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

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2017

BANK OF THE JAMES FINANCIAL GROUP, INC.
(Exact Name of Registrant as Specified in Its Charter)

Commission file number 001-35402

Virginia (State or Other Jurisdiction of Incorporation or Organization)	**20-0500300** (I.R.S. Employer Identification No.)
828 Main Street, Lynchburg, VA (Address of Principal Executive Offices)	**24504** (Zip Code)

(434) 846-2000
(Issuer's telephone number, including area code)

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

Title of Each Class	Name of Exchange on Which Registered
Common Stock, $2.14 par value	**The NASDAQ Capital Markets**

Securities registered under Section 12(g) of the Exchange Act: Common Stock, $2.14 par value

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section13 or Section 15(d) of the Act. ☐ Yes ☑ No

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

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

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

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

Large accelerated filer	☐	Accelerated filer	☐
Non-accelerated filer	☐	Smaller reporting company	☑
		Emerging growth company	☐

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

The aggregate value of the voting common equity held by nonaffiliates as of June 30, 2017, the last business day of the registrant's most recently completed second fiscal quarter, was approximately $58,795,553 based on the price at which the common stock last traded on such day. This price reflects inter-dealer prices without retail mark up, mark down, or commissions, and may not represent actual transactions.

The number of shares outstanding of Common Stock, $2.14 par value as of March 21, 2018 was approximately 4,378,436.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2018 Proxy Statement for the Annual Meeting of Shareholders, scheduled to be held on May 15, 2018, are incorporated by reference into Part III of this Form 10-K

PART I

Item 1. Business

General

Bank of the James Financial Group, Inc. (“Financial” or the “Company”) is a bank holding company with its headquarters in Lynchburg, Virginia. Financial was incorporated at the direction of Bank of the James (the “Bank” or “Bank of the James”) on October 3, 2003 to serve as a bank holding company of the Bank. Financial acquired all of the shares of the Bank in a statutory share exchange on a one-for-one basis on January 1, 2004.

The Bank is a Virginia banking corporation headquartered in Lynchburg, Virginia. The Bank was incorporated under the laws of the Commonwealth of Virginia as a state chartered bank in 1998 and began banking operations in July 1999. The Bank was organized to engage in general retail and commercial banking business.

The Bank’s principal office is located at 828 Main Street, Lynchburg, Virginia 24504 and its telephone number is (434) 846-2000. The Bank also maintains a website at www.bankofthejames.bank.

Financial conducts two principal activities: (1) general retail and commercial banking through Bank of the James; and (2) mortgage brokerage services through Bank of the James, a division of the Bank (the “Mortgage Division”).

In addition, Financial provides securities brokerage and other investment services through BOTJ Investment, a division of the Bank and acts as an agent for insurance and annuity products through BOTJ Insurance, Inc., a wholly-owned subsidiary of the Bank. The operating results of these business operations have not had a material impact on our financial performance and are not considered principal activities of Financial at this time.

The Bank, BOTJ Insurance, and BOTJ Investment Group, Inc., a non-operating subsidiary, are our only subsidiaries and primary assets.

Products and Services

Retail and Commercial Banking

The Bank currently conducts business within Virginia from 13 full-service offices and three limited service offices, one loan production office, and three mortgage production offices. The location of and services provided by each of our facilities is described in “Item 2. Properties” below. The Bank established a mortgage loan origination division that conducts business under the name “Bank of the James Mortgage, a Division of Bank of the James.” The Mortgage Division conducts business primarily from the division’s main office located in the Forest branch of the Bank. In addition, the Bank expanded into Charlottesville in 2013 (opening a full service branch in 2015), Harrisonburg in 2014 (opening a full service branch in 2015), Appomattox in 2016 (opening a permanent full service branch in 2017), and Roanoke in 2013 (opening a full service branch in 2017).

Deposit Services . Deposits are a major source of our funding. The Bank offers a full range of deposit services that are typically available in most banks and other financial institutions including checking accounts, savings accounts and other time deposits of various types, ranging from daily money market accounts to longer-term certificates of deposit. The transaction accounts and time certificates are tailored to the Bank’s market area at rates competitive to those offered in the area. In addition, the Bank offers its customers Individual Retirement Accounts (IRAs) and Health Care Savings Accounts (HSAs). All deposit accounts are insured by the Federal Deposit Insurance Corporation (the “FDIC”) up to the maximum amount allowed by law (generally, $250,000 per depositor, subject to aggregation rules). The Bank solicits such accounts from individuals, businesses, associations and organizations, and governmental authorities.

Lending Services . The Bank offers a full range of short- to medium-term commercial and consumer loans. Our primary focus is on making loans to small businesses and consumers in the Region 2000 (Lynchburg, Amherst, Bedford, Campbell) area, Charlottesville, Harrisonburg, Roanoke, and Appomattox. In addition, we also provide a wide range of real estate finance services. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements), and purchase of equipment and machinery. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education and personal investments. Additionally, the Bank originates fixed and floating-rate mortgage loans and real estate construction and acquisition loans. Where appropriate, the Bank attempts to limit interest rate risk through the use of variable interest rates and terms of less than five years.

In general, the Bank offers the following lending services in our market areas:

- *Commercial Business Lending.* We make loans to small- and medium-sized businesses for purposes such as purchases of equipment, facilities upgrades, inventory acquisition and various working capital purposes.
- *Real Estate Construction* . We make commercial and residential construction and development loans.
- *Commercial Real Estate Mortgage* . We make loans to borrowers secured by commercial real estate. In underwriting these types of loans we consider the historic and projected future cash flows of the real estate.

Consumer . We offer various types of secured and unsecured consumer loans, including personal loans, lines of credit, overdraft lines of credit, automobile loans, installment loans, demand loans, and home equity loans. We make consumer loans primarily for personal, family or household purposes.

We sell loan participations in the ordinary course of business when a loan originated by us exceeds our legal lending limit or we otherwise want to share risk with another bank. We also purchase loan participations from time to time from other banks in the ordinary course of business. Typically or loan participations are without recourse against the originating bank. Purchased loan participations are underwritten in accordance with our loan policy and represent a source of loan growth.

Other Banking Services . Other services offered by the Bank include safe deposit boxes, traveler’s checks, direct deposit of payroll and social security checks, automatic drafts for various accounts, treasury management services and credit card merchant services. The Bank also is associated with a shared network of automated teller machines (ATMs) that may be used by Bank customers throughout Virginia, the United States, and internationally.

The Bank intends to introduce new products and services desired by the public and as permitted by the regulatory authorities. The Bank remains committed to meeting the challenges that require technology. The Bank provides its customers with access to the latest technological products, such as telephone banking and internet banking, including on-line bill pay. This service allows customers to handle routine transactions using a standard touch tone telephone, applications for mobile devices, and via the internet at the Bank’s website.

Mortgage Banking. The Bank, through the Mortgage Division originates conforming and non-conforming home mortgages primarily in the Region 2000 area. As part of the Bank’s overall risk management strategy, the loans originated and closed by the Mortgage Division are pre-sold to major mortgage banking or other financial institutions. Effective April 1, 2011, the Mortgage Division began funding these pre-sold loans. The loans are transferred promptly, typically within 2 to 3 business days, to the buyer for a pre-arranged price. Management believes that there is acceptable risk associated with this arrangement.

Other Activities

We provide brokerage and investment services through the Bank’s Investment division (“Investment Division”). The Investment Division provides securities brokerage services to Bank customers and others through an agreement with Infinex Financial Group, LLC (“Infinex”), a registered broker-dealer. Under our agreement, Infinex operates a service center at 615 Church Street, Lynchburg, Virginia. To date the operating results of the Investment Division have not had a material impact on our financial performance.

We provide insurance and annuity products through BOTJ Insurance as an agent for national insurance companies. As of the date hereof, we offer the following insurance products: credit life, life insurance, fixed annuities, and disability insurance. We began providing these services in September 2008. To date the operating results of BOTJ Insurance have not had a material impact on our financial performance.

Employees

As of March 21, 2018, we had approximately 143 full-time equivalent employees. None of our employees are represented by any collective bargaining agreements, and relations with employees are considered excellent. We maintain employee benefit programs that include health insurance, a flexible spending account, a health savings account, and a 401(k) plan.

Location and Market Area

The Bank’s market area primarily consists of Region 2000, which encompasses the seven jurisdictions of the Town of Altavista, Amherst County, Appomattox County, the Town of Bedford, Bedford County, Campbell County, and the City of Lynchburg. Region 2000 supports a diverse, well-rounded economy. U.S. Routes 29, 60, 221, 460 and 501 and State Routes 24 and 40 all pass through the trade area and provide efficient access to other regions of the state. Regional airport service and rail service provide additional transportation channels.

Total population in the market area equals approximately 252,000. According to the U.S. Census, in 2010 the populations of the localities in the Region 2000 market area were approximately as follows: City of Lynchburg – 76,000; Amherst County – 32,000; Appomattox County – 15,000; Bedford County (including the Town of Bedford) – 74,000; Campbell County (including the Town of Altavista) – 55,000. The area is serviced by one daily newspaper and a number of radio and television stations providing diverse media outlets. Median family income in Region 2000 has risen over the past ten years.

Region 2000 has a broad range of services, light industry, and manufacturing plants. Principal service, industrial, research and development employers include: BWX Technologies, Inc. (nuclear fuel); Framatome (nuclear services); Centra Health, Inc. (health care services); C.B. Fleet, Inc. (medical supplies); Pacific Life (life insurance and other financial products); Frito-Lay, Inc. (snack foods); Griffin Pipe Products Co. (ductile iron pipe); R.R. Donnelley Printing Inc. (printed products); as well as six colleges including Randolph College, Sweet Briar College, Liberty University, and Lynchburg College.

In recent years we have expanded into Charlottesville, Virginia (north of Region 2000), Roanoke, Virginia (west of Region 2000), Harrisonburg, Virginia (northwest of Region 2000), and Appomattox (east of Region 2000).

Even with this expansion outside of Region 2000, the Bank continues to consider its primary market to be Region 2000.

Competition

Retail and Commercial Banking

The banking business is highly competitive. We compete with other commercial banks, savings institutions, credit unions, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market mutual funds and other financial institutions operating in the Region 2000 market area and elsewhere. Many of our nonbank competitors are not subject to the same extensive federal regulations that govern federally-insured banks and state regulations governing state chartered banks. As a result, such nonbank competitors may have certain advantages over the Bank in providing certain services.

Virginia law permits statewide branching by banks. Consequently, the Bank's market area is a highly competitive, highly branched banking market. Competition in the market area for loans to individuals, small businesses, and professional concerns, the Bank's target market, is keen, and pricing is important. Most of the Bank's competitors have substantially greater resources and lending limits than the Bank and offer certain services, such as extensive and established branch networks and trust services, that the Bank is not currently providing. Deposit competition is strong and comes from institutions in the market, U.S. Government securities, private issuers of debt obligations and suppliers of other investment alternatives for depositors, among other sources. As a result, the Bank has paid, and may in the future pay, above-market rates to attract deposits.

The adoption of legislation permitting nationwide interstate banking and branching and the use of financial holding companies may also increase competition in the Bank's market area. See "Supervision and Regulation of Financial" below.

Mortgage Banking

The Mortgage Division competes with large national and regional banks, credit unions, regional mortgage lenders and local mortgage brokers. Following the 2008 downturn in the economy and subsequent real estate turmoil, the guidelines surrounding agency business (i.e., loans sold to Fannie Mae and Freddie Mac) have become much more restrictive and the associated mortgage insurance for loans above 80 percent loan-to-value has continued to tighten. These changes in the conventional market have caused a dramatic increase in government lending and state bond programs. The Mortgage Division competes by attracting the top sales people in our market, providing an operational infrastructure that manages the guideline changes efficiently and effectively, offering a product menu that is both competitive in loan parameters as well as price, and providing consistently high quality customer service.

The Mortgage Division, like other residential mortgage originators and lenders, would be impacted by the inability of Fannie Mae, Freddie Mac, the FHA or the VA to purchase loans. Although the Mortgage Division sells loans to various intermediaries, the ability of these aggregators to purchase loans would be limited if these government-sponsored entities cease to exist or materially limit their purchases of mortgage loans.

SUPERVISION AND REGULATION

General

Financial, as a bank holding company, and the Bank, as a state chartered bank, are subject to extensive federal and state laws and regulations. These laws and regulations impose specific requirements or restrictions on and provide for general regulatory oversight of virtually all aspects of our operations. The following briefly summarizes the more significant provisions of applicable federal and state laws, certain regulations and the potential impact of such provisions on Financial and the Bank. These laws and regulations are generally intended to protect depositors, not shareholders. The following summary is qualified by reference to the statutory and regulatory provisions discussed. No assurance can be given that these statutes or regulations will not change.

Changes in applicable laws or regulations may have a material effect on our business and prospects. Our operations may be affected by legislative changes and the policies of various regulatory authorities. We cannot predict the effect that fiscal or monetary policies, economic control, or new federal or state legislation may have on our business and earnings in the future.

Regulation of Financial

General . Financial is subject to the periodic reporting requirements of the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), including the filing with the Securities and Exchange Commission (the “SEC”) of annual, quarterly and other reports on the financial condition and performance of the organization. Financial is directly affected by the corporate responsibility and accounting reform legislation signed into law on July 30, 2002, known as the Sarbanes-Oxley Act of 2002 (the “SOX Act”), and the related rules and regulations. The SOX Act includes provisions that, among other things, require that periodic reports containing financial statements that are filed with the SEC be accompanied by chief executive officer and chief financial officer certifications as to the accuracy and compliance with law, additional disclosure requirements and corporate governance and other related rules. Although we are not required to receive an opinion from our external auditors regarding our internal controls over financial reporting under section 404 of the SOX Act because of our status as a smaller reporting company, our management’s report on internal control over financial reporting is set forth in Item 8 and incorporated into Item 9A herein. Financial has expended considerable time and money in complying with the SOX Act and expects to continue to incur additional expenses in the future.

Bank Holding Company Act . As a bank holding company registered under the Bank Holding Company Act of 1956 (the “BHCA”), Financial is subject to regulation and examination by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”). Financial is required to file with the Federal Reserve Board an annual report and such other additional information as the Federal Reserve Board may require pursuant to the BHCA.

The Federal Reserve Board requires a bank holding company to act as a source of financial and managerial strength and to take measures to preserve and protect its bank subsidiaries. Financial would be compelled by the Federal Reserve Board to invest additional capital in the event the Bank experiences either significant loan losses or rapid growth of loans or deposits.

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

Pursuant to the BHCA, the FRB has the power to order any bank holding company or its subsidiaries to terminate any activity or to terminate its ownership or control of any subsidiary when the FRB has reasonable grounds to believe that continuation of such activity or ownership constitutes a serious risk to the financial soundness, safety or stability of any bank subsidiary of the bank holding company.

The FRB also has the authority to examine the Company and its subsidiaries, as well as any arrangements between the Company and its subsidiaries, with the cost of any such examinations to be borne by the Company. Banking subsidiaries of bank holding companies are also subject to certain restrictions imposed by federal law in dealings with their holding companies and other affiliates.

Gramm-Leach-Bliley Act of 1999 . The Gramm-Leach-Bliley Act (the “GLB Act”) which was effective March 11, 2000, permits bank holding companies to become financial holding companies and thereby affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. A bank holding company may become a financial holding company by filing a declaration that the bank holding company wishes to become a financial holding company if each of its subsidiary banks (i) is well capitalized under regulatory prompt corrective action provisions, (ii) is well managed, and (iii) has at least a satisfactory rating under the Community Reinvestment Act (“CRA”). No regulatory approval will be required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board.

The GLB Act defines “financial in nature” to include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; and activities that the Board has determined to be closely related to banking. Subsidiary banks of a financial holding company must continue to be well capitalized and well managed in order to continue to engage in activities that are financial in nature without regulatory actions or restrictions, which could include divestiture of the financial in nature subsidiary or subsidiaries. In addition, a financial holding company or a bank may not acquire a company that is engaged in activities that are financial in nature unless each of the subsidiary banks of the financial holding company or the bank has a CRA rating of satisfactory or better.

As discussed in more detail below under “Confidentiality and Required Disclosure of Consumer Information,” the GLB Act also imposes customer privacy requirements on financial institutions.

The cumulative effect of the GLB Act and other recent bank legislation has caused us to strengthen our staff to handle the procedures required by this additional regulation. The increased staff and operational costs have impacted our profitability. Although the above laws may have a significant impact on the banking industry by promoting, among other things, competition, it is not possible for the management of the Bank to determine, with any degree of certainty, the impact of such laws on the Bank.

Limits on the Payment of Dividends . Financial is a legal entity, separate and distinct from the Bank. Financial currently does not have any significant sources of revenue other than cash dividends paid to it by the Bank. Both Financial and the Bank are subject to laws and regulations that limit the payment of cash dividends, including requirements to maintain capital at or above regulatory minimums. As a bank that is a member of the Federal Reserve System (“state member bank”), the Bank must obtain prior written approval for any cash dividend if the total of all dividends declared in any calendar year would exceed the total of its net profits for that year combined with its retained net profits for the preceding two years.

Banking regulators have indicated that Virginia banking organizations should generally pay dividends only (1) from net undivided profits of the bank, after providing for all expenses, losses, interest and taxes accrued or due by the bank and (2) if the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition. In addition, the Federal Deposit Insurance Act (FDIA) prohibits insured depository institutions such as the Bank from making capital distributions, including the payment of dividends, if, after making such distribution, the institution would become undercapitalized as defined in the statute. In addition, the Federal Reserve is authorized to determine under certain circumstances relating to the financial condition of a bank that the payment of dividends would be an unsafe and unsound practice and to prohibit payment thereof. The payment of dividends that deplete a bank's capital base could be deemed to constitute such an unsafe and unsound banking practice. The Federal Reserve has indicated that banking organizations generally pay dividends only out of current operating earnings. In addition, under Virginia law, no dividend may be declared or paid out of a Virginia bank's paid-in capital. The Bank may be prohibited under Virginia law from the payment of dividends if the Virginia Bureau of Financial Institutions determines that a limitation of dividends is in the public interest and is necessary to ensure the Bank's financial soundness, and may also permit the payment of dividends not otherwise allowed by Virginia law.

The Dodd-Frank Act

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

- The Dodd-Frank Reform Act changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital, eliminated the ceiling on the size of the Deposit Insurance Fund (DIF) and increased the floor applicable to the size of the DIF. The Dodd-Frank Act also made permanent the $250,000 limit for federal deposit insurance and increased the cash limit of Securities Investor Protection Corporation protection from $100,000 to $250,000.
- The Dodd-Frank Reform Act repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- The Dodd-Frank Reform Act required new disclosure relating to executive compensation and corporate governance.
- The Dodd-Frank Reform Act implemented amendments to the Truth in Lending Act aimed at improving consumer protections with respect to mortgage originations, including originator compensation, minimum repayment standards, and prepayment considerations.
- The Dodd-Frank Reform Act established the Financial Stability Oversight Council, which will be responsible for identifying and monitoring systemic risks posed by financial firms, activities, and practices.
- The Dodd-Frank Reform Act amended the Electronic Fund Transfer Act (EFTA) to, among other things, require that debit card interchange fees must be reasonable and proportional to the actual cost incurred by the issuer with respect to the transaction. In June 2011, the Federal Reserve Board adopted

regulations setting the maximum permissible interchange fee as the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction, with an additional adjustment of up to one cent per transaction if the issuer implements additional fraud-prevention standards. Although issuers that have assets of less than $10 billion are exempt from the Federal Reserve Board's regulations that set maximum interchange fees, these regulations are expected to significantly affect the interchange fees that financial institutions with less than $10 billion in assets are able to collect.

- The Dodd-Frank Reform Act eliminated (over time) the inclusion of trust preferred securities as a permitted element of Tier 1 capital.
- The Dodd-Frank Reform Act created a special regime to allow for the orderly liquidation of systemically important financial companies, including the establishment of an orderly liquidation fund.
- The Dodd-Frank Reform Act requires the development of regulations to address derivatives markets, including clearing and exchange trading requirements and a framework for regulating derivatives-market participants.
- The Dodd-Frank Reform Act enhanced supervision of credit rating agencies through the Office of Credit Ratings within the SEC.
- The Dodd-Frank Reform Act established a Bureau of Consumer Financial Protection, within the Federal Reserve, to serve as a dedicated consumer-protection regulatory body. The Consumer Financial Protection Bureau is responsible for implementing, examining and enforcing compliance with federal consumer financial laws for institutions with more than $10 billion of assets and, to a lesser extent, small institutions. As a smaller institution, most consumer protection aspects of the Dodd-Frank Reform Act will continue to be overseen by the Federal Reserve.

Many aspects of the Dodd-Frank Reform Act are subject to rulemaking and will take effect over several years. As a result, it is difficult to anticipate the overall impact of the act on Financial. Financial continues to evaluate the potential impact of the Dodd-Frank Reform Act.

Incentive Compensation

In June 2010, the Federal Reserve, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") issued comprehensive final guidance on incentive compensation intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The Federal Reserve will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as Financial, that are not "large, complex banking organizations." These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

The Dodd-Frank Reform Act requires the SEC and the federal bank regulatory agencies to establish joint regulations or guidelines that require financial institutions with assets of at least $1 billion to disclose the structure of their incentive compensation practices and prohibit such institutions from maintaining compensation arrangements that encourage inappropriate risk-taking by providing excessive compensation or that could lead to material financial loss to the financial institution.

Regulation of the Bank

The Bank is a Virginia chartered commercial bank and a state member bank. The Bank's deposit accounts are insured by the Deposit Insurance Fund ("DIF") of the FDIC up to the maximum legal limits of the FDIC and it is subject to regulation, supervision and regular examination by the Virginia Bureau of Financial Institutions and the Federal Reserve. The regulations of these various agencies govern most aspects of the Bank's business, including required reserves against deposits, loans, investments, mergers and acquisitions, borrowings, dividends and location and number of branch offices. The laws and regulations governing the Bank generally have been promulgated to protect depositors and the deposit insurance funds, and not for the purpose of protecting shareholders.

General . As a state-chartered commercial bank, the Bank and its subsidiaries are subject to regulation, supervision and examination by the Federal Reserve and the Virginia State Corporation Commission's Bureau of Financial Institutions (the "Commission"). As such, the Bank is subject to various statutes and regulations administered by these agencies that govern, among other things, required reserves, investments, loans, lending limits, acquisitions of fixed assets, interest rates payable on deposits, transactions among affiliates and the Bank, the payment of dividends, mergers and consolidations, and establishment of branch offices.

