C & F FINANCIAL CORP
Form 10-Q
August 07, 2012

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

FORM 10-Q

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

For the quarterly period ended June 30, 2012

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

For the transition period from to

Commission File Number: 000-23423

C&F Financial Corporation
(Exact name of registrant as specified in its charter)

Virginia (State or other jurisdiction of incorporation or organization)	54-1680165 (I.R.S. Employer Identification No.)
802 Main Street West Point, VA (Address of principal executive offices)	23181 (Zip Code)

(804) 843-2360
(Registrant's telephone number, including area code)

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

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

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

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

At August 3, 2012, the latest practicable date for determination, 3,216,140 shares of common stock, $1.00 par value, of the registrant were outstanding.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS
(In thousands, except for share and per share amounts)

	June 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Cash and due from banks	$5,994	$5,787
Interest-bearing deposits in other banks	4,938	4,723
Federal funds sold	--	997
Total cash and cash equivalents	10,932	11,507
Securities-available for sale at fair value, amortized cost of $132,825 and $137,575, respectively	141,289	144,646
Loans held for sale, net	79,171	70,062
Loans, net of allowance for loan losses of $35,457 and $33,677, respectively	634,621	616,984
Federal Home Loan Bank stock, at cost	3,749	3,767
Corporate premises and equipment, net	28,003	28,462
Other real estate owned, net of valuation allowance of $4,122 and $3,927, respectively	5,236	6,059
Accrued interest receivable	5,360	5,242
Goodwill	10,724	10,724
Other assets	30,629	30,671
Total assets	$949,714	$928,124
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing demand deposits	$109,418	$95,556
Savings and interest-bearing demand deposits	255,772	242,917
Time deposits	292,257	307,943
Total deposits	657,447	646,416
Short-term borrowings	22,383	7,544
Long-term borrowings	132,987	132,987
Trust preferred capital notes	20,620	20,620
Accrued interest payable	974	1,111
Other liabilities	21,398	23,356
Total liabilities	855,809	832,034
Commitments and contingent liabilities	—	
Shareholders' equity		
Preferred stock ($1.00 par value, 3,000,000 shares authorized, 0 and 10,000 shares issued and outstanding, respectively)	—	10
	3,120	3,091

Common stock ($1.00 par value, 8,000,000 shares authorized, 3,214,376 and 3,178,510 shares issued and outstanding, respectively)		
Additional paid-in capital	4,415	13,438
Retained earnings	82,085	76,167
Accumulated other comprehensive income, net	4,285	3,384
Total shareholders' equity	93,905	96,090
Total liabilities and shareholders' equity	$949,714	$928,124

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(In thousands, except for share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Interest income				
Interest and fees on loans	$17,824	$17,043	$35,300	$33,389
Interest on money market investments	5	16	13	31
Interest and dividends on securities				
U.S. government agencies and corporations	52	55	109	106
Tax-exempt obligations of states and political subdivisions	1,186	1,225	2,373	2,419
Corporate bonds and other	31	30	59	56
Total interest income	19,098	18,369	37,854	36,001
Interest expense				
Savings and interest-bearing deposits	197	274	450	606
Certificates of deposit, $100 or more	547	663	1,187	1,336
Other time deposits	637	819	1,361	1,669
Borrowings	967	966	1,940	1,932
Trust preferred capital notes	248	246	497	489
Total interest expense	2,596	2,968	5,435	6,032
Net interest income	16,502	15,401	32,419	29,969
Provision for loan losses	2,860	3,390	5,585	6,210
Net interest income after provision for loan losses	13,642	12,011	26,834	23,759
Noninterest income				
Gains on sales of loans	4,718	3,696	8,821	7,496
Service charges on deposit accounts	825	846	1,626	1,694
Other service charges and fees	1,608	1,314	2,976	2,406
Net gains on calls and sales of available for sale securities	8	--	8	--
Other income	570	502	1,681	1,219
Total noninterest income	7,729	6,358	15,112	12,815
Noninterest expenses				
Salaries and employee benefits	9,596	8,430	19,338	16,922
Occupancy expenses	1,677	1,611	3,398	3,137
Other expenses	3,954	3,928	7,548	7,859
Total noninterest expenses	15,227	13,969	30,284	27,918
Income before income taxes	6,144	4,400	11,662	8,656
Income tax expense	1,963	1,317	3,701	2,604
Net income	4,181	3,083	7,961	6,052
Effective dividends on preferred stock	165	290	311	579
Net income available to common shareholders	$4,016	$2,793	$7,650	$5,473

Per common share data				
Net income – basic	$1.25	$0.89	$2.39	$1.75
Net income – assuming dilution	$1.22	$0.88	$2.33	$1.73
Cash dividends declared	$0.26	$0.25	$0.52	$0.50
Weighted average number of shares – basic	3,208,792	3,131,203	3,199,655	3,127,536
Weighted average number of shares – assuming dilution	3,296,145	3,159,260	3,280,560	3,163,210

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net income	$4,181	$3,083	$7,961	$6,052
Other comprehensive income, net:	5	3	12	7
Changes in defined benefit plan assets and benefit obligations, net				
Unrealized loss on cash flow hedging instruments, net	(19)	(138)	(16)	(84)
Unrealized holding gains on securities, net of reclassification adjustment	780	1,591	905	2,146
Comprehensive income, net	$4,947	$4,539	$8,862	$8,121

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Unaudited)
(In thousands, except per share amounts)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total Shareholders' Equity
Balance December 31, 2011	$10	$3,091	$13,438	$76,167	$ 3,384	$ 96,090
Comprehensive income:						
Net income	—	—	—	7,961	—	7,961
Other comprehensive income, net	—	—	—	—	901	901
Comprehensive income	—	—	—	—	—	8,862
Stock options exercised	—	23	478	—	—	501
Share-based compensation	—	—	242	—	—	242
Restricted stock vested	—	3	(3)	—	—	—
Preferred stock redemption	(10)	—	(9,990)	—	—	(10,000)
Accretion of preferred stock discount	—	—	172	(172)	—	—
Common stock issued	—	3	78	—	—	81
Cash dividends paid – common stock ($0.52 per share)	—	—	—	(1,668)	—	(1,668)
Cash dividends paid – preferred stock (5% per annum)	—	—	—	(203)	—	(203)
Balance June 30, 2012	$—	$3,120	$4,415	$82,085	$ 4,285	$ 93,905

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total Shareholders' Equity
Balance December 31, 2010	$20	$3,032	$22,112	$67,542	$ 71	$ 92,777
Comprehensive income:						
Net income	—	—	—	6,052	—	6,052
Other comprehensive income, net	—	—	—	—	2,069	2,069
Comprehensive income	—	—	—	—	—	8,121
Stock options exercised	—	8	134	—	—	142
Share-based compensation	—	—	132	—	—	132
Restricted stock vested	—	5	(5)	—	—	—
Accretion of preferred stock discount	—	—	79	(79)	—	—
Cash dividends paid – common stock ($0.50 per share)	—	—	—	(1,564)	—	(1,564)
Cash dividends paid – preferred stock (5% per annum)	—	—	—	(500)	—	(500)
Balance June 30, 2011	$20	$3,045	$22,452	$71,451	$ 2,140	$ 99,108

The accompanying notes are an integral part of the consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Six Months Ended June 30,	
	2012	2011
Operating activities:		
Net income	$7,961	$6,052
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,119	1,025
Provision for loan losses	5,585	6,210
Provision for indemnifications	455	406
Provision for other real estate owned losses	350	411
Share-based compensation	242	132
Accretion of discounts and amortization of premiums on securities, net	366	388
Net realized gain on securities	(8)	--
Realized losses on sales of other real estate owned	13	21
Proceeds from sales of loans held for sale	370,848	297,725
Origination of loans held for sale	(379,957)	(273,062)
Change in other assets and liabilities:		
Accrued interest receivable	(118)	(47)
Other assets	(440)	(1,240)
Accrued interest payable	(137)	(15)
Other liabilities	(2,423)	(2,477)
Net cash provided by operating activities	3,856	35,529
Investing activities:		
Proceeds from maturities, calls and sales of securities available for sale	21,074	15,311
Purchases of securities available for sale	(16,682)	(22,219)
Redemption of Federal Home Loan Bank stock	18	--
Net increase in customer loans	(23,660)	(24,034)
Other real estate owned improvements	(205)	--
Proceeds from sales of other real estate owned	1,103	5,894
Purchases of corporate premises and equipment, net	(660)	(1,181)
Net cash used in investing activities	(19,012)	(26,229)
Financing activities:		
Net increase in demand, interest-bearing demand and savings deposits	26,717	7,196
Net decrease in time deposits	(15,686)	(6,485)
Net increase (decrease) in borrowings	14,839	(2,649)
Issuance of common stock	582	142
Redemption of preferred stock	(10,000)	--
Cash dividends	(1,871)	(2,064)
Net cash provided by (used in) financing activities	14,581	(3,860)
Net (decrease) increase in cash and cash equivalents	(575)	5,440
Cash and cash equivalents at beginning of period	11,507	9,680
Cash and cash equivalents at end of period	$10,932	$15,120

Supplemental disclosure		
Interest paid	$5,572	$6,047
Income taxes paid	4,918	4,261
Supplemental disclosure of noncash investing and financing activities		
Unrealized gains on securities available for sale	$1,393	$3,300
Loans transferred to other real estate owned	(438)	(3,621)
Pension adjustment	18	11
Unrealized loss on cash flow hedging instrument	(28)	(138)

The accompanying notes are an integral part of the consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1: Summary of Significant Accounting Policies

Principles of Consolidation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial reporting and with applicable quarterly reporting regulations of the Securities and Exchange Commission (the SEC). They do not include all of the information and notes required by U.S. GAAP for complete financial statements. Therefore, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the C&F Financial Corporation Annual Report on Form 10-K for the year ended December 31, 2011.

The unaudited consolidated financial statements include the accounts of C&F Financial Corporation (the Corporation) and its wholly-owned subsidiary, Citizens and Farmers Bank (the Bank or C&F Bank). All significant intercompany accounts and transactions have been eliminated in consolidation. In addition, C&F Financial Corporation owns C&F Financial Statutory Trust I and C&F Financial Statutory Trust II, which are unconsolidated subsidiaries. The subordinated debt owed to these trusts is reported as a liability of the Corporation.

