringent capital requirements on bank holding companies. As a result of these and other provisions in the Dodd-Frank Act, we could experience additional costs, as well as limitations on the products and services we offer and on our ability to efficiently pursue business opportunities, which may adversely affect our businesses, financial condition or results of operations.

Holders of the TARP preferred stock may, under certain circumstances, have the right to elect two directors to our board of directors.

As of December 31, 2011, we have not made payment of dividends on the TARP preferred stock for three quarterly dividend periods. In the event that we fail to pay dividends on the TARP preferred stock for an aggregate of six quarterly dividend periods or more (whether or not consecutive), the authorized number of directors then constituting our board of directors will be increased by two. Holders of the TARP preferred stock, together with the holders of any outstanding parity stock with like voting rights, voting as a single class, will be entitled to elect the two additional members of our board of directors at the next annual meeting (or at a special meeting called for the purpose of electing these directors prior to the next annual meeting) and at each subsequent annual meeting until all accrued and unpaid dividends for all past dividend periods have been paid in full.

We are subject to executive compensation restrictions because of our participation in the CPP, which could limit our ability to recruit and retain executives.

As a participant in the CPP, we are subject to TARP rules and standards governing executive compensation and corporate governance, which generally apply to our Chief Executive Officer, Chief Financial Officer and the next three most highly compensated employees (together, our “senior executive officers”), as well as a number of other employees. The standards include (i) a requirement to recover any bonus payment to senior executive officers and certain other employees if payment was based on materially inaccurate financial statements or performance metric criteria; (ii) a prohibition on making any golden parachute payments to senior executive officers and certain other employees; (iii) a prohibition on paying or accruing any bonus payment to our most highly compensated employee, subject to limited exceptions; (iv) a prohibition on maintaining any plan for senior executive officers that encourage such officers to take unnecessary and excessive risks that threaten the Company’s value; (v) a prohibition on maintaining any employee compensation plan that encourages the manipulation of reported earnings to enhance the compensation of any employee; and (vi) a prohibition on providing tax gross-ups to senior executive officers and other employees. These restrictions and standards could limit our ability to recruit and retain executives. If we lose the services of our key personnel, or are unable to attract additional qualified personnel, our operations may be disrupted and our businesses, financial condition and results of operations may be adversely impacted.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

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Changes in economic conditions and related uncertainties may have an adverse affect on the Company's profitability.

Commercial banking is affected, directly and indirectly, by local, domestic, and international economic and political conditions, and by governmental monetary and fiscal policies. Conditions such as inflation, recession, unemployment, volatile interest rates, tight money supply, real estate values, international conflicts and other factors beyond the Company's control may adversely affect the potential profitability of the Company. Any future rises in interest rates, while increasing the income yield on the Company's earnings assets, may adversely affect loan demand and the cost of funds and, consequently, the profitability of the Company. Any future decreases in interest rates may adversely affect the Company's profitability because such decreases may reduce the amounts that the Company may earn on its assets. A continued recessionary climate could result in the delinquency of outstanding loans. Management does not expect any one particular factor to have a material effect on the Company's results of operations. However, downtrends in several areas, including real estate, construction and consumer spending, could have a material adverse impact on the Company's profitability.

The supervision and regulation to which the Company is subject can be a competitive disadvantage.

The operations of the Company and the Bank are heavily regulated and will be affected by present and future legislation and by the policies established from time to time by various federal and state regulatory authorities. In particular, the monetary policies of the Federal Reserve have had a significant effect on the operating results of banks in the past, and are expected to continue to do so in the future. Among the instruments of monetary policy used by the Federal Reserve to implement its objectives are changes in the discount rate charged on bank borrowings and changes in the reserve requirements on bank deposits. It is not possible to predict what changes, if any, will be made to the monetary policies of the Federal Reserve or to existing federal and state legislation or the effect that such changes may have on the future business and earnings prospects of the Company.

The Company is subject to changes in federal and state tax laws as well as changes in banking and credit regulations, accounting principles and governmental economic and monetary policies.

During the past several years, significant legislative attention has been focused on the regulation and deregulation of the financial services industry. Non-bank financial institutions, such as securities brokerage firms, insurance companies and money market funds, have been permitted to engage in activities that compete directly with traditional bank business.

The competition the Company faces is increasing and may reduce our customer base and negatively impact the Company's results of operations.

There is significant competition among banks in the market areas served by the Company. In addition, as a result of deregulation of the financial industry, the Bank also competes with other providers of financial services such as savings and loan associations, credit unions, consumer finance companies, securities firms, insurance companies, the mutual funds industry, full service brokerage firms and discount brokerage firms, some of which are subject to less extensive regulations than the Company with respect to the products and services they provide. Some of the Company's competitors have greater resources than the Corporation and, as a result, may have higher lending limits and may offer other services not offered by our Company. See "Item 1: Business — Competition."

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Our deposit insurance premium could be substantially higher in the future which would have an adverse effect on our future earnings.

The FDIC insures deposits at FDIC-insured financial institutions, including Village Bank. The FDIC charges the insured financial institutions premiums to maintain the Deposit Insurance Fund at a certain level. Current economic conditions have increased bank failures and expectations for further failures, which may result in the FDIC making more payments from the Deposit Insurance Fund and, in connection therewith, raising deposit premiums. In addition, the deposit insurance limit on FDIC deposit insurance coverage generally has increased to $250,000, which may result in even larger losses to the Deposit Insurance Fund. These developments have caused an increase to our assessments, and the FDIC may be required to made additional increases to the assessment rates and levy additional special assessments on us. Higher assessments increase our non-interest expense. The FDIC also instituted that non-interest bearing transactional accounts at institutions participating in the Transaction Account Guarantee Program are currently fully insured (unlimited coverage). These programs have placed additional stress on the Deposit Insurance Fund.

In February 2011, the FDIC finalized a rule that increases premiums paid by insured institutions and makes other changes to the assessment system. The Company is generally unable to control the amount of premiums that it is required to pay for FDIC insurance. If there are additional bank or financial institution failures the Company may be required to pay even higher FDIC premiums than the recently increased levels. Any future increases or required prepayments of FDIC insurance premiums may adversely impact its earnings.

Concern of customers over deposit insurance may cause a decrease in deposits.

With the continuing news about bank failures, customers are increasingly concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits in an effort to ensure that the amount they have on deposit with us is fully insured. Decreases in deposits may adversely affect our funding costs and net income.

Fluctuations in the stock market could negatively affect the value of the Company's common stock.

The Company's common stock trades under the symbol "VBFC" on the Nasdaq Capital Market. There can be no assurance that a regular and active market for the Common Stock will develop in the foreseeable future. See "Item 5: Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities." Investors in the shares of common stock may, therefore, be required to assume the risk of their investment for an indefinite period of time. Current lack of investor confidence in large banks may keep investors away from the banking sector as a whole, causing unjustified deterioration in the trading prices of community banks such as the Company.

If the Company fails to maintain an effective system of internal controls, it may not be able to accurately report its financial results or prevent fraud. As a result, current and potential shareholders could lose confidence in the Company's financial reporting, which could harm its business and the trading price of its common stock.

The Company has established a process to document and evaluate its internal controls over financial reporting in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations, which require annual management assessments of the effectiveness of the Company's internal controls over financial reporting. In this regard, management has dedicated internal resources, engaged outside consultants and adopted a detailed work plan to (i) assess and document the adequacy of internal controls over financial reporting, (ii) take steps to improve control processes, where appropriate, (iii) validate through testing that controls are functioning as documented and (iv) implement a continuous reporting and improvement process for internal control over financial reporting. The Company's efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations regarding the Company’s assessment of its internal controls over financial reporting. The Company’s management and audit

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committee have given the Company's compliance with Section 404 a high priority. The Company cannot be certain that these measures will ensure that the Company implements and maintains adequate controls over its financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm the Company's operating results or cause the Company to fail to meet its reporting obligations. If the Company fails to correct any issues in the design or operating effectiveness of internal controls over financial reporting or fails to prevent fraud, current and potential shareholders could lose confidence in the Company's financial reporting, which could harm its business and the trading price of its common stock.

The Company is subject to a variety of operational risks, including reputational risk, legal and compliance risk, and the risk of fraud or theft by employees or outsiders.

The Company is exposed to many types of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, and unauthorized transactions by employees or operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer or telecommunications systems. Negative public opinion can result from its actual or alleged conduct in any number of activities, including lending practices, corporate governance and acquisitions and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect its ability to attract and keep customers and can expose the Company to litigation and regulatory action.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. The Company's necessary dependence upon automated systems to record and process its transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. The Company also may be subject to disruptions of its operating systems arising from events that are wholly or partially beyond its control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. The Company is further exposed to the risk that its external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as the Company is) and to the risk that its (or its vendors') business continuity and data security systems prove to be inadequate. The occurrence of any of these risks could result in a diminished ability of the Company to operate its business, potential liability to clients, reputational damage and regulatory intervention, which could adversely affect its business, financial condition and results of operations, perhaps materially.

The Company relies on other companies to provide key components of its business infrastructure.

Third parties provide key components of the Company's business infrastructure, for example, system support, and Internet connections and network access. While the Company has selected these third party vendors carefully, it does not control their actions. Any problems caused by these third parties, including those resulting from their failure to provide services for any reason or their poor performance of services, could adversely affect its ability to deliver products and services to its customers and otherwise conduct its business. Replacing these third party vendors could also entail significant delay and expense.

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The Company may have to rely on dividends from the Bank.

The Company is a separate and distinct legal entity from its subsidiary bank. Although the Company has never received any dividends from the Bank, it is entitled to receive dividends in accordance with federal and state regulations. These federal and state regulations limit the amount of dividends that the Bank may pay to the Company. In the event the Bank is unable to pay dividends to the Company, the Company may not be able to service debt, pay obligations or pay dividends on the Company's common stock. The inability of the Company to receive dividends from the Bank could have a material adverse effect on the Company's business, financial condition and results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our executive and administrative offices are owned by the Bank and are located at 15521 Midlothian Turnpike, Midlothian, Virginia 23113 in Chesterfield County where an 80,000 square foot corporate headquarters and operations center was opened in August 2008. The Bank currently occupies approximately forty percent of the space, which includes a full service branch location. The Bank leases the other portions to unrelated parties. In addition to the branch, the Bank's wholly-owned subsidiary, Village Bank Mortgage Corporation, also leases space in the building.

In addition to the branch in the corporate headquarters and operations center, the Bank owns 9 full service branch buildings including the land on those buildings and leases an additional four full service branch buildings. Eight of our branch offices are located in Chesterfield County, with three branch offices in Hanover County, two in Henrico County and one in Powhatan County.

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

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. MINE SAFETY DISCLOSURES

None

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PART II

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

Market Information

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

	High	Low
2010		
1st quarter	$ 5.00	$ 2.02
2nd quarter	4.24	2.82
3rd quarter	2.90	1.40
4th quarter	1.98	1.40
2011		
1st quarter	$ 3.85	$ 1.60
2nd quarter	3.01	2.03
3rd quarter	2.98	1.71
4th quarter	2.35	1.13

Dividends

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

We also are subject to a Memorandum of Understanding with the Reserve Bank that we will not pay dividends on our preferred stock, including our Series A preferred Stock, trust preferred securities or common stock without the prior consent of the FDIC and the BFI. Supervisory guidance from the Federal Reserve indicates that Capital Purchase

Program recipients that are experiencing financial difficulties generally should eliminate, reduce or defer dividends on Tier 1 capital instruments, including trust preferred, preferred stock or common stock, if the holding company needs to conserve capital for safe and sound operation and to serve as a source of strength to its subsidiaries. The Company has agreed not to declare or pay any dividends on common stock or preferred stock, including the TARP preferred, or make any payments on its trust preferred securities without prior regulatory approval.

In addition, we are subject to a Consent Order with the FDIC and the BFI that the Bank will not pay any dividends, pay bonuses or make any other form of payment outside the ordinary course of business resulting in a reduction of capital without regulatory approval.

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The Company has deferred interest payments on the junior subordinated debt securities of $317,129 at December 31, 2011. Although we elected to defer payment of the interest due, the amount has been accrued and is included in interest expense.

As required by the Federal Reserve Bank of Richmond, the Company notified the U.S. Treasury in May 2011 that the Company was going to defer the payment of the quarterly cash dividend of $184,225 due on May 16, 2011, and subsequent quarterly payments, on the Fixed Rate Cumulative Perpetual Preferred Stock, Series A. The total arrearage on such preferred stock as of December 31, 2011 is $650,197.

Holders

At March 9, 2012, there were approximately 1,690 holders of record of Common Stock.

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

Recent Sales of Unregistered Securities

None

Purchases of Equity Securities

The Company did not repurchase any of its Common Stock during the fourth quarter of 2011.

Performance Graph

The following graph shows the yearly percentage change in the Company's cumulative total shareholder return on its common stock from December 31, 2006 to December 31, 2011 compared with the NASDAQ Composite Index and peer group indexes based on asset size.