The earnings of the Bank are affected by general economic conditions, management policies and the legislative and governmental actions of the various regulatory authorities, including those referred to above.

FDIC Insurance Premiums. The Bank has deposits that are insured by the FDIC. FDIC maintains the DIFwhich is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory examinations. FDIC may adjust assessments if the insured institution's risk profile changes or if the size of the DIF declines in relation to the total amount of insured deposits. In 2017, the Bank expensed $375,000 in FDIC assessments which compared to $363,000 in 2016. Any increases in FDIC insurance premiums could adversely affect the Bank's profitability.

Deposits at FDIC-insured institutions are insured up to $250,000 per depositor, subject to aggregation rules.

After giving primary regulators an opportunity to first take action, FDIC may initiate an enforcement action against any depository institution it determines is engaging in unsafe or unsound actions or which is in an unsound condition, and the FDIC may terminate that institution's deposit insurance.

New Capital Requirements . On June 7, 2012, the Federal Reserve issued a series of proposed rules that would revise and strengthen its risk-based and leverage capital requirements and its method for calculating risk-weighted assets. The rules were proposed to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Reform Act. On July 2, 2013, the Federal Reserve approved certain revisions to the proposals and finalized new capital requirements for banking organizations.

Effective January 1, 2015, the final rules required Financial and the Bank to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6.0% of risk-weighted assets (increased from the previous requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from the previous requirement); and (iv) a leverage ratio of 4.0% of total assets. These are the initial capital requirements, which will be phased in over a five-year period. When fully phased in on January 1, 2019, the rules will require Financial and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets.

The capital conservation buffer requirement will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

With respect to the Bank, the rules also revised the "prompt corrective action" regulations pursuant to Section 38 of the FDIA by (i) introducing a common equity Tier 1 capital ratio requirement at each level (other than critically undercapitalized), with the required ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum ratio for well-capitalized status being 8.0% (as compared to the previous 6.0%); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3.0% Tier 1 leverage ratio and still be well-capitalized.

The new capital requirements also include changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status, a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital, and increased risk-weights (from 0% to up to 600%) for equity exposures.

If the new minimum capital ratios described above had been effective as of December 31, 2017, based on management's interpretation and understanding of the new rules, Financial would have remained "well capitalized" as of such date.

Transactions with Affiliates . The Bank is subject to the provisions of Section 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W of the Federal Reserve Bank which place limits on the amount of loans or extensions of credit to affiliates (as defined in the Federal Reserve Act), investments in or certain other transactions with affiliates and on the amount of advances to third parties collateralized by the securities or obligations of affiliates. The law and regulation limit the aggregate amount of transactions with any individual affiliate to ten percent (10%) of the capital and surplus of the Bank and also limit the aggregate amount of transactions with all affiliates to twenty percent (20%) of capital and surplus. Loans and certain other extensions of credit to affiliates are required to be secured by collateral in an amount and of a type described in the regulation, and the purchase of low quality assets from affiliates is generally prohibited. The law and Regulation W also, among other things, prohibit an institution from engaging in certain transactions with certain affiliates (as defined in the Federal Reserve Act) unless the transactions are on terms substantially the same, or at least as favorable to such institution and/or its subsidiaries, as those prevailing at the time for comparable transactions with non-affiliated entities. In the absence of comparable transactions, such transactions may only occur under terms and circumstances, including credit standards that in good faith would be offered to or would apply to non-affiliated companies.

Loans to Insiders. The Bank is subject to the restrictions contained in Section 22(h) of the Federal Reserve Act and the Federal Reserve Board's Regulation O thereunder on loans to executive officers, directors and principal stockholders. Under Section 22(h), loans to a director, an executive officer or a greater-than-10% stockholder of a bank as well as certain affiliated interests of any of the foregoing may not exceed, together with all other outstanding loans to such person and affiliated interests, the loans-to-one-borrower limit applicable to national banks (generally 15% of the institution's unimpaired capital and surplus), and all loans to all such persons in the aggregate may not exceed the institution's unimpaired capital and unimpaired surplus. Regulation O also prohibits the making of loans in an amount greater than $25,000 or 5% of capital and surplus but in any event not over $500,000, to directors, executive officers and greater-than-10% stockholders of a bank, and their respective affiliates, unless such loans are approved in advance by a majority of the board of directors of the bank with any "interested" director not participating in the voting. Furthermore, Regulation O requires that loans to directors, executive officers and principal stockholders of a bank be made on terms substantially the same as those that are offered in comparable transactions to unrelated third parties unless the loans are made pursuant to a benefit or compensation program that is widely available to all employees of the bank and does not give preference to insiders over other employees. Regulation O also prohibits a depository institution from paying overdrafts over $1,000 of any of its executive officers or directors unless they are paid pursuant to written pre-authorized extension of credit or transfer of funds plans.

All of the Bank's loans to its and the Company's executive officers, directors and greater-than-10% stockholders, and affiliated interests of such persons, comply with the requirements of Regulation W and Section 22(h) of the Federal Reserve Act and Regulation O.

Community Reinvestment Act. The Community Reinvestment Act ("CRA") requires that, in connection with examinations of financial institutions within their respective jurisdictions, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency or the Office of Thrift Supervision shall evaluate the record of the financial institutions in meeting the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those institutions. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. An institution's CRA activities are considered in, among other things, evaluating mergers, acquisitions and applications to open a branch or facility, as well as determining whether the institution will be permitted to exercise certain of the powers allowed by the GLB Act. The CRA also requires all institutions to make public disclosure of their CRA ratings. The Bank currently has a CRA rating of "satisfactory."

Safety and Soundness . The federal banking agencies have broad powers under current federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institutions in question are "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized," all such terms are defined under uniform regulations defining such capital levels issued by each of the federal banking agencies. An insured depository institution which is less than adequately capitalized must adopt an acceptable capital restoration plan, is subject to increased regulatory oversight and is increasingly restricted in the scope of its permissible activities. As of December 31, 2017, the Bank was considered "well capitalized."

Regulatory Enforcement Authority . Applicable banking laws include substantial enforcement powers available to federal banking regulators. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions, including the filing of misleading or untimely reports with regulatory authorities, may provide the basis for enforcement action.

Confidentiality and Required Disclosures of Consumer Information . The Bank is subject to various laws and regulations that address the privacy of nonpublic personal financial information of consumers. The Gramm-Leach-Bliley Act and certain regulations issued thereunder protect against the transfer and use by financial institutions of consumer nonpublic personal information. A financial institution must provide to its customers, at the beginning of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. These privacy provisions generally prohibit a financial institution from providing a customer's personal financial information to unaffiliated third parties unless the institution discloses to the customer that the information may be so provided and the customer is given the opportunity to opt out of such disclosure. In 2016, the CFPB proposed rules that provide an exception to the requirement to deliver an annual privacy notice if a financial institution only provides nonpublic personal information to unaffiliated third parties under limited exceptions under the Gramm-Leach-Bliley Act and related regulations, and has not changed its policies and practices regarding disclosure of nonpublic personal financial information from those disclosed in the most recent privacy notice provided to the customer.

The Company is also subject to various laws and regulations that attempt to combat money laundering and terrorist financing. The Bank Secrecy Act requires all financial institutions to, among other things, create a system of controls designed to prevent money laundering and the financing of terrorism, and imposes recordkeeping and reporting requirements. The USA Patriot Act facilitates information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering, and requires financial institutions to establish anti-money laundering programs. The Office of Foreign Assets Control (OFAC), which is a division of the U.S. Department of the Treasury, is responsible for helping to ensure that United States entities do not engage in transactions with "enemies" of the United States, as defined by various Executive Orders and Acts of Congress. If the Bank finds a name of an "enemy" of the United States on any transaction, account or wire transfer that is on an OFAC list, it must freeze such account or place transferred funds into a blocked account, file a suspicious activity report with the Treasury and notify the FBI.

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

Effect of Governmental Monetary Policies

Our earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The Federal Reserve Bank's monetary policies have had, and are likely to continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The monetary policies of the Federal Reserve Board have major effects upon the levels of bank loans, investments and deposits through its open market operations in United States government securities and through its regulation of the discount rate on borrowings of member banks and the reserve requirements against member bank deposits. It is not possible to predict the nature or impact of future changes in monetary and fiscal policies.

Future Regulatory Uncertainty

Legislative and regulatory proposals regarding changes in banking, and the regulation of banks, federal savings institutions, and other financial institutions and bank and bank holding company powers are being considered by the executive branch of the federal government, Congress and various state governments. Certain of these proposals, if adopted, could significantly change the regulation or operations of banks and the financial services industry. New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations, and competitive relationships of the nation’s financial institutions.

Because federal regulation of financial institutions changes regularly and is the subject of constant legislative debate, we cannot forecast how federal regulation of financial institutions may change in the future and impact our operations. The recent economic environment has required a greater degree of coordination and overlap of the duties and responsibilities of the U.S. Treasury, federal and state banking regulators and the FDIC. We fully expect that the financial institution industry will remain heavily regulated in the near future and that additional laws or regulations may be adopted further regulating specific banking practices. We cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

Item 1A. Risk Factors

RISK FACTORS

In addition to the other information included in this Annual Report on Form 10-K, the following risk factors should be carefully considered in connection with evaluating our business and any forward-looking statements contained herein. Our business, financial condition, results of operations and cash flows could be harmed by any of the risk factors described below, or other risks that have not been identified or which we believe are immaterial or unlikely. If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, our business, financial condition, operating results and cash flows could be materially adversely affected.

RISKS RELATED TO OUR BUSINESS

Our profitability depends significantly on local economic conditions.

Our success depends primarily on the general economic conditions of the primary markets in Virginia in which we operate and where our loans are concentrated. Unlike nationwide banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in the Lynchburg metropolitan statistical area (“MSA”). Lynchburg’s MSA, which is often referred to as Region 2000, consists of approximately 2,122 square miles, and includes the City of Lynchburg and the Counties of Bedford, Campbell, Amherst and Appomattox. To a lesser extent, our lending market includes the Roanoke, Charlottesville and Harrisonburg MSAs. Our branches in localities outside of Region 2000 have a short operating history. As of December 2017, the Lynchburg MSA had an unemployment rate (not adjusted seasonally) of 3.8 %, as compared to a statewide average unemployment rate of 3.6%.

The local economic conditions in these areas have a significant impact on the Company’s commercial and industrial, real estate and construction loans, the ability of its borrowers to repay their loans and the value of the collateral securing these loans. In addition, if the population or income growth in the Company’s market areas is slower than projected, income levels, deposits and housing starts could be adversely affected and could result in a reduction of the Company’s expansion, growth and profitability. If the Company's market areas experience a downturn or a recession for a prolonged period of time, the Company could experience significant increases in nonperforming loans, which could lead to operating losses, impaired liquidity and eroding capital. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreaks of hostilities or other international or domestic calamities, unemployment, monetary and fiscal policies of the federal government or other factors could impact these local economic conditions and could negatively affect the Company's financial condition, results of operations and cash flows.

A significant portion of our loan portfolio is secured by real estate, and events that negatively impact the real estate market could hurt our business.

A substantial majority of our loans have real estate as a primary or secondary component of collateral. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. Because most of our loans are concentrated in the Region 2000 area in and surrounding the City of Lynchburg, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose real estate loan portfolios are more geographically diverse. A weakening of the real estate market in our primary market areas could result in an increase in the number of borrowers who default on their loans and a reduction in the value of the collateral securing their loans, which in turn could have an adverse effect on our profitability and asset quality. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, our earnings and capital could be adversely affected. Additionally, acts of nature, including hurricanes, tornados, earthquakes, fires and floods, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also negatively impact our financial condition.

Our loan portfolio contains a number of real estate loans with relatively large balances.

A significant portion of our total loan portfolio contains real estate loans with balances in excess of $1,000,000. The deterioration of one or a few of these loans could cause a significant increase in nonperforming loans, which could result in a net loss of earnings, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on our financial condition and results of operations.

Commercial real estate loans increase our exposure to credit risk.

A majority of our loan portfolio is secured by commercial real estate. Loans secured by commercial real estate are generally viewed as having more risk of default than loans secured by residential real estate or consumer loans because repayment of the loans often depends on the successful operation of the property, the income stream of the borrowers, the accuracy of the estimate of the property's value at completion of construction and the estimated cost of construction. An adverse development with respect to one lending relationship can expose us to a significantly greater risk of loss as compared with a single-family residential mortgage loan because we typically have more than one loan with such borrowers. Additionally, these loans typically involve larger loan balances to single borrowers or groups of related borrowers compared with single-family residential mortgage loans. Therefore, the deterioration of one or a few of these loans could cause a significant decline in the related asset quality. These loans represent higher risk and could result in a sharp increase in loans charged-off and could require us to significantly increase our allowance for loan losses, which could have a material adverse impact on our business, financial condition, results of operations and cash flows.

A percentage of the loans in our portfolio currently include exceptions to our loan policies and supervisory guidelines.

All of the loans that we make are subject to written loan policies adopted by our board of directors and to supervisory guidelines imposed by our regulators. Our loan policies are designed to reduce the risks associated with the loans that we make by requiring our loan officers to take certain steps that vary depending on the type and amount of the loan, prior to closing a loan. These steps include, among other things, making sure the proper liens are documented and perfected on property securing a loan, and requiring proof of adequate insurance coverage on property securing loans. Loans that do not fully comply with our loan policies are known as "exceptions." We categorize exceptions as policy exceptions, financial statement exceptions and document exceptions. As a result of these exceptions, such loans may have a higher risk of loan loss than the other loans in our portfolio that fully comply with our loan policies. In addition, we may be subject to regulatory action by federal or state banking authorities if they believe the number of exceptions in our loan portfolio represents an unsafe banking practice.

As a community bank, we have different lending risks than larger banks. We provide services to individuals and small to medium-sized businesses in our local markets who may have fewer financial resources to weather a downturn in the economy.

Our ability to diversify our economic risks is limited by our own local markets and economies. We lend primarily to small to medium-sized businesses, professionals and individuals, which may expose us to greater lending risks than those of banks lending to larger, better-capitalized businesses with longer operating histories. For instance, small to medium-sized businesses frequently have smaller market share than their competition, may be more vulnerable to economic downturns, have fewer financial resources in terms of capital or borrowing capacity than larger entities, often need substantial additional capital to expand or compete and may experience significant volatility in operating results. Any one or more of these factors may impair the borrower's ability to repay a loan. In addition, the success of a small to medium-sized business often depends on the management talents and efforts of one or two persons or a small group of persons, and the death, disability or resignation of one or more of these persons could have a material adverse impact on the business and its ability to repay a loan. Economic downturns and other events that negatively impact the Company's market areas could cause the Company to incur substantial credit losses that could negatively affect the Company's results of operations and financial condition.

We depend on the accuracy and completeness of information about clients and counterparties, and our financial condition could be adversely affected if we rely on misleading information.

In deciding whether to extend credit or to enter into other transactions with clients and counterparties, we may rely on information furnished to us by or on behalf of clients and counterparties, including financial statements and other financial information, which we do not independently verify as a matter of course. We also may rely on representations of clients and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to customers, we may assume that a customer's audited financial statements conform with U.S. Generally Accepted Accounting Principles ("GAAP") and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. Our financial condition and results of operations could be negatively impacted to the extent we rely on financial statements that do not comply with GAAP or are materially misleading.

If we suffer loan losses from a decline in credit quality, our earnings will decrease.

We could sustain losses if borrowers, guarantors or related parties fail to perform in accordance with the terms of their loans. We have adopted underwriting and credit monitoring procedures and policies, including the establishment and review of the allowance for loan losses, that we believe are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying our credit portfolio. These policies and procedures, however, may not prevent unexpected losses that could materially adversely affect our results of operations.

These policies and procedures necessarily rely on our making various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover probable incurred losses in our loan portfolio, resulting in additions to our allowance. Any future additions to our allowance could materially decrease our net income.

In addition, the Federal Reserve Bank of Richmond and the Virginia Bureau of Financial Institutions (the "BFI") periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by regulatory authorities might have a material adverse effect on our financial condition and results of operations.

The markets for our deposit and lending products and services are highly competitive, and we face substantial competition.

The banking and financial services industry is highly competitive. We compete as a financial intermediary with other commercial banks, savings banks, credit unions, finance companies, mutual funds, insurance companies and brokerage and investment banking firms soliciting business from residents of and businesses located in the Virginia localities where the Bank has a presence, surrounding areas and elsewhere. Many of these competing institutions have nationwide or regional operations and have greater resources than we have. We also face competition from local community institutions, such as ones that serve local markets only. Many of our competitors enjoy competitive advantages, including greater name recognition, financial resources, a wider geographic presence or more accessible branch office locations, the ability to offer additional services, greater marketing resources, more favorable pricing alternatives for loans and deposits and lower origination and operating costs. We are also subject to lower lending limits than our larger competitors. Our profitability depends upon our continued ability to successfully compete in our market areas. Increased deposit competition could increase our cost of funds and could adversely affect our ability to generate the funds necessary for our lending operations. If we must raise interest rates paid on deposits or lower interest rates charged on our loans, our net interest margin and profitability could be adversely affected. Competition could result in a decrease in loans we originate and could negatively affect our ability to grow and our results of operations.

Technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services.

We have increased and plan to continue to increase our levels of commercial and industrial loans. We may not be successful in continuing to penetrate this market segment, which has helped to drive some of our recent earnings.

A significant percentage of our loans are commercial and industrial loans. Our portfolio of commercial and industrial loans has increased during the past year.

While we intend to originate these types of loans in a manner that is consistent with safety and soundness, these non-residential loans generally expose us to greater risk of loss than one- to four-family residential mortgage loans, as repayment of such commercial and industrial loans generally depends, in large part, on the borrower's business to cover operating expenses and debt service. In addition, these types of loans typically involve larger loan balances to single borrowers or groups of related borrowers, as compared to one- to four-family residential mortgage loans. Changes in economic conditions that are beyond our or the borrower's control could adversely affect the value of the security for the loan, including the future cash flow of the affected business. As we increase our portfolio of these loans, we may experience higher levels of non-performing assets or loan losses, or both.

Opening new branches may not result in increased assets or revenues for us, or may negatively impact our earnings.

We have recently opened branches in Charlottesville, Harrisonburg, Roanoke, and Appomattox. The additional costs to open and operate these and other future branches may negatively impact our earnings and efficiency ratio in the short term. There is a risk that we will be unable to manage our growth, as the process of opening new branches may divert our time and resources. There is also a risk that these new branches may not be profitable, which would negatively impact our results of operations.

Our plans for future expansion depend, in some instances, on factors beyond our control, and an unsuccessful attempt to achieve growth could have a material adverse effect on our business, financial condition, results of operations and future prospects.

We expect to continue to engage in new branch expansion in the future. We may also seek to acquire other financial institutions, or parts of those institutions, though we have no present plans in that regard. Expansion involves a number of risks, including, without limitation:

- the time and costs of evaluating new markets, hiring experienced local management and opening new offices;
- the time lags between these activities and the generation of sufficient assets and deposits to support the costs of the expansion;
- our entrance into new markets where we lack experience;
- the introduction of new products and services with which we have no prior experience into our business;
- failure to culturally integrate an acquisition target or new branches or failing to identify and select the optimal candidate for integration or expansion; and
- failure to identify and retain experienced key management members with local expertise and relationships in new markets.

We may continue to acquire and hold other real estate owned (OREO) properties, which could lead to increased operating expenses and vulnerability to additional declines in the market value of real estate in our areas of operations.

From time-to-time, we foreclose upon and take title to the real estate serving as collateral for our loans as part of our business. If our OREO balance increases, management expects that our earnings will be negatively affected by various expenses associated with OREO, including personnel costs, insurance and taxes, completion and repair costs, valuation adjustments and other expenses associated with property ownership. Also, at the time that we foreclose upon a loan and take possession of a property, we estimate the value of that property using third-party appraisals and opinions and internal judgments. OREO property is valued on our books at the estimated market value of the property, less the estimated costs to sell (or “fair value”). Upon foreclosure, a charge-off to the allowance for loan losses is recorded for any excess between the value of the asset on our books over its fair value. Thereafter, we periodically reassess our judgment of fair value based on updated appraisals or other factors, including, at times, at the request of our regulators. Any further declines in our estimate of fair value for OREO will result in additional valuation adjustments, with a corresponding expense in our statements of income that is recorded under the line item for “Other real estate expenses.” As a result, our results of operations are vulnerable to additional declines in the market for residential and commercial real estate in the areas in which we operate. The expenses associated with OREO and any further property write downs could have a material adverse effect on our results of operations and financial condition. Any increase in nonaccrual loans may lead to further increases in our OREO balance in the future.

Additional growth and regulatory requirements may require us to raise additional capital in the future, and capital may not be available when it is needed or may have unfavorable terms, which could adversely affect our financial condition and results of operations.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. While the boards of the Company and the Bank intend to take steps to ensure that the capital plan aligns with the Bank's strategic plan, that all material risks to the Bank are identified and measured and that capital limits are appropriate for the institution's risk profile, failure to successfully implement such steps could have a material adverse effect on our financial condition and results of operations. We may at some point need to raise additional capital to support our continued growth. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. Accordingly, we can make no assurances of our ability to raise additional capital, if needed, on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations could be materially impaired.

Our corporate culture has contributed to our success, and if we cannot maintain this culture as we grow, we could lose the teamwork and increased productivity fostered by our culture, which could harm our business.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters teamwork and increased productivity. As our organization grows and we are required to implement more complex organizational management structures, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. This could negatively impact our future success.

If we fail to retain our key employees, our growth and profitability could be adversely affected.

Our success is, and is expected to remain, highly dependent on our executive management team. Four of our key executives are Robert R. Chapman III (President of the Company and President and CEO of the Bank), J. Todd Scruggs (Secretary-Treasurer of the Company and Executive Vice President and CFO of the Bank), Harry P. "Chip" Umberger (Executive Vice President and Senior Credit Officer of the Bank), and Michael A. Syrek (Executive Vice President and Senior Loan Officer of the Bank). We are especially dependent on these executives as well as other key personnel because, as a community bank, we depend on our management team's ties to the community to generate business for us, and our executives have key expertise needed to implement our business strategy. Our executive management and other key personnel have not signed non-competition covenants.

Competition for personnel is intense, and we may not be successful in attracting or retaining qualified personnel. Our failure to compete for these personnel, or the loss of the services of several of such key personnel, could adversely affect our growth strategy and seriously harm our business, results of operations and financial condition.

As a community bank, our ability to maintain our reputation is critical to the success of our business, and our failure to do so may materially adversely affect our performance.