Nature of Operations: The Corporation is a bank holding company incorporated under the laws of the Commonwealth of Virginia. The Corporation owns all of the stock of its subsidiary, C&F Bank, which is an independent commercial bank chartered under the laws of the Commonwealth of Virginia. The Bank and its subsidiaries offer a wide range of banking and related financial services to both individuals and businesses.

The Bank has five wholly-owned subsidiaries: C&F Mortgage Corporation and Subsidiaries (C&F Mortgage), C&F Finance Company (C&F Finance), C&F Title Agency, Inc., C&F Investment Services, Inc. and C&F Insurance Services, Inc., all incorporated under the laws of the Commonwealth of Virginia. C&F Mortgage, organized in September 1995, was formed to originate and sell residential mortgages and through its subsidiaries, Hometown Settlement Services LLC and Certified Appraisals LLC, provides ancillary mortgage loan production services, such as loan settlements, title searches and residential appraisals. C&F Finance, acquired on September 1, 2002, is a regional finance company providing automobile loans. C&F Title Agency, Inc., organized in October 1992, primarily sells title insurance to the mortgage loan customers of the Bank and C&F Mortgage. C&F Investment Services, Inc., organized in April 1995, is a full-service brokerage firm offering a comprehensive range of investment services. C&F Insurance Services, Inc., organized in July 1999, owns an equity interest in an insurance agency that sells insurance products to customers of the Bank, C&F Mortgage and other financial institutions that have an equity interest in the agency. Business segment data is presented in Note 8.

Basis of Presentation: The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the allowance for indemnifications, impairment of loans, impairment of securities, the valuation of other real estate owned, the projected benefit obligation under the defined benefit pension plan, the valuation of deferred taxes, the valuation of derivative financial instruments and goodwill impairment. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results of operations in these financial statements, have been made. Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

Derivative Financial Instruments: The Corporation recognizes derivative financial instruments at fair value as either an other asset or other liability in the consolidated balance sheets. The derivative financial instruments have been designated as and qualify as cash flow hedges. The effective portion of the gain or loss on cash flow hedges is reported as a component of other comprehensive income, net of deferred income taxes, and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings.

Share-Based Compensation: Compensation expense for the second quarter and first six months of 2012 included net expense of $122,000 ($76,000 after tax) and $242,000 ($150,000 after tax), respectively, for restricted stock granted since 2007. As of June 30, 2012, there was $1.35 million of total unrecognized compensation expense related to unvested restricted stock that will be recognized over the remaining requisite service periods.

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Stock option activity during the six months ended June 30, 2012 and stock options outstanding as of June 30, 2012 are summarized below:

	Shares	Exercise Price*	Remaining Contractual Life (in years)*	Intrinsic Value of Unexercised In-The Money Options (in 000's)
Options outstanding at January 1, 2012	325,067	$36.68	3.0	
Exercised	(22,167)	22.60		
Options outstanding and exercisable at June 30, 2012	302,900	$37.71	2.6	$ 460

* Weighted average

A summary of activity for restricted stock awards during the first six months of 2012 is presented below:

	Shares	Weighted-Average Grant Date Fair Value
Unvested, January 1, 2012	87,125	$ 22.59
Granted	11,775	$ 29.81
Vested	(3,650)	$ 19.82
Cancelled	(950)	$ 22.26
Unvested, June 30, 2012	94,300	$ 23.60

Recent Significant Accounting Pronouncements:

In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-03, Transfers and Servicing – Reconsideration of Effective Control for Repurchase Agreements. The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption was not permitted. The adoption of the new guidance did not have a material effect on the Corporation's financial statements.

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

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income – Presentation of Comprehensive Income. The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. The amendments do not require transition disclosures. The Corporation has included the required disclosures in its consolidated financial statements.

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In September 2011, the FASB issued ASU 2011-08, Intangible – Goodwill and Other – Testing Goodwill for Impairment. The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued. The adoption of the new guidance did not have a material effect on the Corporation's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, Comprehensive Income - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05. The amendments are being made to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Corporation has included the required disclosures in its consolidated financial statements.

NOTE 2: Securities

Debt and equity securities, all of which were classified as available for sale, are summarized as follows:

	June 30, 2012			
(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agencies and corporations	$13,530	$15	$(13)	$13,532
Mortgage-backed securities	2,635	73	(1)	2,707
Obligations of states and political subdivisions	116,633	8,392	(70)	124,955
Preferred stock	27	68	—	95
	$132,825	$8,548	$(84)	$141,289

	December 31, 2011			
(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agencies and corporations	$15,248	$39	$(4)	$15,283
Mortgage-backed securities	2,135	81	—	2,216
Obligations of states and political subdivisions	120,165	6,998	(84)	127,079
Preferred stock	27	41	—	68

	$137,575	$7,159	$(88)	$144,646

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The amortized cost and estimated fair value of securities, all of which were classified as available for sale, at June 30, 2012, by the earlier of contractual maturity or expected maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

	June 30, 2012	
(Dollars in thousands)	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 22,574	$ 22,712
Due after one year through five years	37,385	39,103
Due after five years through ten years	47,837	51,840
Due after ten years	25,002	27,539
Preferred stock	27	95
	$ 132,825	$ 141,289

Proceeds from the maturities, calls and sales of securities available for sale for the six months ended June 30, 2012 were $21.07 million.

The Corporation pledges securities primarily as collateral for public deposits and repurchase agreements. Securities with an aggregate amortized cost of $92.57 million and an aggregate fair value of $99.39 million were pledged at June 30, 2012. Securities with an aggregate amortized cost of $106.97 million and an aggregate fair value of $112.66 million were pledged at December 31, 2011.

Securities in an unrealized loss position at June 30, 2012, by duration of the period of the unrealized loss, are shown below.

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agencies and corporations	$5,677	$13	$—	$—	$5,677	$13
Mortgage-backed securities	910	1	—	—	910	1
Obligations of states and political subdivisions	4,309	37	675	33	4,984	70
Total temporarily impaired securities	$10,896	$51	$675	$33	$11,571	$84

There are 35 debt securities with fair values totaling $11.57 million considered temporarily impaired at June 30, 2012. The primary cause of the temporary impairments in the Corporation's investments in debt securities was fluctuations in interest rates. During the second quarter of 2012, the municipal bond sector, which is included in the Corporation's obligations of states and political subdivisions category of securities, experienced rising securities prices due to declining interest rates over the quarter, gradual fundamental municipal credit improvement, and strong demand trends for municipal securities. The vast majority of the Corporation's municipal bond portfolio is made up of securities where the issuing municipalities have unlimited taxing authority to support their debt service obligations. At June 30, 2012, approximately 96 percent of the Corporation's obligations of states and political subdivisions, as measured by market value, were rated "A" or better by Standard & Poor's or Moody's Investors Service. Of those in a net unrealized loss position, approximately 83 percent were rated, as measured by market value, "A" or better at June 30, 2012. Because the Corporation intends to hold these investments in debt securities to maturity and it is more likely than not that the Corporation will not be required to sell these investments before a recovery of unrealized losses, the

Corporation does not consider these investments to be other-than-temporarily impaired at June 30, 2012 and no other-then-temporary impairment has been recognized.

Securities in an unrealized loss position at December 31, 2011, by duration of the period of the unrealized loss, are shown below.

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agencies and corporations	$2,064	$4	$—	$—	$2,064	$4
Obligations of states and political subdivisions	3,305	35	1,328	49	4,633	84
Total temporarily impaired securities	$5,369	$39	$1,328	$49	$6,697	$88

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The Corporation's investment in Federal Home Loan Bank (FHLB) stock totaled $3.75 million at June 30, 2012 and $3.77 million at December 31, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Corporation does not consider this investment to be other-than-temporarily impaired at June 30, 2012 and no impairment has been recognized. FHLB stock is shown as a separate line item on the balance sheet and is not a part of the available for sale securities portfolio.

NOTE 3: Loans

Major classifications of loans are summarized as follows:

(Dollars in thousands)	June 30, 2012	December 31, 2011
Real estate – residential mortgage	$ 146,256	$ 147,135
Real estate – construction 1	4,983	5,737
Commercial, financial and agricultural 2	215,419	212,235
Equity lines	33,490	33,192
Consumer	6,148	6,057
Consumer finance	263,782	246,305
	670,078	650,661
Less allowance for loan losses	(35,457)	(33,677)
Loans, net	$ 634,621	$ 616,984

1 Includes the Corporation's real estate construction lending and consumer real estate lot lending.

2 Includes the Corporation's commercial real estate lending, land acquisition and development lending, builder line lending and commercial business lending.

Consumer loans included $504,000 and $299,000 of demand deposit overdrafts at June 30, 2012 and December 31, 2011, respectively.

Loans on nonaccrual status were as follows:

(Dollars in thousands)	June 30, 2012	December 31, 2011
Real estate – residential mortgage	$ 1,412	$ 2,440
Real estate – construction:		
Construction lending	—	—
Consumer lot lending	—	—
Commercial, financial and agricultural:		
Commercial real estate lending	4,435	5,093
Land acquisition and development lending	2,756	—
Builder line lending	1,936	2,303
Commercial business lending	768	673
Equity lines	9	123
Consumer	—	—
Consumer finance	259	381

Total loans on nonaccrual status	$ 11,575	$ 11,013

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The past due status of loans as of June 30, 2012 was as follows:

(Dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due	Current	Total Loans	90+ Days Past Due and Accruing
Real estate – residential mortgage	$1,189	$198	$366	$1,753	$144,503	$146,256	$13
Real estate – construction:							
Construction lending	—	—	—	—	3,079	3,079	—
Consumer lot lending	—	—	—	—	1,904	1,904	—
Commercial, financial and agricultural:							
Commercial real estate lending	272	—	129	401	125,106	125,507	—
Land acquisition and development lending	—	—	2,756	2,756	30,806	33,562	—
Builder line lending	—	—	—	—	17,718	17,718	—
Commercial business lending	23	—	551	574	38,058	38,632	281
Equity lines	130	40	—	170	33,320	33,490	—
Consumer	—	—	2	2	6,146	6,148	2
Consumer finance	5,431	1,260	259	6,950	256,832	263,782	—
Total	$7,045	$1,498	$4,063	$12,606	$657,472	$670,078	$296

For the purposes of the above table, “Current” includes loans that are 1-29 days past due.