	Period Ending					
Index	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
Village Bank and Trust Financial Corp.	100.00	75.35	31.69	16.43	10.49	8.80
NASDAQ Composite	100.00	110.66	66.42	96.54	114.06	113.16
SNL Bank $250M-$500M	100.00	81.28	46.42	42.96	48.07	45.15
SNL Bank $500M-$1B	100.00	80.13	51.35	48.90	53.38	46.96

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ITEM 6. SELECTED FINANCIAL DATA

The following consolidated selected financial data is derived from the Company's audited financial statements for the five years ended December 31, 2011. This information should be read in conjunction with the following Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated statements and notes thereto.

	Year Ended December 31,				
	2011	2010	2009	2008	2007
Balance Sheet Data					
At year-end					
Assets	$ 581,704,319	$ 591,779,215	$ 601,993,355	$ 572,407,993	$ 393,263,999
Loans, net of unearned income	428,638,491	453,866,801	467,568,547	470,722,286	327,343,013
Investment securities	30,163,292	53,597,174	54,857,211	24,300,962	13,711,399
Goodwill	-	-	-	7,422,141	689,108
Deposits	485,521,052	499,012,193	498,285,124	466,232,043	339,297,258
Borrowings	52,292,661	41,679,430	52,593,521	57,726,898	24,736,569
Stockholders' equity	36,247,642	48,320,194	47,848,091	46,162,574	26,893,299
Number of shares outstanding	4,243,378	4,238,416	4,230,628	4,229,372	2,575,985
Average for the year					
Assets	609,974,864	603,760,108	600,034,107	442,604,327	337,750,179
Stockholders' equity	49,912,896	49,801,210	56,089,455	31,067,165	27,798,307
Weighted average shares outstanding	4,243,025	4,237,735	4,230,462	3,013,175	2,569,529
Income Statement Data					
Interest income	$ 27,980,498	$ 30,181,838	$ 33,195,973	$ 29,072,146	$ 25,665,235
Interest expense	8,345,903	10,885,413	16,407,679	15,969,783	13,806,715
Net interest income	19,634,595	19,296,425	16,788,294	13,102,363	11,858,520
Provision for loan losses	18,764,295	4,842,000	13,220,000	2,005,633	1,187,482
Noninterest income	10,843,781	10,990,667	8,285,100	4,184,727	2,666,956
Goodwill impairment	-	-	7,422,141	-	-
Noninterest expense	23,961,075	23,303,156	20,915,735	14,572,271	11,821,232
Income tax expense (benefit)	(426,872)	711,627	(3,879,386)	241,097	515,699
Net income (loss)	(11,820,122)	1,430,309	(12,605,096)	468,089	1,001,063
Preferred stock dividends and amortization of discount	882,882	881,402	590,151	-	-
Net income (loss) available to					

common shareholders	$ (12,703,004)	$ 548,907	$ (13,195,247)	$ 468,089	$ 1,001,063
Per Share Data					
Earnings (loss) per share - basic	$ (3.05)	$ 0.13	$ (3.12)	$ 0.16	$ 0.39
Earnings (loss) per share - diluted	$ (3.05)	$ 0.13	$ (3.12)	$ 0.16	$ 0.37
Book value at year-end	$ 4.92	$ 7.87	$ 7.81	$ 10.91	$ 10.44
Performance Ratios					
Return on average assets	(1.94)%	0.24 %	(2.10)%	0.11 %	0.30 %
Return on average equity	(23.68)%	2.87 %	(22.47)%	1.51 %	3.60 %
Net interest margin(1)	3.59 %	3.57 %	3.13 %	3.27 %	3.80 %
Efficiency(2)	78.62 %	76.94 %	83.42 %	84.30 %	81.38 %
Loans to deposits	88.28 %	90.95 %	93.84 %	100.96 %	96.48 %
Equity to assets	6.23 %	8.17 %	7.95 %	8.06 %	6.84 %
Asset Quality Ratios					
ALLL to loans at year-end	3.75 %	1.61 %	2.25 %	1.29 %	1.06 %
ALLL to nonaccrual loans	33.41 %	35.98 %	40.61 %	71.05 %	134.20 %
Nonperforming assets to total assets	9.85 %	5.47 %	6.17 %	2.00 %	0.73 %
Nonperforming loans to total loans	13.36 %	7.13 %	7.95 %	2.43 %	0.87 %
Net charge-offs to average loans	2.27 %	1.74 %	1.83 %	0.49 %	0.10 %

(1) Net interest margin is computed by dividing net interest income for the period by average interest earning assets.
(2) Efficiency ratio is computed by dividing noninterest expense by the sum of net interest income and noninterest income. The
goodwill impairment write-off is excluded in 2009 from noninterest expense.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist readers in understanding and evaluating the financial condition, changes in financial condition and the results of operations of the Company, consisting of the parent company and its wholly-owned subsidiary, the Bank. This discussion should be read in conjunction with the consolidated financial statements and other financial information contained elsewhere in this report.

Caution About Forward-Looking Statements

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

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

- the inability of the Bank to comply with the requirements of agreements with its regulators;
- the inability to reduce nonperforming assets consisting of nonaccrual loans and foreclosed real estate;
- our inability to improve our regulatory capital position;
- the risks of changes in interest rates on levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities;
- changes in assumptions underlying the establishment of allowances for loan losses, and other estimates;
- changes in market conditions, specifically declines in the residential and commercial real estate market, volatility and disruption of the capital and credit markets, soundness of other financial institutions we do business with;
- risks inherent in making loans such as repayment risks and fluctuating collateral values;
- changes in operations of Village Bank Mortgage Corporation as a result of the activity in the residential real estate market;
- legislative and regulatory changes, including the Financial Reform Act and other changes in banking, securities, and tax laws and regulations and their application by our regulators, and changes in scope and cost of FDIC insurance and other coverages;
- exposure to repurchase loans sold to investors for which borrowers failed to provide full and accurate information on or related to their loan application or for which appraisals have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor;
- the effects of future economic, business and market conditions;
- governmental monetary and fiscal policies;
- changes in accounting policies, rules and practices;
- reliance on our management team, including our ability to attract and retain key personnel;
- competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;
- demand, development and acceptance of new products and services;
- problems with technology utilized by us;
- changing trends in customer profiles and behavior; and
- other factors described from time to time in our reports filed with the SEC.

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

General

The Company's primary source of earnings is net interest income, and its principal market risk exposure is interest rate risk. The Company is not able to predict market interest rate fluctuations and its asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on the Company's results of operations and financial condition.

Although we endeavor to minimize the credit risk inherent in the Company's loan portfolio, we must necessarily make various assumptions and judgments about the collectability of the loan portfolio based on our experience and evaluation of economic conditions. If such assumptions or judgments prove to be incorrect, the current allowance for loan losses may not be sufficient to cover loan losses and additions to the allowance may be necessary, which would have a negative impact on net income. Over the last three years, the Company has recorded record provisions for loan losses due primarily to decline in the performance of loans collateralized by real estate located in its principal market area.

There is intense competition in all areas in which the Company conducts its business. The Company competes with banks and other financial institutions, including savings and loan associations, savings banks, finance companies, and credit unions. Many of these competitors have substantially greater resources and lending limits and provide a wider array of banking services. To a limited extent, the Company also competes with other providers of financial services, such as money market mutual funds, brokerage firms, consumer finance companies and insurance companies. Competition is based on a number of factors, including prices, interest rates, services, availability of products and geographic location.

Effect of Economic Trends

The twelve months ended December 31, 2011 continued to reflect the tumultuous economic conditions which have negatively impacted the liquidity and credit quality of financial institutions in the United States. Concerns regarding increased credit losses from the weakening economy have negatively affected capital and earnings of most financial institutions. Financial institutions have experienced significant declines in the value of collateral for real estate loans and heightened credit losses, which have resulted in record levels of non-performing assets, charge-offs and foreclosures. In addition, hundreds of financial institutions failed or merged with other institutions during the last three years, and two of the government sponsored housing enterprises were placed into conservatorship with the U.S. Government in 2008.

Liquidity in the debt markets remains low in spite of efforts by Treasury and the Federal Reserve to inject capital into financial institutions. The federal funds rate set by the Federal Reserve has remained at 0.25% since December 2008, following a decline from 4.25% to 0.25% during 2008 through a series of seven rate reductions.

The Treasury Department, the FDIC and other governmental agencies continue to enact rules and regulations to implement the EESA, the TARP, the Recovery Act and related economic recovery programs, many of which contain limitations on the ability of financial institutions to take certain actions or to engage in certain activities if the financial institution is a participant in the CPP or related programs. Future regulations, or enforcement of the terms of programs already in place, may require financial institutions to raise additional capital and result in the conversion of preferred equity issued under TARP or other programs to common equity. There can be no assurance as to the actual impact of the EESA, the Dodd-Frank Act or any other governmental program on the financial markets.

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The weak economic conditions are expected to continue into 2012. Financial institutions likely will continue to experience heightened credit losses and higher levels of non-performing assets, charge-offs and foreclosures. In light of these conditions, financial institutions also face heightened levels of scrutiny from federal and state regulators. These factors negatively influenced, and likely will continue to negatively influence, earning asset yields at a time when the market for deposits is intensely competitive. As a result, financial institutions experienced, and are expected to continue to experience, pressure on credit costs, loan yields, deposit and other borrowing costs, liquidity, and capital.

Results of Operations

The following presents management's discussion and analysis of the financial condition of the Company at December 31, 2011 and 2010, and results of operations for the Company for the years ended December 31, 2011, 2010 and 2009. This discussion should be read in conjunction with the Company's audited Financial Statements and the notes thereto appearing elsewhere in this Annual Report.

Income Statement Analysis

Summary

We recorded a net loss of $(11,820,000) and a net loss available to common shareholders of $(12,703,000), or $(2.99) per fully diluted share, in 2011, compared to net income of $1,430,000 and $548,907 net income available to common shareholders, or $0.13 per fully diluted share, in 2010, and a net loss of $(12,605,000) and a net loss available to common shareholders of $(13,195,247), or $3.12 per fully diluted share, in 2009. The most significant factor affecting earnings in the last three years has been costs associated with loan defaults – the provision for loan losses and expenses related to foreclosed real estate. The impact these costs have had on our operations is illustrated in the following table which adjusts pretax earnings for gains and losses on sales of assets other than loan sales by the mortgage company as well as the effect of problem assets and goodwill impairment. Such adjusted earnings is not a measurement under accounting principles generally accepted in the United States.

	Year Ended December 31,		
	2011	2010	2009
Pretax income (loss) - GAAP	$(12,246,995)	$2,141,936	$(16,484,482)
Less			
Gain (loss) on securities	1,217,554	768,551	329,183
Gain (loss) on sale of assets	(407)	243,566	(43,637)
	1,217,147	1,012,117	285,546
Add			
Goodwill impairment	-	-	7,422,141
Provision for loan losses	18,764,295	4,842,000	13,220,000
OREO expenses	1,413,961	1,693,524	1,475,338
	20,178,256	6,535,524	22,117,479
Pretax income as adjusted	6,714,114	7,665,343	5,347,451
Income tax expense	2,282,799	2,606,217	1,818,133
Net income as adjusted	$4,431,315	$5,059,126	$3,529,318

The $628,000 decrease in net income as adjusted in 2011 was primarily attributable to a decline in the profitability of our mortgage company of $514,000 as its mortgage loan production declined by $47 million in 2011. The $1,530,000 increase in net income as adjusted in 2010 was attributable to

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two factors. First, net interest income increased by $2,508,000, a direct result of decreasing the cost of funds from 3.27% for 2009 to 2.15% for 2010. Second, our mortgage company's profitability increased by $808,000.

Net interest income

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

Net interest income increased to $19,635,000 in 2011 from $19,296,000 in 2010 and $16,788,000 in 2009. While the increase in net interest income in 2011 is not significant, changes to the components of net interest income are worthy of note. Yields on average interest-earning assets declined from 5.59% in 2010 to 5.11% in 2011 resulting in a decline in interest income of $1,049,000, and the amount of average interest-earning assets declined by $7,145,000 resulting in a decline in interest income of $1,152,000. This decline in yields on average interest-earning assets is a result of a strategic shift by management in the makeup of our average interest-earning assets, from loans to investment securities and federal funds sold, primarily to increase liquidity. Yields on loans are generally higher than yields on more liquid assets such as investment securities and federal funds sold. Additionally, an increase in nonaccrual loans has had a negative effect on asset yields. Rates paid on average interest-bearing liabilities declined from 2.15% in 2010 to 1.68% in 2011 resulting in a decline in interest expense of $1,750,000. Reducing our cost of funds has been strategic focus of management the last three years which has been aided by the historic low short-term interest rates by the Federal Reserve.

The increase in net interest income in 2010 of $2,508,000 was a result of a reduction in our cost of average deposits from 3.20% in 2009 to 1.98% in 2010 resulting in a decrease in interest expense of $2,429,000 as well as a decline in the amount of average deposits of $2,977,000 which resulted in a decline in interest expense of $2,908,000. This was somewhat offset by a decline in the yield on our interest-bearing assets from 6.19% in 2009 to 5.59% in 2010 resulting in a decline in interest income of $2,884,000. As discussed previously, we have focused on reducing our cost of funds for the last three years and 2010 saw the largest decline of 1.12%.