As a community bank, our reputation is one of the most valuable components of our business. As such, we strive to conduct our business in a manner that enhances our reputation. This is done, in part, by recruiting, hiring and retaining employees who share our core values of being an integral part of the communities we serve, delivering superior service to our customers and caring about our customers and associates. Negative publicity can result from our actual or alleged conduct in any number of activities, including lending practices, corporate governance, acquisitions and actions taken or threatened by government regulators and community organizations in response to those activities. If our reputation is negatively affected by the actions of our employees or otherwise, there may be an adverse effect on our ability to keep and attract customers, and we might be exposed to litigation and regulatory action. Any of such events could harm our business, and, therefore, our operating results may be materially adversely affected. As a financial services company with a high profile in our market area, we are inherently exposed to this risk. While we take steps to minimize reputation risk in dealing with customers and other constituencies, we will continue to face additional challenges maintaining our reputation with respect to customers of the Bank in our current primary market area in Region 2000 and in establishing our reputation in new market areas.

Our decisions regarding how we manage our credit exposure may materially and adversely affect our business.

We manage our credit exposure through careful monitoring of lending relationships and loan concentrations in particular industries, and through loan approval and review procedures.

We have established an evaluation process designed to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of loan losses is an estimate based on experience, judgment and expectations regarding our borrowers and the economies in which we and our borrowers operate, as well as the judgment of our regulators. While our board and senior management are continuing to improve the Bank's risk management framework and align the Bank's risk philosophy with its capital and strategic plans, failure to continue to improve such risk management framework could have a material adverse effect on our financial condition and results of operations. We can make no assurances that our loan loss reserves will be sufficient to absorb future loan losses or prevent a material adverse effect on our business, financial condition or results of operations.

Our profitability is vulnerable to interest rate fluctuations and changes in monetary policies.

Our profitability depends substantially upon our net interest income. Net interest income is the difference between the interest earned on interest-earning assets, such as loans and investment securities, and the interest expense paid on interest-bearing liabilities, such as NOW accounts, savings accounts, time deposits and other borrowings. Market interest rates for loans, investments and deposits are highly sensitive to many factors beyond our control. Interest rate spreads have seen a sustained period of narrowness due to many factors, such as market conditions, policies of various government and regulatory authorities and competitive pricing pressures, and we cannot predict whether these rate spreads will narrow further. This narrowing of interest rate spreads could adversely affect our financial condition and results of operations. In addition, we cannot predict whether interest rates will continue to remain at present levels. Changes in interest rates may cause significant changes, up or down, in our net interest income. Depending on our portfolio of loans and investments, our results of operations may be adversely affected by changes in interest rates.

Our financial condition and results of operations are affected by credit policies of monetary authorities, particularly the Federal Reserve Board. Actions by monetary and fiscal authorities, including the Federal Reserve Board, could have an adverse effect on our deposit levels, loan demand or business and earnings.

A failure in or breach of our operational or security systems or infrastructure, or those of our third party vendors and other service providers, including as a result of cyber-attacks, could disrupt our business, result in the disclosure or misuse of confidential or proprietary information, damage our reputation, increase our costs and cause losses.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer-relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur; or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could disrupt our business, increase our costs, result in the disclosure of confidential client information, damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability; any of which could have a material adverse effect on our financial condition and results of operations.

Our computer systems, software and networks have been and will continue to be vulnerable to unauthorized access, loss or destruction of data (including confidential client information), account takeovers, unavailability of service, computer viruses or other malicious code, cyber-attacks and other events. These threats may derive from human error, fraud or malice on the part of employees or third parties, or may result from accidental technological failure. Information security risks for financial institutions such as ours have generally increased in recent years in part because of the proliferation of new technologies, the use of the Internet and digital technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists, activists and other external parties. Some of our operations rely on the secure processing, transmission and storage of confidential information in our computer systems and networks. Our business relies on our digital technologies, computer and email systems, software and networks to conduct its operations. In addition, to access our products and services, our customers may use personal smartphones, tablets, personal computers and other mobile devices that are beyond our control systems. Although we have information security procedures and controls in place, our technologies, systems, networks and our customers' devices may become the target of cyber-attacks or information security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss or destruction of our or our customers' confidential, proprietary and other information, or otherwise disrupt our or our customers' or other third parties' business operations.

Although we maintain safeguards to protect against these risks, there can be no assurance that we will not suffer losses in the future that may be material in amount or nature.

Changes in consumers' use of banks and changes in consumers' spending and saving habits could adversely affect our financial results.

Technology and other changes now allow many consumers to complete financial transactions without using banks. For example, consumers can pay bills and transfer funds directly without going through a bank. This disintermediation could result in the loss of fee income, as well as the loss of customer deposits and income generated from those deposits. In addition, changes in consumer spending and saving habits could adversely affect our operations, and we may be unable to timely develop competitive new products and services in response to these changes that are accepted by new and existing customers.

Failure to implement new technologies in our operations may adversely affect our growth or profits.

The market for financial services, including banking services and consumer finance services, is increasingly affected by advances in technology, including developments in telecommunications, data processing, computers, automation, Internet-based banking and telebanking. Our ability to compete successfully in our markets may depend on the extent to which we are able to exploit such technological changes. However, we can provide no assurance that we will be able to properly or timely anticipate or implement such technologies or properly train our staff to use such technologies. Any failure to adapt to new technologies could adversely affect our business, financial condition or operating results.

We are subject to operational risks.

The Company may also be subject to disruptions of its systems arising from events that are wholly or partially beyond its control (including, for example, computer viruses or electrical or telecommunications outages), which may give rise to losses in service to customers and to financial loss or liability. The

Company is further exposed to the risk that its external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as is the Company) and to the risk that the Company's (or its vendors') business continuity and data security systems prove to be inadequate.

We are subject to liquidity risk.

Liquidity risk is the potential that we will be unable to meet our obligations as they become due, capitalize on growth opportunities as they arise or pay regular cash dividends because of an inability to liquidate assets or obtain adequate funding in a timely basis, at a reasonable cost and within acceptable risk tolerances. A failure to adequately manage our liquidity risk could adversely affect our business, financial condition or operating results, especially in the event of another financial crisis. Further, the Federal Reserve could impose additional requirements on the Company if the agency determines that our enhanced liquidity risk management practices do not adequately manage our liquidity risk.

We may lose lower-cost funding sources.

Checking, savings and money market deposit account balances and other forms of customer deposits can decrease when customers perceive alternative investments, such as the stock market, as providing a better risk/return tradeoff. If customers move money out of bank deposits and into other investments, the Bank could lose a relatively low-cost source of funds, thereby increasing its funding costs and reducing the Bank's net interest income and net income.

If we fail to maintain an effective system of internal and disclosure controls, we may not be able to accurately report our financial results or prevent or detect fraud.

Effective internal control over financial reporting and disclosure controls and procedures are necessary for us to provide reliable financial reports and effectively prevent or detect fraud and to operate successfully as a public company.

The Company faces the risk that the design of its controls and procedures, including those to mitigate the risk of fraud by employees or outsiders, may prove to be inadequate or are circumvented, thereby causing delays in detection of errors or inaccuracies in data and information. We regularly review and update the Company's internal controls, disclosure controls and procedures and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Company's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Company's business, results of operations and financial condition.

Any failure to maintain effective controls or timely effect any necessary improvement of our internal and disclosure controls could hinder our ability to accurately report our operating results or cause us to fail to meet our reporting obligations, which could affect our ability to remain listed with The NASDAQ Capital Market. Ineffective internal and disclosure controls could also harm our reputation, negatively impact our operating results or cause investors to lose confidence in our reported financial information, which likely would have a negative effect on the trading price of our securities.

Changes in the financial markets could impair the value of our investment portfolio.

Our investment securities portfolio is a significant component of our total earning assets. Turmoil in the financial markets could impair the market value of our investment portfolio, which could adversely affect our net income and possibly our capital.

We hold as investments certain securities that have unrealized losses (representing a majority of our securities portfolio). While we currently maintain substantial liquidity which supports our intent and ability to hold these investments until they mature, or until there is a market price recovery, if we were to cease to have the ability and intent to hold these investments until maturity or if the market prices do not recover, and we were to sell these securities at a loss, it could adversely affect our net income and possibly our capital.

Our deposit insurance premiums could be substantially higher in the future, which could have a material adverse effect on our future earnings.

The FDIC insures deposits at FDIC-insured depository institutions, such as the Bank, up to applicable limits. The amount of a particular institution's deposit insurance assessment is based on that institution's risk classification under an FDIC risk-based assessment system. An institution's risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to its regulators. Bank failures significantly depleted the FDIC's Deposit Insurance Fund and reduced the ratio of reserves to insured deposits. As a result of recent economic conditions and the enactment of the Dodd-Frank Reform Act, banks are now assessed deposit insurance premiums based on the bank's average consolidated total assets, and the FDIC has modified certain risk-based adjustments, which increase or decrease a bank's overall assessment rate. This has resulted in increases to the deposit insurance assessment rates, and thus raised deposit premiums for many insured depository institutions. If these increases are insufficient for the Deposit Insurance Fund to meet its funding requirements, further special assessments or increases in deposit insurance premiums may be required. We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures, we may be required to pay even higher FDIC premiums than the recently increased levels. Any future additional assessments, increases or required prepayments in FDIC insurance premiums could reduce our profitability, may limit our ability to pursue certain business opportunities or otherwise negatively impact our operations.

We may be adversely affected by the soundness of other financial institutions.

Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by a counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by the Bank cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to the Bank. Any such losses could have a material adverse effect on our financial condition and results of operations.

REGULATORY AND LEGAL RISKS

We are subject to extensive regulation that could limit or restrict our activities and impose financial requirements or limitations on the conduct of our business, which limitations or restrictions could adversely affect our profitability.

As a bank holding company, we are primarily regulated by the Federal Reserve. The Bank is primarily regulated by the BFI and the Federal Reserve. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of a financial institution, the classification of assets by a financial institution and the adequacy of a financial institution's allowance for loan losses. The Company periodically reviews its policies, procedures and limits, and undertakes reporting, to ensure all guidance is appropriate for the Bank's current and planned operations and aligns with regulatory expectations. In this regard, regulatory authorities may impose particular requirements on the Bank, which could have a material adverse effect on our results of operations. Any change in such regulation and regulatory oversight, whether in the form of regulatory policy, regulations or legislation, could have a material impact on us and our operations. Further, our compliance with Federal Reserve and the BFI regulations is costly. Because our business is highly regulated, the applicable laws, rules and regulations are subject to regular modification and change. Laws, rules and regulations may be adopted in the future that could make compliance more difficult or expensive or otherwise adversely affect our business, financial condition or prospects. For instance, such changes may limit our growth and restrict certain of our activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices. We are also subject to capital requirements by our regulators.

The laws and regulations, including the Dodd-Frank Reform Act, applicable to the banking industry could change at any time, and these changes may adversely affect our business and profitability.

We are subject to extensive federal and state regulation. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, our cost of compliance could adversely affect our ability to operate profitably. The increased scope, complexity, and cost of corporate governance, reporting, and disclosure practices are proportionately higher for a company of our size and will affect our profitability more than that of some of our larger competitors. We expect to experience increasing compliance costs related to this supervision and regulation.

Also, the 2016 national election results and new administration have introduced additional uncertainty into future implementation and enforcement of the Dodd-Frank Reform Act and other financial sector regulatory requirements. Such additional regulation and supervision may increase our costs and limit our ability to pursue business opportunities. The effects of any such recently enacted, or proposed, legislation and regulatory programs on us cannot reliably be determined at this time.

The Consumer Financial Protection Bureau (the "CFPB") recently issued "ability-to-repay" and "qualified mortgage" rules that may have a negative impact on our loan origination process and foreclosure proceedings, which could adversely affect our business, operating results and financial condition.

On January 10, 2013, the CFPB issued a final rule to implement the "qualified mortgage" provisions of the Dodd-Frank Reform Act requiring mortgage lenders to consider consumers' ability to repay home loans before extending them credit. The CFPB's "qualified mortgage" rule, which became effective on January 10, 2014, describes certain minimum requirements for lenders making ability-to-repay determinations, but does not dictate that they follow particular underwriting models. Lenders will be presumed to have complied with the ability-to-repay rule if they issue "qualified mortgages," which are generally defined as mortgage loans prohibiting or limiting certain risky features. Loans that do not meet the ability-to-repay standard can be challenged in court by borrowers who default, and the absence of ability-to-repay status can be used against a lender in foreclosure proceedings. Any loans that we make outside of the "qualified mortgage" criteria could expose us to an increased risk of liability and reduce or delay our ability to foreclose upon the underlying property. Any decreases in loan origination volume or increases in compliance and foreclosure costs caused by the rule could negatively affect our business, operating results and financial condition. The CFPB also has adopted a number of additional requirements and issued additional guidance, including with respect to appraisals, escrow accounts and servicing, each of which entails increased compliance costs. In addition, the CFPB likely will continue to make rules relating to consumer protection, and it is difficult to predict which of our products and services will be subject to these rules or how these rules will be implemented.

Compliance with the Dodd-Frank Reform Act will increase our regulatory compliance burdens, and may increase our operating costs and may adversely impact our earnings or capital ratios, or both.

Signed into law on July 21, 2010, the Dodd-Frank Reform Act has represented a significant overhaul of many aspects of the regulation of the financial services industry. Among other things, the Dodd-Frank Reform Act created the CFPB, tightened capital standards, imposed clearing and margining requirements on many derivatives activities and generally increased oversight and regulation of financial institutions and financial activities.

In addition to the self-implementing provisions of the statute, the Dodd-Frank Reform Act calls for over 200 administrative rulemakings by numerous federal agencies to implement various parts of the legislation. While many rules have been finalized or issued in proposed form, additional rules have yet to be proposed. It is not possible at this time to predict when all such additional rules will be issued or finalized, and what the content of such rules will be. We will have to apply resources to ensure that we are in compliance with all applicable provisions of the Dodd-Frank Reform Act and any implementing rules, which may increase our costs of operations and adversely impact our earnings or capital, or both.

The Dodd-Frank Reform Act and any implementing rules that are ultimately issued could have adverse implications on the financial industry, the competitive environment and our ability to conduct business.

The short-term and long-term impact of the changing regulatory capital requirements and new capital rules is uncertain.

On July 2, 2013, the Federal Reserve Board, and shortly thereafter, the other federal bank regulatory agencies, issued a final rule that revised their risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Reform Act. The final rule applies to all depository institutions, top-tier bank holding companies and top-tier savings and loan holding companies with total consolidated assets of $1 billion or more. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4.0% to 6.0% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain “available-for-sale” securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-in or opt-out is exercised. The Bank exercised this one-time opt-out. The rule limits a banking organization’s capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule became effective for the Bank on January 1, 2015. The capital conservation buffer requirement began phasing in on January 1, 2016, at 0.625% of risk-weighted assets, and will increase each year until fully implemented at 2.5% on January 1, 2019, when the full capital conservation buffer requirement will be effective.

Under the new capital standards, in order to be well-capitalized, the Bank is required to have a common equity to Tier 1 capital ratio of 6.5% and a Tier 1 capital ratio of 8.0%. The application of more stringent capital requirements for the Bank could, among other things, result in lower returns on invested capital, require the raising of additional capital and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models or increase our holdings of liquid assets, or all or any combination of the foregoing. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital or additional capital conservation buffers, or both, could result in management modifying its business strategy, and could limit our ability to make distributions, including paying out dividends or buying back shares.

RISKS RELATED TO OUR STOCK

Our ability to pay cash dividends is limited, and we may be unable to pay future dividends even if we desire to do so.

The Company is a legal entity, separate and distinct from the Bank. The Company currently does not have any significant sources of revenue other than cash dividends paid to it by the Bank. Both the Company and the Bank are subject to laws and regulations that limit the payment of cash dividends, including requirements to maintain capital at or above regulatory minimums. As a bank that is a member of the Federal Reserve System, the Bank must obtain prior written approval for any cash dividend if the total of all dividends declared in any calendar year would exceed the total of its net profits for that year combined with its retained net profits for the preceding two years.

Banking regulators have indicated that Virginia banking organizations should generally pay dividends only (1) from net undivided profits of the bank, after providing for all expenses, losses, interest and taxes accrued or due by the bank and (2) if the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality and overall financial condition. In addition, the FDIA prohibits insured depository institutions such as the Bank from making capital distributions, including the payment of dividends, if, after making such distribution, the institution would become undercapitalized as defined in the statute. Moreover, the Federal Reserve is authorized to determine under certain circumstances relating to the financial condition of a bank that the payment of dividends would be an unsafe and unsound practice and to prohibit payment thereof. The payment of dividends that deplete a bank's capital base could be deemed to constitute such an unsafe and unsound banking practice. The Federal Reserve has indicated that banking organizations generally pay dividends only out of current operating earnings. The Bank may be prohibited under Virginia law from the payment of dividends, including in the event the BFI determines that a limitation of dividends is in the public interest and is necessary to ensure the Bank's financial soundness.

In addition, the Bank's ability to pay dividends will be limited if the Bank does not have the capital conservation buffer required by the new capital rules, which may limit the Company's ability to pay dividends to stockholders.

If the Bank is not permitted to pay cash dividends to the Company, it is unlikely that the Company would be able to pay cash dividends on our common stock. Moreover, holders of our common stock are entitled to receive dividends only when and if declared by our board of directors. Although we currently pay cash dividends on our common stock, we are not required to do so and our board of directors could reduce or eliminate the amount of our common stock dividends in the future.

A limited market exists for our common stock.

Our common stock commenced trading on The NASDAQ Capital Market on January 25, 2012, and trading volumes since that time have been relatively low as compared to other larger financial services companies. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market. Accordingly, holders of our common stock may have difficulty selling our common stock at prices which holders find acceptable or which accurately reflect the value of the Company.

Future offerings of debt or other securities may adversely affect the market price of our stock.

In the future, we may attempt to increase our capital resources or, if our or the Bank's capital ratios fall below the required minimums, we or the Bank could be forced to raise additional capital by making additional offerings of debt or preferred equity securities, including medium-term notes, trust preferred securities, senior or subordinated notes and preferred stock. Upon liquidation, holders of any debt securities and shares of preferred stock and lenders with respect to other borrowings will receive distributions of our available assets prior to the holders of our common stock.

Our stockholders may experience dilution due to our issuance(s) of additional securities in the future.

We may in the future issue additional shares of our common stock to raise cash for operations or to fund acquisitions, to provide equity based incentives to our management and employees, to permit our stockholders to invest cash dividends and optional cash payments in shares of our common stock or as consideration in acquisition transactions. Additional equity offerings and issuance(s) of additional shares of our common stock may dilute the holdings of our existing stockholders or reduce the market price of our common stock, or both. No assurances can be given that the Company will not issue additional securities that will have the effect of diluting the equity interest of our stockholders. Holders of our common stock are not entitled to preemptive rights or other protections against dilution.

Virginia law and the provisions of our articles of incorporation and bylaws could deter or prevent takeover attempts by a potential purchaser of our common stock that would be willing to pay holders a premium for their shares of our common stock.

Our articles of incorporation and bylaws contain provisions that may be deemed to have the effect of discouraging or delaying uninvited attempts by third parties to gain control of us. These provisions include the division of our board of directors into classes with staggered terms, the ability of our board of directors to set the price, terms and rights of, and to issue, one or more series of our preferred stock and the ability of our board of directors, in evaluating a proposed business combination or other fundamental change transaction, to consider the effect of the business combination on us and our stockholders, employees, customers and the communities which we serve. Similarly, the Virginia Stock Corporation Act contains provisions designed to protect Virginia corporations and employees from the adverse effects of hostile corporate takeovers. These provisions reduce the possibility that a third party could effect a change in control without the support of our incumbent directors. These provisions may also strengthen the position of current management by restricting the ability of stockholders to change the composition of the board of directors, to affect its policies generally and to benefit from actions which are opposed by the current board of directors.

An investment in our common stock is not an insured deposit.

Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. An investment in our common stock is inherently risky for the reasons described in these “Risk Factors” and the Company’s filings with the SEC and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire our common stock, you may lose some or all of your investment.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Current Locations and Property

Depending on such factors as cost, availability, and location, we may either lease or purchase our operating facilities. The existing facilities that we have purchased typically have been former branches of other financial institutions. As of February 28, 2018, the Bank conducts its operations from 16 locations, of which we own 8 and lease 8. The following table describes the location and general character of our operating facilities:

Address	Type of Facility	Year Opened	Owned/Leased
5204 Fort Avenue Lynchburg, Virginia	Full service branch with drive thru and ATM	2000	Owned
4698 South Amherst Highway Madison Heights, Virginia	Full service branch with drive thru and ATM	2002	Owned
17000 Forest Road Forest, Virginia	Full service branch with drive thru and ATM Headquarters for Mortgage Division	2005	Owned
164 South Main Street Amherst, Virginia	Full service branch with drive thru and ATM	2007	Owned
1405 Ole Dominion Blvd Bedford, Virginia	Full service branch with drive thru and ATM	2008	Owned
1110 Main Street Altavista, Virginia	Full service branch with drive thru and ATM	2009	Owned
828 Main Street Lynchburg, Virginia	Corporate Headquarters; Full service branch with ATM	2004	Leased (1)
615 Church Street Lynchburg, Virginia	Full service branch with drive thru and ATM Headquarters for Investment and Insurance operations	1999	Leased (2)
4935 Boonsboro Road, Suites C and D Lynchburg, Virginia	Full service branch with drive thru and ATM	2006	Leased (3)
501 VES Road Lynchburg, Virginia	Limited service branch	2010	Leased (4)
1430 Rolkin Court Suite 203 Charlottesville, Virginia	Commercial loan origination and mortgage office as well as a limited service branch	2013	Leased (5)

Address	Type of Facility	Year Opened	Owned/Leased
1391 South High Street Harrisonburg, Virginia	Full service branch with drive thru and ATM	2015	Owned
250 Pantops Mountain Road Charlottesville, Virginia	Limited service branch	2015	Leased (6)
1745 Confederate Blvd Appomattox, Virginia	Full service branch with drive thru and ATM	2017	Owned
225 Merchant Walk Avenue Charlottesville, Virginia	Full service branch with drive thru and ATM	2016	Leased (7)
3562 Electric Road Roanoke, Virginia	Full service branch with ATM	2017	Leased (8)

(1) Base lease expired July 31, 2014 at which the Bank elected to exercise its first five-year renewal option. The Bank currently has one more five-year renewal option that we may exercise at our discretion subject to the terms and conditions outlined in the lease. The Bank leases this property from Jamesview Investment, LLC, which is wholly-owned by William C. Bryant III, a member of the Board of Directors of both Financial and the Bank.