The past due status of loans as of December 31, 2011 was as follows:

(Dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due	Current	Total Loans	90+ Days Past Due and Accruing
Real estate – residential mortgage	$1,270	$1,445	$533	$3,248	$143,887	$147,135	$65
Real estate – construction:							
Construction lending	—	—	—	—	5,084	5,084	—
Consumer lot lending	—	—	—	—	653	653	—

Commercial, financial and agricultural:							
Commercial real estate lending	986	1,311	—	2,297	114,475	116,772	—
Land acquisition and development lending	—	—	—	—	32,645	32,645	—
Builder line lending	—	—	—	—	17,637	17,637	—
Commercial business lending	480	—	—	480	44,701	45,181	—
Equity lines	69	90	33	192	33,000	33,192	—
Consumer	13	—	—	13	6,044	6,057	3
Consumer finance	5,327	1,041	381	6,749	239,556	246,305	—
Total	$8,145	$1,445	$947	$12,979	$637,682	$650,661	$68

For the purposes of the above table, “Current” includes loans that are 1-29 days past due.

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Impaired loans, which included troubled debt restructurings (TDRs) of $15.77 million, and the related allowance at June 30, 2012, were as follows:

(Dollars in thousands)	Recorded Investment in Loans	Unpaid Principal Balance	Related Allowance	Average Balance-Impaired Loans	Interest Income Recognized
Real estate – residential mortgage	$2,272	$2,309	$426	$ 2,298	$66
Real estate – construction:					
Construction lending	—	—	—	—	—
Consumer lot lending	—	—	—	—	—
Commercial, financial and agricultural:					
Commercial real estate lending	5,084	5,329	1,447	5,409	74
Land acquisition and development lending	8,185	8,185	2,031	8,290	176
Builder line lending	1,919	1,919	455	1,920	—
Commercial business lending	636	639	145	642	6
Equity lines	—	—	—	—	—
Consumer	432	432	65	432	8
Total	$18,528	$18,813	$4,569	$ 18,991	$330

The Corporation has no obligation to fund additional advances on its impaired loans.

Impaired loans, which included TDRs of $17.09 million, and the related allowance at December 31, 2011 were as follows:

(Dollars in thousands)	Recorded Investment in Loans	Unpaid Principal Balance	Related Allowance	Average Balance Impaired Loans	Interest Income Recognized
Real estate – residential mortgage	$3,482	$3,698	$657	$ 3,723	$137
Real estate – construction:					
Construction lending	—	—	—	—	—
Consumer lot lending	—	—	—	—	—
Commercial, financial and agricultural:					
Commercial real estate lending	5,861	5,957	1,464	6,195	102
Land acquisition and development lending	5,490	5,814	1,331	6,116	372
Builder line lending	2,285	2,285	318	2,397	—
Commercial business lending	652	654	161	663	6
Equity lines	—	—	—	—	—
Consumer	324	324	49	324	14
Total	$18,094	$18,732	$3,980	$ 19,418	$631

Loan modifications that were classified as TDRs during the three and six months ended June 30, 2012 and 2011 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2012	2011	2012	2011
	$ 122	$ 230	$ 122	$ 352

Real estate-residential mortgage-interest reduction				
Real estate-residential mortgage-interest rate concession	--	96	--	96
Commercial, financial and agricultural:				
Builder line lending-interest rate concession	--	2,285	--	2,285
Commercial business lending-interest reduction	--	186	--	186
Commercial business lending-interest rate concession	373	277	373	363
Consumer-interest reduction	--	--	108	--
Total	$ 495	$ 3,074	$ 603	$ 3,282

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TDR payment defaults during three and six months ended June 30, 2012 and 2011 were as follows:

(Dollars in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Real estate-residential mortgage	$ --	$ 70	$ --	$ 154
Commercial, financial and agricultural:				
Builder line lending	88	--	88	--
Commercial business lending	363	--	363	--
Consumer	--	--	--	4
Total	$ 451	$ 70	$ 451	$ 158

For purposes of this disclosure, a TDR payment default occurs when, within 12 months of the original TDR modification, either a full or partial charge-off occurs or a TDR becomes 90 days or more past due.

NOTE 4: Allowance for Loan Losses

The following table presents the changes in the allowance for loan losses by major classification during the six months ended June 30, 2012.

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at December 31, 2011	$2,379	$ 480	$ 10,040	$912	$319	$19,547	$33,677
Provision charged to operations	576	(94)	917	130	76	3,980	5,585
Loans charged off	(638)	—	(402)	(121)	(171)	(4,102)	(5,434)
Recoveries of loans previously charged off	23	—	36	—	99	1,471	1,629
Balance at June 30, 2012	$2,340	$ 386	$ 10,591	$921	$323	$20,896	$35,457

The following table presents the changes in the allowance for loan losses by major classification during the six months ended June 30, 2011.

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
	$1,442	$ 581	$ 8,688	$380	$307	$17,442	$28,840

Balance December 31, 2010							
Provision charged to operations	811	147	1,376	177	74	3,625	6,210
Loans charged off	(283)	—	(2,530)	(9)	(167)	(3,115)	(6,104)
Recoveries of loans previously charged off	14	—	21	—	41	1,189	1,265
Balance June 30, 2011	$1,984	$ 728	$ 7,555	$548	$255	$19,141	$30,211

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The following table presents, as of June 30, 2012, the total allowance for loan losses the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment), total loans, and loans by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment).

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at June 30, 2012	$2,340	$ 386	$ 10,591	$921	$323	$20,896	$35,457
Ending balance: individually evaluated for impairment	$426	$ —	$ 4,078	$—	$65	$—	$4,569
Ending balance: collectively evaluated for impairment	$1,914	$ 386	$ 6,513	$921	$258	$20,896	$30,888
Loans:							
Balance June 30, 2012	$146,256	$ 4,983	$ 215,419	$33,490	$6,148	$263,782	$670,078
Ending balance: individually evaluated for impairment	$2,272	$ —	$ 15,824	$—	$432	$—	$18,528
Ending balance: collectively evaluated for impairment	$143,984	$ 4,983	$ 199,595	$33,490	$5,716	$263,782	$651,550

The following table presents, as of December 31, 2011, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment), total loans, and loans by impairment methodology (individually evaluated for impairment or collectively evaluated for impairment).

(Dollars in thousands)	Real Estate Residential Mortgage	Real Estate Construction	Commercial, Financial and Agricultural	Equity Lines	Consumer	Consumer Finance	Total
Allowance for loan losses:							
Balance at December 31, 2011	$2,379	$ 480	$ 10,040	$912	$319	$19,547	$33,677
Ending balance: individually evaluated for	$657	$ —	$ 3,274	$—	$49	$—	$3,980

impairment							
Ending balance: collectively evaluated for impairment	$1,722	$ 480	$ 6,766	$912	$270	$19,547	$29,697
Loans:							
Balance at December 31, 2011	$147,135	$ 5,737	$ 212,235	$33,192	$6,057	$246,305	$650,661
Ending balance: individually evaluated for impairment	$3,482	$ —	$ 14,288	$—	$324	$—	$18,094
Ending balance: collectively evaluated for impairment	$143,653	$ 5,737	$ 197,947	$33,192	$5,733	$246,305	$632,567

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Loans by credit quality indicators as of June 30, 2012 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total1
Real estate – residential mortgage	$140,665	$2,110	$2,437	$1,044	$146,256
Real estate – construction:					
Construction lending	212	—	2,867	—	3,079
Consumer lot lending	1,904	—	—	—	1,904
Commercial, financial and agricultural:					
Commercial real estate lending	104,722	7,036	9,314	4,435	125,507
Land acquisition and development lending	15,257	9,468	6,081	2,756	33,562
Builder line lending	13,222	1,484	1,076	1,936	17,718
Commercial business lending	35,165	1,819	880	768	38,632
Equity lines	31,204	1,436	841	9	33,490
Consumer	5,270	26	852	—	6,148
	$347,621	$23,379	$24,348	$10,948	$406,296

(Dollars in thousands)	Performing	Non-Performing	Total
Consumer finance	$263,523	$ 259	$263,782

1 At June 30, 2012, the Corporation did not have any loans classified as Doubtful or Loss.

Loans by credit quality indicators as of December 31, 2011 were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Substandard Nonaccrual	Total1
Real estate – residential mortgage	$140,304	$1,261	$3,130	$2,440	$147,135
Real estate – construction:					
Construction lending	2,214	—	2,870	—	5,084
Consumer lot lending	653	—	—	—	653
Commercial, financial and agricultural:					
Commercial real estate lending	96,773	5,413	9,493	5,093	116,772
Land acquisition and development lending	13,605	9,939	9,101	—	32,645
Builder line lending	12,480	1,434	1,420	2,303	17,637
Commercial business lending	41,590	2,001	917	673	45,181
Equity lines	31,935	298	836	123	33,192
Consumer	5,271	10	776	—	6,057
	$344,825	$20,356	$28,543	$10,632	$404,356

(Dollars in thousands)	Performing	Non-Performing	Total
Consumer finance	$245,924	$ 381	$246,305

1 At December 31, 2011, the Corporation did not have any loans classified as Doubtful or Loss.

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NOTE 5: Stockholders' Equity and Earnings Per Common Share

Stockholders' Equity - Other Comprehensive Income

The following table presents the cumulative balances of the components of other comprehensive income, net of deferred tax assets of $2.27 million and $1.13 million as of June 30, 2012 and 2011, respectively.

(Dollars in thousands)	June 30, 2012	June 30, 2011
Net unrealized gains on securities	$ 5,501	$ 2,646
Net unrecognized loss on cash flow hedges	(330)	(174)
Net unrecognized losses on defined benefit pension plan	(886)	(332)
Total cumulative other comprehensive income	$ 4,285	$ 2,140

The following tables present the changes in accumulated other comprehensive income, by category, net of tax.

(Dollars in thousands)	Unrealized Loss on Cash Flow Hedging Instruments	Unrealized Holding Gains on Securities	Defined Benefit Pension Plan Assets and Benefit Obligations	Total
Balance December 31, 2011	$ (314)	$ 4,596	$ (898)	$ 3,384
Net change for the six months ended June 30, 2012	(16)	905	12	901
Balance at June 30, 2012	$ (330)	$ 5,501	$ (886)	$ 4,285

(Dollars in thousands)	Unrealized Loss on Cash Flow Hedging Instruments	Unrealized Holding Gains on Securities	Defined Benefit Pension Plan Assets and Benefit Obligations	Total
Balance December 31, 2010	$ (90)	$ 500	$ (339)	$ 71
Net change for the six months ended June 30, 2011	(84)	2,146	7	2,069
Balance at June 30, 2011	$ (174)	$ 2,646	$ (332)	$ 2,140

The following tables present the change in each component of other comprehensive income on a pre-tax and after-tax basis for the six months ended June 30, 2012 and 2011.