Lost interest on nonaccrual loans has also had an effect on net interest income the last two years as reflected in the following schedule:

	Actual		Lost Interest on Nonaccrual Loans	Adjusted	
	Amount	Yield Rate		Amount	Yield Rate
2011					
Interest income	$ 27,980,498	5.11 %	$ 2,377,204	$ 30,357,702	5.54 %
Interest expense	8,345,903	1.68 %	-	8,345,903	1.68 %
Net interest income	$ 19,634,595	3.43 %	$ 2,377,204	$ 22,011,799	3.86 %
2010					
Interest income	$ 30,181,838	5.59 %	$ 1,241,757	$ 31,423,595	5.81 %

Interest expense		10,885,413	2.15	%		-		10,885,413	2.15	%
Net interest income	$	19,296,425	3.44	%	$	1,241,757	$	20,538,182	3.66	%

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Our interest spread (average yield on interest-earning assets less average rate in interest-bearing liabilities) was reduced by .43% (43 basis points) in 2011 and by .22% (22 basis points) in 2010 as a result of lost interest on nonaccrual loans.

Average interest-earning assets and average interest-bearing liabilities remained relatively stable over the last three year period. This lack of growth was due to our minimal growth strategy as discussed previously.

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

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Average Balance Sheets
(In thousands)

	Year Ended December 31, 2011			Year Ended December 31, 2010			Year Ended December 31, 2009		
	Average Balance	Interest Income/ Expense	Yield Rate	Average Balance	Interest Income/ Expense	Yield Rate	Average Balance	Interest Income/ Expense	Yield Rate
Loans									
Commercial	$ 37,734	$ 2,253	5.97 %	$ 37,421	$ 2,337	6.25 %	$ 43,046	$ 2,485	5.77 %
Real estate - residential	143,047	8,333	5.83 %	154,091	9,188	5.96 %	147,200	8,702	5.91 %
Real estate - commercial	169,300	10,942	6.46 %	174,337	11,426	6.55 %	162,028	11,045	6.82 %
Real estate - construction	86,497	4,265	4.93 %	92,190	4,939	5.36 %	117,766	8,438	7.17 %
Consumer	4,863	272	5.59 %	5,326	357	6.70 %	7,319	508	6.94 %
Gross loans	441,441	26,065	5.90 %	463,365	28,247	6.10 %	477,359	31,178	6.53 %
Investment securities	53,834	1,309	2.43 %	36,066	1,087	3.01 %	33,174	1,458	5.76 %
Loans held for sale	10,733	516	4.81 %	16,820	793	4.71 %	10,305	533	6.05 %
Federal funds and other	41,545	91	0.22 %	24,157	55	0.23 %	15,034	27	2.23 %
Total interest earning assets	547,553	27,981	5.11 %	540,408	30,182	5.59 %	535,872	33,196	6.19 %
Allowance for loan losses	(9,267)			(9,722)			(8,367)		
Cash and due from banks	10,317			13,103			15,998		
Premises and equipment, net	27,265			27,630			27,880		
Other assets	34,107			32,341			28,651		
Total assets	$ 609,975			$ 603,760			$ 600,034		
Interest bearing deposits									
Interest checking	37,377	229	0.61 %	34,521	336	0.97 %	$ 26,530	$ 443	1.67 %
Money market	86,860	578	0.67 %	98,762	1,077	1.09 %	69,267	1,242	1.79 %
Savings	12,656	85	0.67 %	10,081	80	0.79 %	7,009	85	1.21 %
Certificates	310,634	6,273	2.02 %	315,205	7,604	2.41 %	347,698	12,664	3.64 %
Total deposits	447,527	7,165	1.60 %	458,569	9,097	1.98 %	450,504	14,434	3.20 %
Borrowings									
Long-tern debt - trust preferred securities	8,764	353	4.03 %	8,764	346	3.95 %	8,764	392	4.47 %

FHLB advances	36,824	810	4.22 %	28,425	864	4.22 %	26,348	970	4.22 %
Other borrowings	5,009	18	1.77 %	11,473	578	1.77 %	16,337	612	1.77 %
Total interest bearing liabilities	498,124	8,346	1.68 %	507,231	10,885	2.15 %	501,953	16,408	3.27 %
Noninterest bearing deposits	59,011			44,495			39,626		
Other liabilities	3,927			2,233			2,366		
Total liabilities	561,062			553,959			543,945		
Equity capital	48,913			49,801			56,089		
Total liabilities and capital	$ 609,975			$ 603,760			$ 600,034		
Net interest income before provision for loan losses		$ 19,635			$ 19,297			$ 16,788	
Interest spread - average yield on interest earning assets, less average rate on interest bearing liabilities			3.43 %			3.44 %			2.93 %
Net interest margin (net interest income expressed as a percentage of average earning assets)			3.59 %			3.57 %			3.13 %

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

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Rate/Volume Analysis
(In thousands)

	2011 vs. 2010 Increase (Decrease) Due to Changes in			2010 vs. 2009 Increase (Decrease) Due to Changes in		
	Volume	Rate	Total	Volume	Rate	Total
Interest income						
Loans	$(1,555)	$(904)	$(2,459)	$(291)	$(2,380)	$(2,671)
Investment securities	365	(143)	222	142	(513)	(371)
Fed funds sold and other	38	(2)	36	19	9	28
Total interest income	(1,152)	(1,049)	(2,201)	(130)	(2,884)	(3,014)
Interest expense						
Deposits						
Interest checking	32	(138)	(106)	279	(385)	(106)
Money market accounts	(117)	(381)	(498)	(2,066)	1,902	(164)
Savings accounts	13	(8)	5	(24)	19	(5)
Certificates of deposit	(109)	(1,224)	(1,333)	(1,097)	(3,965)	(5,062)
Total deposits	(182)	(1,750)	(1,932)	(2,908)	(2,429)	(5,337)
Borrowings						
Long-term debt	-	7	7	-	(46)	(46)
FHLB Advances	(833)	779	(54)	87	(193)	(106)
Other borrowings	(560)	-	(560)	(34)	-	(34)
Total interest expense	(1,575)	(963)	(2,539)	(2,855)	(2,668)	(5,523)
Net interest income	$423	$(86)	$338	$2,725	$(216)	$2,509

Note: the combined effect on interest due to changes in both volume and rate, which cannot be separately identified, has been allocated proportionately to the change due to volume and the change due to rate.

Provision for loan losses

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

The level of the allowance reflects changes in the size of the portfolio or in any of its components as well as management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, and political and regulatory conditions. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

Profitability has been negatively impacted by historic provisions for loan losses the last three years. The provision for loan losses increased to $18,764,000 in 2011 from $4,842,000 in 2010 and $13,220,000 in 2009. The significant increase in the provision for loan losses in 2011 reflects management's determination that continuing depressed market conditions in 2011 as well as some financial difficulties experienced by some of our more significant borrowers warranted the addition of a significant provision for loan losses. The significant provisions for loan losses the last three years reflect the impact of the recessionary economy and borrowers' ability to repay loans. Although we believe that the allowance for loan losses of $16,071,000 at December 31, 2011, which represents

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3.75% of loans outstanding, is adequate to absorb potential losses in the Company's loan portfolio at that date, we can make no assurance that significant provisions for loan losses will not be necessary in the future. The continuation of depressed economic conditions, especially in our primary market area, will have a negative effect on the collectability of our loan portfolio.

Noninterest income

Noninterest income includes service charges and fees on deposit accounts, fee income related to loan origination, and gains and losses on sale of mortgage loans and securities held for sale. Over the last three years the most significant noninterest income item has been gain on loan sales generated by Village Bank Mortgage, representing 70% in 2009, 63% in 2010 and 60% in 2011 of total noninterest income. Noninterest income amounted to $8,285,000 in 2009, $10,991,000 in 2010 and $10,844,000 in 2011.

The decrease in noninterest income in 2011 of $147,000 is primarily attributable to a decrease in gain on sale of loans of $481,000, The decreased gain on sale of loans resulted from a decrease in loan production by our mortgage company, from $285 million in 2010 to $238 million in 2011.

The increase in noninterest income in 2010 of $2,706,000 is primarily attributable to an increase in gain on sale of loans of $1,176,000 and gains on sale of assets (land behind one of our branches and sales and calls of investment securities available for sale) of $1,012,000. The increased gain on sale of loans resulted from an increase in loan production by our mortgage company from $252 million in 2009 to $285 million in 2010.

Noninterest expense

Noninterest expense includes all expenses of the Company with the exception of interest expense on deposits and borrowings, provision for loan losses and income taxes. Some of the primary components of noninterest expense are salaries and benefits, occupancy and equipment costs and expenses related to foreclosed real estate. Over the last three years, the most significant noninterest expense item has been salaries and benefits, representing 50%, 53% and 53% of noninterest expense (excluding the write-off of goodwill in 2009) in 2009, 2010 and 2011, respectively. Noninterest expense decreased from $28,338,000 in 2009, to $23,303,000 in 2010 and increased to $23,961,000 in 2011. In 2009 the write-off of all goodwill of $7,422,141 was included in noninterest expense. This was a one time expense as we no longer have any goodwill.

The increase in noninterest expense of $658,000 in 2011 resulted primarily from increases in salaries and benefits of $288,000, audit and accounting expense of $206,000 and occupancy expense of $181,000.

The decrease in noninterest expense of $5,035,000 in 2010 resulted from the goodwill write-off of $7,422,000 in 2009. Not taking the goodwill write-off into consideration noninterest expense increased by $2,387,000. The increase resulted primarily from increases in salaries and benefits of $1,861,000 and other real estate owned expenses of $218,000.

Income taxes

Applicable tax benefit on the 2011 loss amounted to $426,000, resulting in an effective tax rate of 3.49%, compared to income tax expense on 2010 earnings of $712,000, resulting in an effective tax rate of 33.2%, and an income tax benefit of $(3,879,000), or 23.5%, in 2009. The effective tax rate of the benefit in 2009 was lower due to the non-deductibility of the goodwill impairment charge of $7,422,000. The net operating loss is limited by IRS section 382 to $908,000 per year.

The net deferred tax asset is included in other assets on the balance sheet. Accounting Standards Codification Topic 740, Income Taxes, requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. Management considers both positive and negative evidence and analyzes changes in near-term market conditions as well as other factors

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which may impact future operating results. In making such judgments, significant weight is given to evidence that can be objectively verified. The deferred tax assets are analyzed quarterly for changes affecting realization. Management determined that as of December 31, 2011, the objective negative evidence represented by the Company's recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance on its net deferred tax asset of approximately $3,900,000. The net operating losses available to offset future taxable income amounted to $4,519,000 at December 31, 2011 and expire through 2030.

Commercial banking organizations conducting business in Virginia are not subject to Virginia income taxes. Instead, they are subject to a franchise tax based on bank capital. The Bank recorded a franchise tax expense of $328,000, $358,000 and $355,000 for 2011, 2010 and 2009, respectively.

Balance Sheet Analysis

Investment securities

At December 31, 2011 and 2010, all of our investment securities were classified as available-for-sale. Investment securities classified as available for sale may be sold in the future, prior to maturity. These securities are carried at fair value. Net aggregate unrealized gains or losses on these securities are included, net of taxes, as a component of shareholders' equity. Given the generally high credit quality of the portfolio, management expects to realize all of its investment upon market recovery or, the maturity of such instruments and thus believes that any impairment in value is interest rate related and therefore temporary. Available for sale securities included net unrealized gains of $145,000 at December 31, 2011 and net unrealized losses of $397,000 at December 31, 2010. As of December 31, 2011, management does not have the intent to sell any of the securities classified as available for sale and which have unrealized losses and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

Sales and calls of investment securities increased from $51,123,000 in 2010 to $102,116,000 in 2011. This increase was attributable to calls on higher interest rate securities as well as sales of securities to realize gains in value.

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The following table presents the composition of our investment portfolio at the dates indicated.

Investment Securities Available-for-Sale
(Dollars in thousands)

	Par Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Average Yield
December 31, 2011						
US Government Agencies						
More than ten years	$2,000	$2,000	$1	$-	$2,001	3.81 %
Mortgage-backed securities						
One to five years	11	11	-	-	11	0.01 %
More than ten years	19,870	20,621	220	(49)	20,792	1.83 %
Total	19,881	20,632	220	(49)	20,803	1.83 %
Other investments						
More than ten years	7,356	7,386	-	(27)	7,359	0.55 %
Total investment securities	$29,237	$30,018	$221	$(76)	$30,163	1.65 %
December 31, 2010						
US Treasuries						
One to five years	$28,000	$28,017	$-	$-	$28,017	0.22 %
US Government Agencies						
Five to ten years	3,000	3,000		(111)	2,889	2.00 %
Mortgage-backed securities						
One to five years	686	703	31	(10)	724	4.90 %
More than ten years	14,410	14,796	91	(58)	14,829	2.86 %
Total	15,096	15,499	122	(68)	15,553	5.39 %
Municipals						
More than ten years	6,000	6,060	-	(337)	5,723	4.69 %
Other investments						
More than ten years	1,418	1,418	-	(3)	1,415	0.69 %
Total investment securities	$53,514	$53,994	$122	$(519)	$53,597	2.31 %

Loans

A management objective is to maintain the quality of the loan portfolio. The Company seeks to achieve this objective by maintaining rigorous underwriting standards coupled with regular evaluation of the creditworthiness of and the designation of lending limits for each borrower. The portfolio strategies include seeking industry and loan size diversification in order to minimize credit exposure and originating loans in markets with which the Company is familiar.