(2) Base lease expires July 31, 2019. We have one or more renewal options that we may exercise at our discretion subject to the terms and conditions outlined in the lease.

(3) The current term expires on December 31, 2020. The Bank intends to continue operating at this location.

(4) Base lease expires May 31, 2020. The Bank intends to continue operating at this location.

(5) Base lease expires December 31, 2018. We have one renewal option that we may exercise at our discretion subject to the terms and conditions outlined in the lease.

(6) Base lease expires April 30, 2020. We have one or more renewal options that we may exercise at our discretion subject to the terms and conditions outlined in the lease.

(7) Base lease expires October 31, 2026. We have one or more renewal options that we may exercise at our discretion subject to the terms and conditions outlined in the lease.

(8) Base lease expires January 31, 2022. We have one or more renewal options that we may exercise at our discretion subject to the terms and conditions outlined in the lease.

We believe that each of these operating facilities is maintained in good operating condition and is suitable for our operational needs.

Interest in Additional Properties

As discussed in "Management's Discussion and Analysis—Expansion Plans" in addition to the facilities set forth above, the Bank owns the following properties which are being held for possible expansion:

- real property located in the Timberlake Road area of Campbell County (Lynchburg), Virginia. The existing structure located on the property is not suitable for its intended use as a branch bank. Management anticipates that it will be necessary to raze the current structures and replace it with appropriate new construction.
- real property located at 5 Village Highway (near the intersection of Routes 501 and 24) in Rustburg, Virginia. The structure on the property has been demolished and removed. The Bank does not anticipate opening a branch at this location prior to 2019.
- real property located at 45 South Main Street, Lexington, Virginia. The Bank does not anticipate opening a branch at this location prior to 2019.

Management of the Bank continues to look for and evaluate additional locations for future branch growth and will consider opening an additional branch in the next 18 months if a suitable location is available on acceptable terms. The opening of all additional branches is contingent upon the receipt of regulatory approval.

We will use the internet, consistent with applicable regulatory guidelines, to augment our growth plans. We currently offer online account access, bill payment, and account management functions through our website. The Bank recently released an application that enables customers to transact banking business on smartphones and other mobile devices.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which the Company is a party or to which the property of the Company is subject.

Item 4. Mine Safety Disclosures — Not applicable.

PART II

Item 5. Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Prices and Dividends

As of January 25, 2012, the Common Stock of Financial is traded on the NASDAQ Capital Market LLC (NASDAQ) under the symbol "BOTJ." Prior to this time, the Common Stock of Financial was quoted on the Over the Counter Bulletin Board (OTCBB) under the symbol "BOJF ("BOJF.OB" on some systems) and transactions generally involved a small number of shares. The following table sets forth the quarterly high and low bid prices for each quarter in fiscal 2017 and 2016 for Financial and was obtained from Bloomberg. Management believes this source to be accurate.

	Market Prices and Dividends		
	Bid Price ($)		
	High	Low	Dividends ($)
Fiscal 2017			
Fourth Quarter	15.29	14.21	0.06
Third Quarter	15.36	13.54	0.06
Second Quarter	15.35	14.40	0.06
First Quarter	16.37	13.02	0.06
Fiscal 2016			
Fourth Quarter	15.20	12.15	0.06
Third Quarter	13.10	11.96	0.06
Second Quarter	12.40	11.55	0.06
First Quarter	12.61	11.43	0.06

The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

As of March 16, 2018 (the most recent date available), the Common Stock traded for $15.74 per share. As of March 21, 2018, there were approximately 4,378,436 shares of Common Stock outstanding, which shares are held by approximately 1,600 active shareholders of record.

Dividend Policy

The Company's future dividend policy is subject to the discretion of its Board of Directors and will depend upon a number of factors, including future earnings, financial condition, liquidity and capital requirements of both the Company and the Bank, applicable governmental regulations and policies and other factors deemed relevant by its Board of Directors.

The Company is organized under the Virginia Stock Corporation Act, which prohibits the payment of a dividend if, after giving it effect, the corporation would not be able to pay its debts as they become due in the usual course of business or if the corporation's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the corporation were to be dissolved, to satisfy the preferential rights upon dissolution of any preferred shareholders.

The Company is a legal entity separate and distinct from its subsidiaries. Its ability to distribute cash dividends will depend primarily on the ability of the Bank to pay dividends to it, and the Bank is subject to laws and regulations that limit the amount of dividends that it can pay. As a state member bank, the Bank is subject to certain restrictions imposed by the reserve and capital requirements of federal and Virginia banking statutes and regulations. For a discussion of these restrictions, see "Supervision and Regulation of Financial – Limits on the Payment of Dividends."

On January 16, 2018 Financial declared a cash dividend for the fourth quarter of 2017 of $0.06 per common share. The dividend is payable on March 23, 2018 to shareholders of record at the close of business on March 9, 2018. Financial will evaluate the factors set forth above when making a determination of whether to continue to pay a cash dividend in 2018.

Securities Authorized for Issuance under Equity Compensation Plans

The following table summarizes information concerning Financial's equity compensation plans at December 31, 2017. All figures have been adjusted to reflect all prior stock dividends declared by Financial. All outstanding stock options have been issued under plans approved by shareholders.

Plan Category	Number of Shares to be Issued Upon Exercise of Outstanding Options	Weighted Average Exercise Price of Outstanding Options	Number of Shares Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Shares Reflected in First Column)
Equity compensation plans approved by shareholders—1999 Stock Option Plan of Bank of the James Financial Group, Inc.	636	$ 12.79	—
Equity compensation plans not approved by shareholders	N/A	N/A	N/A
Total	636	$ 12.79	—

Item 6. Selected Financial Data — Not applicable

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion is intended to assist readers in understanding and evaluating our financial condition and results of operations. You should read this discussion in conjunction with our financial statements and accompanying notes included elsewhere in this report. Because Bank of the James Financial Group, Inc. ("Financial") has no material operations and conducts no business other than the ownership of its operating subsidiary, Bank of the James (and its divisions and subsidiary), the discussion primarily concerns the business of the Bank. However, for ease of reading and because our financial statements are presented on a consolidated basis, references to "we," "us," or "our" refer to Financial, Bank of the James, and their divisions and subsidiaries as appropriate. The comparison of operating results for Financial between the years ended December 31, 2017 and 2016 should be read in the context of both the size and the time frame in which the Bank has been operating.

Cautionary Statement Regarding Forward-Looking Statements

This report contains statements that constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. The words "believe," "estimate," "expect," "intend," "anticipate," "plan" and similar expressions and variations thereof identify certain of such forward-looking statements which speak only as of the dates on which they were made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those indicated in the forward-looking statements as a result of various factors. Factors that could cause actual results to differ from the results discussed in the forward-looking statements include, but are not limited to: economic conditions (both generally and more specifically in the markets in which we operate); competition for our customers from other providers of financial services; government legislation and regulation relating to the banking industry (which changes from time to time and over which we have no control) including but not limited to the Dodd-Frank Wall Street Reform and Consumer Protection Act; changes in the value of real estate securing loans made by the Bank; changes in interest rates; and material unforeseen changes in the liquidity, results of operations, or financial condition of our customers. Other risks, uncertainties and factors could cause our actual results to differ materially from those projected in any forward-looking statements we make.

Overview

Financial is a bank holding company headquartered in Lynchburg, Virginia. Our primary business is retail banking which we conduct through our wholly-owned subsidiary, Bank of the James (which we refer to as the "Bank"). We conduct three other business activities, mortgage banking through the Bank's Mortgage Division (which we refer to as "Mortgage"), investment services through the Bank's Investment division (which we refer to as "Investment Division"), and insurance activities through BOTJ Insurance, Inc., a subsidiary of the Bank, (which we refer to as "Insurance").

Although we intend to increase other sources of revenue, our operating results depend primarily upon the Bank's net interest income, which is determined by the difference between (i) interest and dividend income on earning assets, which consist primarily of loans, investment securities and other investments, and (ii) interest expense on interest-bearing liabilities, which consist principally of deposits and other borrowings. The Bank's net income also is affected by its provision for loan losses, as well as the level of its noninterest income, including loan fees and service charges, and its noninterest expenses, including salaries and employee benefits, occupancy expense, data processing expenses, miscellaneous other expenses, franchise taxes, and income taxes.

As discussed in more detail below,

- For the year ended December 31, 2017, Financial had net income of $2,922,000, a decrease of $364,000 from net income of $3,286,000, from the year ended December 31, 2016;
- For the year ended December 31, 2017, earnings per basic and diluted common share was $0.67, as compared earnings of $0.75 per basic and diluted common share for the year ended December 31, 2016;
- Net interest income increased to $20,672,000 for the current year from $19,224,000 for the year ended December 31, 2016;
- Noninterest income (exclusive of net gains on sales and calls of securities) increased to $4,614,000 for the year ended December 31, 2017 from $4,301,000 for the year ended December 31, 2016;
- Total assets as of December 31, 2017 were $626,341,000 compared to $574,195,000 at the end of 2016, an increase of $52,146,000 or 9.08%;
- Net loans (excluding loans held for sale), net of unearned income and allowance for loan loss, increased to $491,022,000 as of December 31, 2017 from $464,353,000 as of the end of December 31, 2016, an increase of 5.74%; and
- The net interest margin decreased 10 basis points to 3.67% for 2017, compared to 3.77% for 2016.

- Income tax expense increased in the amount of $871,000 related to the write-down of the company's deferred tax asset as a result of the decrease in the corporate income tax rate set forth by the Tax and Jobs Act of 2017.

The following table sets forth selected financial ratios:

	For the Year Ended December 31,		
	2017	2016	2015
Return on average equity	5.64%	6.60%	9.78%
Return on average assets	0.49%	0.60%	0.74%
Dividend yield %	1.60%	1.57%	1.70%
Average equity to total average assets	8.61%	9.16%	7.59%

Effect of Economic Trends

The U.S. economy continued to improve in 2017, with the economy growing more rapidly in the final three quarters of 2017 as compared to 2015 and 2016. Locally, real estate values appear stable and with some increase in valuation. Region 2000 experienced positive trends in housing during 2016 and 2017. During the first half of 2017, loan demand from small and medium sized businesses decreased as compared to 2016. However, in the second half of 2017 and continuing into 2018, demand for these loans has increased. Despite recent and potential future rate increases, management expects loan demand to increase through the remainder of 2018. Due to increased asset growth, the Bank's capital levels decreased slightly, but the Bank remains "well-capitalized" under regulatory standards.

For additional information regarding the local economy and its impact on the Company's business refer to the Business Section in this 10-K under the caption "Location and Market Area" (*Part I. Item 1. Business Section – Location and Market Area).*

Management expects economic conditions to continue remain favorable in 2018, which could result in increased competition for banking services. Financial institutions also face continued heightened levels of scrutiny from federal and state regulators. Financial institutions experienced, and are expected to continue to experience, pressure on credit costs, loan yields, deposit and other borrowing costs, liquidity, and capital.

A variety and wide scope of economic factors affect Financial's success and earnings. Although interest rate trends are one of the most important of these factors, Financial believes that interest rates cannot be predicted with a reasonable level of confidence and therefore does not attempt to do so with complicated economic models. Management believes that the best defense against wide swings in interest rate levels is to minimize vulnerability at all potential interest rate levels. Rather than concentrate on any one interest rate scenario, Financial prepares for the opposite as well, in order to safeguard margins against the unexpected.

The downward trend in short term interest rates which began in the last quarter of 2007 was due to the actions of the Federal Open Market Committee ("FOMC") resulting from a deteriorating economy. Since December 2008, the federal funds target rate set by the Federal Reserve had been set at 0.00% to 0.25%. This trend began to reverse in December 2015 when the FOMC raised the target rate by 25 basis points and did so again in December 2016, and in March, June and December 2017, which resulted in the current target rate of 1.25% increasing to 1.50%. Long term interest rates have likewise begun to increase and the yield curve, while flatter, remains positively sloped. Although it cannot be certain, as discussed below under "Results of Operations—Net Interest Income" management believes that short term interest rates will either increase or remain stable for the foreseeable future. An increase in long-term interest rates would have an adverse impact on the Mortgage Division, primarily due to reduced refinancing opportunities.

Critical Accounting Policies

Financial's financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. The Bank uses historical loss factors as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from the historical factors that the Bank uses in estimating risk. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of Financial's transactions would be the same, the timing of events that would impact the transactions could change.

The allowance for loan losses is management's estimate of the probable losses inherent in our loan portfolio. The allowance is based on two basic principles of accounting: (i) ASC 450, Contingencies, which requires that losses be accrued when they are probable of occurring and are reasonably estimable and (ii) ASC 310, Receivables, which requires that losses on impaired loans be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. Guidelines for determining allowances for loan losses are also provided in the SEC Staff Accounting Bulletin No. 102 – "Selected Loan Loss Allowance Methodology and Documentation Issues" and the Federal Financial Institutions Examination Council's interagency guidance, "Interagency Policy Statement on the Allowance for Loan and Lease Losses" (the "FFIEC Policy Statement"). See "Management Discussion and Analysis Results of Operations – Allowance for Loan Losses and Loan Loss Reserve" below for further discussion of the allowance for loan losses.

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDR"). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loans reach nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans. The Bank had loans totaling $440,000 and $455,000 that were classified as TDRs as of December 31, 2017 and 2016, respectively.

Management considers historical trends, industry trends, peer comparisons, as well as individual classified impaired loans, in addition to historical experience to evaluate the allowance for loan losses. Our method for determining the allowance for loan losses is discussed more fully under "Provision and Allowance for Loan Losses for the Bank" below.

Other real estate owned (OREO) consists of properties acquired through foreclosure or deed in lieu of foreclosure. These properties are carried at fair value less estimated costs to sell at the date of foreclosure establishing a new cost basis. These properties are subsequently accounted for at the lower of cost or fair value less estimated costs to sell. Losses from the acquisition of property in full or partial satisfaction of loans are charged against the allowance for loan losses. Subsequent write-downs, if any, are charged against expense. Gains and losses on the sales of foreclosed properties are included in determining net income in the year of the sale. Operating costs after acquisition are expensed. The Bank had OREO totaling $2,650,000 and $2,370,000 as of December 31, 2017 and 2016, respectively.

RESULTS OF OPERATIONS

Year Ended December 31, 2017 compared to year ended December 31, 2016

Net Income

The net income for Financial for the year ended December 31, 2017 was $2,922,000 or $0.67 per basic and diluted share compared with net income of $3,286,000 or $0.75 per basic and diluted share for the year ended December 31, 2016. Note 13 of the consolidated financial statements provides additional information with respect to the calculation of Financial's earnings per share.

The decrease of $364,000 in 2017 net income compared to 2016 was due in large part the following: i) an increase in income tax expense related to the write-down of the company's deferred tax asset in the amount of $871,000 as a result of the decrease in the corporate income tax rate set forth by the Tax and Jobs Act of 2017; and ii) an increase in non-interest expenses of $1,452,000, or 8.25%. These decreases were partially offset by i) an increase in net interest income of $1,448,000, or 7.53%; and ii) a decrease in the provision for loan losses of $619,000, or 38.40%. As discussed in more detail below, we charged off $2,094,000 in nonperforming loans during the year ended December 31, 2017 as compared with $759,000 in 2016. The amount of the provision for loan losses was $993,000 in the year ended December 31, 2017 as compared to $1,612,000 in 2016.

These operating results represent a return on average stockholders' equity of 5.64% for the year ended December 31, 2017 compared to 6.60% for the year ended December 31, 2016. As discussed below, Financial issued $11,520,000 in additional common stock on December 3, 2015. This increased capital was the primary reason for the decrease in the return on average stockholders' equity in 2016 while a decrease in net income was the primary reason for the decrease in return on equity in 2017. The return on average assets for the year ended December 31, 2017 was 0.49% compared to 0.60% in 2016.

Net Interest Income

The fundamental source of Financial's earnings, net interest income, is defined as the difference between income on earning assets and the cost of funds supporting those assets. The significant categories of earning assets are loans, federal funds sold, and investment securities, while deposits, fed funds purchased, and other borrowings represent interest-bearing liabilities. The level of net interest income is impacted primarily by variations in the volume and mix of these assets and liabilities, as well as changes in interest rates when compared to previous periods of operation.

Interest income increased to $23,665,000 for the year ended December 31, 2017 from $21,568,000 for the year ended December 31, 2016. This increase was due to the interest earned on the increase in loan balances and was mitigated by a decrease in the yields on average earning assets which primarily consist of loans and investment securities, as discussed below.

Net interest income for 2017 increased $1,448,000 to $20,672,000 or 7.53% from net interest income of $19,224,000 in 2016. The growth in net interest income was due primarily to the additional interest generated from increased loan balances but offset by an increase in our interest expense of $649,000 to $2,993,000 in 2017 from $2,344,000 in 2016. Our interest expense increased primarily because of the sale of $5,000,000 in 4% notes that were issued in January 2017 as well as an increase in the average balances of our time deposits (which typically pay depositors a higher rate of interest than demand accounts) from $155,346,000 during 2016 to $174,064,000 in 2017. The average interest rate paid on time deposits increased by 7 basis points during 2017 as compared to 2016. The increase was also due in part to an increase in the average balance in interest bearing demand deposit accounts to $192,932,000 in 2017 from $169,963,000 in 2016 along with an increase in the average rate paid on the interest bearing demand deposit accounts to 0.26% in 2017 from 0.21% in 2016.

The net interest margin decreased to 3.67% in 2017 from 3.77% in 2016. The average rate on earning assets decreased 3 basis points from 4.23% in 2016 to 4.20% in 2017 and the average rate on interest-bearing liabilities increased from 0.54% in 2016 to 0.63% in 2017. Management cannot predict with certainty future interest rate decisions by the FOMC

The following table shows the average balances of total interest earning assets and total interest bearing liabilities for the periods indicated, showing the average distribution of assets, liabilities, stockholders' equity and related revenue, expense and corresponding weighted average yields and rates. The average balances used in this table and other statistical data were calculated using average daily balances.

Net Interest Margin Analysis
Average Balance Sheets
For the Years Ended December 31, 2017, 2016 and 2015
(*dollars in thousands*)

	2017			2016			2015		
	Average Balance Sheet	Interest Income/ Expense	Average Rates Earned/ Paid	Average Balance Sheet	Interest Income/ Expense	Average Rates Earned/Paid	Average Balance Sheet	Interest Income/ Expense	Average Rates Earned/Paid
ASSETS									
Loans, including fees (1)(2)	$485,210	$ 21,980	4.53%	$451,100	$ 20,356	4.51%	$417,594	$ 19,291	4.62%
Loans AFS	2,628	101	3.84%	3,611	125	3.46%	2,220	86	3.87%
Federal funds sold	11,869	133	1.12%	7,029	34	0.48%	7,883	18	0.23%
Interest-bearing bank balances	7,457	82	1.10%	6,093	31	0.51%	5,197	14	0.27%
Securities (3)	54,913	1,311	2.39%	41,083	976	2.38%	32,578	847	2.60%
Federal agency equities	1,345	73	5.43%	1,243	67	5.39%	1,268	67	5.28%
CBB equity	116	—	0.00%	116	—	0.00%	116	—	0.00%
Total earning assets	563,538	23,680	4.20%	510,275	21,589	4.23%	466,856	20,323	4.35%
Allowance for loan losses	(5,072)			(4,819)			(4,705)		
Non-earning assets	43,354			38,441			34,876		
Total assets	$601,820			$543,897			$497,027		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Deposits									
Demand interest bearing (4)	$192,932	$ 494	0.26%	$169,963	$ 352	0.21%	$140,575	$ 256	0.18%
Savings	105,996	228	0.22%	110,422	238	0.22%	114,828	253	0.22%
Time deposits	174,064	2,071	1.19%	155,346	1,742	1.12%	137,374	1,552	1.13%
Total interest bearing deposits	472,992	2,793	0.59%	435,731	2,332	0.54%	392,777	2,061	0.52%
Other borrowed funds									
Fed funds purchased	1	—	0.00%	371	4	1.08%	184	2	1.09%
Repurchase agreements	795	13	1.64%	—	—	0.00%	—	—	0.00%
Other borrowings	—	—	0.00%	—	—	0.00%	2,269	28	1.23%
Capital Notes	4,671	187	4.00%	82	8	6.00%	10,000	600	6.00%
Total interest-bearing liabilities	478,459	2,993	0.63%	436,184	2,344	0.54%	405,230	2,691	0.66%
Non-interest bearing deposits (4)	70,791			56,741			53,417		
Other liabilities	781			1,165			634		
Total liabilities	550,031			494,090			459,281		
Stockholders' equity	51,789			49,807			37,746		

Total liabilities and Stockholders’ equity	$601,820		$543,897		$497,027	
Net interest earnings	$20,687		$19,245		$17,632	
Net interest margin		3.67%		3.77%		3.78%
Interest spread		3.58%		3.69%		3.69%

(1) Net deferred loan fees and costs are included in interest income.
(2) Nonperforming loans are included in the average balances. However, interest income and yields calculated do not reflect any accrued interest associated with nonaccrual loans.
(3) The interest income and yields calculated on securities have been tax affected to reflect any tax exempt interest on municipal securities using the Company’s applicable federal tax rate of 34%.
(4) The 2016 and 2015 year-to-date average balances in the table above reflect reclassifications of $42.2 million and $32.4 million, respectively, from non-interest bearing demand to interest bearing demand, consistent with the reclassification resulting from the restatement described in Note 2 of the consolidated financial statements.

Interest income and expenses 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 shows the direct causes of the year-to-year changes in components of net interest income on a taxable equivalent basis.