(Dollars in thousands)	Six Months Ended June 30, 2012		
	Pre-Tax	Tax Expense (Benefit)	Net-of-Tax
Defined benefit pension plan:			
Net loss	$ 53	$ 19	$ 34
Amortization of prior service costs	(35)	(13)	(22)
Defined benefit pension plan assets and benefit obligations, net	18	6	12

Unrealized gain on cash flow hedging instruments		(28	)		(12	)		(16	)
Unrealized holding gains on securities		1,393			488			905	
Total increase in other comprehensive income	$	1,383		$	482		$	901	

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(Dollars in thousands)	Six Months Ended June 30, 2011		
	Pre-Tax	Tax Expense (Benefit)	Net-of-Tax
Defined benefit pension plan:			
Net loss	$ 47	$ 17	$ 30
Amortization of prior service costs	(34)	(12)	(22)
Amortization of net obligation at transition	(2)	(1)	(1)
Defined benefit pension plan assets and benefit obligations, net	11	4	7
Unrealized gain on cash flow hedging instruments	(138)	(54)	(84)
Unrealized holding gains on securities	3,300	1,155	2,146
Total increase in other comprehensive income	$ 3,173	$ 1,105	$ 2,069

The Corporation had $8,000 and $0 of net gains from securities reclassified from other comprehensive income to earnings for the six months ended June 30, 2012 and 2011.

Earnings Per Common Share

The components of the Corporation's earnings per common share calculations are as follows:

(Dollars in thousands)	Three Months Ended June 30,	
	2012	2011
Net income	$ 4,181	$ 3,083
Accumulated dividends on Series A Preferred Stock	(14)	(250)
Accretion of Series A Preferred Stock discount	(151)	(40)
Net income available to common shareholders	$ 4,016	$ 2,793
Weighted average number of common shares used in earnings per common share – basic	3,208,792	3,131,203
Effect of dilutive securities:		
Stock option awards and Warrant	87,353	28,057
Weighted average number of common shares used in earnings per common share – assuming dilution	3,296,145	3,159,260

(Dollars in thousands)	Six Months Ended June 30,	
	2012	2011
Net income	$ 7,961	$ 6,052
Accumulated dividends on Series A Preferred Stock	(139)	(500)
Accretion of Series A Preferred Stock discount	(172)	(79)
Net income available to common shareholders	$ 7,650	$ 5,473
Weighted average number of common shares used in earnings per common share – basic	3,199,655	3,127,536
Effect of dilutive securities:		
Stock option awards and Warrant	80,905	35,674
Weighted average number of common shares used in earnings per common share – assuming dilution	3,280,560	3,163,210

Potential common shares that may be issued by the Corporation for its stock option awards and Warrant (defined below) are determined using the treasury stock method. Approximately 276,500 and 354,000 shares issuable upon exercise of options were not included in computing diluted earnings per common share for the three months ended

June 30, 2012 and 2011, respectively, and approximately 276,500 and 328,000 shares issuable upon exercise of options were not included in computing diluted earnings per common share for the six months ended June 30, 2012 and 2011, respectively, because they were anti-dilutive.

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In January 2009, the Corporation issued to the United States Department of the Treasury (Treasury) under the Capital Purchase Program (CPP) $20.00 million of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Stock) and a warrant to purchase 167,504 shares of the Corporation's common stock (the Warrant). On July 27, 2011 the Corporation redeemed $10.00 million of the Preferred Stock, and on April 12, 2012 the Corporation redeemed the remaining $10.00 million of the Preferred Stock. As a result of this redemption, the Corporation will pay no future dividends on the Preferred Stock. Further, in connection with this redemption, the Corporation accelerated the accretion of the remaining preferred stock discount during April 2012, which reduced net income available to common shareholders by approximately $151,000.

NOTE 6: Employee Benefit Plans

The Bank has a non-contributory defined benefit plan for which the components of net periodic benefit cost are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2012	2011	2012	2011
Service cost	$ 159	$ 153	$ 318	$ 306
Interest cost	99	109	198	218
Expected return on plan assets	(158)	(145)	(316)	(290)
Amortization of net obligation at transition	—	(1)	—	(2)
Amortization of prior service cost	(17)	(17)	(34)	(34)
Amortization of net loss	26	16	52	32
Net periodic benefit cost	$ 109	$ 115	$ 218	$ 230

The Bank made a $500,000 contribution to this plan during the second quarter of 2012.

NOTE 7: Fair Value of Assets and Liabilities

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP requires that valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. U.S. GAAP also establishes a fair value hierarchy which prioritizes the valuation inputs into three broad levels. Based on the underlying inputs, each fair value measurement in its entirety is reported in one of the three levels. These levels are:

Level 1—Valuation is based upon quoted prices for identical instruments traded in active markets. Level 1 assets and liabilities include debt and equity securities traded in an active exchange market, as well as U.S. Treasury securities.

Level 2—Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Valuations of other real estate owned are based upon appraisals by independent, licensed appraisers, general market conditions and recent sales of like properties.

Level 3—Valuation is determined using model-based techniques with significant assumptions not observable in the market.

U.S. GAAP allows an entity the irrevocable option to elect fair value (the fair value option) for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. The Corporation has not made any fair value option elections as of June 30, 2012.

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Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present the balances of financial assets measured at fair value on a recurring basis.

	June 30, 2012 Fair Value Measurements Using			
(Dollars in thousands)	Level 1	Level 2	Level 3	Assets at Fair Value
Assets:				
Securities available for sale				
U.S. government agencies and corporations	—	$13,532	—	$13,532
Mortgage-backed securities	—	2,707	—	2,707
Obligations of states and political subdivisions	—	124,955	—	124,955
Preferred stock	—	95	—	95
Total securities available for sale	—	$141,289	—	$141,289
Liabilities:				
Derivative payable	—	$542	—	$542

	December 31, 2011 Fair Value Measurements Using			
(Dollars in thousands)	Level 1	Level 2	Level 3	Assets at Fair Value
Assets:				
Securities available for sale				
U.S. government agencies and corporations	—	$15,283	—	$15,283
Mortgage-backed securities	—	2,216	—	2,216
Obligations of states and political subdivisions	—	127,079	—	127,079
Preferred stock	—	68	—	68
Total securities available for sale	—	$144,646	—	$144,646
Liabilities:				
Derivative payable	—	$515	—	$515

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Corporation is also required to measure and recognize certain other financial assets at fair value on a nonrecurring basis in the consolidated balance sheets. For assets measured at fair value on a nonrecurring basis and still held on the consolidated balance sheets, the following table provides the fair value measures by level of valuation assumptions used. Fair value adjustments for other real estate owned (OREO) are recorded in other noninterest expense and fair value adjustments for impaired loans are recorded in the provision for loan losses, in the consolidated statements of income.

	June 30, 2012 Fair Value Measurements Using			
(Dollars in thousands)	Level 1	Level 2	Level 3	Assets at Fair Value
Impaired loans, net	—	$13,959	—	$13,959
OREO, net	—	5,236	—	5,236
Total	—	$19,195	—	$19,195

(Dollars in thousands)	December 31, 2011 Fair Value Measurements Using Level 1	Level 2	Level 3	Assets at Fair Value
Impaired loans, net	—	$14,114	—	$14,114
OREO, net	—	6,059	—	6,059
Total	—	$20,173	—	$20,173

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Fair Value of Financial Instruments

The carrying values and estimated fair values of the Corporation's financial instruments, whether or not recognized on the consolidated balance sheets at fair value, as of June 30, 2012 are as follows:

		Fair Value Measurements at June 30, 2012 Using			
(Dollars in thousands)	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Balance
Financial assets:					
Cash and short-term investments	$ 10,932	$10,232	$—	$ —	$10,932
Securities	141,289	—	141,289	—	141,289
Loans, net	634,621	—	645,645	—	645,645
Loans held for sale, net	79,171	—	81,776	—	81,776
Accrued interest receivable	5,360	—	5,360	—	5,360
Financial liabilities:					
Demand deposits	$ 365,190	$—	$365,190	$ —	$365,190
Time deposits	292,257	—	295,920	—	295,920
Borrowings	175,990	—	172,004	—	172,004
Derivative payable	542	—	542	—	542
Accrued interest payable	974	—	974	—	974

The carrying values and estimated fair values of the Corporation's financial instruments, whether or not recognized on the consolidated balance sheets at fair value, as of December 31, 2011 are as follows:

	December 31, 2011	
(Dollars in thousands)	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash and short-term investments	$ 11,507	$ 11,507
Securities	144,646	144,646
Loans, net	616,984	624,219
Loans held for sale, net	70,062	72,859
Accrued interest receivable	5,242	5,242
Financial liabilities:		
Demand deposits	338,473	338,473
Time deposits	307,943	312,095
Borrowings	161,151	157,863
Derivative payable	515	515
Accrued interest payable	1,111	1,111

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The following describes the valuation techniques used by the Corporation to measure financial assets and financial liabilities at fair value as of June 30, 2012 and December 31, 2011.

Cash and short-term investments. The nature of these instruments and their relatively short maturities provide for the reporting of fair value equal to the historical cost.

Securities available for sale. Securities available for sale are recorded at fair value on a recurring basis using a third-party model based on valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data.

Loans, net. The estimated fair value of the loan portfolio is based on present values using discount rates equal to the market rates currently charged on similar products.

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Certain loans are accounted for under ASC Topic 310 - Receivables, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. A significant portion of the collateral securing the Corporation's impaired loans is real estate. The fair value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Corporation using observable market data, which in some cases may be adjusted to reflect current trends, including sales prices, expenses, absorption periods and other current relevant factors (Level 2). The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business's financial statements, if not considered significant, using observable market data (Level 2).

Loans Held for Sale. Loans held for sale are required to be measured at the lower of cost or fair value. These loans currently consist of residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data (Level 2). As such, the Corporation records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the six months ended June 30, 2012.

Accrued interest receivable. The carrying amount of accrued interest receivable approximates fair value.

Deposits. The fair value of all demand deposit accounts is the amount payable at the report date. For all other deposits, the fair value is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products.

Borrowings. The fair value of borrowings is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products.

Derivative payable. The fair value of derivatives is determined using the discounted cash flow method.

Accrued interest payable. The carrying amount of accrued interest payable approximates fair value.