The Company's real estate loan portfolios, which represent approximately 90% of all loans, are secured by mortgages on real property located principally in the Commonwealth of Virginia. Sources of repayment are from the borrower's operating profits, cash flows and liquidation of pledged collateral. The Company's commercial loan portfolio represents approximately 9% of all loans. Loans in this category are typically made to individuals, small and medium-sized businesses and range between $250,000 and $2.5 million. Based on underwriting standards, commercial and industrial loans may be secured in whole or in part by collateral such as liquid assets, accounts receivable, equipment, inventory, and real property. The collateral securing any loan may depend on the type of loan and may vary in value based on market conditions. The remainder of our loan portfolio is in consumer loans which represent 1% of the total.

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The following tables present the composition of our loan portfolio at the dates indicated and maturities of selected loans at December 31, 2011.

Loan Portfolio, Net
(In thousands)

	December 31, 2011	2010	2009	2008	2007
Commercial	$37,734	$37,228	$41,201	$44,748	$25,229
Real estate - Construction, land development & other loans	80,527	90,773	118,128	145,081	136,458
Real estate - Commercial	168,796	173,227	161,501	152,096	92,891
Real estate - 1-4 Residential	135,948	146,647	139,101	121,020	68,525
Consumer	4,865	5,368	7,429	7,973	4,673
Total loans	427,870	453,243	467,360	470,918	327,776
Deferred loan cost (unearned income), net	768	624	209	(196)	(433)
Less: Allowance for loan losses	(16,071)	(7,312)	(10,522)	(6,059)	(3,469)
Total loans, net	$412,567	$446,555	$457,047	$464,663	$323,874

Maturities of Selected Loans
December 31, 2011
(In thousands)

		Fixed Rate			Variable Rate			
	Within 1 Year	1 to 5 Years	After 5 Years	Total	1 to 5 Years	After 5 Years	Total	Total Maturities
Commercial	$ 17,095	$ 13,463	$ 7,124	$ 20,587	$ 52	$ -	$ 52	$ 37,734
Real estate - Construction, land development & other loans	54,348	13,817	9,957	23,774	1,805	600	2,405	80,527
Real estate - Commercial	32,434	29,644	85,847	115,491	18,926	1,945	20,871	168,796
Real estate - 1-4 Residential	34,508	20,875	62,781	83,656	16,148	1,636	17,784	135,948
Consumer	1,548	2,664	309	2,973	96	248	344	4,865

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

- Risk rated 1 to 4 loans are considered of sufficient quality to preclude and adverse rating. 1-4 assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral;
- Risk rated 5 loans are defined as having potential weaknesses that deserve management’s close attention;

- Risk rated 6 loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledge, if any, and;
- Risk rated 7 loans have all the weaknesses inherent in substandard loans, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

Loans are considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing

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rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Allowance for loan losses

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

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

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

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

The allowance for loan losses was $16,071,000, $7,312,000 and $10,522,000 at December 31, 2011, 2010 and 2009, respectively. The ratio of the allowance for loan losses to gross loans was 3.75% at December 31, 2011, 1.61% at December 31, 2010, and 2.25% December 31, 2009. The allowance for loan losses as a percentage of net loans increased in 2011 to 3.75% primarily as a result of a decline in asset quality caused by the continued recessionary economy. The decrease in the allowance for loan losses in 2010 was primarily a result of significant charge-offs recognized during the year for which specific provisions for loan losses had been previously provided. We believe the amount of the allowance for loan losses at December 31, 2011 is adequate to absorb the losses that can reasonably be anticipated from the loan portfolio at that date.

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

Analysis of Allowance for Loan Losses
(In thousands)

	Year Ended December 31,				
	2011	2010	2009	2008	2007
Beginning balance	$7,312	$10,522	$6,059	$3,469	$2,553
Provision for loan losses	18,764	4,842	13,220	2,006	1,187
Charge-offs					
Commercial	(2,160)	(183)	(1,781)	(468)	(31)
Real estate - Construction, land development & other loans	(4,359)	(5,067)	(5,562)	(202)	(120)
Real estate - Commercial	(576)	(1,880)	(99)	(96)	-
Real estate - 1-4 Residential	(2,724)	(1,045)	(436)	(1,475)	(66)
Consumer	(249)	(191)	(889)	(2)	(54)
	(10,068)	(8,366)	(8,767)	(2,243)	(271)
Recoveries					
Commercial	3	2	-	7	-
Real estate - Construction, land development & other loans	19	187	3	2	-
Real estate - Commercial	-	121	-	-	-
Real estate - 1-4 Residential	39	2	-	395	-
Consumer	2	2	7	19	-
	63	314	10	423	-
Net charge-offs	(10,005)	(8,052)	(8,757)	(1,820)	(271)
Acquisition of River City Bank	-	-	-	2,404	-
Ending balance	$16,071	$7,312	$10,522	$6,059	$3,469
Loans outstanding at end of year(1)	$428,639	$453,867	$467,569	$470,722	$327,343
Ratio of allowance for loan losses as a percent of loans outstanding at end of year	3.75%	1.61%	2.25%	1.29%	1.06%
Average loans outstanding for the year(1)	$441,441	$463,365	$477,359	$374,221	$284,423
Ratio of net charge-offs to average loans outstanding for the year	2.27%	1.74%	1.83%	0.49%	0.10%

(1) Loans are net of unearned income.

Charge-offs increased from $8,366,000 in 2010 to $10,068,000 in 2011. Charge-offs continue to be primarily attributable to loans for real estate acquisition, development and construction in Chesterfield County, our primary lending market. The Company experienced an increase in commercial charge offs in 2011 as a result of defaults and restructuring of commercial loans. In addition, charge-offs related to 1-4 residential real estate loans have increased over the last three years as the residential real estate market has deteriorated in Chesterfield County. The elevated charge-off levels experienced in the last three years warrant the heightened level of provisioning and justify management's use of a higher historical charge-off factor when considering the losses currently inherent in the loan portfolio during the calculation of the allowance for loan losses.

We have allocated the allowance for loan losses according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within each of the categories of loans. The allocation of the allowance as shown in the table below should not be interpreted as an indication that losses in future years will occur in the same proportions or that the allocation indicates future loss trends. Furthermore, the portion allocated to each loan category is not the total amount

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available for future losses that might occur within such categories since the total allowance is a general allowance applicable to the entire portfolio.

Allocation of the Allowance for Loan Losses
(In thousands)

	December 31, 2011		December 31, 2010		December 31, 2009		December 31, 2008		December 31, 2007	
	Total	%	Total	%	Total	%	Total	%	Total	%
Commercial	$1,656	10.3 %	$1,316	18.0 %	$1,367	13.0 %	$671	11.1 %	$724	20.9 %
Real estate - Construction, land development and other loans	7,504	46.8 %	3,126	42.8 %	3,771	35.8 %	2,600	42.9 %	2,430	70.0 %
Real estate - Commercial	3,452	21.5 %	99	1.3 %	2,104	20.0 %	1,472	24.3 %	147	4.2 %
Real estate - 1-4 Residential	3,139	19.5 %	2,342	32.0 %	3,196	30.4 %	1,221	20.2 %	165	4.8 %
Consumer	320	2.0 %	429	5.9 %	84	0.8 %	95	1.6 %	3	0.1 %
Total	$16,071	100.0%	$7,312	100.0%	$10,522	100.0%	$6,059	100.0%	$3,469	100.0%

Construction, land development and other real estate loans receive the largest allocation of the allowance for loan losses as this type of loan represents the most risk of loss. Prior to 2009, charge-offs were not significant with the largest amount of $1,475,000 occurring in 2009 related to 1-4 residential real estate loans. For the last three years with the recessionary economy, charge-offs have increased significantly with the largest amounts related to construction, land development and other real estate loans which represented 43%, 61% and 63% of total charge-offs for 2011, 2010 and 2009, respectively.

Asset quality

The following table summarizes asset quality information at the dates indicated.

Asset Quality
(In thousands)

	December 31,				
	2011	2010	2009	2008	2007
Nonaccrual loans	$48,097	$20,324	$25,913	$8,528	$2,585
Foreclosed properties	9,177	12,028	11,279	2,932	270
Total nonperforming assets	$57,274	$32,352	$37,192	$11,460	$2,855
Restructured loans	$37,001	$21,695	$15,289	$-	$-
Loans past due 90 days and still accruing (not included in nonaccrual loans above)	$1,172	$315	$4,787	$6,197	$1,219

Nonperforming assets to loans at end of year(1)	13.39	%	7.14	%	7.95	%	2.43	%	0.87	%
Nonperforming assets to total assets	9.85	%	5.47	%	6.17	%	2.00	%	0.73	%
Allowance for loan losses to nonaccrual loans	33.4	%	36.0	%	40.6	%	71.0	%	134.2	%

(1) Loans are net of unearned income.

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The following table presents an analysis of the changes in nonperforming assets for 2011.

Nonperforming Assets
(In thousands)

	Nonaccrual Loans	Foreclosed Properties	Total
Balance December 31, 2010	20,324	12,028	32,352
Additions, net	43,272	160	43,432
Sales	-	(6,061)	(6,061)
Transfers	(3,621)	3,621	-
Repayments	(2,440)	-	(2,440)
Charge-offs	(9,438)	(571)	(10,009)
Balance December 31, 2011	$ 48,097	$ 9,177	$ 57,274

The significant increase in nonaccrual loans during 2011 was a result of defaults and restructuring of larger real estate loans related to land development and commercial real estate. Until a nonperforming restructured loan has performed in accordance with its restructured terms for a minimum of six months, it will remain on nonaccrual status.

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

Of the total nonaccrual loans of $48,097,000 at December 31, 2011 that were considered impaired, 47 loans totaling $20,034,000 had specific allowances for loan losses totaling $5,034,000. This compares to $20,324,000 in nonaccrual loans at December 31, 2010 of which five loans totaling $1,811,000 had specific allowances for loan losses of $330,000.

Cumulative interest income that would have been recorded had nonaccrual loans been performing would have been $2,377,000, $1,242,000 and $569,000 for 2011, 2010 and 2009, respectively. Nine loans totaling $1,172,000 at December 31, 2011 were past due 90 days or more and interest was still being accrued as such amounts were considered collectible.

Other real estate owned consists of assets acquired through or in lieu of foreclosure. $7,011,000 of the $9,177,000 at December 31, 2011 relates to loans previously classified as construction loans.

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Deposits

The following table gives the composition of our deposits at the dates indicated.

Deposits
(In thousands)

	December 31, 2011			December 31, 2010			December 31, 2009		
	Amount	%		Amount	%		Amount	%	
Demand accounts	$66,535	13.7	%	$41,036	8.2	%	$38,521	7.7	%
Interest checking accounts	40,237	8.3	%	33,292	6.7	%	36,441	7.3	%
Money market accounts	75,488	15.5	%	90,156	18.1	%	115,167	23.1	%
Savings accounts	15,166	3.1	%	10,538	2.1	%	8,901	1.8	%
Time deposits of $100,000 and over	129,436	26.7	%	140,847	28.2	%	119,352	24.0	%
Other time deposits	158,659	32.7	%	183,143	36.7	%	179,903	36.1	%
Total	$485,521	100.0	%	$499,012	100.0	%	$498,285	100.0	%

Total deposits decreased by 2.8% in 2011 and increased by 0.1% and 7% in 2010, 2009 respectively. Although total deposits did not decrease significantly in 2011, the composition did change. Transactional deposit accounts (demand, interest checking, money market and savings accounts) increased to 40.6% of total deposits compared to 35.1% at December 31, 2010. Most significantly, checking accounts (demand and interest bearing) increased from 14.9% of total deposits at December 31, 2010 to 22% at December 31, 2011. As our branch network has increased and is more convenient to a larger segment of our target customer base, we have experienced a move to a higher percentage of our deposits in checking accounts.

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

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

Average Deposits and Rates Paid
(In thousands)

	Year Ended December 31,								
	2011			2010			2009		
Account Type	Amount	Rate		Amount	Rate		Amount	Rate	
Noninterest-bearing demand accounts	$59,011			$44,495			$39,626		
Interest-bearing deposits									
Interest checking accounts	37,377	0.61	%	34,521	0.97	%	26,530	1.67	%
Money market accounts	86,859	0.67	%	98,762	1.09	%	69,267	1.79	%

Savings accounts	12,656	0.67	%	10,081	0.80	%	7,009	1.21	%
Time deposits of $100,000 and over	122,442	1.98	%	112,260	2.50	%	121,440	3.72	%
Other time deposits	188,193	2.04	%	202,945	2.36	%	226,258	3.60	%
Total interest-bearing deposits	447,527	1.60	%	458,569	1.98	%	450,504	3.20	%
Total average deposits	$506,538			$503,064			$490,130		

With short-term interest rates remaining at historic lows throughout 2011, we were able to significantly reduce the interest rates paid on deposits, particularly on longer term certificates of deposit, as higher rate certificates of deposit matured in 2011.