	Volume and Rate (dollars in thousands) Years Ending December 31,								
	2017			2016			2015		
	Volume Effect	Rate Effect	Change in Income/ Expense	Volume Effect	Rate Effect	Change in Income/ Expense	Volume Effect	Rate Effect	Change in Income/ Expense
Loans	$1,466	$ 134	$ 1,600	$1,606	$(502)	$ 1,104	$2,307	$(441)	$ 1,866
Federal funds sold	34	65	99	(2)	18	16	13	1	14
Interest bearing deposits	8	43	51	3	14	17	1	—	1
Securities	331	4	335	191	(62)	129	(183)	(165)	(348)
Restricted stock	167	(161)	6	—	—	—	3	1	4
Total earning assets	2,006	85	2,091	1,798	(532)	1,266	2,141	(604)	1,537
Liabilities:									
Demand interest bearing	51	91	142	53	43	96	179	(138)	41
Savings	(10)	—	(10)	(15)	—	(15)	(36)	18	(18)
Time deposits	216	112	328	204	(14)	190	446	(46)	400
Federal funds purchased	(2)	(2)	(4)	2	—	2	(9)	2	(7)
Capital notes	180	(1)	179	(592)	—	(592)	—	—	—
Other borrowings	6	7	13	(14)	(14)	(28)	(18)	(32)	(50)
Total interest-bearing liabilities	$ 441	$ 207	$ 648	$ (362)	$ 15	$ (347)	$ 562	$(196)	$ 366
Change in net interest income	$1,564	$(122)	$ 1,442	$2,160	$(547)	$ 1,613	$1,579	$(408)	$ 1,171

Noninterest Income of Financial

Noninterest income has been and will continue to be an important factor for increasing our profitability. Our management continues to review and consider areas where noninterest income can be increased. Noninterest income (excluding securities gains and losses) consists of income from mortgage originations and sales, service fees, distributions from a title insurance agency in which we have an ownership interest, income from credit and debit card transactions, and fees generated by the investment services of Investment. Service fees consist primarily of monthly service and minimum account balance fees and charges on transactional deposit accounts, treasury management fees, overdraft charges, and ATM service fees.

The Bank, through the Mortgage Division originates both conforming, non-conforming consumer residential mortgage, and reverse mortgage loans primarily in the Region 2000 area as well as in Charlottesville, Harrisonburg, and Roanoke. As part of the Bank’s overall risk management strategy, all of the loans originated and closed by the Mortgage Division are presold to mortgage banking or other financial institutions. The Mortgage Division assumes no credit or interest rate risk on these mortgages.

The Mortgage Division originated 434 mortgage loans, totaling approximately $89,522,000 during the year ended December 31, 2017 as compared with 452 mortgage loans, totaling $84,743,000 in 2016. Income improved with the increased origination volume. We continued to benefit from an improved pricing model that resulted from the migration of the Mortgage Division’s broker relationships to hybrid correspondent in 2013. The hybrid correspondent relationship allows the Bank to close loans in its name before an investor purchases the loan. By using the Bank's funds to close the loan (as compared to a broker relationship in which loans are funded by the purchaser of the mortgage), the Bank is able to obtain better pricing due to the slight increase in risk. In 2016 and 2017, the Mortgage Division continued to operate in an environment in which real estate values continued to improve. Loans for new home purchases comprised 57% of the total volume in 2016 as compared to 66% in 2017. For the year ended December 31, 2017, the Mortgage Division accounted for 8.57% of Financial's total revenue as compared with 9.32% of Financial's total revenue for the year ended December 31, 2016. Mortgage contributed $515,000 and $558,000 to Financial's pre-tax net income in 2017 and 2016, respectively. Although management anticipates that residential mortgage rates will remain low by historical standards throughout 2018, management also anticipates that if rates trend higher, the majority of the loan mix will continue to lean towards new home purchases and away from refinancing. In addition, the Tax and Jobs Act is likely to increase the number of taxpayers that utilize the standard deduction, which could make mortgage loans less attractive. Management believes it is too early to assess the impact of the Tax and Jobs Act on future mortgage production.

The Mortgage Division continues to increase its market share in its service areas. We opened a new mortgage origination office in Roanoke in October, 2013 and began originating mortgages in Charlottesville in March, 2014. In addition, in the first quarter of 2016, we hired a new mortgage loan origination officer for the Harrisonburg Market. It is anticipated that 2 additional mortgage producers will join the Mortgage Division in the Roanoke area in the first quarter of 2018. Management expects that continued historically low rates coupled with the Mortgage Division's reputation in its markets and our recently-added offices and producers present an opportunity for us to continue to grow the Mortgage Division's revenue.

Service charges and fees and commissions increased to $1,759,000 for the year ended December 31, 2017 from $1,444,000 for the year ended December 31, 2016 primarily due to increases related to the following: commission on the sales of securities, debit and credit card interchange fees, and treasury management fees.

Investment provides brokerage services through an agreement with a third-party broker-dealer. Pursuant to this arrangement, the third party broker-dealer operates a service center adjacent to one of the branches of the Bank. The center is staffed by dual employees of the Bank and the broker-dealer. Investment receives commissions on transactions generated and in some cases ongoing management fees such as mutual fund 12b-1 fees. Investment's financial impact on our consolidated revenue has been minimal. Although management cannot predict the financial impact of Investment with certainty, management anticipates it will continue to be a relatively small component of revenue in 2018.

In the third quarter of 2008, we began providing insurance and annuity products to Bank customers and others, through the Bank's Insurance subsidiary. The Bank has one full-time and one part-time employee that are dedicated to selling insurance products through Insurance. Insurance generates minimal revenue and its financial impact on our consolidated revenue has been immaterial. Management anticipates that Insurance's impact on noninterest income will remain immaterial in 2018.

Noninterest income, exclusive of gains and losses on the sale and call of securities, increased to $4,614,000 in 2017 from $4,301,000 in 2016. Inclusive of gains and losses on the sale and call of securities, noninterest income decreased to $4,727,000 in 2017 from $4,795,000 in 2016. The following table summarizes our noninterest income for the periods indicated.

	Noninterest Income (*dollars in thousands)* December 31,	
	2017	2016
Gains on sale of loans held for sale	$ 2,434	$ 2,433
Service charges, fees and commissions	1,759	1,444
Increase in cash value of life insurance	345	292
Other	76	132
Gain on sales and calls of securities, net	113	494
Total noninterest income	$ 4,727	$ 4,795

The decrease in noninterest income for 2017 as compared to 2016 was primarily due to a decrease in income from gains on sales of available-for-sale securities.

Noninterest Expense of Financial

Noninterest expenses increased from $17,954,000 for the year ended December 31, 2016 to $19,046,000 for the year ended December 31, 2017. The following table summarizes our noninterest expense for the periods indicated.

	Noninterest Expense (dollars in thousands) December 31,	
	2017	2016
Salaries and employee benefits	$10,012	$ 9,230
Occupancy	1,493	1,312
Equipment	1,521	1,287
Supplies	520	480
Professional, data processing and other outside expenses	2,795	2,731
Marketing	739	686
Credit expense	467	425
Other real estate expenses	88	68
FDIC insurance expense	375	363
Other	1,036	1,012
Total noninterest expense	$19,046	$17,594

The increase in non-interest expense was due in large part to an increase in compensation and benefits and occupancy and equipment. To a lesser degree supplies, professional expenses, marketing, credit, other real estate expense and FDIC insurance also contributed to the overall increase. Our total personnel expense, net of direct salary costs incurred in originating certain loans (in accordance with current accounting rules), increased to $10,012,000 for the year ended December 31, 2017, from $9,230,000 for the year ended December 31, 2016. Compensation for some employees of the Mortgage Division and Investment is commission-based and therefore subject to fluctuation.

The efficiency ratio, that is the cost of producing each dollar of revenue, is determined by dividing noninterest expense by the sum of net interest income plus noninterest income. Financial’s efficiency ratio increased from 73.25% in 2016 to 74.99% in 2017, in large part due to the increases in the above expenses most of which were associated with the recent expansion into Charlottesville, Harrisonburg, Roanoke and Appomattox.

Income Tax Expense

For the year ended December 31, 2017, Financial had federal income tax expense of $2,438,000, as compared to a federal income tax expense of $1,527,000 in 2016, which equates to effective tax rates of 45.49% and 31.72%, respectively. Our effective rate was higher than the statutory corporate tax rate in 2017 due to the $871,000 write-down of deferred tax assets which flowed through income tax expense as a result of the decrease in corporate tax rate from 34% to 21% as mandated by the Tax and Jobs Act of 2017. Our effective tax rate was lower than the statutory corporate tax rate in 2016 because of federal income tax benefits resulting from the tax treatment of earnings on bank owned life insurance, and certain tax free municipal securities. Note 12 of the consolidated financial statements provides additional information with respect to our 2017 federal income tax expense and the deferred tax accounts.

ANALYSIS OF FINANCIAL CONDITION

As of December 31, 2017 and December 31, 2016

General

Our total assets were $626,341,000 at December 31, 2017, an increase of $52,146,000 or 9.08% from $574,195,000 at December 31, 2016, primarily due to an increase in loans, as well as increases in both securities available-for-sale and securities held to maturity, and an increase in the cash value of bank-owned life insurance. As explained in more detail below, deposits increased from $523,112,000 on December 31, 2016 to $567,493,000 on December 31, 2017. Loans, net of unearned income and allowance, increased to $491,022,000 on December 31, 2017 from $464,353,000 on December 31, 2016.

Loans

Our loan portfolio is the largest and most profitable component of our earning assets. The Bank has comprehensive policies and procedures which cover both commercial and consumer loan origination and management of credit risk. Loans are underwritten in a manner that focuses on the borrower's ability to repay. Management's goal is not to avoid risk, but to manage it and to include credit risk as part of the pricing decision for each product.

The Bank's loan portfolio consists of commercial short-term lines of credit, term loans, mortgage financing and construction loans that are used by the borrower to build or develop real estate properties, and consumer loans. The consumer portfolio includes residential real estate mortgages, home equity lines and installment loans.

Loans, net of unearned income and allowance, increased to $491,022,000 on December 31, 2017 from $464,353,000 on December 31, 2016. Total loans, including loans held for sale increased to $498,400,000 on December 31, 2017 from $473,902,000 on December 31, 2016. The increase in total loans was partially due to enhanced marketing efforts and increased penetration into the Charlottesville, Harrisonburg, and Roanoke markets. We anticipate that these offices will continue to add to our loan balances. The increase is also attributed to increased calling and sales efforts by our lenders. Despite these factors, strong competition for number of qualified borrowers remains strong.

As of December 31, 2017, the Bank had $4,309,000, or 0.87% of its total loans, in non-accrual status compared with $3,465,000, or 0.74% of its total loans, at December 31, 2016. Management is continuing its efforts to reduce non-performing assets through enhanced collection efforts and the liquidation of underlying collateral. The Bank attempts to work with borrowers on a case-by-case basis to attempt to protect the Bank's interests. However, despite our commitment, a reduction of non-accrual loans can be dependent on a number of factors, including improvements in employment, housing, and overall economic conditions at the local, regional and national levels. See "Asset Quality" below.

The following table summarizes the composition of the Bank's loan portfolio for the periods indicated by dollar amount:

	Loan Portfolio (*dollars in thousands*) December 31,				
	2017	2016	2015	2014	2013
Commercial	$ 96,127	$ 88,085	$ 76,773	$ 63,259	$ 55,803
Commercial real estate	251,807	237,638	217,125	207,262	172,117
Consumer	83,746	85,099	81,531	76,380	71,165
Residential	64,094	59,247	59,699	52,462	46,095
Total loans	495,774	470,069	435,128	399,363	345,180
Less allowance for loan losses	4,752	5,716	4,683	4,790	5,186
Net loans	$491,022	$464,353	$430,445	$394,573	$339,994

The following table sets forth the maturities of the loan portfolio at December 31, 2017.

	Remaining Maturities of Selected Loans (*dollars in thousands*) At December 31, 2017			
	Less than One Year	One to Five Years	Greater than Five Years	Total
Commercial	$ 14,726	$ 20,631	$ 60,770	$ 96,127
Commercial real estate	23,186	43,485	185,136	251,807
Consumer	6,434	31,359	45,953	83,746
Residential	11,362	9,984	42,748	64,094
Total	$ 55,708	$105,459	$334,607	$495,774
For maturities over one year:				
Fixed Rates	$103,700	23.56%		
Variable Rates	336,366	76.44%		
Total	$440,066			

Deposits

We experienced an increase in deposits from $523,112,000 at December 31, 2016 to $567,493,000 at December 31, 2017, for an increase of 8.48%. Noninterest-bearing deposits increased $11,967,000 or 19.26% from $62,135,000 at December 31, 2016 to $74,102,000 at December 31, 2017. The increase in non-interest bearing deposits was due to our increased presence in Charlottesville, Harrisonburg, Roanoke, and most recently, Appomattox as well as increased and continued efforts to procure the primary checking accounts of our commercial loan customers. The increase can also be attributed to end of the year real estate and business closings related to our professional settlement accounts. Interest-bearing deposits increased $32,414,000, or 7.03%, from $460,977,000 at December 31, 2016 to $493,391,000 at December 31, 2017.

A total of $22,044,000 and $20,064,000 in brokered certificates of deposit was included in total time deposits at December 31, 2016 and December 31, 2017, respectively. The year end balances for both non-interest bearing deposits and interest bearing deposits reflect the reclassification resulting from the restatement of certain demand deposits from non-interest bearing to interest bearing as described in Note 2 to consolidated financial statements.

The following table sets forth the average deposit balances and the rates paid on deposits for the years indicated:

	Average Deposits and Rates Paid (*dollars in thousands*) Year Ended December 31,					
	2017		2016		2015	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing deposits (1)	$ 70,791	—	$ 56,741	—	$ 53,417	—
Interest-bearing deposits						
Interest checking (1)	$127,711	0.21%	$119,352	0.19%	$101,122	0.17%
Money market	65,221	0.38%	50,611	0.29%	39,453	0.22%
Savings	105,996	0.19%	110,422	0.22%	114,828	0.22%
Time deposits						
Less than $100,000	77,418	1.13%	69,185	1.10%	67,790	1.07%
$100,000 but < $250,000	58,381	1.17%	50,282	1.16%	45,456	1.15%
Greater than $250,000	38,265	1.34%	35,879	1.20%	24,128	1.14%
Total interest-bearing deposits	$472,992	0.59%	$435,731	0.54%	$392,777	0.52%
Total deposits	$543,783		$492,472		$446,194	

(1) The 2016 and 2015 year-to-date average balances in the table above reflect reclassifications of $42.2 million and $32.4 million, respectively, from non-interest bearing deposits to interest checking, consistent with the reclassification resulting from the restatement described in Note 2 of the consolidated financial statements.

The following table includes a summary of maturities of CDs greater than $100,000:

	Maturities of CD's Greater than $ 100,000 (dollars in thousands)				
	Less than Three Months	Three to Six Months	Six to Twelve Months	Greater than One Year	Total
At December 31, 2017	$ 25,172	$13,189	$12,326	$52,255	$102,942

Cash and Cash Equivalents

Cash and cash equivalents increased from $28,683,000 on December 31, 2016 to $37,018,000 on December 31, 2017. Federal funds sold amounted to $16,751,000 on December 31, 2017 compared to $11,745,000 on December 31, 2016. Fluctuations in federal funds sold generally are related to fluctuations in transactional accounts and professional settlement accounts as discussed above, and use of cash and cash equivalents to fund loan growth.

Investment Securities

The investment securities portfolio of the Bank is used as a source of income and liquidity.

The following table summarizes the fair value of the Bank's securities portfolio for the periods indicated:

	Securities Portfolio (*dollars in thousands*) December 31,		
	2017	2016	2015
Held-to-maturity			
U.S. agency obligations	$ 5,619	$ 3,273	$ 2,649
Available-for-sale			
U.S. treasuries	1,858	1,833	—
U.S. agency obligations	23,850	13,113	18,810
Mortgage—backed securities	13,388	12,005	10,647
Municipals	12,274	9,947	5,034
Corporates	3,942	3,878	1,505
Total available-for-sale	$55,312	$40,776	$35,996

Deposited funds are generally invested in overnight vehicles, including federal funds sold, until approved loans are funded. The decision to purchase investment securities is based on several factors or a combination thereof, including:

a) The fact that yields on acceptably rated investment securities (S&P "A" rated or better) are significantly better than the overnight federal funds rate;

b) Whether demand for loan funding exceeds the rate at which deposits are growing, which leads to higher or lower levels of surplus cash;

c) Management’s target of maintaining a minimum of 6% of the Bank’s total assets in a combination of federal funds sold and investment securities (aggregate of available-for-sale and held-to-maturity portfolios); and

d) Whether the maturity or call schedule meets management’s asset/liability plan.

Available-for-sale securities (as opposed to held-to-maturity securities) may be liquidated at any time as funds are needed to fund loans. Liquidation of securities may result in a net loss or net gain depending on current bond yields available in the primary and secondary markets and the shape of the U.S. Treasury yield curve. Management is cognizant of its credit standards policy and does not feel pressure to maintain loan growth at the same levels as deposit growth and thus sacrifice credit quality in order to avoid security purchases.

Management has made the decision to maintain a significant portion of its available funds in liquid assets so that funds are available to fund future growth of the loan portfolio. Management believes that this strategy will allow us to maximize interest margins while maintaining appropriate levels of liquidity.

Securities held-to-maturity at carrying cost increased from $3,299,000 as of December 31, 2016 to $5,713,000 as of December 31, 2017. This increase resulted from the purchase of additional held-to-maturity securities and was partially offset by the amortization of premiums within the held-to-maturity portfolio. The decision to invest in securities held-to-maturity is based on the same factors as the decision to invest in securities available-for-sale except that management invests surplus funds in securities held-to-maturity only after concluding that such funds will not be necessary for liquidity purposes during the term of such security. However, the held-to-maturity securities may be pledged for such purposes as short term borrowings and as collateral for public deposits.

The portfolio of securities available-for-sale increased to $55,312,000 as of December 31, 2017 from $40,776,000 as of December 31, 2016. The increase is a result of management’s desire to continue to increase on-balance sheet liquidity. During 2017, the Bank purchased $27,395,000 of available-for-sale securities and sold available-for-sale securities totaling $9,940,000. In addition, the Bank realized $3,233,000 from calls, maturities, and paydowns of available-for-sale securities.

The following table shows the maturities of held-to-maturity and available-for-sale securities at amortized cost and fair value at December 31, 2017 and December 31, 2016 and approximate weighted average yields of such securities. Yields on state and political subdivision securities are not shown on a tax equivalent basis. Financial attempts to maintain diversity in its portfolio and maintain credit quality and repricing terms that are consistent with its asset/liability management and investment practices and policies. For further information on Financial’s securities, see Note 4 to the consolidated financial statements included in Item 8 of this Form 10-K.

Securities Portfolio Maturity Distribution /Yield Analysis (*dollars in thousands*) At December 31, 2017	Less than One Year	One to Five Years	Five to Ten Years	Greater than Ten Years and Other Securities	Total
Held-to-maturity					
U.S. Agency					
Amortized cost	$2,002	$ —	$ —	$ 3,711	$ 5,713
Fair value	$2,009	$ —	$ —	$ 3,610	$ 5,619
Weighted average yield	4.00%			2.98%	
Available-for-sale securities					
U.S Treasury					
Amortized cost	$ —	$ —	$ 1,956	$ —	$ 1,956
Fair value	$ —	$ —	$ 1,858	$ —	$ 1,858
Weighted average yield			1.77%		
U.S. Agency					
Amortized cost	$ —	$ —	$10,851	$ 14,030	$24,880
Fair value	$ —	$ —	$10,392	$ 13,458	$23,850
Weighted average yield			2.12%	2.50%	
Mortgage Backed Securities					
Amortized cost	$ —	$ —	$ 5,340	$ 8,322	$13,662
Fair value	$ —	$ —	$ 5,279	$ 8,109	$13,388
Weighted average yield			1.97%	2.23%	
Municipals					
Amortized cost	$ —	$1,287	$ 2,960	$ 8,309	$12,556
Fair value	$ —	$1,274	$ 2,916	$ 8,084	$12,274
Weighted average yield		2.15%	2.21%	2.88%	
Corporates					
Amortized cost	$ —	$ —	$ 4,117	$ —	$ 4,117
Fair value	$ —	$ —	$ 3,942	$ —	$ 3,942
Weighted average yield			2.28%		
Total portfolio					
Amortized cost	$2,002	$1,287	$25,224	$ 34,372	$62,885
Fair value	$2,009	$1,274	$24,387	$ 33,261	$60,931
Weighted average yield	4.00%	2.15%	2.10%	2.58%	

Securities Portfolio Maturity Distribution /Yield Analysis (*dollars in thousands*) At December 31, 2016	Less than One Year	One to Five Years	Five to Ten Years	Greater than Ten Years and Other Securities	Total
Held-to-maturity					
U.S. Agency					
Amortized cost	$—	$2,015	$ —	$ 1,284	$ 3,299
Fair value	$—	$2,080	$ —	$ 1,193	$ 3,273
Weighted average yield		4.00%		3.18%	
Available-for-sale securities					
U.S. Treasuries					
Amortized cost	$—	$ —	$ 1,952	$ —	$ 1,952
Fair value	$—	$ —	$ 1,833	$ —	$ 1,833
Weighted average yield			1.77%		
U.S. Agency					
Amortized cost	$—	$ —	$ 3,005	$ 11,327	$14,332
Fair value	$—	$ —	$ 2,847	$ 10,266	$13,113
Weighted average yield			1.78%	2.08%	
Mortgage Backed Securities					
Amortized cost	$—	$ —	$ 2,594	$ 9,764	$12,358
Fair value	$—	$ —	$ 2,555	$ 9,450	$12,005
Weighted average yield			1.54%	2.09%	
Municipals					
Amortized cost	$—	$ 551	$ 3,191	$ 6,684	$10,426
Fair value	$—	$ 535	$ 3,205	$ 6,207	$ 9,947
Weighted average yield		1.80%	2.95%	2.96%	
Corporates					
Amortized cost	$—	$ —	$ 4,132	$ —	$ 4,132
Fair value	$—	$ —	$ 3,878	$ —	$ 3,878
Weighted average yield			2.28%		
Total portfolio					
Amortized cost	$—	$2,566	$14,874	$ 29,059	$46,499
Fair value	$—	$2,615	$14,318	$ 27,116	$44,049
Weighted average yield		3.53%	2.12%	2.34%	

Cash surrender value of bank owned life insurance

On July 1, 2009, the Company funded bank owned life insurance (BOLI) for a small group of its officers, where the Company is the owner and sole beneficiary of the policies. As of December 31, 2017, the BOLI had a cash surrender value of $13,018,000, an increase of $345,000 from the cash surrender value of $12,673,000 as of December 31, 2016. The entire $345,000 increase resulted from an increase in the cash surrender value relating to the aggregate earnings on all of the BOLI policies and there were no additional BOLI purchases in 2017. The value of BOLI increases from the cash surrender values of the pool of insurance. The increase in cash surrender value is recorded as a component of noninterest income; however, the Company does not pay tax on increase in cash value. This profitability is used to offset a portion of current and future employee benefit costs. BOLI can be liquidated if necessary with associated tax costs. However, the Company intends to hold this pool of insurance, because it provides income that enhances the Company's capital position. Therefore, the Company has not provided for deferred income taxes on the earnings from the increase in cash surrender value.

Liquidity

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities.