Letters of credit. The estimated fair value of letters of credit is based on estimated fees the Corporation would pay to have another entity assume its obligation under the outstanding arrangements. These fees are not considered material.

Unused portions of lines of credit. The estimated fair value of unused portions of lines of credit is based on estimated fees the Corporation would pay to have another entity assume its obligation under the outstanding arrangements. These fees are not considered material.

The Corporation assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Corporation's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Corporation. Management attempts to match maturities of assets and liabilities to the extent believed necessary to balance minimizing interest rate risk and increasing net interest income in current market conditions. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors interest rates, maturities and repricing dates of assets and liabilities and attempts to manage interest rate risk by adjusting terms of new loans, deposits and borrowings and by investing in securities with terms that mitigate the Corporation's overall interest rate risk.

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NOTE 8: Business Segments

The Corporation operates in a decentralized fashion in three principal business segments: Retail Banking, Mortgage Banking and Consumer Finance. Revenues from Retail Banking operations consist primarily of interest earned on loans and investment securities and service charges on deposit accounts. Mortgage Banking operating revenues consist principally of gains on sales of loans in the secondary market, loan origination fee income and interest earned on mortgage loans held for sale. Revenues from Consumer Finance consist primarily of interest earned on automobile retail installment sales contracts.

The Corporation's other segment includes an investment company that derives revenues from brokerage services, an insurance company that derives revenues from insurance services, and a title company that derives revenues from title insurance services. The results of the other segment are not significant to the Corporation as a whole and have been included in "Other." Certain expenses of the Corporation are also included in "Other," and consist primarily of interest expense associated with the Corporation's trust preferred capital notes and other general corporate expenses.

	Three Months Ended June 30, 2012					
(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	$8,096	$566	$11,695	$—	$ (1,259)	$ 19,098
Gains on sales of loans	—	4,718	—	—	—	4,718
Other noninterest income	1,464	979	234	336	(2)	3,011
Total operating income	9,560	6,263	11,929	336	(1,261)	26,827
Expenses:						
Interest expense	1,920	113	1,574	248	(1,259)	2,596
Provision for loan losses	750	30	2,080	—	—	2,860
Salaries and employee benefits	3,742	3,810	1,846	198	—	9,596
Other noninterest expenses	2,862	1,613	1,051	105	—	5,631
Total operating expenses	9,274	5,566	6,551	551	(1,259)	20,683
	>	>	>	>	>	>
Income (loss) before income taxes	286	697	5,378	(215)	(2)	6,144
Provision for (benefit from) income taxes	(332)	278	2,098	(81)	—	1,963
Net income (loss)	$618	$419	$3,280	$(134)	$ (2)	$ 4,181
Total assets	$791,327	$91,025	$265,995	$2,974	$ (201,607)	$ 949,714
Capital expenditures	$173	$158	$41	$—	$ —	$ 372

	Three Months Ended June 30, 2011					
(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	$8,174	$386	$10,877	$—	$ (1,068)	$ 18,369
Gains on sales of loans	—	3,696	—	—	—	3,696
Other noninterest income	1,501	703	157	301	—	2,662
Total operating income	9,675	4,785	11,034	301	(1,068)	24,727
Expenses:						

Interest expense	2,290	50	1,442	254	(1,068)	2,968
Provision for loan losses	1,500	15	1,875	—	—	3,390
Salaries and employee benefits	3,586	2,978	1,674	192	—	8,430
Other noninterest expenses	3,217	1,356	878	88	—	5,539
Total operating expenses	10,593	4,399	5,869	534	(1,068)	20,327
	>	>	>	>	>	>
Income (loss) before income taxes	(918)	386	5,165	(233)	—	4,400
Provision for (benefit from) income taxes	(764)	154	2,015	(87)	(1)	1,317
Net income (loss)	$(154)	$232	$3,150	$(146)	$ 1	$ 3,083
Total assets	$752,252	$53,119	$246,730	$2,778	$ (148,308)	$ 906,571
Capital expenditures	$237	$(8)	$415	$1	$ —	$ 645

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	Six Months Ended June 30, 2012					
(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	$16,163	$1,140	$23,034	$—	$(2,483)	$37,854
Gains on sales of loans	—	8,821	—	—	—	8,821
Other noninterest income	3,030	2,095	494	672	—	6,291
Total operating income	19,193	12,056	23,528	672	(2,483)	52,966
Expenses:						
Interest expense	4,078	219	3,124	497	(2,483)	5,435
Provision for loan losses	1,500	105	3,980	—	—	5,585
Salaries and employee benefits	7,748	7,393	3,722	475	—	19,338
Other noninterest expenses	5,771	2,945	1,974	256	—	10,946
Total operating expenses	19,097	10,662	12,800	1,228	(2,483)	41,304
	>	>	>	>	>	>
Income (loss) before income taxes	96	1,394	10,728	(556)	—	11,662
Provision for (benefit from) income taxes	(829)	557	4,184	(211)	—	3,701
Net income (loss)	$925	$837	$6,544	$(345)	$—	$7,961
Total assets	$791,327	$91,025	$265,995	$2,974	$(201,607)	$949,714
Capital expenditures	$352	$209	$99	$—	$—	$660

	Six Months Ended June 30, 2011					
(Dollars in thousands)	Retail Banking	Mortgage Banking	Consumer Finance	Other	Eliminations	Consolidated
Revenues:						
Interest income	$16,204	$787	$21,086	$—	$(2,076)	$36,001
Gains on sales of loans	—	7,496	—	—	—	7,496
Other noninterest income	2,975	1,442	339	563	—	5,319
Total operating income	19,179	9,725	21,425	563	(2,076)	48,816
Expenses:						
Interest expense	4,677	112	2,815	506	(2,078)	6,032
Provision for loan losses	2,550	35	3,625	—	—	6,210
Salaries and employee benefits	7,486	5,723	3,329	384	—	16,922
Other noninterest expenses	6,213	2,907	1,639	237	—	10,996
Total operating expenses	20,926	8,777	11,408	1,127	(2,078)	40,160
	>	>	>	>	>	>
Income (loss) before income taxes	(1,747)	948	10,017	(564)	2	8,656
Provision for (benefit from) income taxes	(1,469)	379	3,907	(214)	1	2,604
Net income (loss)	$(278)	$569	$6,110	$(350)	$1	$6,052
Total assets	$752,252	$53,119	$246,730	$2,778	$(148,308)	$906,571
Capital expenditures	$486	$69	$623	$3	$—	$1,181

The Retail Banking segment extends a warehouse line of credit to the Mortgage Banking segment, providing a portion of the funds needed to originate mortgage loans. The Retail Banking segment charges the Mortgage Banking segment interest at the daily FHLB advance rate plus 50 basis points. The Retail Banking segment also provides the Consumer Finance segment with a portion of the funds needed to originate loans by means of a variable rate line of credit that carries interest at one-month LIBOR plus 200 basis points and fixed rate loans that carry interest rates ranging from 5.4 percent to 8.0 percent. The Retail Banking segment acquires certain residential real estate loans from the Mortgage Banking segment at prices similar to those paid by third-party investors. These transactions are eliminated to reach consolidated totals. Certain corporate overhead costs incurred by the Retail Banking segment are not allocated to the Mortgage Banking, Consumer Finance and Other segments.

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NOTE 9: Commitments and Financial Instruments with Off-Balance-Sheet Risk

C&F Mortgage sells substantially all of the residential mortgage loans it originates to third-party investors, some of whom may require the repurchase of loans in the event of loss due to borrower misrepresentation, fraud or early default. Mortgage loans and their related servicing rights are sold under agreements that define certain eligibility criteria for the mortgage loans. Recourse periods for early payment default vary from 90 days up to one year. Recourse periods for borrower misrepresentation or fraud, or underwriting error do not have a stated time limit. C&F Mortgage maintains an indemnification reserve for potential claims made under these recourse provisions. Risks also arise from the possible inability of counterparties to meet the terms of their contracts. C&F Mortgage has procedures in place to evaluate the credit risk of investors and does not expect any counterparty to fail to meet its obligations. The following table presents the changes in the allowance for indemnification losses for the periods presented:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2012	2011	2012	2011
Allowance, beginning of period	$ 1,827	$ 1,522	$ 1,702	$ 1,291
Provision for indemnification losses	330	175	455	406
Payments	(500)	(161)	(500)	(161)
Allowance, end of period	$ 1,657	$ 1,536	$ 1,657	$ 1,536

NOTE 10: Derivatives

The Corporation uses derivatives to manage exposure to interest rate risk through the use of interest rate swaps. Interest rate swaps involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional principal amount and maturity date with no exchange of underlying principal amounts. The Corporation’s interest rate swaps qualify as cash flow hedges. The Corporation’s cash flow hedges effectively modify a portion of the Corporation’s exposure to interest rate risk by converting variable rates of interest on $10.00 million of the Corporation’s trust preferred capital notes to fixed rates of interest until September 2015.

The cash flow hedges total notional amount is $10.00 million. At June 30, 2012, the cash flow hedges had a fair value of ($542,000), which is recorded in other liabilities. The cash flow hedges were fully effective at June 30, 2012 and therefore the loss on the cash flow hedges was recognized as a component of other comprehensive income (loss), net of deferred income taxes.

NOTE 11: Other Noninterest Expenses

The following table presents the significant components in the consolidated statements of income line “Noninterest Expenses – Other Expenses.”