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The following table is a schedule of maturities for time deposits of $100,000 or more at December 31, 2011.

Maturities of Time Deposits of $100,000 or More
(In thousands)

Due within three months	$	6,318
Due after three months through six months		2,632
Due after six months through twelve months		7,341
Over twelve months		113,145
	$	129,436

The Dodd-Frank Act permanently raises the current standard maximum deposit insurance amount to $250,000. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category. The Emergency Economic Stabilization Act also temporarily raised the limit on federal deposit insurance coverage to an unlimited amount for non-interest or low-interest bearing demand deposits. Pursuant to the Dodd-Frank Act, unlimited coverage for non-interest transaction accounts will continue upon expiration of the Temporary Liquidity Guarantee Program until December 31, 2012.

Borrowings

We utilize borrowings to supplement deposits when they are available at a lower overall cost to us or they can be invested at a positive rate of return.

As a member of the Federal Home Loan Bank of Atlanta (“FHLB”), the Bank is required to own capital stock in the FHLB and is authorized to apply for borrowings from the FHLB. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses to which the advances may be put, as well as on the size of the advances and repayment provisions. Borrowings from the FHLB were $37,750,000 and $28,750,000 at December 31, 2011 and 2010 respectively. The FHLB advances are secured by the pledge of residential mortgage loans and our FHLB stock. Available borrowings at December 31, 2011 were approximately $10.8 million.

Federal funds purchased represent unsecured borrowings from other banks and generally mature daily. We did not have any purchased federal funds at December 31, 2011 or 2010.

Other borrowings increased by $1,614,000 from $4,165,000 at December 31, 2010 to $5,779,000 at December 31, 2011. These borrowings represent business checking accounts that bear interest and are secured by pledged securities.

Off-balance sheet arrangements

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve elements of credit risk and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contractual amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and letters of credit written is represented by the contractual amount of these instruments. The Company uses the same credit policies in making

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commitments and conditional obligations as it does for on-balance sheet instruments. Unless noted otherwise, the Company does not require collateral or other security to support financial instruments with credit risk.

At December 31, 2011, the Company had outstanding the following approximate off-balance-sheet financial instruments whose contract amounts represent credit risk:

	Contract Amount 2011	Contract Amount 2010
Undisbursed credit lines	$ 40,661,000	$ 43,683,000
Commitments to extend or originate credit	18,214,000	12,014,000
Standby letter of credit	3,719,000	3,543,000
Total commitments to extend credit	$ 62,594,000	$ 59,240,000

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being completely drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Capital resources

Stockholders' equity at December 31, 2011 was $36,248,000, compared to $48,320,000 at December 31, 2010 and $47,848,000 at December 31, 2009. On May 1, 2009, the Company received a $14,738,000 investment by the United States Department of the Treasury under its Capital Purchase Program (the TARP Program). The TARP Program is a voluntary program designed to provide capital for healthy banks to improve the flow of funds from banks to their customers. Under the TARP Program, the Company issued to the Treasury $14,738,000 of preferred stock and warrants to purchase 499,030 shares of the Company's common stock at a purchase price of $4.43 per share. The preferred stock issued by the Company under the TARP Capital Purchase Program carries a 5% dividend for each of the first 5 years of the investment, and 9% thereafter, unless the shares are redeemed by the Company. The decrease in equity in 2011 of $12,072,000 is primarily due to the loss from operations of $11,820,000. The increase in equity in 2010 of $472,000 is primarily due to net income of $1,430,000 offset by dividends paid to the U.S. Treasury on the TARP investment of $737,000.

During the first quarter of 2005, the Company issued $5.2 million in Trust Preferred Capital Notes to increase its regulatory capital and to help fund its expected growth in 2005. During the third quarter of 2007, the Company issued $3.6 million in Trust Preferred Capital Notes to partially fund the construction of an 80,000 square foot headquarters building completed in July 2008. The Trust Preferred Capital Notes may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion. See Note 16 of the Notes to Consolidated Financial Statements for a more detailed discussion of the Trust Preferred Capital Notes.

The Company is currently prohibited by its Memorandum of Understanding with the Reserve Bank from making dividend or interest payments on the TARP program preferred stock or trust preferred capital notes without prior regulatory approval. In addition, the Consent Order with the FDIC and BFI provides that the Bank will not pay any dividends, pay bonuses or make any other form of payment outside the ordinary course of business resulting in a reduction of capital, without regulatory approval. At December 31, 2011, the Bank had accrued but deferred payment on TARP dividend payments of $650,197 and interest payments on trust preferred capital notes of $317,129.

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The following table presents the composition of regulatory capital and the capital ratios at the dates indicated for the Company.

Analysis of Capital
(In thousands)

	As of December 31,		
	2011	2010	2009
Tier 1 capital			
Preferred stock	$59	$59	$59
Common stock	16,974	16,954	16,922
Additional paid-in capital	40,732	40,634	40,569
Retained earnings (deficit)	(21,896)	(9,193)	(9,741)
Warrant Surplus	732	732	732
Discount on preferred stock	(346)	(492)	(636)
Qualifying trust preferred securities	8,764	8,764	8,764
Less intangible assets	(491)	(589)	(687)
Disallowed Deferred tax asset	(2,125)	-	-
Total equity	42,403	56,869	56,669
Total Tier 1 capital	42,403	56,869	56,669
Tier 2 capital			
Allowance for loan losses	5,629	5,900	6,310
Total Tier 2 capital	5,629	5,900	6,310
Total risk-based capital	48,032	62,769	62,979
Risk-weighted assets	$439,873	$470,662	$501,864
Average assets	$578,330	$596,765	$615,184
Capital ratios			
Leverage ratio (Tier 1 capital to average assets)	7.33%	9.53%	9.21%
Tier 1 capital to risk-weighted assets	9.64%	12.08%	11.29%
Total capital to risk-weighted assets	10.92%	13.34%	12.55%
Equity to total assets	6.23%	8.17%	7.95%

Federal regulatory agencies are required by law to adopt regulations defining five capital tiers: well capitalized, adequately capitalized, under capitalized, significantly under capitalized, and critically under capitalized. The Bank met the criteria to be categorized as a "well capitalized" institution as of December 31, 2011, 2010 and 2009. However, due to the Consent Order the Bank currently is considered adequately capitalized. In addition, the Consent Order requires the Bank to maintain a leverage ratio of at least 8% and a total capital to risk-weighted assets ratio of at least 11%. At December 31, 2011, the Bank's leverage ratio was 6.46% and the total capital to risk-weighted assets ratio was 10.26%. Under the Consent Order, the Bank must provide a capital plan to the FDIC and BFI that demonstrates how the Bank will come into compliance with the required minimum capital ratios set forth in the Consent Order. When capital falls below the "well capitalized" requirement, consequences can include: new branch approval could be withheld; more frequent examinations by the FDIC; brokered deposits cannot be renewed without a waiver from the FDIC; and other potential limitations as described in FDIC Rules and Regulations sections 337.6 and 303, and FDIC Act section 29. In addition, the FDIC insurance assessment increases when an institution falls below the "well capitalized" classification.

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Liquidity

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

At December 31, 2011 and 2010, our liquid assets, consisting of cash, cash equivalents and investment securities available-for-sale, totaled $92,949,000 and $65,609,000, or 15.9% and 11.1% of total assets, respectively. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, approximately $9,612,000 of these securities are pledged against borrowings. Therefore, the related borrowings would need to be repaid prior to the securities being sold in order for these securities to be converted to cash.

Our holdings of liquid assets plus the ability to maintain and expand our deposit base and borrowing capabilities serve as our principal sources of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain two federal funds lines of credit with correspondent banks totaling $22 million for which there were no borrowings against the lines at December 31, 2011.

We are also a member of the Federal Home Loan Bank of Atlanta (FHLB), from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at December 31, 2011 was $10,800,000, based on the Bank's $2,647,000 investment in FHLB stock, as well as qualifying mortgages available to secure any future borrowings. However, we are able to pledge additional securities to the FHLB in order to increase our available borrowing capacity. Liquidity provides us with the ability to meet normal deposit withdrawals, while also providing for the credit needs of customers. We are committed to maintaining liquidity at a level sufficient to protect depositors, provide for reasonable growth, and fully comply with all regulatory requirements.

At December 31, 2011, we had commitments to originate $62,594,000 of loans. Fixed commitments to incur capital expenditures were less than $25,000 at December 31, 2011. Certificates of deposit scheduled to mature or reprice in the 12-month period ending December 31, 2012 total $144,044,000. We believe that a significant portion of such deposits will remain with us. We further believe that deposit growth, loan repayments and other sources of funds will be adequate to meet our foreseeable short-term and long-term liquidity needs.

Interest Rate Sensitivity

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

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

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

The data in the following table reflects repricing or expected maturities of various assets and liabilities at December 31, 2011. The gap analysis represents the difference between interest-sensitive assets and liabilities in a specific time interval. Interest sensitivity gap analysis presents a position that existed at one particular point in time, and assumes that assets and liabilities with similar repricing characteristics will reprice at the same time and to the same degree.

Interest Rate Sensitivity GAP Analysis
December 31, 2011
(In thousands)

	Within 3 Months	3 to 6 Months	6 to 12 Months	13 to 36 Months	More than 36 Months	Total
Interest Rate Sensitive Assets						
Loans (1)						
Fixed rate	$25,066	$13,261	$20,008	$32,284	$102,543	$193,162
Variable rate	97,946	4,669	15,979	28,123	87,992	234,709
Investment securities	-	12	-	-	30,151	30,163
Loans held for sale	16,168	-	-	-	-	16,168
Federal funds sold	7,228	-	-	-	-	7,228
Total rate sensitive assets	146,408	17,942	35,987	60,407	220,686	481,430
Cumulative rate sensitive assets	146,408	164,350	200,337	260,744	481,430	
Interest Rate Sensitive Liabilities						
Interest checking (2)	-	-	-	40,237	-	40,237
Money market accounts	75,488	-	-	-	-	75,488
Savings (2)	-	-	-	15,166	-	15,166
Certificates of deposit	37,017	31,435	75,592	75,508	68,543	288,095
FHLB advances	1,000	7,750	1,000	18,000	10,000	37,750
Trust Preferred Securities	-	-	-		8,764	8,764
Other borrowings	5,779	-	-	-	-	5,779
Total rate sensitive liabilities	119,284	39,185	76,592	148,911	87,307	471,279
Cumulative rate sensitive liabilities	119,284	158,469	235,061	383,972	471,279	
Rate sensitivity gap for period	$27,124	$(21,243)	$(40,605)	$(88,504)	$133,379	$10,151
	$27,124	$5,881	$(34,724)	$(123,228)	$10,151	

Cumulative rate sensitivity gap										
Ratio of cumulative gap to total assets	4.6	%	1.0	%	(5.9	)%	(21.0	)%	1.7	%
Ratio of cumulative rate sensitive assets to cumulative rate sensitive liabilities	122.7	%	103.7	%	85.2	%	67.9	%	102.2	%
Ratio of cumulative gap to cumulative rate sensitive assets	18.5	%	3.6	%	(17.3	)%	(47.3	)%	2.1	%

(1) Includes nonaccrual loans of approximately $48,097,000, which are spread throughout the categories.
(2) Management believes that interest checking and savings accounts are generally not sensitive to changes in interest rates and therefore has placed such deposits in the "13 to 36 months" category.

At December 31, 2011, our balance sheet is asset sensitive for the next six months, meaning that our assets reprice more quickly than our liabilities during that period, and liability sensitive for the next six to thirty-six months, meaning that our liabilities will reprice more quickly than our assets during that period and asset sensitive after thirty-six months with a ratio of cumulative gap to total assets ranging from a positive gap of 5.8% for the first three months to a negative gap of (19.9)% for

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the thirteen to thirty-six month period. A negative gap can adversely affect earnings in periods of increasing interest rates. Given the Federal Reserve's recent announcement that it will maintain short-term interest rates at current levels until the end of 2014, we do not expect interest rates to increase for the foreseeable future. However, we believe our balance sheet should be asset sensitive and, accordingly, we have adopted pricing policies to lengthen the maturities/repricing of our liabilities relative to the maturities/pricing of our assets.

Critical Accounting Policies

General

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

The more critical accounting and reporting policies include the Company's accounting for the allowance for loan losses, real estate acquired in settlement of loans, goodwill and income taxes. The Company's accounting policies are fundamental to understanding the Company's consolidated financial position and consolidated results of operations. Accordingly, the Company's significant accounting policies are discussed in detail in Note 1 of the Notes to Consolidated Financial Statements.