The liquidity of Financial depends primarily on Financial's current assets, available credit, and the dividends paid to it by the Bank. Payment of cash dividends by the Bank is limited by regulations of the Federal Reserve Board and is tied to the regulatory capital requirements. Although Financial's liquidity is limited, management believes that Financial has sufficient liquidity to meet its current obligations. See " *Capital Resources,* " below.

The objective of liquidity management for the Bank is to ensure the continuous availability of funds to meet the demands of depositors, investors and borrowers. Liquidity management involves monitoring the Bank's sources and uses of funds in order to meet the day-to-day cash flow requirements while maximizing profits. Stable core deposits and a strong capital position are the components of a solid foundation for the Bank's liquidity position. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of securities held-to-maturity is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

Funding sources for the Bank primarily include paid-in capital and customer-based deposits but also include borrowed funds and cash flow from operations. The Bank has in place several agreements that will provide alternative sources of funding, including, but not limited to, lines of credit, sale of investment securities, purchase of federal funds, advances through the Federal Home Loan Bank of Atlanta ("FHLBA") and correspondents, and brokered certificate of deposit arrangements. Management believes that the Bank has the ability to meet its liquidity needs.

At December 31, 2017, liquid assets, which include cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, and securities available-for-sale totaled $92,330,000 as compared to $69,459,000 at December 31, 2016. Management deems liquidity to be adequate. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, approximately $12,123,000 (current carrying value) of these securities are pledged to secure public deposits, or unfunded lines of credit. In the event any secured line of credit is drawn upon, the related debt would need to be repaid before the securities could be sold and converted to cash.

The following table sets forth non-deposit sources of funding:

	Funding Sources (*dollars in thousands*) December 31, 2017		
Source	**Capacity**	**Outstanding**	**Available**
Federal funds purchased lines (unsecured)	$ 26,000	$ —	$ 26,000
Federal funds purchased lines (secured)	3,151	—	3,151
Reverse repurchase agreements	5,000	—	5,000
Borrowings from FHLB Atlanta (1)	156,641	—	156,641
Total	$190,792	$ —	$190,792

(1) Currently the Bank has in place pledged collateral in the amount of approximately $43,600,000 against which $0 was drawn and outstanding on December 31, 2017. Additional collateral would be required to be pledged in order for the full $156,641,000 to be available.

At the end of 2017, approximately 41.96%, or $208,002,000 of the loan portfolio would mature or could reprice within a one-year period. At December 31, 2017, non-deposit sources of available funds totaled $190,792,000, which included $156,641,000 available from the FHLBA.

Capital Resources

Capital adequacy is an important measure of financial stability and performance. Management's objectives are to maintain a level of capitalization that is sufficient to sustain asset growth and promote depositor and investor confidence.

Regulatory agencies measure capital adequacy utilizing a formula that takes into account the individual risk profiles of financial institutions. The guidelines define capital as Tier 1 (primarily common stockholders' equity, defined to include certain debt obligations) and Tier 2 (remaining capital generally consisting of a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, preferred stock and a limited amount of the general valuation allowance for loan losses).

On June 7, 2012, the Federal Reserve issued a series of proposed rules that would revise and strengthen its risk-based and leverage capital requirements and its method for calculating risk-weighted assets. The rules were proposed to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. On July 2, 2013, the Federal Reserve approved certain revisions to the proposals and finalized new capital requirements for banking organizations.

Effective January 1, 2015, the final rules required Financial and the Bank to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6.0% of risk-weighted assets (increased from the previous requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from the previous requirement); and (iv) a leverage ratio of 4.0% of total assets. These are the initial capital requirements, which will be phased in over a five-year period. When fully phased in on January 1, 2019, the rules will require Financial and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets.

The capital conservation buffer requirement was phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

With respect to the Bank, the rules also revised the “prompt corrective action” regulations pursuant to Section 38 of the FDIA by (i) introducing a common equity Tier 1 capital ratio requirement at each level (other than critically undercapitalized), with the required ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum ratio for well-capitalized status being 8.0% (as compared to the previous 6.0%); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3.0% Tier 1 leverage ratio and still be well-capitalized.

The new capital requirements also include changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status, a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital, and increased risk-weights (from 0% to up to 600%) for equity exposures.

The Bank’s regulatory capital levels exceed those established for well-capitalized institutions. If the new minimum capital ratios described above had been effective as of December 31, 2015, based on management’s interpretation and understanding of the new rules, Financial would have remained “well capitalized” as of such date.

The following table (along with Note 18 of the consolidated financial statements) shows the minimum capital requirements and the Bank’s capital position as of December 31, 2017 and 2016.

Analysis of Capital for Bank of the James (Bank only)
(*dollars in thousands*)

	December 31, 2017	December 31, 2016
Tier 1 Capital:		
Common stock	$ 3,742	$ 3,742
Additional paid in capital	22,325	19,325
Retained earnings	31,069	27,582
Total Tier 1 Capital	$ 57,136	$ 50,649
Common Equity Tier 1 Capital (CET1)	$ 57,136	$ 50,649
Tier 2 Capital:		
Allowable portion of allowance for loan losses	$ 4,752	$ 5,716
Total Tier 2 Capital	4,752	5,716
Total risk-based capital	$ 61,888	$ 56,365
Risk weighted assets	$ 513,419	$ 488,607
Average total assets	$ 626,422	$ 566,399

	December 31,		Regulatory Minimums	
	2017	2016	Capital Adequacy (1)	Well Capitalized
Capital Ratios				
Tier 1 capital to average total assets	9.12%	8.94%	4.000%	5.000%
Common Equity Tier 1 capital	11.13%	10.37%	7.000%	6.500%
Tier 1 risk-based capital ratio	11.13%	10.37%	8.500%	8.000%
Total risk-based capital ratio	12.05%	11.54%	10.500%	10.000%

(1) Includes capital conservation buffer after full phase-in.

During the third quarter of 2012, Financial closed a private placement of unregistered debt securities (the “2012 Offering”) pursuant to which Financial issued $10,000,000 in principal of notes (the “2012 Notes”). The 2012 Notes bore interest at the rate of 6% per year with interest payable quarterly in arrears. The 2012 Notes were scheduled to mature on April 1, 2017, but were subject to prepayment in whole or in part on or after April 1, 2013 at Financial’s sole discretion on 30 days written notice to the holders. The notes were called on December 3, 2015 and paid in full on January 5, 2016 with the proceeds from a private placement of Financial’s common stock discussed in the following paragraph.

On December 3, 2015, Financial closed a private placement of common stock pursuant to which it received gross proceeds of $11,520,000 by selling an aggregate of 1,000,000 shares of Financials’ Common Stock at a price of $11.52 per share, as part of a private placement (the “Common Stock Private Placement”). Financial used $10,000,000 of the proceeds from the Common Stock Private Placement to prepay in full the 2012 Notes.

During the first quarter of 2017, Financial closed a private placement of unregistered debt securities (the “2017 Offering”) pursuant to which Financial issued $5,000,000 in principal of notes (the “2017 Notes”). The 2012 Notes bore interest at the rate of 4% per year with interest payable quarterly in arrears. The 2017 Notes are scheduled to mature on January 24, 2022, but were subject to prepayment in whole or in part on or after January 24, 2018 at Financial’s sole discretion on 30 days written notice to the holders. The Company contributed $3,000,000 of the proceeds to the Bank as additional paid in capital. The remainder of the proceeds were retained at the parent level to service the debt and pay dividends.

The proceeds from the Common Stock Private Placement, proceeds from the 2017 Offering, existing capital, and funds generated from operations provide Financial with sufficient liquidity and capital with which to operate.

The capital ratios set forth in the above tables state the capital position and analysis for the Bank only. Because total assets on a consolidated basis are less than $1,000,000,000, Financial is not subject to the consolidated capital requirements imposed by the Bank Holding Company Act. Consequently, Financial does not calculate its financial ratios on a consolidated basis. If calculated, the capital ratios for the Company on a consolidated basis would be slightly lower than the capital ratios of the Bank because the of the Company's decision to contribute $3,000,000 in proceeds from the 2017 Offering to the Bank.

As further described under " *Regulation of the Bank – Capital Requirements* ," the Basel Committee released in June 2011 a revised framework for the regulation of capital and liquidity of internationally active banking organizations. The new framework is generally referred to as "Basel III". As discussed above, when full phased in, Basel III will require certain bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity. On July 2, 2013, the Federal Reserve adopted a final rule implementing the Basel III standards and complementary parts of Basel II and Basel 2.5.

Stockholders' Equity

Stockholders' equity increased by $2,244,000 from $49,421,000 on December 31, 2016 to $51,665,000 on December 31, 2017 because of the net income of $2,922,000 less cash dividends paid and other comprehensive income for the period.

ASSET QUALITY

We perform monthly reviews of all delinquent loans and loan officers are charged with working with customers to resolve potential payment issues. We generally classify a loan as nonaccrual when interest is deemed uncollectible or when the borrower is 90 days or more past due. We generally restore a loan if i) a borrower is no longer 90 days past due on the loan and the borrower has demonstrated the capacity to repay the loan for six consecutive months or ii) the loan committee of the Board of Directors determines that a borrower has the capacity to repay the loan.

Non-accrual loans decreased to $4,309,000 on December 31, 2017 from $3,465,000 on December 31, 2016. While we have been successful in resolving a significant portion of our problem assets that were a result of the economic downturn, our non-accrual loans increased. The increase in non-accrual loans year over year included $1,757,000 of impaired loans related to four customer relationships. These loans were charged down to the estimated net realizable value of their underlying collateral during the fourth quarter of 2017 and as such, management anticipates that little to no additional loan loss provisions are expected to be required for these credits. As set forth in tabular form below, total charge-offs during the fourth quarter were $1,543,000. This included $1,411,000 related to the four relationships noted above.

We also classify other real estate owned (OREO) as a nonperforming asset. OREO is the value of real property acquired by the Bank either at a foreclosure sale of collateral on which the Bank has a lien or by deed in lieu of foreclosure. During the twelve months ended December 31, 2017 the Bank acquired seven additional OREO properties and disposed of six OREO properties. As of December 31, 2017 the Bank is carrying seven OREO properties at a value of $2,650,000, a slight increase from six properties with a value of $2,370,000 as of December 31, 2016. The following table represents the changes in OREO balance in 2017 and 2016.

	OREO Changes (*Dollars in Thousands*) Year Ended December 31,	
	2017	2016
Balance at the beginning of the year (net)	$ 2,370	$ 1,965
Transfers from Loans	815	470
Capitalized costs	40	—
Valuation Adjustment	(60)	(45)
Sales proceeds	(514)	(21)
Gain (loss) on disposition	(1)	1
Balance at the end of the year (net)	$ 2,650	$ 2,370

Non-accrual loans plus OREO increased to $6,959,000 on December 31, 2017 from $5,835,000 on December 31, 2016, an increase of 19.26%.

We also classify troubled debt restructurings (TDRs) as both performing and nonperforming assets. We measure impaired loans based on the present value of expected future cash flows discounted at the effective interest rate of the loan or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. We maintain a valuation allowance to the extent that the measure of the impaired loan is less than the recorded investment. TDRs occur when we agree to significantly modify the original terms of a loan by granting a concession due to the deterioration in the financial condition of the borrower. TDRs are considered impaired loans. These concessions typically are made for loss mitigation purposes and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Performing TDRs decreased to $440,000 on December 31, 2017 from $455,000 on December 31, 2016.

The following table sets forth the number of outstanding TDR contracts and the total amount of the Bank's TDRs as of December 31, 2017 and 2016.

	Troubled Debt Restructurings (*Dollars in Thousands*) December 31,	
	2017	2016
Number of performing TDR contracts	3	3
Number of nonperforming TDR contracts	—	—
Total number of TDR contracts	3	3
Amount of performing TDR contracts	$ 440	$ 455
Amount of nonperforming TDR contracts	—	—
Total amount of TDRs contracts	$ 440	$ 455

The amount allocated during the year to the provision for loan losses represents management's analysis of the existing loan portfolio and credit risks. Management's policy is to maintain the allowance for loan losses at a level sufficient to absorb the estimated losses inherent in the loan portfolio. Both the amount of the provision and the level of the allowance for loan losses are impacted by many factors, including general economic conditions, actual and expected credit losses, loan performance measures, historical trends and specific conditions of the individual borrower.

In performing its loan loss analysis, the Bank assigns a risk rating to each commercial loan in the Bank's portfolio.

The Bank's allowance for loan losses decreased 16.86% from $5,716,000 on December 31, 2016 to $4,752,000 on December 31, 2017, primarily due to the change in specific reserves discussed in the following paragraph that were partially offset by an increase in the general reserves.

The Company's allowance for loan losses to total losses declined from 1.22% at December 31, 2016 to 0.96% at December 31, 2017, primarily as a result of the decline in recorded specific reserves that were reduced through charge-offs (ASC 310). The general reserve component of the allowance for loan losses remained relatively consistent with the prior year end. Management intends to continue to be proactive in quantifying and mitigating the ongoing risk associated with all asset classes. Management has provided for the anticipated losses on its non-accrual loans through specific impairment in the allowance for loan loss.

Despite the decrease in individual loan impairment, our general reserves (ASC 450) increased in the commercial, consumer, and residential segments. The increase was largely driven by increased balances in the commercial and residential asset classes.

No nonaccrual loans were excluded from impaired loans at December 31, 2017 and 2016. If interest on these loans had been accrued, such income cumulatively would have approximated $472,000 and $406,000 at December 31, 2017 and December 31, 2016, respectively. Loan payments received on nonaccrual loans are applied to principal. When a loan is placed on non-accrual status there are several negative implications. First, all interest accrued but unpaid at the time of the classification is deducted from the interest income totals for the Bank. Second, accruals of interest are discontinued until it becomes certain that both principal and interest can be repaid. Third, there may be actual losses that necessitate additional provisions for credit losses charged against earnings. These loans were included in the nonperforming loan totals listed below. The following table sets forth the detail of loans charged-off, recovered, and the changes in the allowance for loan losses as of the dates indicated:

	Allowance for Loan Losses *(dollars in thousands)* At December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Balance, beginning of period	$5,716	$4,683	$4,790	$5,186	$5,535
Loans charged-off:					
Commercial	1,652	328	294	165	19
Commercial real estate	91	156	64	187	932
Consumer	246	275	257	79	126
Residential	105	—	—	120	28
Total loans charged off	$2,094	$ 759	$ 615	$ 551	$1,105
Recoveries:					
Commercial	$ 6	$ 7	$ 14	$ 51	$ 37
Commercial real estate	41	127	122	10	42
Consumer	51	44	54	39	137
Residential	39	2	36	—	—
Total recoveries	$ 137	$ 180	$ 226	$ 100	$ 216
Net charge-offs	$1,957	$ 579	$ 389	$ 451	$ 889
Provision for loan losses	993	1,612	282	55	540
Balance, end of period	$4,752	$5,716	$4,683	$4,790	$5,186

The following table shows the balance and percentage of the Bank's allowance for loan losses allocated to each major category of loans:

	Allocation of Allowance for Loan Losses (dollars in thousands) At December 31,									
	2017		2016		2015		2014		2013	
	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans
Commercial	$ 1,264	19.39%	$ 2,192	18,74%	$ 1,195	17.64%	$ 1,235	15.84%	$ 1,015	16.17%
Commercial – real estate	1,738	50.79%	2,109	50.55%	1,751	49.90%	2,194	51.89%	2,631	49.86%
Consumer	1,172	16.89%	954	18.10%	1,073	18.74%	812	19.13%	935	20.62%
Residential	578	12.93%	461	12.61%	664	13.72%	549	13.14%	605	13.35%
	$ 4,752	100.00%	$ 5,716	100.00%	$ 4,683	100.00%	$ 4,790	100.00%	$ 5,186	100.00%

The following table provides information on the Bank's nonperforming assets as of the dates indicated:

	Nonperforming Assets (dollars in thousands) At December 31,				
	2017	2016	2015	2014	2013
Nonaccrual loans	$ 4,309	$ 2,550	$ 3,406	$ 3,506	$ 3,066
Foreclosed property (OREO)	2,650	2,370	1,965	956	1,451
Loans past due 90 days accruing interest	—	—	—	—	—
Total nonperforming assets	$ 6,959	$ 4,920	$ 5,371	$ 4,462	$ 4,517
Restructured loans – performing portion (TDR)	$ 440	$ 455	$ 646	$ 376	$ 564
Allowance for loan losses to period end loans	0.96%	1.22%	1.08%	1.20%	1.50%
Nonperforming assets to period end loans	1.40%	1.05%	1.23%	1.13%	1.33%
Net charge-offs to average loans	0.40%	0.13%	0.09%	0.12%	0.27%
Allowance for loan losses to non-performing loans	110.28%	224.16%	137.49%	136.62%	169.15%

Interest Rate Sensitivity

The most important element of asset/liability management is the monitoring of Financial's sensitivity to interest rate movements. The income stream of Financial is subject to risk resulting from interest rate fluctuations to the extent there is a difference between the amount of Financial's interest earning assets and the amount of interest bearing liabilities that prepay, mature or reprice in specified periods. Management's goal is to maximize net interest income with acceptable levels of risk to changes in interest rates. Management seeks to meet this goal by influencing the maturity and re-pricing characteristics of the various lending and deposit taking lines of business and by managing discretionary balance sheet asset and liability portfolios.

Management also is attempting to mitigate interest rate risk by limiting the dollar amount of loans carried on its balance sheet that have fixed rates in excess of five years. To reduce our exposure to interest rate risks inherent with longer term fixed rate loans, we generally do not hold such mortgages on our books. The Bank established the Mortgage Division to serve potential customers that desired fixed rate loans in excess of five years.

Management monitors interest rate levels on a daily basis and meets in the form of the Enterprise Risk Management and Asset/Liability Committee ("ALCO") at least quarterly or when a special situation arises (e.g., FOMC unscheduled rate change). The following reports and/or tools are used to assess the current interest rate environment and its impact on Financial's earnings and liquidity: monthly and year-to-date net interest margin and spread calculations, monthly and year-to-date balance sheet and income statements versus budget (including quarterly interest rate shock analysis), quarterly economic value of equity analysis, a weekly survey of rates offered by other local competitive institutions, and gap analysis which matches maturities or repricing dates of interest sensitive assets to those of interest sensitive liabilities.

Financial currently subscribes to computer simulated modeling tools made available through its consultant, FinPro, Inc., to aid in asset/liability analysis. In addition to monitoring by ALCO, the board is informed of the current asset/liability position and its potential effect on earnings at least quarterly.

Other Borrowings

Financial uses borrowing in conjunction with deposits to fund lending and investing activities. Borrowings include funding of a short-term nature.

Short-term borrowings consist of securities sold under agreements to repurchase, which are secured transactions with customers and generally mature the day following the date sold. As discussed above, the Bank ceased offering sweep accounts to its customers and therefore no longer has short term borrowings in the form repurchase agreements. Short-term borrowings may also include federal funds purchased, which are unsecured overnight borrowings from other financial institutions, which totaled $0 as of December 31, 2017 and December 31, 2016. Unsecured federal funds lines and their respective limits are maintained with the following institutions: Community Bankers' Bank, $13,000,000, PNC Bank $6,000,000, Suntrust Bank, $3,000,000, and Zions Bank, $4,000,000. In addition, the Bank maintains a $5,000,000 reverse repurchase agreement with Suntrust whereby securities may be pledged as collateral in exchange for funds for a minimum of 30 days with a maximum of 90 days. The Bank also maintains a secured federal funds line with Community Bankers' Bank whereby it may pledge securities as collateral with no specified minimum or maximum amount or term. The amount outstanding on the Community Bankers' Bank secured fed funds line was $0 as of December 31, 2017 and 2016.

Long-term borrowings may be obtained through the Federal Home Loan Bank of Atlanta ("FHLBA"). The Bank's remaining available credit through the FHLBA is $156,641,000 as of December 31, 2017, the most recent calculation.

The following information is provided for borrowings balances, rates and maturities:

	As of December 31,	
	2017	2016
Short Term:		
Federal funds purchased		
Balance at end of year	$ —	$ —
Maximum month-end outstanding balance	—	6,255
Average outstanding balance during the year	1	371
Average interest rate during the year	0.00%	1.08%
Average interest rate at end of year	N/A	N/A
Reverse repurchase agreements		
Balance at end of year	$ —	$ —
Maximum month-end outstanding balance	5,000	—
Average outstanding balance during the year	795	—
Average interest rate during the year	1.76%	N/A
Average interest rate at end of year	N/A	N/A

Off-Balance Sheet Arrangements

At December 31, 2017, the Bank had rate lock commitments to originate mortgage loans through its Mortgage Division amounting to approximately $8,329,000 and loans held for sale of $2,626,000. The Bank has entered into corresponding commitments with third party investors to sell each of these loans that close. No other obligation exists. As a result of these contractual relationships with these investors, the Bank is not exposed to losses nor will it realize gains related to its rate lock commitments due to changes in interest rates.

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

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

	Contract Amounts (*dollars in thousands*) at December 31,	
	2017	2016
Commitments to extend credit	$115,152	$93,247
Standby letters of credit	2,770	3,466
Total	$117,922	$96,713

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on its credit evaluation of the customer.

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

Management does not anticipate any material losses as a result of these transactions.

The Bank rents, under non-cancelable leases, three of its banking facilities and one mortgage production office. The Bank has liability in the form of minimum annual rental commitments under these leases as follows:

Year Ending	Amount (in thousands)
2018	$ 643
2019	430
2020	173
2021	116
2022	82
Thereafter	302
	$ 1,746

Expansion Plans

Subject to regulatory approval, the Bank anticipates opening additional branches during the next two fiscal years. Although numerous factors could influence the Bank's expansion plans, the following discussion provides a general overview of the additional branch location that the Bank currently is considering.

Developed real property:

45 South Main Street, Lexington, Virginia. In December 2015, the Bank purchased a former bank branch building located at 45 South Main Street, Lexington, Virginia. Management is in the process of determining how much additional investment in the property is necessary in order to open a bank branch/commercial loan office at this location. The Bank has not determined when it will open a branch at this location.

Undeveloped real property:

Timberlake Road Area, Campbell County (Lynchburg), Virginia. As previously disclosed, the Bank has purchased certain real property located at the intersection of Turnpike and Timberlake Roads, Campbell County, Virginia. The Bank has not determined when it will open a branch at this location. The Bank has determined that the existing structure is not suitable for use as a bank branch.

Rustburg, Virginia . In March 2011, the Bank purchased certain real property near the intersection of Routes 501 and 24 in Rustburg, Virginia. The structure on the property has been removed. The Bank has not determined when it will open a branch at this location.