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2012	2011	2012	2011
Provision for indemnification losses	$ 330	$ 175	$ 455	$ 406
Loan and OREO expenses	306	717	655	1,187
Data processing fees	563	580	1,059	1,131
Telecommunication expenses	303	284	587	547
FDIC expenses	168	248	327	496
Professional fees	398	475	854	1,028
All other noninterest expenses	1,886	1,449	3,611	3,064

Total Other Noninterest Expenses	$ 3,954	$ 3,928	$ 7,548	$ 7,859

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ITEM 2.MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains statements concerning the Corporation's expectations, plans, objectives, future financial performance and other statements that are not historical facts. These statements may constitute "forward-looking statements" as defined by federal securities laws and may include, but are not limited to, statements regarding profitability, liquidity, the Corporation's and each business segment's loan portfolio, allowance for loan losses, trends regarding the provision for loan losses, trends regarding net loan charge-offs, trends regarding levels of nonperforming assets and troubled debt restructurings and expenses associated with nonperforming assets, provision for indemnification losses, levels of noninterest income and expense, interest rates and yields, the deposit portfolio, including trends in deposit maturities and rates, interest rate sensitivity, market risk, regulatory developments, capital requirements, growth strategy and financial and other goals. These statements may address issues that involve estimates and assumptions made by management and risks and uncertainties. Actual results could differ materially from historical results or those anticipated by such statements. Factors that could have a material adverse effect on the operations and future prospects of the Corporation include, but are not limited to, changes in:

interest rates

general business conditions, as well as conditions within the financial markets

general economic conditions, including unemployment levels

the legislative/regulatory climate, including the Dodd-Frank Act and regulations promulgated thereunder and the Consumer Financial Protection Bureau (CFPB) and the regulatory and enforcement activities of the CFPB

monetary and fiscal policies of the U.S. Government, including policies of the Treasury and the Federal Reserve Board

the value of securities held in the Corporation's investment portfolios

the quality or composition of the loan portfolios and the value of the collateral securing those loans

the inventory level and pricing of used automobiles

the level of net charge-offs on loans and the adequacy of our allowance for loan losses

the level of indemnification losses related to mortgage loans sold

demand for loan products

deposit flows

the strength of the Corporation's counterparties

competition from both banks and non-banks

demand for financial services in the Corporation's market area technology

reliance on third parties for key services

the commercial and residential real estate markets

demand in the secondary residential mortgage loan markets

the Corporation’s expansion and technology initiatives

accounting principles, policies and guidelines

Any forward-looking statements should be considered in context with the various disclosures made by us about our businesses in our public filings with the Securities and Exchange Commission, including without limitation the risks identified above and those more specifically described in Item 1A. “Risk Factors” of our Annual Report on Form 10-K for the year ended December 31, 2011.

The following discussion supplements and provides information about the major components of the results of operations, financial condition, liquidity and capital resources of the Corporation. This discussion and analysis should be read in conjunction with the accompanying consolidated financial statements.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements requires us to make estimates and assumptions. Those accounting policies with the greatest uncertainty and that require our most difficult, subjective or complex judgments affecting the application of these policies, and the likelihood that materially different amounts would be reported under different conditions, or using different assumptions, are described below.

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Allowance for Loan Losses: We establish the allowance for loan losses through charges to earnings in the form of a provision for loan losses. Loan losses are charged against the allowance when we believe that the collection of the principal is unlikely. Subsequent recoveries of losses previously charged against the allowance are credited to the allowance. The allowance represents an amount that, in our judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Our judgment in determining the level of the allowance is based on evaluations of the collectibility of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective because it requires estimates that are susceptible to significant revision as more information becomes available.

Allowance for Indemnifications: The allowance for indemnifications is established through charges to earnings in the form of a provision for indemnifications, which is included in other noninterest expenses. A loss is charged against the allowance for indemnifications under certain conditions when a purchaser of a loan (investor) sold by C&F Mortgage incurs a loss due to borrower misrepresentation, fraud, early default, or underwriting error. The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses arising from indemnification requests. Management's judgment in determining the level of the allowance is based on the volume of loans sold, current economic conditions and information provided by investors. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

Impairment of Loans: We consider a loan impaired when it is probable that the Corporation will be unable to collect all interest and principal payments as scheduled in the loan agreement. We do not consider a loan impaired during a period of delay in payment if we expect the ultimate collection of all amounts due. We measure impairment on a loan-by-loan basis for commercial, construction and residential loans in excess of $500,000 by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. We maintain a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. Troubled debt restructurings (TDRs) are also considered impaired loans, even if the loan balance is less than $500,000. A TDR occurs when we agree to significantly modify the original terms of a loan due to the deterioration in the financial condition of the borrower.

Impairment of Securities: Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) we intend to sell the security or (ii) it is more-likely-than-not that we will be required to sell the security before recovery of its amortized cost basis. If, however, we do not intend to sell the security and it is not more-likely-than-not that we will be required to sell the security before recovery, we must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income. For equity securities, impairment is considered to be other-than-temporary based on our ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. We regularly review each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, our best estimate of the present value of cash flows expected to be collected from debt securities, our intention with regard to holding the security to maturity and the likelihood that we would be required to sell the security before recovery.

Other Real Estate Owned (OREO): Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of the loan balance or the fair value less costs to sell at the date of foreclosure. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of like properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Corporation may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further other-than-temporary deterioration in market conditions.

Goodwill: Goodwill is no longer subject to amortization over its estimated useful life. In assessing the recoverability of the Corporation’s goodwill, all of which was recognized in connection with the Bank’s acquisition of C&F Finance Company in September 2002, we must make assumptions in order to determine the fair value of the respective assets. Major assumptions used in determining if goodwill is impaired were increases in future income, sales multiples in determining terminal value and the discount rate applied to future cash flows. As part of the impairment test, we performed a sensitivity analysis by increasing the discount rate, lowering sales multiples and reducing increases in future income. We completed the annual test for impairment during the fourth quarter of 2011 and determined there was no impairment to be recognized in 2011. With the adoption of Accounting Standards Update 2011-08, Intangible-Goodwill and Other-Testing Goodwill for Impairment, in 2012, the Corporation will no longer be required to complete a test for impairment unless, based on an assessment of qualitative factors related to goodwill, we determine that it is more likely than not that the fair value of C&F Finance Company is less than its carrying amount. If the likelihood of impairment is more than 50 percent, the Corporation will perform a test for impairment and we may be required to record impairment charges.

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Retirement Plan: The Bank maintains a non-contributory, defined benefit pension plan for eligible full-time employees as specified by the plan. Plan assets, which consist primarily of mutual funds invested in marketable equity securities and corporate and government fixed income securities, are valued using market quotations. The Bank's actuary determines plan obligations and annual pension expense using a number of key assumptions. Key assumptions may include the discount rate, the interest crediting rate, the estimated future return on plan assets and the anticipated rate of future salary increases. Changes in these assumptions in the future, if any, or in the method under which benefits are calculated may impact pension assets, liabilities or expense.

Derivative Financial Instruments: The Corporation recognizes derivative financial instruments at fair value as either an other asset or an other liability in the consolidated balance sheets. The derivative financial instruments have been designated as and qualify as cash flow hedges. The effective portion of the gain or loss on the cash flow hedges is reported as a component of other comprehensive income, net of deferred taxes, and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings.

Accounting for Income Taxes: Determining the Corporation's effective tax rate requires judgment. In the ordinary course of business, there are transactions and calculations for which the ultimate tax outcomes are uncertain. In addition, the Corporation's tax returns are subject to audit by various tax authorities. Although we believe that the estimates are reasonable, no assurance can be given that the final tax outcome will not be materially different than that which is reflected in the income tax provision and accrual.

For further information concerning accounting policies, refer to Item 8 "Financial Statements and Supplementary Data" under the heading "Note 1: Summary of Significant Accounting Policies" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

OVERVIEW

Our primary financial goals are to maximize the Corporation's earnings and to deploy capital in profitable growth initiatives that will enhance long-term shareholder value. We track three primary financial performance measures in order to assess the level of success in achieving these goals: (i) return on average assets (ROA), (ii) return on average common equity (ROE), and (iii) growth in earnings. In addition to these financial performance measures, we track the performance of the Corporation's three principal business activities: retail banking, mortgage banking, and consumer finance. We also actively manage our capital through growth and dividends, while considering the need to maintain a strong regulatory capital position.

Financial Performance Measures

Net income for the Corporation was $4.2 million for the three months ended June 30, 2012, compared with $3.1 million for the three months ended June 30, 2011. Net income for the Corporation was $8.0 million for the first six months of 2012, compared with $6.1 million for the first six months of 2011. Net income available to common shareholders was $4.0 million, or $1.22 per common share assuming dilution, for the three months ended June 30, 2012, compared with $2.8 million, or $0.88 per common share assuming dilution, for the three months ended June 30, 2012. Net income available to common shareholders was $7.7 million, or $2.33 per common share assuming dilution for the first half of 2012, compared with $5.5 million, or $1.73 per common share assuming dilution for the first half of 2011. The difference between reported net income and net income available to common shareholders is a result of the Preferred Stock dividends and amortization of the Warrant related to the Corporation's participation in the CPP. The Corporation's earnings for the second quarter and first half of 2012 were primarily a result of the strong earnings in the Consumer Finance segment, which continues to benefit from (1) sustained loan growth and (2) the low funding costs on its variable-rate borrowings. The Mortgage Banking segment benefited from (1) higher gains on loans sold as a result of higher loan production and correspondingly higher sales volume during 2012 and (2) lower legal and consulting expenses. The Retail Banking segment benefited from the effects of (1) the continued low interest rate environment on the cost of deposits, (2) lower provisions for loan losses, (3) higher interchange activity fee income and (4) lower expenses associated with FDIC deposit insurance and foreclosed properties.

The Corporation's ROE and ROA were 17.96 percent and 1.77 percent, respectively, on an annualized basis for the second quarter of 2012, compared with 14.41 percent and 1.24 percent, respectively, for the second quarter of 2011. For the first six months of 2012, on an annualized basis, the Corporation's ROE and ROA were 17.35 percent and 1.69 percent, respectively, compared with 14.46 percent and 1.21 percent, respectively, for the first six months of 2011. The increase in these ratios during 2012 was primarily due to the earnings improvement of each of the Corporation's significant business segments. In addition, the effect of dividends on the Corporation's Preferred Stock on net income available to common shareholders was lessened for the second quarter and first half of 2012 by the redemptions of Preferred Stock in July 2011 and in April 2012.

Principal Business Activities. An overview of the financial results for each of the Corporation's principal business segments is presented below. A more detailed discussion is included in "Results of Operations."

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Retail Banking: C&F Bank reported net income of $618,000 for the second quarter of 2012, compared to a net loss of $154,000 for the second quarter of 2011. For the first six months of 2012, C&F Bank reported net income of $925,000, compared to a net loss of $278,000 for the first six months of 2011. Factors contributing to the improvement in financial results for the three and six months ended June 30, 2012, relative to the same periods of 2011, were higher activity-based interchange income, the effects of the continued low interest rate environment on the cost of deposits, lower provisions for loan losses, lower expenses associated with holding costs of foreclosed properties, and lower FDIC deposit insurance premiums. Partially offsetting these positive factors were the negative effects of the following: (1) a decrease in average loans to nonaffiliates resulting from weak demand in the current economic environment and intensified competition for loans in our markets, (2) a decline in overdraft fees and (3) higher occupancy expenses associated with depreciation and maintenance of technology related to expanding the banking services we offer to customers and improving operational efficiency and security.