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

Allowance for loan losses

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

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

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

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

Troubled debt restructurings

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

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

Real estate acquired in settlement of loans

Real estate acquired in settlement of loans represent properties acquired through foreclosure or physical possession. Write-downs to fair value of foreclosed assets at the time of transfer are charged to allowance for loan losses. Subsequent to foreclosure, the Company periodically evaluates the value of foreclosed assets held for sale and records an impairment charge for any subsequent declines in fair value less selling costs. Subsequent declines in value are charged to operations. Fair value is based on an assessment of information available at the end of a reporting period and depends upon a number of factors, including historical experience, economic conditions, and issues specific to individual properties. The evaluation of these factors involves subjective estimates and judgments that may change.

Goodwill

Goodwill represents the cost in excess of the fair value of net assets acquired (including identifiable intangibles) in transactions accounted for as business combinations. Goodwill has an indefinite useful life and is evaluated for impairment annually or more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. The goodwill impairment analysis is a two-step test. The first, used to identify potential impairment, involves comparing each reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of a reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds

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estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. If required, the second step involves calculating an implied fair value of goodwill for each reporting unit for which the first step indicated impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to a reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. The Company's annual goodwill impairment evaluation in 2009 resulted in a goodwill impairment charge of $7,422,000 which was recorded to noninterest expense for the year ended December 31, 2009. Of the total $7,422,000 in goodwill, $6,733,000 related to the acquisition of River City Bank and $689,000 related to the acquisition of the mortgage company. This impairment charge, representing the full amount of goodwill on the consolidated balance sheet, was primarily due to a significant decline in the market value of the Company's common stock during 2009 to below tangible book value for an extended period of time. Other intangible assets include premiums paid for acquisitions of core deposits and other identifiable intangible assets. Intangible assets other than goodwill, which are determined to have finite lives, are amortized based upon the estimated economic benefits received.

Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established. Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if management projects lower levels of future taxable income. Management determined that as of December 31, 2011, the objective negative evidence represented by the Company's recent losses outweighed the more subjective positive evidence and, as a result, recognized a valuation allowance of $3,929,000 on its net deferred tax asset.

New accounting standards

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures, amending Topic 820. The ASU provides for additional disclosures of transfers between assets and liabilities valued under Level 1 and 2 inputs as well as additional disclosures regarding those assets and liabilities valued under Level 3 inputs. The new disclosures are effective for interim and annual reporting periods beginning after December 15, 2009 except for those provisions addressing Level 3 fair value measurements which provisions are effective for fiscal years, and periods therein, beginning after December 15, 2010. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

New authoritative accounting guidance under ASC Topic 860, "Transfers and Servicing," amended prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new authoritative accounting guidance eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing

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involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative accounting guidance under ASC Topic 860 became effective January 1, 2010 and did not have a significant impact on the Company's consolidated financial statements.

In July 2010, The FASB issued ASU No. 2010-20, Receivables - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, Topic 830. This ASU requires entities to provide disclosures designed to facilitate financial statement users' evaluation of(i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 will be effective for the Company's consolidated financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period will be required for the Company's consolidated financial statements that include periods beginning on or after January 1, 2011. This ASU requires additional disclosures only and will not have an impact on the Company's consolidated financial statements. See Notes 3 and 4 of the Notes to Consolidated Financial Statements for these additional disclosures.

In April 2011, the FASB issued ASU 2011-02, A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. This update to codification topic 310 provides guidance for what constitutes a concession and whether a debtor is experiencing financial difficulties. The amendments in this update were effective for The Company on July 1, 2011, with retrospective application from January 1, 2011. This update did not have a material effect on The Company's consolidated financial statements.

In June 2011, The FASB issued ASU No. 2011-05, Presentation of Comprehensive Income, Topic 220. This ASU eliminates the option of presenting the components of other comprehensive income (OCI) as part of the statement of changes in stockholders' equity. The ASU instead permits an entity to present the total of comprehensive income, the components of net income, and the components of OCI either in a single continuous statement of comprehensive income or in two separate but consecutive statements. With either format, the entity is required to present each component of net income along with total net income, each component of OCI along with the total for OCI, and a total amount for comprehensive income. Also, the ASU requires entities to present, for either format, reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. This ASU is to be applied retrospectively. For public entities, the ASU is effective for interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. Early adoption is permitted, since compliance with the amendments is already permitted.

Impact of inflation and changing prices

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

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general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

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Report of Independent Registered Public Accounting Firm

Board of Directors
Village Bank and Trust Financial Corp.
Midlothian, Virginia

We have audited the accompanying consolidated balance sheets of Village Bank and Trust Financial Corp. and Subsidiary as of December 31, 2011 and 2010, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Village Bank and Trust Financial Corp. and Subsidiary as of December 31, 2011 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA, LLP

Richmond, Virginia
March 30, 2011

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Balance Sheets
December 31, 2011 and 2010

	2011	2010
Assets		
Cash and due from banks	$ 55,557,541	$ 9,390,377
Federal funds sold	7,228,475	2,621,934
Total cash and cash equivalents	62,786,016	12,012,311
Investment securities available for sale	30,163,292	53,597,174
Loans held for sale	16,168,405	19,871,787
Loans		
Outstandings	427,870,716	453,242,950
Allowance for loan losses	(16,071,424)	(7,311,712)
Deferred fees and costs	767,775	623,851
	412,567,067	446,555,089
Premises and equipment, net	26,826,524	27,437,452
Accrued interest receivable	2,046,524	2,347,211
Bank owned life insurance	6,065,305	5,871,765
Other real estate owned	9,177,167	12,028,111
Other assets	15,904,019	12,058,315
	$ 581,704,319	$ 591,779,215
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest bearing demand	$ 66,534,956	$ 41,036,262
Interest bearing	418,986,096	457,975,931
Total deposits	485,521,052	499,012,193
Federal Home Loan Bank advances	37,750,000	28,750,000
Long-term debt - trust preferred securities	8,764,000	8,764,000
Other borrowings	5,778,661	4,165,430
Accrued interest payable	592,283	404,801
Other liabilities	7,050,681	2,362,597
Total liabilities	545,456,677	543,459,021
Stockholders' equity		
Preferred stock, $4 par value, $1,000 liquidation preference, 1,000,000 shares authorized, 14,738 shares issued and outstanding	58,952	58,952

Common stock, $4 par value - 10,000,000 shares authorized; 4,243,378 shares issued and outstanding at December 31, 2011 4,238,416 shares issued and outstanding at December 31, 2010		16,973,512		16,953,664
Additional paid-in capital		40,732,178		40,633,581
Retained earnings (deficit)		(21,895,557)		(9,192,552)
Common stock warrant		732,479		732,479
Discount on preferred stock		(346,473)		(492,456)
Accumulated other comprehensive loss		(7,449)		(373,474)
Total stockholders' equity		36,247,642		48,320,194
	$	581,704,319	$	591,779,215

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Operations
Years Ended December 31, 2011, 2010 and 2009

	2011	2010	2009
Interest income			
Loans	$ 26,580,965	$ 29,040,137	$ 31,711,644
Investment securities	1,308,727	1,086,963	1,457,694
Federal funds sold	90,806	54,738	26,635
Total interest income	27,980,498	30,181,838	33,195,973
Interest expense			
Deposits	7,165,169	9,097,177	14,433,943
Borrowed funds	1,180,734	1,788,236	1,973,736
Total interest expense	8,345,903	10,885,413	16,407,679
Net interest income	19,634,595	19,296,425	16,788,294
Provision for loan losses	18,764,295	4,842,000	13,220,000
Net interest income after provision for loan losses	870,300	14,454,425	3,568,294
Noninterest income			
Service charges and fees	1,942,721	1,865,190	1,612,769
Gain on sale of loans	6,522,848	7,003,873	5,828,006
Gain (loss) on sale of assets	(407)	243,566	(43,637)
Gain on sale of investment securities	1,217,554	768,551	329,183
Rental income	706,078	464,792	187,786
Other	454,987	644,695	370,993
Total noninterest income	10,843,781	10,990,667	8,285,100
Noninterest expense			
Salaries and benefits	12,625,396	12,337,065	10,476,065
Occupancy	2,112,072	1,931,334	1,757,939
Equipment	891,412	847,536	877,205
Supplies	428,011	501,928	495,562
Professional and outside services	2,425,347	2,028,225	1,726,130
Advertising and marketing	416,963	492,423	308,598
Expenses related to foreclosed real estate	1,413,961	1,693,524	1,475,338
FDIC insurance premium	1,002,226	1,168,830	1,366,612
Other operating expense	2,645,687	2,302,291	2,432,286
Goodwill impairment			7,422,141
Total noninterest expense	23,961,075	23,303,156	28,337,876
Net income (loss) before income taxes	(12,246,994)	2,141,936	(16,484,482)
Income tax expense (benefit)	(426,872)	711,627	(3,879,386)

Net income (loss)		(11,820,122)		1,430,309		(12,605,096)
Preferred stock dividends and amortization of discount		882,882		881,402		590,151
Net income (loss) available to common shareholders	$	(12,703,004)	$	548,907	$	(13,195,247)
Earnings (loss) per share, basic	$	(2.99)	$	0.13	$	(3.12)
Earnings (loss) per share, diluted	$	(2.99)	$	0.13	$	(3.12)

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2011, 2010 and 2009

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Warrant	Discount on Preferred Stock	Accumulated Other Comprehensive Income (loss)	Total
Balance, December 31, 2008	$-	$16,917,488	$25,737,048	$3,453,788	$-	$-	$54,250	$46,162,574
Issuance of preferred stock	58,952	-	14,679,048	-	732,479	(732,479)	-	14,738,000
Amortization of preferred stock discount	-	-	-	(95,520)	-	95,520	-	-
Preferred stock dividend	-	-	-	(494,631)	-	-	-	(494,631)
Issuance of common stock	-	5,024	(5,024)	-	-	-	-	-
Stock based compensation	-	-	157,699	-	-	-	-	157,699
Minimum pension adjustment (net of income taxes of $2,917)	-	-	-	-	-	-	8,580	8,580
Net loss	-	-	-	(12,605,096)	-	-	-	(12,605,096)
Change in unrealized gain on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	(119,035)	(119,035)
Total comprehensive loss	-	-	-	-	-	-	-	(12,715,551)
Balance, December 31, 2009	58,952	16,922,512	40,568,771	(9,741,459)	732,479	(636,959)	(56,205)	47,848,091

Amortization of preferred stock discount	-	-	-	(144,503)	-	144,503	-	-
Preferred stock dividend	-	-	-	(736,899)	-	-	-	(736,899)
Issuance of common stock	-	31,152	(31,152)	-	-	-	-	-
Stock based compensation	-	-	95,962	-	-	-	-	95,962
Minimum pension adjustment (net of income taxes of $2,917)	-	-	-	-	-	-	8,580	8,580
Net income	-	-	-	1,430,309	-	-	-	1,430,309
Change in unrealized gain on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	(325,849)	(325,849)
Total comprehensive income	-	-	-	-	-	-	-	1,113,040
Balance, December 31, 2010	58,952	16,953,664	40,633,581	(9,192,552)	732,479	(492,456)	(373,474)	48,320,194
Amortization of preferred stock discount	-	-	-	(145,983)	-	145,983	-	-
Preferred stock dividend	-	-	-	(736,900)	-	-	-	(736,900)
Issuance of common stock	-	19,848	(19,848)	-	-	-	-	-
Stock based compensation	-	-	118,445	-	-	-	-	118,445
Minimum pension adjustment (net of income taxes of $2,917)	-	-	-	-	-	-	8,580	8,580
Net income	-	-	-	(11,820,122)	-	-	-	(11,820,122)

Change in unrealized gain on investment securities available-for-sale, net of reclassification and tax effect	-	-	-	-	-	-	357,445	357,445
Total comprehensive loss	-	-	-	-	-	-	-	(11,454,097)
Balance, December 31, 2011	$58,952	$16,973,512	$40,732,178	$(21,895,557)	$732,479	$(346,473)	$(7,449)	$36,247,642

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary
Consolidated Statements of Cash Flows
Years Ended December 31, 2011 2010 and 2009