The Bank estimates that the cost of improvements, furniture, fixtures, and equipment necessary to upfit the property at the undeveloped locations will be between $900,000 and $1,500,000 per location.

Although the Bank cannot predict with certainty the financial impact of each new branch, management generally anticipates that each new branch will become profitable within 12 to 18 months of opening.

Recent Accounting Pronouncements

For information regarding recent accounting pronouncements and their effect on us, see “Impact of Recent Accounting Pronouncements” in Note 23 to the consolidated financial statements included in Item 8 of this Form 10-K.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

Not applicable

Item 8. Financial Statements and Supplementary Data

The following financial statements are filed as a part of this report:

Management’s Annual Report on Internal Control Over Financial Reporting

Report of Independent Registered Public Accounting Firm

Consolidated Financial Statements

- Balance Sheets, December 31, 2017 and December 31, 2016
- Statements of Income, Years Ended December 31, 2017 and December 31, 2016
- Statements of Comprehensive Income, Years Ended December 31, 2017 and December 31, 2016
- Statements of Changes in Stockholders’ Equity, Years Ended December 31, 2017 and December 31, 2016
- Statements of Cash Flows, Years Ended December 31, 2017 and December 31, 2016
- Notes to Consolidated Financial Statements

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for the preparation and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management's judgments and estimates concerning effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining adequate internal control over financial reporting. Financial's internal control over financial reporting includes those policies and procedures that pertain to Financial's ability to record, process, summarize and report reliable financial data. Management recognizes that there are inherent limitations in the effectiveness of any internal control over financial reporting, including the possibility of human error and the circumvention or overriding of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that Financial's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2017. This assessment was based on criteria for effective internal control over financial reporting described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) in 2013, by the Treadway Commission. Based on this assessment, management has concluded that the internal control over financial reporting was effective as of December 31, 2017.

This annual report does not include an attestation report of Financial's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by Financial's registered public accounting firm pursuant to the rules of the Securities and Exchange Commission that permit Financial to provide only management's report in the annual report.

The Board of Directors, acting through its Audit Committee, is responsible for the oversight of Financial's accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent registered public accounting firm and approves decisions regarding the appointment or removal of Financial's Internal Auditor. It meets periodically with management, the independent registered public accounting firm and the internal auditors to ensure that they are carrying out their responsibilities. The Audit Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of Financial in addition to reviewing Financial's financial reports. The independent registered public accounting firm and the internal auditors have full and unlimited access to the Audit Committee, with or without management, to discuss the adequacy of internal control over financial reporting, and any other matter which they believe should be brought to the attention of the Audit Committee.

/s/ Robert R. Chapman III	/s/ J. Todd Scruggs
Chief Executive Officer & President	Secretary-Treasurer (Principal Financial Officer)
March 21, 2018	March 21, 2018

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors
Bank of the James Financial Group, Inc.
Lynchburg, Virginia

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Bank of the James Financial Group, Inc. and its subsidiaries (the Company) as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United Statements of America.

Basis for Opinion

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

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

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

/s/ Yount, Hyde & Barbour, P.C.

We have served as the Company's auditor since 2006.

Winchester, Virginia
March 21, 2018

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except per share data)

	December 31, 2017	December 31, 2016
Assets		
Cash and due from banks	$ 20,267	$ 16,938
Federal funds sold	16,751	11,745
Total cash and cash equivalents	37,018	28,683
Securities held-to-maturity (fair value of $5,619 in 2017 and $3,273 in 2016)	5,713	3,299
Securities available-for-sale, at fair value	55,312	40,776
Restricted stock, at cost	1,505	1,373
Loans, net of allowance for loan losses of $4,752 in 2017 and $5,716 in 2016	491,022	464,353
Loans held for sale	2,626	3,833
Premises and equipment, net	12,055	10,947
Interest receivable	1,713	1,378
Cash value—bank owned life insurance	13,018	12,673
Other real estate owned	2,650	2,370
Income taxes receivable	1,366	1,214
Deferred tax asset, net	1,418	2,374
Other assets	925	922
Total assets	$ 626,341	$ 574,195
Liabilities and Stockholders' Equity		
Deposits		
Noninterest bearing demand	$ 74,102	$ 62,135
NOW, money market and savings	307,987	295,948
Time	185,404	165,029
Total deposits	567,493	523,112
Capital notes	5,000	—
Interest payable	111	88
Other liabilities	2,072	1,574
Total liabilities	$ 574,676	$ 524,774
Commitments and Contingencies		
Stockholders' equity		
Preferred stock; authorized 1,000,000 shares; none issued and outstanding	$ —	$ —

See Notes to Consolidated Financial Statements

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except per share data)

	2017	2016
Common stock $2.14 par value; authorized 10,000,000 shares; issued and outstanding 4,378,436 as of December 31, 2017 and 2016	9,370	9,370
Additional paid-in-capital	31,495	31,495
Retained earnings	12,269	10,156
Accumulated other comprehensive (loss)	(1,469)	(1,600)
Total stockholders' equity	$ 51,665	$ 49,421
Total liabilities and stockholders' equity	$626,341	$574,195

See Notes to Consolidated Financial Statements

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(dollars in thousands, except per share amounts)

	For the Year Ended December 31, 2017	For the Year Ended December 31, 2016
Interest Income		
Loans	$22,081	$20,481
Securities		
US Government and agency obligations	550	479
Mortgage backed securities	299	201
Municipals—taxable	313	199
Municipals—tax exempt	29	41
Dividends	73	67
Other (Corporates)	105	35
Interest bearing deposits	82	31
Federal Funds sold	133	34
Total interest income	23,665	21,568
Interest Expense		
Deposits		
NOW, money market savings	722	590
Time Deposits	2,071	1,742
Federal Funds purchased	—	4
Reverse repurchase agreements	13	—
Capital notes	187	8
Total interest expense	2,993	2,344
Net interest income	20,672	19,224
Provision for loan losses	993	1,612
Net interest income after provision for loan losses	19,679	17,612
Noninterest income		
Gain on sales of loans held for sale	2,434	2,433
Service charges, fees and commissions	1,759	1,444
Increase in cash value of life insurance	345	292
Other	76	132
Gain on sales and calls of securities, net	113	494
Total noninterest income	4,727	4,795

See Notes to Consolidated Financial Statements

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(dollars in thousands, except per share amounts)

	2017	2016
Noninterest expenses		
Salaries and employee benefits	10,012	9,230
Occupancy	1,493	1,312
Equipment	1,521	1,287
Supplies	520	480
Professional, data processing, and other outside expense	2,795	2,731
Marketing	739	686
Credit expense	467	425
Other real estate expenses	88	68
FDIC insurance expense	375	363
Other	1,036	1,012
Total noninterest expenses	19,046	17,594
Income before income taxes	5,360	4,813
Income tax expense	2,438	1,527
Net Income	$ 2,922	$ 3,286
Weighted average shares outstanding—basic	4,378,436	4,378,436
Weighted average shares outstanding—diluted	4,378,521	4,378,442
Earnings per common share—basic	$ 0.67	$ 0.75
Earnings per common share—diluted	$ 0.67	$ 0.75

See Notes to Consolidated Financial Statements

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in thousands)

	For the Year Ended December 31, 2017	2016
Net Income	$2,922	$ 3,286
Other comprehensive income (loss)		
Unrealized gains (losses) on securities available-for-sale	677	(1,044)
Tax effect	(230)	354
Reclassification adjustment for gains included in net income (1)	(113)	(487)
Tax effect (2)	38	166
Other comprehensive income (loss), net of tax	372	(1,011)
Comprehensive income	$3,294	$ 2,275

(1) Gains are included in "gain on sales and calls of available-for-sale securities, net" on the consolidated statements of income.

(2) The tax effect on these reclassifications is reflected in "income tax expense" on the consolidated statements of income.

See Notes to Consolidated Financial Statements

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(dollars in thousands except per share amounts)

	Total Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss)	Total
Balance at December 31, 2015	4,378,436	$ 9,370	$ 31,495	$ 7,920	$ (589)	$48,196
Net Income	—	—	—	3,286	—	3,286
Dividends paid on common stock ($0.24 per share)	—	—	—	(1,050)	—	(1,050)
Other comprehensive loss	—	—	—	—	(1,011)	(1,011)
Balance at December 31, 2016	4,378,436	$ 9,370	$ 31,495	$10,156	$ (1,600)	$49,421
Net Income	—	—	—	2,922	—	2,922
Dividends paid on common stock ($0.24 per share)	—	—	—	(1,050)	—	(1,050)
Reclassification of Stranded Tax Effects from Change in Tax Rate	—	—	—	241	(241)	—
Other comprehensive income	—	—	—	—	372	372
Balance at December 31, 2017	4,378,436	$ 9,370	$ 31,495	$12,269	$ (1,469)	$51,665

See Notes to Consolidated Financial Statements

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

	For the Year Ended December 31, 2017	2016
Cash flows from operating activities		
Net Income	$ 2,922	$ 3,286
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	811	767
Net amortization and accretion of premiums and discounts on securities	386	276
(Gain) on sales of available-for-sale securities	(113)	(487)
(Gain) on call of held-to-maturity securities	—	(7)
(Gain) on sales of loans held for sale	(2,434)	(2,433)
Provision for loan losses	993	1,612
Loss (gain) on sale of other real estate owned	1	(1)
Expense (benefit) for deferred income taxes	764	(455)
(Increase) in cash value of life insurance	(345)	(292)
(Increase) in interest receivable	(335)	(130)
(Increase) in other assets	(3)	(167)
(Increase) in income taxes receivable	(152)	(118)
Increase in interest payable	23	27
Increase in other liabilities	498	298
Proceeds from sales of loans held for sale	93,163	85,307
Origination of loans held for sale	(89,522)	(84,743)
Valuation adjustment on other real estate owned	60	45
Net cash provided by operating activities	$ 6,717	$ 2,785
Cash flows from investing activities		
Purchases of securities held-to-maturity	$ (2,437)	$ (1,290)
Proceeds from maturities and calls of securities held-to-maturity	—	500
Purchases of securities available-for-sale	(27,395)	(40,464)
Proceeds from maturities, calls and paydowns of securities available-for-sale	3,233	9,744
Proceeds from sale of securities available-for-sale	9,940	24,637
Purchases of bank owned life insurance	—	(2,600)
(Purchase) of Federal Reserve Bank stock	(90)	—
(Purchase) of Federal Home Loan Bank stock	(42)	(60)
Proceeds from sale of other real estate owned	514	21
Improvements to other real estate owned	(40)	—
Origination of loans, net of principal collected	(18,824)	(35,990)
Purchases of loans, net of principal collected	(9,653)	—
Purchases of premises and equipment	(1,919)	(1,707)
Net cash (used in) investing activities	$(46,713)	$(47,209)

See Notes to Consolidated Financial Statements

BANK OF THE JAMES FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

	2017	2016
Cash flows from financing activities		
Net increase in deposits	$44,381	$ 55,502
Dividends paid to common stockholders	(1,050)	(1,050)
Retirement of capital notes	—	(10,000)
Proceeds from sale of 4% capital notes due 1/24/2022	5,000	—
Net cash provided by financing activities	$48,331	$ 44,452
Increase in cash and cash equivalents	8,335	28
Cash and cash equivalents at beginning of period	$28,683	$ 28,655
Cash and cash equivalents at end of period	$37,018	$ 28,683
Non cash transactions		
Transfer of loans to other real estate owned	$ 815	$ 470
Fair value adjustment for securities	564	(1,531)
Cash transactions		
Cash paid for interest	$ 2,970	$ 2,317
Cash paid for taxes	1,825	2,100

See Notes to Consolidated Financial Statements

Note 1—Organization

Bank of the James Financial Group, Inc. ("Financial" or the "Company"), a Virginia corporation, was organized in 2003 and is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. Financial is headquartered in Lynchburg, Virginia. Financial conducts its business activities through the branch offices and loan production offices of its wholly owned subsidiary bank, Bank of the James (the "Bank"), the Bank's wholly-owned subsidiary, BOTJ Insurance, Inc. ("BOTJ-Ins."), and through the Bank's two divisions, Bank of the James Mortgage division ("Mortgage Division") and BOTJ Investment Services division ("Investment Division"). The Mortgage Division originates conforming and non-conforming home mortgages primarily in the Region 2000 area, which includes the counties of Amherst, Appomattox, Bedford and Campbell (which includes the Town of Altavista), the Town of Bedford and the City of Lynchburg, Virginia. Financial exists primarily for the purpose of holding the stock of its subsidiaries, the Bank and such other subsidiaries as it may acquire or establish. Financial also has one wholly-owned non-operating subsidiary.

Bank of the James was incorporated on October 23, 1998, and began banking operations on July 22, 1999. The Bank is a Virginia chartered bank and is engaged in lending and deposit gathering activities in Region 2000 and other markets in Central Virginia. It operates under the laws of Virginia and the Rules and Regulations of the Federal Reserve System and the Federal Deposit Insurance Corporation. The Bank's locations consist of five branches (one of which is a limited service branch) in Lynchburg, Virginia, one in Forest, Virginia which includes the Mortgage Division, one in Madison Heights, Virginia, one in the Town of Amherst, Virginia, one in the Town of Bedford, Virginia, one in the Town of Altavista, Virginia, and one in the Town of Appomattox. The Bank also operates one full service branch, two limited service branches and a loan production office in Charlottesville, Virginia, a full service branch in Harrisonburg, Virginia, and a full service branch in Roanoke, Virginia.

Note 2—Summary of significant accounting policies

Restatement

Certain amounts in the Company's December 31, 2016 consolidated balance sheet have been restated. The Company has determined that certain interest bearing demand deposits were incorrectly disclosed as non-interest bearing demand deposits in the Company's December 31, 2016 consolidated financial statements. The correction of this error to our consolidated balance sheet at December 31, 2016 increased the NOW, money market, and savings line item and decreased the non-interest bearing demand line item each by $40.5 million. Additionally, in Note 8 at December 31, 2016, non-interest bearing demand deposits were decreased and interest bearing demand deposits were increased each by the same $40.5 million. Otherwise this error did not impact any other line items within our consolidated financial statements or notes thereto as of and for the year ended December 31,2016 including net income and stockholders' equity as interest expense was appropriately recorded in 2016 for the interest bearing accounts classified as non-interest bearing accounts in the December 31, 2016 consolidated balance sheet.

Consolidation

The consolidated financial statements include the accounts of Bank of the James Financial Group, Inc. and its wholly owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

Basis of presentation and use of estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial

Note 2—Summary of significant accounting policies (continued)

statements, as well as the amounts of income 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 and valuation of other real estate owned.

Cash and cash equivalents

Cash and cash equivalents include cash and balances due from banks and federal funds sold, all of which mature within ninety days. Generally, federal funds are purchased and sold for one-day periods.

Securities

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

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 (1) the Bank intends to sell the security or (2) it is more likely than not that the Bank will be required to sell the security before recovery of its amortized cost basis. If, however, the Bank does not intend to sell the security and it is not more likely than not that the Bank will be required to sell the security before recovery, the Bank must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost 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 include 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.

Restricted investments

As members of the Federal Reserve Bank (FRB) and the Federal Home Loan Bank of Atlanta (FHLBA), the Bank is required to maintain certain minimum investments in the common stock of the FRB and FHLBA. Required levels of investment are based upon the Bank's capital and a percentage of qualifying assets. The Bank also maintains stock ownership in Community Bankers' Bank (CBB). The investment in CBB is minimal and is not mandated but qualifies the Bank for preferred pricing on services offered by CBB. Based on liquidation restrictions, all of these investments are carried at cost.

Note 2—Summary of significant accounting policies (continued)

Loans

Financial makes real estate, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by real estate loans collateralized by real estate within Region 2000. The ability of Financial's debtors to honor their contracts is dependent upon the real estate and general economic conditions in the area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

Past due status

Past due status is based on the contractual terms of the loan. In all cases, loans are placed on non-accrual and potentially charged-off at an earlier date if collection of principal or interest is considered doubtful.

Non-accrual status

Financial stops accruing interest on a loan at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. At the time the loan is placed on non-accrual status, all previously accrued but not collected interest is reversed against interest income. While the loan is classified as non-accrual, any payments collected are accounted for using the cost-recovery method which requires the entire amount of the payment to be applied directly to principal, until qualifying for return to performing status. Loans may be, but are not always, returned to performing status when all the principal and interest amounts contractually due are brought current (within 90 days past due), future payments are reasonably assured, and contractually required payments have been made on a timely basis for at least six consecutive months.

Charge-off

At the time a loan is placed on non-accrual status, it is generally reevaluated for expected loss and a specific reserve, if not already assigned, is established against the loan. Consumer term loans are typically charged-off no later than 120 days whereas consumer revolving credit loans are typically charged-off no later than 180 days. Although the goal for commercial and commercial real estate loans is for charge off no later than 180 days, a commercial or commercial real estate loan may not be fully charged off until there is reasonable certainty that no additional workout efforts, troubled debt restructurings or any other types of concession can or will be made by Financial.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are sold, servicing released, and carried at the lower of cost or fair value, which is determined in the aggregate based on sales commitments to permanent investors or on current market rates for loans of similar quality and type. In addition, the Company requires a firm purchase commitment from a permanent investor before a loan can be closed, thus limiting interest rate risk. The amount of interest rate lock commitments is currently an immaterial amount.

Allowance for loan losses

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

Note 2—Summary of significant accounting policies (continued)

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

The allowance consists of specific, historical and general components. The specific component relates to loans that are classified as doubtful or substandard. For such loans that are also classified as impaired, an allowance is established when the collateral value of the impaired loan or discounted cash flows is lower than the carrying value of that loan. The historical component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. A general component is maintained to cover uncertainties that could affect management's estimate of probable losses. The general component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. The qualitative factors used to derive the general component of the allowance may include but are not limited to:

1. Known improvement or deterioration in certain classes of loans or collateral;
2. Trends in portfolio volume, maturity, or composition;
3. Volume and trends in delinquencies and non-accruals;
4. Local economic and industrial conditions;
5. Lending, charge-off, and collection policies; and
6. Experience, ability, and depth of lending staff.

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

Management considers the following four components when calculating its loan loss reserve requirement:

- In accordance with current accounting rules (ASC 310) and the Bank's impairment methodology, the Bank performs an individual impairment analysis on all loans having a principal balance greater than $100,000 (unless related to another classified relationship or a TDR) with a risk rating of substandard, doubtful, and loss (our internal risk ratings of 7 through 9). The Bank also performs individual loan analysis and assesses potential future losses associated with those relationships risk rated as special mention (our internal risk rating of 6).
- In accordance with current accounting rules (ASC 450), the Bank examines historical charge-off data by segment in order to determine a portion of the reserve related to homogeneous pools. The Bank updates its historical charge-off data quarterly and adjusts the reserve accordingly.

Note 2—Summary of significant accounting policies (continued)

- The Bank applies various risk factors, including, for example, levels of trends in delinquencies, current and expected economic conditions, and levels of and trends in recoveries of prior charge-offs.
- The Bank applies factors to determine the method by which to determine the general reserve for inherent losses related to the loan pool, including, for example, loan concentrations, policy and procedure changes, national and local economic trends and conditions, and overall portfolio quality.

Troubled debt restructurings

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDR"). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loans reach nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of collateral. In cases where borrowers are granted new terms that generally (although not required to be considered a TDR) provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans. The Bank had $440 and $455 classified as TDRs as of December 31, 2017 and 2016, respectively.

Premises, equipment and depreciation

Premises and equipment, including leasehold improvements, are stated at cost less accumulated depreciation. Depreciation is provided over the estimated useful lives of the respective assets on the straight-line basis, which range from 3 to 7 years for equipment and 10 to 39.5 years for buildings and improvements. Leasehold improvements are amortized over a term which includes the remaining lease term and probable renewal periods. Land is carried at cost and is not depreciable. Expenditures for major renewals and betterments are capitalized and those for maintenance and repairs are charged to operating expenses as incurred.

Bank owned life insurance

Financial has purchased life insurance policies on certain key employees. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value.

Other real estate owned

Other real estate owned consists of properties acquired through foreclosure or deed in lieu of foreclosure. These properties are carried at fair value less estimated costs to sell at the date of foreclosure establishing a new cost basis. These properties are subsequently accounted for at the lower of cost or fair value less estimated costs to sell. Losses from the acquisition of property in full or partial satisfaction of loans are charged against the allowance for loan losses. Subsequent write-downs, if any, are charged against expense. Gains and losses on the sales of foreclosed properties are included in determining net income in the year of the sale. Operating costs after acquisition are expensed.

Transfers of financial assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank – put presumptively beyond reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Note 2—Summary of significant accounting policies (continued)

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absences of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

Operating Segments

While the chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance evaluated on a Company-wide basis. Operating segments are aggregated into one as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

Retirement Plans

Employee 401(k) and profit sharing expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

Income taxes

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the consolidated statements of income. At December 31, 2017 and 2016, there were no liabilities recorded for unrecognized tax benefits.

Note 2—Summary of significant accounting policies (continued)

Stock options

Current accounting guidance requires the costs resulting from all share-based payments to employees be recognized in the financial statements. Stock-based compensation is estimated at the date of grant, using the Black-Scholes option valuation model for determining fair value, and recognized over the option's vesting period. As of December 31, 2017, all compensation expense related to the Company's option plan had been recognized. The Company's ability to grant additional option shares under the 1999 Plan has expired.

Earnings per common share

Basic earnings per common share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

Reclassification

Management has made certain immaterial reclassifications to the prior year financial statements to conform to the 2017 presentation. Reclassifications had no effect on prior year net income or stockholders' equity.

Comprehensive income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains (losses) on available-for-sale securities.

Marketing

The Company expenses advertising costs as incurred. Advertising expenses were $739 and $686 for 2017 and 2016, respectively.

Note 3—Restrictions on cash

To comply with Federal Reserve regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirements were approximately $6,733 and $5,562 for the weeks including December 31, 2017 and 2016, respectively.