The Bank’s nonperforming assets were $16.2 million at June 30, 2012, compared to $16.1 million at December 31, 2011. Nonperforming assets at June 30, 2012 included $11.0 million in nonaccrual loans, compared to $10.0 million at December 31, 2011, and $5.2 million in foreclosed properties, compared to $6.1 million at December 31, 2011. Troubled debt restructurings were $15.8 million at June 30, 2012, of which $7.5 million were included in nonaccrual loans, as compared to $17.1 million of troubled debt restructurings at December 31, 2011, of which $8.4 million were included in nonaccrual loans. The increase in nonaccrual loans primarily resulted from one commercial relationship secured by undeveloped residential property, which was partially offset by nonaccrual loan pay-offs, charge-offs and transfers to foreclosed properties. Management believes it has provided adequate loan loss reserves for the retail banking segment’s loans. Foreclosed properties at June 30, 2012 consist of both residential and non-residential properties. These properties are evaluated regularly and have been written down to their estimated fair values less selling costs.

Mortgage Banking: C&F Mortgage Corporation reported net income of $419,000 for the second quarter of 2012, compared to $232,000 for the second quarter of 2011. For the first six months of 2012, C&F Mortgage Corporation reported net income of $837,000, compared to $569,000 for the first six months of 2011. Factors contributing to the improvements in financial results for the three months and six months ended June 30, 2012, relative to the same periods of 2011, were (1) higher gains on sales of loans and ancillary loan production fees, (2) higher interest income on loans held for sale and (3) lower legal and consulting fees. Loan origination volume increased to $206.7 million in the second quarter of 2012, a 38.7 percent increase as compared to $149.0 million in the second quarter of 2011, and to $379.9 million in the first half of 2012, a 39.1 percent increase as compared to $273.1 million in the first half of 2011. For the second quarter of 2012, the amount of loan originations for refinancings and home purchases were $55.8 million and $150.9 million, respectively, compared to $21.5 million and $127.5 million, respectively, for the second quarter of 2011. For the first half of 2012, the amount of loan originations for refinancings and home purchases were $135.5 million and $244.5 million, respectively, compared to $60.1 million and $213.0 million, respectively, for the first half of 2011. The increases in loan originations are a result of the continued low interest rate environment that has led to increased mortgage borrowing and refinancing activity. These increases have led to correspondingly higher sales volume, which increased to $191.2 million for the second quarter of 2012, compared to $134.7 million during the second quarter of 2011, and which increased to $370.8 million for the first half of 2012, compared to $297.8 million during the first half of 2011. In connection with the higher sales volumes in 2012, the mortgage banking segment incurred higher production and income based compensation expense.

Consumer Finance: C&F Finance Company reported net income of $3.3 million for the second quarter of 2012, compared to net income of $3.2 million for the second quarter of 2011. For the first six months of 2012, C&F Finance reported net income of $6.5 million, compared to net income of $6.1 million for the first six months of 2011. The improvements in financial results for 2012 resulted from a 9.5 percent and a 10.7 increase in average loans outstanding and the sustained low cost of the consumer finance segment’s variable-rate borrowings. These items were partially offset by (1) increases of $205,000 and $355,000 in the provision for loan losses for the three and six months ended June 30, 2012, respectively, resulting from loan growth and higher net charge-offs, (2) increases of $166,000 and $387,000 in personnel costs for the three and six months ended June 30, 2012, respectively, resulting from an increase in the number of personnel to support loan growth and (3) increases of $49,000 and $149,000 in occupancy expenses for the three and six months ended June 30, 2012, respectively, resulting from C&F Finance Company's relocation in April 2011 to a larger leased headquarters building and depreciation and maintenance of technology to support growth. The allowance for loan losses as a percentage of consumer finance loans at June 30, 2012 was 7.92 percent, as compared with 7.94 percent at December 31, 2011. Management believes that the current allowance for loan losses is adequate to absorb probable losses in the Consumer Finance segment's loan portfolio.

Other and Eliminations: The net loss for the three months ended June 30, 2012 for this combined segment was $136,000, compared to a net loss of $145,000 for the three months ended June 30, 2011. The net loss for the first half of 2012 for this combined segment was $345,000, compared to a net loss of $349,000 for the first half of 2011. Revenue and expense of this combined segment include the results of operations of our investment, insurance and title subsidiaries, interest expense associated with the Corporation's trust preferred capital notes, other general corporate expenses and the effects of intercompany eliminations.

Capital Management. Total shareholders' equity was $93.9 million at June 30, 2012, compared to $96.1 million at December 31, 2011, which was a decrease of $2.2 million primarily attributable to the redemption of the Corporation's Preferred Stock, as described below, which was offset in part by earnings in 2012. The Corporation paid cash dividends of 26 cents and 52 cents per common share during the second quarter and first half of 2012, respectively, which was a 20.8 percent and a 21.8 percent payout ratio of net income available to common shareholders for the second quarter and first half of 2012, respectively.

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On April 11, 2012, the Corporation redeemed the remaining 10,000 shares of its Preferred Stock issued to Treasury in January 2009 under the CPP. The redemption consisted of $10.0 million in liquidation value and $78,000 of accrued and unpaid dividends associated with the Preferred Stock. As a result of this redemption, the Corporation will pay no future dividends on the Preferred Stock. The Corporation funded this redemption without raising additional capital because of its strong capital position and financial performance. The redemption results in no dilution to common shareholders because no new capital was issued. In connection with this redemption, the Corporation accelerated the accretion of the remaining Preferred Stock discount, which reduced net income available to common shareholders by approximately $151,000 in the second quarter of 2012, but eliminated any future accretion.

RESULTS OF OPERATIONS

The following table presents the average balance sheets, the amounts of interest earned on earning assets, with related yields, and interest expense on interest-bearing liabilities, with related rates, for the three and six months ended June 30, 2012 and 2011. Loans include loans held for sale. Loans placed on nonaccrual status are included in the balances and are included in the computation of yields, but had no material effect. Interest on tax-exempt loans and securities is presented on a taxable-equivalent basis (which converts the income on loans and investments for which no income taxes are paid to the equivalent yield as if income taxes were paid using the federal corporate income tax rate of 34 percent).

TABLE 1: Average Balances, Income and Expense, Yields and Rates

	Three Months Ended June 30,					
	2012			2011		
(Dollars in thousands)	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
Assets						
Securities:						
Taxable	$19,856	$82	1.65 %	$19,909	$85	1.71 %
Tax-exempt	118,709	1,797	6.06	119,086	1,856	6.26
Total securities	138,565	1,879	5.42	138,995	1,941	5.59
Loans, net	720,881	17,837	9.92	672,925	17,058	10.17
Interest-bearing deposits in other banks and Federal funds sold	10,558	5	0.19	22,465	16	0.29
Total earning assets	870,004	19,721	9.07	834,385	19,015	9.14
Allowance for loan losses	(35,180)			(29,195)		
Total non-earning assets	91,591			97,676		
Total assets	$926,415			$902,866		
Liabilities and Shareholders' Equity						
Time and savings deposits:						
Interest-bearing deposits	$109,039	$97	0.36 %	$109,228	$129	0.48 %
Money market deposit accounts	92,975	90	0.39	75,521	135	0.71
Savings accounts	45,316	12	0.11	42,413	10	0.09
Certificates of deposit, $100 or more	138,831	546	1.58	131,495	663	2.02
Other certificates of deposit	164,072	637	1.56	173,644	819	1.89
Total time and savings deposits	550,233	1,382	1.00	532,301	1,756	1.32

Borrowings	159,961	1,215	3.04		159,332	1,212	3.04	
Total interest-bearing liabilities	710,194	2,597	1.46		691,633	2,968	1.72	
	>	>	>		>	>	>	
Demand deposits	103,450				94,209			
Other liabilities	20,275				19,472			
Total liabilities	833,919				805,314			
Shareholders’ equity	92,496				97,552			
Total liabilities and shareholders’ equity	$926,415				$902,866			
Net interest income		$17,124				$16,047		
		>				>		
Interest rate spread			7.60	%			7.42	%
Interest expense to average earning assets (annualized)			1.19	%			1.43	%
Net interest margin (annualized)			7.87	%			7.71	%

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	Six Months Ended June 30,					
	2012			2011		
(Dollars in thousands)	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
Assets						
Securities:						
Taxable	$20,610	$168	1.63 %	$20,316	$162	1.60 %
Tax-exempt	118,652	3,595	6.06	117,133	3,665	6.26
Total securities	139,262	3,763	5.40	137,449	3,827	5.57
Loans, net	716,166	35,327	9.94	671,034	33,418	10.04
Interest-bearing deposits in other banks and Federal funds sold	12,971	13	0.20	25,772	31	0.24
Total earning assets	868,399	39,103	9.01	834,255	37,276	9.00
Allowance for loan losses	(34,648)			(29,206)		
Total non-earning assets	92,318			96,342		
Total assets	$926,069			$901,391		
Liabilities and Shareholders' Equity						
Time and savings deposits:						
Interest-bearing deposits	$110,953	$239	0.43 %	$112,457	$321	0.58 %
Money market deposit accounts	89,745	190	0.43	73,416	265	0.73
Savings accounts	44,687	22	0.10	42,112	20	0.10
Certificates of deposit, $100 or more	139,025	1,187	1.72	132,559	1,336	2.03
Other certificates of deposit	166,293	1,361	1.65	174,805	1,669	1.93
Total time and savings deposits	550,703	2,999	1.09	535,349	3,611	1.36
Borrowings	159,489	2,437	3.06	159,708	2,421	3.03
Total interest-bearing liabilities	710,192	5,436	1.53	695,057	6,032	1.74
	>	>	>	>	>	>
Demand deposits	98,922			90,741		
Other liabilities	21,450			19,879		
Total liabilities	830,564			805,677		
Shareholders' equity	95,505			95,714		
Total liabilities and shareholders' equity	$926,069			$901,391		
Net interest income		$33,667			$31,244	
		>			>	
Interest rate spread			7.47 %			7.26 %
Interest expense to average earning assets (annualized)			1.25 %			1.45 %
Net interest margin (annualized)			7.75 %			7.55 %

Interest income and expense are affected by fluctuations in interest rates, by changes in the volume of earning assets and interest-bearing liabilities, and by the interaction of rate and volume factors. The following table presents the direct causes of the period-to-period changes in the components of net interest income on a taxable-equivalent basis. We calculated the rate and volume variances using a formula prescribed by the Securities and Exchange Commission

(SEC). Rate/volume variances, the third element in the calculation, are not shown separately in the table, but are allocated to the rate and volume variances in proportion to the relationship of the absolute dollar amounts of the change in each. Loans include both nonaccrual loans and loans held for sale.