	2011	2010	2009
Cash Flows from Operating Activities			
Net income (loss)	$(11,820,122)	$1,430,309	$(12,605,096)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,418,393	1,308,770	1,250,315
Deferred income taxes	(4,139,276)	(3,718,495)	(3,031,268)
Valuation allowance	3,928,886	-	-
Provision for loan losses	18,764,295	4,842,000	13,220,000
Write-down of other real estate owned	571,331	294,000	1,329,991
Write-off of goodwill		-	7,422,141
Gain on securities sold	(1,217,149)	(768,551)	(329,183)
Gain on loans sold	(6,522,848)	(7,003,873)	(5,828,006)
Gain on sale of premises and equipment	407	(242,936)	43,353
(Gain) loss on sale of other real estate owned	266,729	96,595	(46,173)
Stock compensation expense	118,445	95,962	157,699
Proceeds from sale of mortgage loans	248,108,754	279,387,475	255,007,702
Origination of mortgage loans for sale	(237,882,524)	(284,749,137)	(252,360,202)
Amortization of premiums and accrection of discounts on securities, net	169,804	416,619	337,251
(Increase) decrease in interest receivable	300,687	1,019,507	133,075
Increase in bank owned life insurance	(193,540)	(440,763)	(331,980)
(Increase) decrease in other assets	(3,810,873)	5,882,742	(5,554,084)
Increase (decrease) in interest payable	187,481	(96,268)	(513,465)
Increase (decrease) in other liabilities	4,135,410	(402,954)	1,493,607
Net cash provided by (used in) operating activities	12,384,290	(2,648,998)	(204,323)
Cash Flows from Investing Activities			
Purchases of available for sale securities	(80,991,271)	(52,283,980)	(46,117,779)
Proceeds from the sale or calls of available for sale securities	102,116,301	51,122,666	15,373,106
Proceeds from maturities and principal payments of available for sale securities	3,897,780	2,279,573	-
Net decrease (increase) in loans	11,442,522	(1,448,154)	(18,109,329)
Proceeds from sale of other real estate owned	5,794,090	5,957,507	2,875,478
Purchases of premises and equipment	(807,872)	(1,081,523)	(1,023,928)
Proceeds from sale of premises and equipment	-	377,321	104,693
Net cash provided by (used in) investing activities	41,451,550	4,923,410	(46,897,759)
Cash Flows from Financing Activities			
Issuance of preferred stock			14,738,000
Net increase (decrease) in deposits	(13,491,141)	727,069	32,053,081
Net increase (decrease) in Federal Home Loan Bank Advances	9,000,000	(250,000)	4,000,000
Net increase (decrease) in other borrowings	1,613,231	(10,664,091)	(9,133,377)
Dividends on preferred stock	(184,225)	(736,899)	(494,631)
Net cash provided by (used in) financing activities	(3,062,135)	(10,923,921)	41,163,073

Net increase (decrease) in cash and cash equivalents	50,773,705	(8,649,509)	(5,939,009)
Cash and cash equivalents, beginning of period	12,012,311	20,661,820	26,600,829
Cash and cash equivalents, end of period	$62,786,016	$12,012,311	$20,661,820
Supplemental Schedule of Non Cash Activities			
Real estate owned assets acquired in settlement of loans	$3,781,206	$7,097,681	$12,505,727
Dividends on preferred stock accrued	$552,674	$-	$-

See accompanying notes to consolidated financial statements.

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Village Bank and Trust Financial Corp. and Subsidiary
Notes to Consolidated Financial Statements
Years Ended December 31, 2011, 2010 and 2009

Note 1. Summary of Significant Accounting Policies

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

Business
The Company is the holding company of and successor to the Village Bank (the "Bank"). Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction. In the transaction, the shares of the Bank's common stock were exchanged for shares of the Company's common stock, par value $4.00 per share ("Common Stock"), on a one-for-one basis. As a result, the Bank became a wholly owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company.

The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Bank acquired or formed three wholly owned subsidiaries, Village Bank Mortgage Corporation ("Village Mortgage"), a full service mortgage banking company, Village Insurance Agency, Inc. ("Village Insurance"), a full service property and casualty insurance agency, and Village Financial Services Corporation ("Village Financial Services"), a financial services company. Through these subsidiaries, the Bank provides a broad array of financial services to its customers.

On October 14, 2008, the Company completed its merger with River City Bank pursuant to an Agreement and Plan of Reorganization and Merger, dated as of March 9, 2008, by and among the Company, the Bank and River City Bank.

The Company is subject to intense competition from existing bank holding companies, commercial banks and savings banks which have been in business for many years and have established customer bases. Competition also comes from a variety of other non-bank businesses that offer financial services. Many of these competitors operate in the same geographic market where the Company operates, are well-known with long-standing relationships with businesses and individuals in the communities, and are substantially larger with greater resources than the Company.

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

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

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Basis of Presentation and Consolidation

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

Use of estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the statements of financial condition and revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses and the related provision.

Investment securities

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

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

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

Loans held for sale

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

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Residential mortgage loans held for sale are sold to the permanent investor with the mortgage servicing rights released. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

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

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

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

At December 31, 2011, Village Bank Mortgage Company had rate lock commitments to originate mortgage loans aggregating $18.0 million and loans held for sale of $16.2 million. VBMC has entered into corresponding commitments with third party investors to sell loans of approximately $34.2 million. Under the best efforts contractual relationship with these investors, VBMC is obligated to sell the loans, and the investor is obligated to purchase the loans, only if the loans close. No other obligation exists. As a result of these best efforts contractual relationships with these investors VBMC is not exposed to losses, nor will it realize gains, related to its rate lock commitments due to changes in interest rates.

Transfers of financial assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Bank and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets. Our transfers of financial assets are limited to commercial loan participations sold, which were insignificant for 2011, 2010 and 2009, and the sale of residential mortgage loans in the secondary market; the extent of which are disclosed in the Consolidated Statements of Cash Flows.

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

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

Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The total contract amount of standby letters of credit, whose contract amount represent credit risk was $3,719,000 at December 31, 2011 and $3,543,000 at December 31, 2010.

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

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

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

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment

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delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Troubled debt restructurings

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

Real estate acquired in settlement of loans

Real estate acquired through or in lieu of foreclosure is initially recorded at estimated fair value less estimated selling costs. Subsequent to the date of acquisition, it is carried at the lower of cost or fair value, adjusted for net selling costs. Fair values of real estate owned are reviewed regularly and write downs are recorded when it is determined that the carrying value of real estate exceeds the fair value less estimated costs to sell. Costs relating to the development and improvement of such property are capitalized when appropriate, whereas those costs relating to holding the property are expensed.

Premises and equipment

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

Goodwill

Goodwill represents the cost in excess of the fair value of net assets acquired (including identifiable intangibles) in transactions accounted for as business combinations. Goodwill has an indefinite useful life and is evaluated for impairment annually, or more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. The goodwill impairment analysis is a two-step test. The first, used to identify potential impairment, involves comparing each reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of a reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. If required, the second step involves calculating an implied fair value of goodwill for each reporting unit for which the first step indicated impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business

combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to a reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess.

The Company's annual goodwill impairment evaluation in 2009 resulted in a goodwill impairment charge of $7,422,000 which was recorded to noninterest expense for the year ended December 31, 2009. Of the total $7,422,000 in goodwill, $6,733,000 related to the acquisition of River City Bank and $689,000 related to the acquisition of the mortgage company. This impairment charge, representing the full amount of goodwill on the consolidated balance sheet, was primarily due to a significant decline in the market value of the Company's common stock during 2009 to below tangible book value for an extended period of time. Other intangible assets include premiums paid for acquisitions of core deposits and other identifiable intangible assets. Intangible assets other than goodwill, which are determined to have finite lives, are amortized based upon the estimated economic benefits received.

Income taxes

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

Consolidated statements of cash flows

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, due from banks (including cash items in process of collection), interest-bearing deposits with banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods. Cash flows from loans originated by the Bank and deposits are reported net. The Company paid interest of $8,158,000, $10,982,000 and $16,921,000 in 2011, 2010, and 2009, respectively. The Company did not pay income taxes in 2011 and 2010 and paid $290,000 in 2009. The Company received a refund of $290,000 in 2010 related to taxes paid in 2009.

Comprehensive income

Comprehensive income is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. Total comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). The Company's other comprehensive income (loss) and accumulated other comprehensive income (loss) are comprised of unrealized gains and losses on investment securities available for sale and amortization of the unfunded pension liability. At December 31, 2011 the accumulated other comprehensive income was comprised of unrealized gains on securities available for sale of $95,458 and unfunded pension liability of $102,907.

Earnings per common share

Basic earnings (loss) per common share represent net income available to common stockholders, which represents net income (loss) less dividends paid or payable to preferred stock shareholders, divided by the weighted-average number of common shares outstanding during the period. For diluted earnings per common share, net income available to common shareholders is divided by the

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

Stock incentive plan
The Company's shareholders approved the Company's 2000 stock incentive plan which authorizes the issuance of up to 455,000 shares of common stock (increased from 255,000 shares by amendment to the Incentive Plan approved by the Company's shareholders) to assist the Company in recruiting and retaining key personnel. The incentive plan includes issuances of stock options and awards of 444,590 common shares. The expiration date on options granted is ten years with a three year vesting schedule. See Note 15 for more information on the stock incentive plan.

Fair values of financial instruments
The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are independent, knowledgeable, able to transact and willing to transact. See Note 18 for the methods and assumptions the Bank uses in estimating fair values of financial instruments:

New accounting pronouncements
In January 2010, the FASB issued ASU No. 2010-06- Fair Value Measurements and Disclosures amending Topic 820. The ASU provides for additional disclosures of transfers between assets and liabilities valued under Level 1 and 2 inputs as well as additional disclosures regarding those assets and liabilities valued under Level 3 inputs. The new disclosures became effective for interim and annual reporting periods beginning after December 15, 2009 except for those provisions addressing Level 3 fair value measurements which provisions are effective for fiscal years, and periods therein, beginning in 2011. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

In July 2010, The FASB issued ASU No. 2010-20, Receivables - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, Topic 830. This ASU requires entities to provide disclosures designed to facilitate financial statement users' evaluation of(i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 became effective for the Company's consolidated financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting

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period became required for the Company's consolidated financial statements for periods beginning on in 2011. This ASU requires additional disclosures only and did not have an impact on the Company's consolidated financial statements

In January 2011, the FASB issued ASC Update 2011-01, Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20. This update temporarily delays the effective date of the disclosures about troubled debt restructuring postponed the effective date of the disclosures about troubled debt restructuring in ASU 2010-20 for public companies. The delay is intended to allow FASB to complete its deliberations on what constitutes a troubled debt restructuring. The guidance on both disclosures about troubled debt restructuring and determining what constitutes a troubled debt restructuring will be coordinated and is anticipated to be issued for interim and annual periods after June 15, 2011.

In April 2011, the FASB issued ASU 2011-02, A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. This update to codification topic 310 provides guidance for what constitutes a concession and whether a debtor is experiencing financial difficulties. The amendments in this update were effective for The Company on July 1, 2011, with retrospective application from January 1, 2011. This update did not have a material effect on The Company's consolidated financial statements.

In June 2011, The FASB issued ASU No. 2011-05, Presentation of Comprehensive Income, Topic 220. This ASU eliminates the option of presenting the components of other comprehensive income (OCI) as part of the statement of changes in stockholders' equity. The ASU instead permits an entity to present the total of comprehensive income, the components of net income, and the components of OCI either in a single continuous statement of comprehensive income or in two separate but consecutive statements. With either format, the entity is required to present each component of net income along with total net income, each component of OCI along with the total for OCI, and a total amount for comprehensive income. Also, the ASU requires entities to present, for either format, reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. This ASU is to be applied retrospectively. The ASU is effective for interim and annual periods beginning in 2012. Early adoption is permitted, since compliance with the amendments is already permitted.

Note 2. Investment securities available-for-sale

The amortized cost and estimated fair value of investment securities available-for-sale as of December 31, 2011 and 2010 are as follows:

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	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2011				
U.S. Government agencies	$2,000,000	$733	$-	$2,000,733
Mortgage-backed securities	20,632,756	220,322	(49,005)	20,804,073
Small Business Administration	7,385,903	-	(27,417)	7,358,486
Total	$30,018,659	$221,055	$(76,422)	$30,163,292
December 31, 2010				
U.S. Treasuries	$28,017,617	$191	$(291)	$28,017,517
U.S. Government agencies	3,000,000	-	(110,708)	2,889,292
Mortgage-backed securities	15,498,544	121,888	(68,046)	15,552,386
Municipals	6,060,000	-	(337,431)	5,722,569
Small Business Administration	1,417,962		(2,552)	1,415,410
Total	$53,994,123	$122,079	$(519,028)	$53,597,174

Investment securities with book values of approximately $9,612,000 and $4,835,000 at December 31, 2011 and 2010, respectively, were pledged to secure municipal deposits.

Gross gains and losses pertaining to available for sale securities are detailed as follows:

	December 31, 2011	2010	2009
Gross realized gains	1,232,584	773,826	329,183
Gross realized losses	(15,030)	(5,275)	-
	1,217,554	768,551	329,183

Investment securities available for sale that have an unrealized loss position at December 31, 2011 and December 31, 2010 are detailed below:

	Securities in a Loss Position for Less Than 12 Months		Securities in a Loss Position for More Than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(In thousands)			
December 31, 2011						
US Treasuries	$7,358	$(27)	$-	$-	$7,358	$(27)
Mortgage-backed securities	10,221	(47)	205	(2)	10,426	(49)
Total	$10,221	$(74)	$205	$(2)	$10,426	$(76)

December 31, 2010						
US Treasuries	$30,286	$(114)	$-	$-	$30,286	$(114)
Mortgage-backed securities	7,079	(68)	-	-	7,079	(68)
Municipals	5,723	(337)	-	-	5,723	(337)
Total	$43,088	$(519)	$-	$-	$43,088	$(519)

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Management does not believe that any individual unrealized loss as of December 31, 2011 is other than a temporary impairment. These unrealized losses are primarily attributable to changes in interest rates. As of December 31, 2011, management does not have the intent to sell any of the securities classified as available for sale and management believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

The amortized cost and estimated fair value of investment securities available-for-sale as of December 31, 2011, by contractual maturity, are as follows:

	Amortized Cost	Estimated Fair Value
One to five years	$ 11,893	$ 11,578
Five to ten years	2,000,000	2,000,733
More than ten years	28,006,766	28,150,981
Total	$ 30,018,659	$ 30,163,292

During 2011 and 2010, investment securities available-for-sale totaling $42,000 and $17,530,000 respectively, were called or matured with no net losses.