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TABLE 2: Rate-Volume Recap

(Dollars in thousands)	Three Months Ended June 30, 2012 from 2011 Increase (Decrease) Due to Rate	Volume	Total Increase (Decrease)
Interest income:			
Loans	$(415)	$1,194	$779
Securities:			
Taxable	(3)	—	(3)
Tax-exempt	(53)	(6)	(59)
Interest-bearing deposits in other banks and Federal funds sold	—	(11)	(11)
Total interest income	(471)	1,177	706
Interest expense:			
Time and savings deposits:			
Interest-bearing deposits	(31)	(1)	(32)
Money market deposit accounts	(71)	26	(45)
Savings accounts	1	1	2
Certificates of deposit, $100 or more	(152)	35	(117)
Other certificates of deposit	(139)	(43)	(182)
Total time and savings deposits	(392)	18	(374)
Borrowings (including Trust preferred capital notes)	—	3	3
Total interest expense	(392)	21	(371)
Change in net interest income	$(79)	$1,156	$1,077

(Dollars in thousands)	Six Months Ended June 30, 2012 from 2011 Increase (Decrease) Due to Rate	Volume	Total Increase (Decrease)
Interest income:			
Loans	$(1,361)	$3,270	$1,909
Securities:			
Taxable	3	3	6
Tax-exempt	(117)	47	(70)
Interest-bearing deposits in other banks and Federal funds sold	—	(18)	(18)
Total interest income	(1,475)	3,302	$1,827
Interest expense:			
Time and savings deposits:			
Interest-bearing deposits	(78)	(4)	(82)
Money market deposit accounts	(125)	50	(75)
Savings accounts	1	1	2
Certificates of deposit, $100 or more	(212)	63	(149)
Other certificates of deposit	(230)	(78)	(308)
Total time and savings deposits	(644)	32	(612)
Borrowings (including Trust preferred capital notes)	(157)	173	16

Total interest expense	(801)	205	(596)
Change in net interest income	$(674)	$3,097	$2,423

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Net interest income, on a taxable-equivalent basis, for the three months ended June 30, 2012 was $17.1 million, compared to $16.0 million for the three months ended June 30, 2011. Net interest income, on a taxable-equivalent basis, for the first half of 2012 was $33.7 million, compared to $31.2 million for the first half of 2011. The higher net interest income during the second quarter of 2012, as compared to the same period of 2011, resulted from a 16 basis point increase in net interest margin to 7.87 percent, coupled with a 4.3 percent increase in average earning assets. The higher net interest income during the first half of 2012, as compared to the same period of 2011, resulted from a 20 basis point increase in net interest margin to 7.75 percent, coupled with a 4.1 percent increase in average earning assets. The increases in net interest margin for the three and six months ended June 30, 2012, compared to the same periods in 2011, were principally a result of decreases in the rates paid on savings and time deposits, partially offset by lower yields on loans and municipal securities. The decreases in rates paid on time and savings deposits were primarily a result of the sustained low interest rate environment, and the repricing of higher rate certificates of deposit as they matured to lower rates. In addition, the mix in interest-bearing deposits has shifted to shorter-term deposit accounts. The decreases in the yields on loans resulted primarily from higher average loans held for sale at the Mortgage Banking segment, which typically are lower yielding than loans held for investment. The increases in average loans held for sale offset the favorable effects of a changes in the mix of loans held for investment, namely increases in higher yielding average loans at the Consumer Finance segment and declines in lower yielding average loans at the Retail Banking segment resulted in higher yields on loans held for investment. The decline in the yields on securities resulted from calls and maturities of higher-yielding securities and purchases of municipal securities with lower yields in the current low interest rate environment.

Average loans, which includes both loans held for investment and loans held for sale, increased $48.0 million to $720.9 million for the quarter ended June 30, 2012 from $672.9 million for the second quarter of 2011. Likewise average loans increased $45.1 million to $716.2 million for the first half of 2012 from $671.0 million for the first half of 2011. A portion of the increase occurred in the Mortgage Banking segment's portfolio of loans held for sale, the average balance of which increased $28.0 million during the second quarter of 2012 and $27.2 million during the first half of 2012. This increase is indicative of the higher loan production due to the continued low interest rate environment that has led to increased mortgage borrowing and refinancing activity. In total, average loans to non-affiliates held for investment increased $19.9 million during the second quarter of 2012 and $17.9 million during the first six months of 2012, compared to the same respective periods of 2011. The Consumer Finance segment's average loan portfolio, which increased $22.4 million during the second quarter of 2012 and $23.2 million during the first six months of 2012 increased as a result of robust demand in existing and new markets. The increases in average loans at the Consumer Finance segment were offset in part by decreases of $2.5 million during the second quarter of 2012 and $5.3 million during the first half of 2012 in the Retail Banking and Mortgage Banking segments' portfolios of average loans held for investment. Loan production at the Retail Banking segment has been negatively affected by weak demand for new loans in the current economic environment and intensified competition for loans in our markets.

The overall yields on average loans decreased 25 basis points to 9.92 percent for the second quarter of 2012 and 10 basis points to 9.94 percent for the for the first half of 2012, when compared to the same periods in 2011, principally as a result of higher levels of lower-yielding Mortgage Banking loans held for sale as a percentage of total loans, as well as a slight decrease in the yield for the three months and six months ended June 30, 2012 on the Consumer Finance segment loans as a result of increased competition from institutions re-entering the automobile financing market.

Average securities available for sale decreased $430,000 in the second quarter of 2012 and increased $1.8 million in the first half of 2012 as compared to the same periods in 2011. The second quarter decrease in average securities available for sale and the slight increase in average securities available for sale during the first half of 2012, as compared to the same periods in 2011, reflect the effect of the lower interest rate environment on call activity, as well as on the availability of reinvestment opportunities that satisfy the investment portfolio's role in managing interest rate sensitivity, providing liquidity and serving as an additional source of interest income. The lower yields on the available-for-sale securities portfolio during the second quarter and first half of 2012, compared to the same periods in 2011, resulted from the calls and maturities of higher-yielding securities and purchases of lower-yielding securities in the current low interest rate environment, as well as purchases of shorter-term securities with lower yields throughout 2011 and continuing into 2012.

Average interest-bearing deposits in other banks and Federal funds sold decreased $11.9 million and $12.8 million during the second quarter and first half of 2012, respectively, compared to the same periods in 2011, as a result of deploying excess liquidity to partially fund loan demand at the Mortgage Banking and Consumer Finance segments. The average yield on these overnight funds declined 10 basis points and 4 basis points during the second quarter and first half of 2012, respectively, compared to the same periods in 2011, as a result of the continuing low interest rate environment.

Average interest-bearing time and savings deposits increased $17.9 million in the second quarter of 2012 and $15.4 million in the first half of 2012, compared to the same periods in 2011, mainly due to a shift to shorter-term interest-bearing demand and money market deposit accounts, which allows depositors greater flexibility for funds management and investing decisions in this low interest rate environment. The average cost of deposits declined 32 basis points for the second quarter of 2012 and 27 basis points for the first half of 2012, compared to the same periods in 2011, because time deposits that matured throughout 2011 and into 2012 repriced at lower interest rates or were not renewed, interest rates paid on interest-bearing demand and money market deposit accounts decreased as a result of the sustained low interest rate environment, and the balances of shorter-term savings and money market deposits, which pay a lower interest rate, increased.

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Average borrowings increased $629,000 in the second quarter of 2012 and decreased $219,000 in the first half of 2012, compared to the same periods in 2011. These minimal changes in average borrowings reflect that funding needs for the growth in average earning assets during 2012 have been met through the utilization of excess liquidity and the growth in average deposits during 2012. There were minimal changes in the average cost of borrowings because of the stable low interest rate environment.

It will be challenging to maintain the Retail Banking segment's net interest margin at its current level if funds obtained from loan repayments and from deposit growth cannot be fully used to originate new loans and instead are reinvested in lower-yielding earning assets, and if the reduction in earning asset yields exceeds interest rate declines in interest-bearing liabilities. With the expectation that short-term interest rates will not change significantly during 2012 and the current low rate environment will be relatively unchanged, the net interest margin at the Consumer Finance segment will be most affected by competition from institutions re-entering the automobile financing market and loan pricing strategies that these competitors may use to grow market share.

Noninterest Income

TABLE 3: Noninterest Income

(Dollars in thousands)	Three Months Ended June 30, 2012				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Gains on sales of loans	$—	$4,718	$—	$ —	$4,718
Service charges on deposit accounts	825	—	—	—	825
Other service charges and fees	608	941	2	57	1,608
Gains on calls of available for sale securities	8	—	—	—	8
Other income	23	38	232	277	570
Total noninterest income	$1,464	$5,697	$234	$ 334	$7,729

(Dollars in thousands)	Three Months Ended June 30, 2011				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Gains on sales of loans	$—	$3,696	$—	$ —	$3,696
Service charges on deposit accounts	846	—	—	—	846
Other service charges and fees	576	699	2	37	1,314
Gains on calls of available for sale securities	—	—	—	—	—
Other income	79	4	155	264	502
Total noninterest income	$1,501	$4,399	$157	$ 301	$6,358

(Dollars in thousands)	Six Months Ended June 30, 2012				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Gains on sales of loans	$—	$8,821	$—	$ —	$8,821
Service charges on deposit accounts	1,626	—	—	—	1,626
Other service charges and fees	1,178	1,701	6	91	2,976
Gains on calls of available for sale securities	8	—	—	—	8
Other income	218	394	488	581	1,681
Total noninterest income	$3,030	$10,916	$494	$ 672	$15,112

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(Dollars in thousands)	Six Months Ended June 30, 2011				
	Retail Banking	Mortgage Banking	Consumer Finance	Other and Eliminations	Total
Gains on sales of loans	$—	$7,496	$—	$ —	$7,496
Service charges on deposit accounts	1,694	—	—	—	1,694
Other service charges and fees	1,095	1,228	4	79	2,406
Gains on calls of available for sale securities	—	—	—	—	—
Other income	186	214	335	484	1,219
Total noninterest income	$2,975	$8,938	$339	$ 563	