Note 3. Loans

Loans classified by type as of December 31, 2011 and 2010 are as follows:

	2011	2010
Commercial	$ 37,734,516	$ 37,227,599
Real estate - Construction, land development & other loans	80,527,002	90,773,214
Real estate - Commercial	168,795,606	173,227,491
Real estate - 1-4 Residential	135,948,087	146,646,780
Consumer	4,865,505	5,367,866
Total loans	427,870,716	453,242,950
Deferred loan cost (unearned income), net	767,775	623,851
Less: Allowance for loan losses	(16,071,424)	(7,311,712)
	$ 412,567,067	$ 446,555,089

Gains on the sale of loans totaling approximately $6,523,000, $7,004,000 and $5,828,000 were realized during the years ended December 31, 2011, 2010 and 2009, respectively.

Gross loans pledged as collateral with the FHLB as part of their lending arrangements with the Company totaled $38,750,000 and $28,750,000 as of December 31, 2011 and 2010, respectively.

The following is a summary of loans directly or indirectly with executive officers or directors of the Company for the years ended December 31, 2011 and 2010:

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		2011		2010
Beginning balance	$	11,108,283	$	9,724,791
Additions		3,221,846		7,800,850
Reductions		(4,943,700)		(6,417,358)
Ending balance	$	9,386,430	$	11,108,283

Executive officers and directors also had unused credit lines totaling $1,752,000 and $1,772,000 at December 31, 2011 and 2010, respectively. All loans and credit lines to executive officers and directors were made in the ordinary course of business at the Company's normal credit terms, including interest rate and collateralization prevailing at the time for comparable transactions with other persons.

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

Year-end nonaccrual loans, segregated by class of loans, were as follows:

		2011		2010
Commercial	$	1,246,437	$	3,401,381
Real estate - Construction, land development & other loans		19,920,190		6,631,608
Real estate - Commercial		15,316,663		4,283,204
Real estate - 1-4 Residential		11,203,351		5,728,804
Consumer		410,407		278,890
Total loans	$	48,097,048	$	20,323,887

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

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

highly questionable and improbable.

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The following tables provide information on the risk rating of loans at the dates indicated:

	December 31, 2011				
	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	Total Loans
Commercial	$31,322,834	$4,289,037	$2,122,645	$-	$37,734,516
Real estate - Construction, land development and other loans	49,258,535	-	31,268,467	-	80,527,002
Real estate - Commercial	92,517,583	19,389,807	56,888,216	-	168,795,606
Real estate - 1-4 Residential	117,035,665	8,131,614	10,780,808	-	135,948,087
Consumer	3,508,768	384,387	972,350	-	4,865,505
	$293,643,385	$32,194,845	$102,032,486	$-	$427,870,716

	December 31, 2010				
	Risk Rated 1-4	Risk Rated 5	Risk Rated 6	Risk Rated 7	Total Loans
Commercial	$30,842,071	$2,577,779	$3,283,334	$524,415	$37,227,599
Real estate - Construction, land development and other loans	62,685,768	3,438,546	24,648,900	-	90,773,214
Real estate - Commercial	124,085,473	20,391,192	28,557,575	193,251	173,227,491
Real estate - 1-4 Residential	130,860,442	5,717,843	9,904,670	163,825	146,646,780
Consumer	4,337,390	623,556	299,191	107,729	5,367,866
	$352,811,144	$32,748,916	$66,693,670	$989,220	$453,242,950

The following table presents the aging of the recorded investment in past due loans and leases at the dates indicated:

	December 31, 2011						
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial	$46,392	$3,313	$54,918	$104,623	$37,629,893	$37,734,516	$54,918
Real estate - Construction, land development and other loans	1,942,560	659,799	36,770	2,639,129	77,887,873	80,527,002	36,770
Real estate - Commercial	765,286	965,729	-	1,731,015	167,064,591	168,795,606	-
	1,321,138	1,805,394	1,080,549	4,207,081	131,741,006	135,948,087	1,080,549

Real estate - 1-4 Residential							
Consumer	59,697	3,176	-	62,873	4,802,632	4,865,505	-
	$4,135,073	$3,437,411	$1,172,237	$8,744,721	$419,125,995	$427,870,716	$1,172,237

	December 31, 2010						
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial	$190,585	$501,378	$-	$691,963	$36,535,636	$37,227,599	$-
Real estate - Construction, land development and other loans	5,515,931	673,204	79,343	6,268,478	257,732,227	264,000,705	79,343
Real estate - 1-4 Residential	2,672,157	973,269	213,478	3,858,904	142,787,876	146,646,780	213,478
Consumer	149,804	42,645	22,322	214,771	5,153,095	5,367,866	22,322
	$8,528,477	$2,190,496	$315,143	$11,034,116	$442,208,834	$453,242,950	$315,143

Loans are considered impaired when, based on current information and events it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Loans evaluated individually for impairment include non-performing loans, such as loans on non-accrual, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the

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evaluation shows that a loan is individually impaired, then a specific reserve is established for the amount of impairment. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Year-end impaired loans are set forth in the following table.

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2011					
With no related allowance recorded:					
Commercial	$1,194,913	$1,494,913	$-	$1,064,936	$216
Real estate - Construction, land development & other loans	10,346,783	11,806,651	-	13,700,340	214,171
Real estate - Commercial	15,580,568	15,580,568	-	4,885,563	299,798
Real estate - 1-4 Residential	7,358,432	7,831,432	-	10,497,315	38,660
Consumer	143,241	143,241	-	100,456	204
	$34,623,937	$36,856,805	$-	$30,248,611	$553,049
With an allowance recorded:					
Commercial	$818,597	$818,597	$452,773	$782,036	$-
Real estate - Construction, land development & other loans	15,472,776	16,372,776	4,234,070	8,093,406	- 425,892
Real estate - Commercial	11,228,083	11,372,083	2,481,740	2,970,546	253,348
Real estate - 1-4 Residential	5,148,740	5,673,740	1,360,285	2,164,492	-
Consumer	267,166	267,166	266,178	191,974	-
	$32,935,362	$34,504,362	$8,795,046	$14,202,454	$679,240
Total					
Commercial	$2,013,510	$2,313,510	$452,773	$1,846,972	$216
Real estate - Construction, land development & other loans	25,819,559	28,179,427	4,234,070	21,793,746	640,063
Real estate - Commercial	26,808,651	26,952,651	2,481,740	7,856,109	553,146
Real estate - 1-4 Residential	12,507,172	13,505,172	1,360,285	12,661,807	38,660
Consumer	410,407	410,407	266,178	292,430	204
	$67,559,299	$71,361,167	$8,795,046	$44,451,065	$1,232,289

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December 31, 2010	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$3,223,061	$3,223,061	$-	$3,547,829	$-
Real estate - Construction, land development & other loans	9,438,288	12,579,130	-	12,810,232	955,540
Real estate - 1-4 Residential	5,669,182	6,181,182	-	6,647,941	209,214
Consumer	278,890	278,890	-	288,539	-
	$18,609,421	$22,262,263	$-	$23,294,541	$1,164,754
With an allowance recorded:					
Commercial	$178,320	$356,640	$178,320	$207,553	$6,195
Real estate - Construction, land development & other loans	1,476,524	1,586,524	110,000	3,371,943	- 11,750
Real estate - 1-4 Residential	69,622	86,122	16,500	276,996	-
Consumer	-	-	-	-	-
	$1,724,466	$2,029,286	$304,820	$3,856,492	$17,945
Total					
Commercial	$3,401,381	$3,579,701	$178,320	$3,755,382	$6,195
Real estate - Construction, land development & other loans	10,914,812	14,165,654	110,000	16,182,175	967,290
Real estate - 1-4 Residential	5,738,804	6,267,304	16,500	6,924,937	209,214
Consumer	278,890	278,890	-	288,539	-
	$20,333,887	$24,291,549	$304,820	$27,151,033	$1,182,699

As of December 31, 2011, 2010 and 2009, the Company had impaired loans of $48,097,000, $20,034,000 and $25,913,000, respectively, which were on nonaccrual status. These loans had valuation allowances of $5,034,000, $305,000 and $5,522,000 as of December 31, 2011, 2010 and 2009, respectively. Cumulative interest income that would have been recorded had nonaccrual loans been performing would have been $2,377,000, $1,242,000 and $569,000 for 2011, 2010 and 2009, respectively.

Included in impaired loans are loans classified as troubled debt restructurings (TDRs). A modification of a loan's terms constitutes a TDR if the creditor grants a concession to the borrower for economic or legal reasons related to the borrowers financial difficulties that it would not otherwise consider. For loans classified as impaired TDRs, the Company further evaluates the loans as performing or nonperforming. If, at the time of restructure, the loan is not considered nonaccrual, it will be classified as performing. TDRs originally classified as nonperforming are able to be reclassified as performing if, subsequent to restructure, they experience six months of payment performance according to the restructured terms. The following table provides certain information concerning TDRs as of December 31, 2011.

Specific

	Total	Performing	Nonaccrual	Past Due 31-89 Days	Valuation Allowance
Commercial	$159,073	$7,283	$151,790	$-	$-
Real estate - Construction, land development & other loans	16,437,372	3,908,273	12,529,099	-	2,727,872
Real estate - Commercial	16,733,214	8,561,088	8,135,154	36,972	1,813,700
Real estate - 1-4 Residential	3,543,267	608,953	2,934,314	-	530,035
Consumer	128,419	128,419	-	-	-
	$37,001,345	$13,214,016	$23,750,357	$36,972	$5,071,607
Number of loans	48	38	9	1	10

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The following table provides information about TDRs identified during the current period:

	Year Ended December 31, 2011			Year Ended December 31, 2010		
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
TDRs						
Commercial	3	$ 159,073	$ 159,073		$ -	$ -
Real estate - Construction, land development & other loans	11	6,604,400	6,604,400	5	4,679,022	4,679,022
Real estate - Commercial	14	13,779,930	13,779,930			-
Real estate - 1-4 Residential	2	1,422,772	1,422,772	6	1,511,542	1,511,542
Consumer	1	128,419	128,419		-	-
	31	$ 22,094,594	$ 22,094,594	11	$ 6,190,564	$ 6,190,564

Defaults on TDRs	Number of Loans	Recorded Balance
Commercial	2	$ 151,790
Real estate - Construction, land development & other loans	10	9,901,811
Real estate - Commercial	7	8,172,126
Real estate - 1-4 Residential	8	2,934,314
Consumer	1	128,419
	28	$ 21,288,460

Note 4. Allowance for loan losses

Activity in the allowance for loan losses was as follows for the periods indicated:

	Commercial	Real Estate Construction Land Development and other loans	Real Estate Commercial	Real Estate 1-4 Residentail	Consumer	Total
December 31, 2009						
Beginning balance	1,366,751	1,192,405	4,682,956	3,196,225	83,595	10,521,932

Provision for loan losses	129,412	6,813,442	(2,824,452)	189,314	534,284	4,842,000
Charge-offs	(182,876)	(5,067,183)	(1,880,397)	(1,044,692)	(191,099)	(8,366,246)
Recoveries	2,295	187,296	120,815	1,736	1,884	314,026
Ending balance	1,315,582	3,125,960	98,922	2,342,583	428,665	7,311,712
Loans Individually Evaluated for Impairment	13,072,826	18,395,168	154,935,277	36,466,596	3,948,720	226,818,587
Loans collectively Evaluated for Impairment	23,391,292	84,990,146	106,581,880	8,753,682	7,465,242	231,182,242
Total Loans December 31, 2010	$ 36,464,118	$ 103,385,314	$ 261,517,157	$ 45,220,278	$ 11,413,962	$ 458,000,829
December 31, 2010						
Beginning balance	1,315,582	3,125,960	98,922	2,342,583	428,665	7,311,713
Provision for loan losses	2,496,729	8,716,507	3,928,991	3,481,720	140,349	18,764,296
Charge-offs	(2,159,668)	(4,358,762)	(575,914)	(2,724,193)	(249,527)	(10,068,063)
Recoveries	3,070	19,200	-	39,172	2,038	63,480
Ending balance	1,655,714	7,502,906	3,452,000	3,139,282	321,525	16,071,426
Loans Individually Evaluated for Impairment	14,343,224	32,123,938	142,163,729	19,112,379	3,501,524	211,244,794
Loans collectively Evaluated for Impairment	23,391,292	48,403,064	26,631,877	116,835,708	1,363,981	216,625,922
Total Loans December 31, 2011	$ 37,734,516	$ 80,527,002	$ 168,795,606	$ 135,948,087	$ 4,865,505	$ 427,870,716

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Note 5. Premises and equipment

The following is a summary of premises and equipment as of December 31, 2011 and 2010:

	2011	2010
Land	$ 6,190,561	$ 6,190,561
Buildings and improvements		