(dollars in thousands, except per share data)

Note 4—Securities

A summary of the amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity				
U.S. agency obligations	$ 5,713	$ 8	$ (102)	$ 5,619
Available-for-sale				
U.S. Treasuries	$ 1,956	$—	$ (98)	$ 1,858
U.S. agency obligations	24,881	5	(1,036)	23,850
Mortgage-backed securities	13,662	2	(276)	13,388
Municipals	12,556	16	(298)	12,274
Corporates	4,117	—	(175)	3,942
	$ 57,172	$ 23	$(1,883)	$55,312

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity				
U.S. agency obligations	$ 3,299	$ 65	$ (91)	$ 3,273
Available-for-sale				
U.S. Treasuries	$ 1,952	$—	$ (119)	$ 1,833
U.S. agency obligations	14,332	5	(1,224)	13,113
Mortgage-backed securities	12,358	—	(353)	12,005
Municipals	10,426	55	(534)	9,947
Corporates	4,132	—	(254)	3,878
	$ 43,200	$ 60	$(2,484)	$40,776

(dollars in thousands, except per share data)

Note 4—Securities (continued)

Temporarily Impaired Securities

The following tables show the gross unrealized losses and fair value of the Bank's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2017 and 2016:

December 31, 2017	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Held-to-maturity						
U.S. agency obligations	$ 2,367	$ 70	$ 1,243	$ 32	$ 3,610	$ 102
Available-for-sale						
U.S. Treauries	—	—	1,858	98	1,858	98
U.S. agency obligations	11,465	215	12,379	821	23,844	1,036
Mortgage-backed securities	2,802	26	9,712	250	12,514	276
Municipals	4,823	41	5,644	257	10,467	298
Corporates	—	—	3,942	175	3,942	175
Total temporarily impaired securities	$19,090	$ 282	$33,535	$ 1,601	$52,625	$ 1,883

December 31, 2016	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Held-to-maturity						
U.S. agency obligations	$ 1,193	$ 91	$ —	$ —	$ 1,193	$ 91
Available-for-sale						
U.S. Treasuries	1,833	119	—	—	1,833	119
U.S. agency obligations	13,109	1,224	—	—	13,109	1,224
Mortgage-backed securities	11,331	353	—	—	11,331	353
Municipals	7,170	534	—	—	7,170	534
Corporates	3,878	254	—	—	3,878	254
Total temporarily impaired securities	$38,514	$ 2,575	$ —	$ —	$38,514	$ 2,575

Note 4—Securities (continued)

U.S. Treasuries. The unrealized losses on these two investments in U.S. Treasuries at December 31, 2017 were caused by an increase in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2017. Each of these two investments carries a Moody's investment grade rating of AA.

U.S. agency obligations. The unrealized losses on the 21 investments in U.S. agency obligations at December 31, 2017 were caused by an increase in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2017. Each of these 21 investments carries an S&P investment grade rating of AA.

Mortgage-backed securities. The unrealized loss on the 11 investments in U.S. government agency mortgage-backed securities at December 31, 2017 was caused by an increase in interest rates. The contractual terms of those investments does not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of the amortized cost basis, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2017. Each of these 11 investments carries an S&P investment grade rating of AA.

Municipals. The unrealized losses on the 17 investments in municipal obligations at December 31, 2017 were caused by an increase in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2017. Each of these 17 investments carries an S&P investment grade rating of A or above.

Corporates. The unrealized losses on the five investments in domestic corporate issued securities at December 31, 2017 were caused by an increase in interest rates. The contractual terms of those investments does not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of the amortized cost basis, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2017. Each of these five investments carries an S&P investment grade rating of A or above.

The amortized costs and fair values of securities at December 31, 2017, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(dollars in thousands, except per share data)

Note 4—Securities (continued)

	Held-to-Maturity		Available-for-Sale	
	Amortized Cost	Fair Values	Amortized Cost	Fair Values
Due in one year or less	$ 2,002	$2,009	$ —	$ —
Due after one year through five years	—	—	1,287	1,274
Due after five years through ten years	—	—	25,224	24,387
Due after ten years	3,711	3,610	30,660	29,651
	$5,713	$5,619	$57,171	$55,312

The Bank received $9,940 in proceeds from sales of securities available-for-sale in 2017. Gross realized gains amounted to $113 and gross realized losses amounted to $0. The Bank received $24,637 in proceeds from sales of securities available-for-sale in 2016. Gross realized gains amounted to $487 and gross realized losses amounted to $0.

At December 31, 2017 and 2016, securities with a carrying value of $12,123 and $11,756, respectively, were pledged as collateral for public deposits and for other purposes as required or permitted by law.

Note 5—Loans and allowance for loan losses

The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Management's judgment in determining the level of the allowance is based on evaluations of the collectability 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, as it requires estimates that are susceptible to significant revision as more information becomes available.

Management has an established methodology used to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Bank has segmented certain loans in the portfolio by product type. Within these segments, the Bank has sub-segmented its portfolio by classes within the segments, based on the associated risks within these classes. The classifications set forth below do not correspond directly to the classifications set forth in the call report (Form FFIEC 041). Management has determined that the classifications set forth below are more appropriate for use in identifying and managing risk in the loan portfolio.

Loan Segments:	Loan Classes:
Commercial	Commercial and industrial loans
Commercial real estate	Commercial mortgages – owner occupied Commercial mortgages – non-owner occupied Commercial construction
Consumer	Consumer unsecured Consumer secured
Residential	Residential mortgages Residential consumer construction

Note 5—Loans and allowance for loan losses (continued)

The evaluation also considers the following risk characteristics of each loan segment:

- Commercial loans carry risks associated with the successful operation of a business because the repayment of these loans may be dependent upon the profitability and cash flows of the business or project. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time and cannot be appraised with as much precision.
- Commercial real estate loans carry risks associated with a real estate project and other risks associated with the ownership of real estate. In addition, for real estate construction loans there is a risk that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may, at any point in time, be less than the principal amount of the loan. Construction loans also bear the risk that the general contractor, who may or may not be a loan customer, may be unable to finish the construction project as planned because of financial pressure unrelated to the project.
- Consumer loans carry risks associated with the continued credit-worthiness of the borrower and the value of the collateral (e.g., rapidly-depreciating assets such as automobiles), or lack thereof. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy. Unsecured consumer loans carry additional risks associated with the continued credit-worthiness of borrowers who may be unable to meet payment obligations.
- Residential mortgage and construction loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral. Equity lines of credit carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

The Bank's internal risk rating system is in place to grade commercial and commercial real estate loans. Category ratings are reviewed periodically by lenders and the credit review area of the Bank based on the borrower's individual situation. Additionally, internal and external monitoring and review of credits are conducted on an annual basis.

Below is a summary and definition of the Bank's risk rating categories:

RATING 1	Excellent
RATING 2	Above Average
RATING 3	Satisfactory
RATING 4	Acceptable / Low Satisfactory
RATING 5	Monitor
RATING 6	Special Mention
RATING 7	Substandard
RATING 8	Doubtful
RATING 9	Loss

Based on the above criteria, we segregate loans into the above categories for special mention, substandard, doubtful and loss from non-classified, or pass rated, loans. We review the characteristics of each rating at least annually, generally during the first quarter. The characteristics of these ratings are as follows:

Note 5—Loans and allowance for loan losses (continued)

- "Pass." These are loans having risk ratings of 1 through 4. Pass loans are to persons or business entities with an acceptable financial condition, appropriate collateral margins, appropriate cash flow to service the existing loan, and an appropriate leverage ratio. The borrower has paid all obligations as agreed and it is expected that this type of payment history will continue. When necessary, acceptable personal guarantors support the loan.
- "Monitor." These are loans having a risk rating of 5. Monitor loans have currently acceptable risk but may have the potential for a specific defined weakness in the borrower's operations and the borrower's ability to generate positive cash flow on a sustained basis. The borrower's recent payment history may currently or in the future be characterized by late payments. The Bank's risk exposure is mitigated by collateral supporting the loan. The collateral is considered to be well-margined, well maintained, accessible and readily marketable.
- "Special Mention." These are loans having a risk rating of 6. Special Mention loans have weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. Special Mention loans are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. These loans do warrant more than routine monitoring due to a weakness caused by adverse events.
- "Substandard." These are loans having a risk rating of 7. Substandard loans are considered to have specific and well-defined weaknesses that jeopardize the viability of the Bank's credit extension. The payment history for the loan has been inconsistent and the expected or projected primary repayment source may be inadequate to service the loan. The estimated net liquidation value of the collateral pledged and/or ability of the personal guarantor(s) to pay the loan may not adequately protect the Bank. There is a distinct possibility that the Bank will sustain some loss if the deficiencies associated with the loan are not corrected in the near term. A substandard loan would not automatically meet our definition of impaired unless the loan is significantly past due and the borrower's performance and financial condition provide evidence that it is probable that the Bank will be unable to collect all amounts due.
- "Doubtful." These are loans having a risk rating of 8. Doubtful rated loans have all the weaknesses inherent in a loan that is classified substandard but with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is high.
- "Loss." These are loans having a risk rating of 9. Loss rated loans are not considered collectible under normal circumstances and there is no realistic expectation for any future payment on the loan. Loss rated loans are fully charged off.

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

The Bank grants primarily commercial, real estate, and installment loans to customers throughout its market area, which consists primarily of Region 2000 which includes the counties of Amherst, Appomattox, Bedford and Campbell, the Town of Bedford, and the City of and the City of Lynchburg, Virginia. The real estate portfolio can be affected by the condition of the local real estate market. The commercial and installment loan portfolio can be affected by the local economic conditions.

A summary of loans, net is as follows:

	December 31,	
	2017	**2016**
Commercial	$ 96,127	$ 88,085
Commercial real estate	251,807	237,638
Consumer	83,746	85,099
Residential	64,094	59,247
Total loans (1)	495,774	470,069
Less allowance for loan losses	4,752	5,716
Net loans	$491,022	$464,353

(1) Includes net deferred costs and premiums of $940 and $182, respectively.

The amount of overdrafts reclassified as loans was $36 and $54 as of December 31, 2017 and 2016, respectively.

The Company's officers, directors and their related interests have various types of loan relationships with the Bank. The total outstanding balances of these related party loans at December 31, 2017 and 2016 were $14,592 and $15,869 respectively. During 2017, new loans and advances amounted to $1,626 and repayments amounted to $2,903.

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

The following tables set forth information regarding impaired and non-accrual loans as of December 31, 2017 and 2016:

Loans on Non-Accrual Status

	As of December 31, 2017	As of December 31, 2016
Commercial	$ 727	$ 915
Commercial Real Estate:		
Commercial Mortgages-Owner Occupied	1,465	855
Commercial Mortgages-Non-Owner Occupied	468	—
Commercial Construction	—	256
Consumer		
Consumer Unsecured	—	—
Consumer Secured	566	80
Residential:		
Residential Mortgages	1,025	1,292
Residential Consumer Construction	58	67
Totals	$4,309	$3,465

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

	Impaired Loans As of and for the Year Ended December 31, 2017				
2017	**Recorded Investment**	**Unpaid Principal Balance**	**Related Allowance**	**Average Recorded Investment**	**Interest Income Recognized**
With No Related Allowance Recorded:					
Commercial	$ 925	$ 1,505	$ —	$ 812	$ 54
Commercial Real Estate					
Commercial Mortgages-Owner Occupied	2,427	2,539	—	2,723	179
Commercial Mortgage Non-Owner Occupied	675	690	—	512	30
Commercial Construction	—	—	—	—	—
Consumer					
Consumer Unsecured	—	—	—	—	—
Consumer Secured	279	283	—	149	11
Residential					
Residential Mortgages	1,580	1,673	—	1,568	63
Residential Consumer Construction	—	—	—	—	—
With an Allowance Recorded:					
Commercial	$ 317	$ 323	$ 112	$ 919	$ 16
Commercial Real Estate					
Commercial Mortgages-Owner Occupied	665	665	93	1,126	39
Commercial Mortgage Non-Owner Occupied	73	73	18	74	5
Commercial Construction	169	695	79	169	—
Consumer					
Consumer Unsecured	2	2	2	1	—
Consumer Secured	427	445	255	269	11
Residential					
Residential Mortgages	151	178	4	425	3
Residential Consumer Construction	—	—	—	—	—
Totals:					
Commercial	$ 1,242	$ 1,828	$ 112	$ 1,731	$ 70
Commercial Real Estate					
Commercial Mortgages-Owner Occupied	3,092	3,204	93	3,849	218
Commercial Mortgage Non-Owner Occupied	748	763	18	586	35
Commercial Construction	169	695	79	169	—
Consumer					
Consumer Unsecured	2	2	2	1	—
Consumer Secured	706	728	255	418	22
Residential					
Residential Mortgages	1,731	1,851	4	1,993	66
Residential Consumer Construction	—	—	—	—	—
	$7,690	$9,071	$563	$8,747	$411

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

2016	Impaired Loans As of and for the Year Ended December 31, 2016 Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With No Related Allowance Recorded:					
Commercial	$ 698	$ 698	$ —	$ 349	$ 37
Commercial Real Estate					
Commercial Mortgages-Owner Occupied	3,019	3,077	—	3,051	142
Commercial Mortgage Non-Owner Occupied	349	349	—	263	23
Commercial Construction	—	—	—	14	—
Consumer					
Consumer Unsecured	—	—	—	—	—
Consumer Secured	18	18	—	19	1
Residential					
Residential Mortgages	1,555	1,687	—	1,776	55
Residential Consumer Construction	—	—	—	86	—
With an Allowance Recorded:					
Commercial	$ 1,521	$ 1,521	$ 1,233	$ 1,351	$ 81
Commercial Real Estate					
Commercial Mortgages-Owner Occupied	1,587	1,618	249	1,232	81
Commercial Mortgage Non-Owner Occupied	74	74	20	373	6
Commercial Construction	169	657	76	255	—
Consumer					
Consumer Unsecured	—	—	—	16	—
Consumer Secured	110	110	110	150	8
Residential					
Residential Mortgages	699	736	83	675	30
Residential Consumer Construction	—	—	—	—	—
Totals:					
Commercial	$ 2,219	$ 2,219	$ 1,233	$ 1,700	$ 118
Commercial Real Estate					
Commercial Mortgages-Owner Occupied	4,606	4,695	249	4,283	223
Commercial Mortgage Non-Owner Occupied	423	423	20	636	29
Commercial Construction	169	657	76	269	—
Consumer					
Consumer Unsecured	—	—	—	16	—
Consumer Secured	128	128	110	169	9
Residential					
Residential Mortgages	2,254	2,423	83	2,451	85
Residential Consumer Construction	—	—	—	86	—
	$9,799	$10,545	$1,771	$9,610	$464

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

The following tables set forth the allowance for loan losses activity for the years ended December 31, 2017 and 2016:

	Allowance for Loan Losses and Recorded Investment in Loans As of and for the Year Ended December 31, 2017				
2017	**Commercial**	**Commercial Real Estate**	**Consumer**	**Residential**	**Total**
Allowance for Loan Losses:					
Beginning Balance	$ 2,192	$ 2,109	$ 954	$ 461	$ 5,716
Charge-offs	(1,652)	(91)	(246)	(105)	(2,094)
Recoveries	6	41	51	39	137
Provision	718	(321)	413	183	993
Ending Balance	$ 1,264	$ 1,738	$ 1,172	$ 578	$ 4,752
Ending Balance: Individually evaluated for impairment	$ 112	$ 190	$ 257	$ 4	$ 563
Ending Balance: Collectively evaluated for impairment	1,152	1,548	915	574	4,189
Totals:	$ 1,264	$ 1,738	$ 1,172	$ 578	$ 4,752
Loans:					
Ending Balance: Individually evaluated for impairment	$ 1,242	$ 4,009	$ 708	$ 1,731	$ 7,690
Ending Balance: Collectively evaluated for impairment	94,885	247,798	83,038	62,363	488,084
Totals:	$ 96,127	$ 251,807	$ 83,746	$ 64,094	$495,774

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

2016	Allowance for Loan Losses and Recorded Investment in Loans As of and for the Year Ended December 31, 2016				
	Commercial	Commercial Real Estate	Consumer	Residential	Total
Allowance for Loan Losses:					
Beginning Balance	$ 1,195	$ 1,751	$ 1,073	$ 664	$ 4,683
Charge-offs	(328)	(156)	(275)	—	(759)
Recoveries	7	127	44	2	180
Provision	1,318	387	112	(205)	1,612
Ending Balance	$ 2,192	$ 2,109	$ 954	$ 461	$ 5,716
Ending Balance: Individually evaluated for impairment	$ 1,233	$ 345	$ 110	$ 83	$ 1,771
Ending Balance: Collectively evaluated for impairment	959	1,764	844	378	3,945
Totals:	$ 2,192	$ 2,109	$ 954	$ 461	$ 5,716
Loans:					
Ending Balance: Individually evaluated for impairment	$ 2,219	$ 5,198	$ 128	$ 2,254	$ 9,799
Ending Balance: Collectively evaluated for impairment	85,866	232,440	84,971	56,993	460,270
Totals:	$ 88,085	$ 237,638	$ 85,099	$ 59,247	$470,069

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

Age Analysis of Past Due Loans as of December 31, 2017

2017	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days & Accruing
Commercial	$ 320	$ —	$ 250	$ 570	$ 95,557	$ 96,127	$ —
Commercial Real Estate:							
Commercial Mortgages-Owner Occupied	904	64	177	1,145	92,504	93,649	—
Commercial Mortgages-Non-Owner Occupied	—	361	299	660	138,101	138,761	—
Commercial Construction	—	—	169	169	19,228	19,397	—
Consumer:							
Consumer Unsecured	3	—	—	3	6,977	6,980	—
Consumer Secured	245	139	462	846	75,920	76,766	—
Residential:							
Residential Mortgages	706	414	532	1,652	51,545	53,197	—
Residential Consumer Construction	—	—	58	58	10,839	10,897	—
Total	$ 2,178	$ 978	$ 1,947	$ 5,103	$ 490,671	$ 495,774	$ —

Age Analysis of Past Due Loans as of December 31, 2016

2016	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days & Accruing
Commercial	$ 283	$ 5	$ 78	$ 366	$ 87,719	$ 88,085	$ —
Commercial Real Estate:							
Commercial Mortgages-Owner Occupied	1,136	72	855	2,063	88,698	90,761	—
Commercial Mortgages-Non-Owner Occupied	140	—	—	140	134,262	134,402	—
Commercial Construction	—	—	256	256	12,219	12,475	—
Consumer:							
Consumer Unsecured	9	—	—	9	8,558	8,567	—
Consumer Secured	531	301	—	832	75,700	76,532	—
Residential:							
Residential Mortgages	539	161	1,063	1,763	49,525	51,288	—
Residential Consumer Construction	—	—	67	67	7,892	7,959	—
Total	$ 2,638	$ 539	$ 2,319	$ 5,496	$ 464,573	$ 470,069	$ —

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

Credit Quality Information—by Class December 31, 2017

2017	Pass	Monitor	Special Mention	Substandard	Doubtful	Totals
Commercial	$ 93,571	$ 1,217	$ 4	$ 1,335	$ —	$ 96,127
Commercial Real Estate:						
Commercial Mortgages-Owner Occupied	83,834	2,926	3,734	3,155	—	93,649
Commercial Mortgages-Non-Owner Occupied	135,855	1,898	152	856	—	138,761
Commercial Construction	18,423	—	805	169	—	19,397
Consumer						
Consumer Unsecured	6,978	—	—	2	—	6,980
Consumer Secured	75,774	90	—	902	—	76,766
Residential:						
Residential Mortgages	50,816	—	241	2,140	—	53,197
Residential Consumer Construction	10,839	—	—	58	—	10,897
Totals	$476,090	$ 6,131	$ 4,936	$ 8,617	$ —	$495,774

Credit Quality Information—by Class December 31, 2016

2016	Pass	Monitor	Special Mention	Substandard	Doubtful	Totals
Commercial	$ 83,912	$ 1,473	$ 301	$ 1,484	$ 915	$ 88,085
Commercial Real Estate:						
Commercial Mortgages-Owner Occupied	83,008	2,975	101	4,677	—	90,761
Commercial Mortgages-Non-Owner Occupied	129,794	3,525	525	558	—	134,402
Commercial Construction	11,774	—	445	256	—	12,475
Consumer						
Consumer Unsecured	8,567	—	—	—	—	8,567
Consumer Secured	76,215	—	—	317	—	76,532
Residential:						
Residential Mortgages	48,366	—	245	2,677	—	51,288
Residential Consumer Construction	7,892	—	—	67	—	7,959
Totals	$449,528	$ 7,973	$ 1,617	$ 10,036	$ 915	$470,069

(dollars in thousands, except per share data)

Note 5—Loans and allowance for loan losses (continued)

Troubled Debt Restructurings (TDRs)

There were no loan modifications that would have been classified as Troubled Debt Restructurings (TDR) during the twelve months ended December 31, 2017 or 2016.

Loans that were previously classified as TDRS and currently on the Bank's balance sheet are factored into the determination of the allowance for loan losses as of the period indicated and are included in the Bank's impaired loan analysis and individually evaluated for impairment.

At December 31, 2017 and December 31, 2016, the Bank had no outstanding commitments to disburse additional funds on loans classified as TDRs.

There were no loan modifications classified as TDRs within the last twelve months that defaulted (90 days past due) during the twelve months ended December 31, 2017 and 2016.

Note 6—Other real estate owned

At December 31, 2017 and 2016, OREO was $2,650 and $2,370 respectively. OREO is primarily comprised of residential properties and non-residential properties associated with commercial relationships. As of December 31, 2017 and 2016 respectively, there was $0 and $264 of consumer mortgage loans secured by residential real estate that were in the process of foreclosure. The following table represents the changes in OREO balance in 2017 and 2016.

OREO Changes

	Year Ended December 31,	
	2017	**2016**
Balance at the beginning of the year	$2,370	$1,965
Transfers from Loans	815	470
Capitalized costs	40	—
Valuation adjustments	(60)	(45)
Sales	(514)	(21)
Gain (loss) on sales	(1)	1
Balance at the end of the year	$2,650	$2,370

There were three residential properties being carried in OREO at a value of $520 as of December 31, 2017. There was one residential property being carried in OREO at a value of $65 as of December 31, 2016.

(dollars in thousands, except per share data)

Note 6—Other real estate owned (continued)

The following table sets forth the OREO expenses in 2017 and 2016.

OREO Expense

	Year Ended December 31, 2017	Year Ended December 31, 2016
(Gain) loss on sales	$ 1	$ (1)
Valuation adjustments	60	45
Expenses	27	24
Total	$ 88	$ 68

Note 7—Premises and equipment

Premises and equipment at December 31, 2017 and 2016 are summarized as follows:

	December 31, 2017	December 31, 2016
Land	$ 3,302	$ 3,302
Building and improvements	6,921	5,864
Property for future expansion	814	2,098
Furniture and equipment	7,476	6,328
Leasehold improvements	2,473	1,611
Software	2,337	2,205
	23,323	21,408
Less accumulated depreciation	11,268	10,461
Net premises and equipment	$12,055	$10,947

Total depreciation and amortization expense related to premises and equipment for the years ended December 31, 2017 and 2016 was $811 and $767, respectively.

(dollars in thousands, except per share data)

Note 8—Deposits

A summary of deposit accounts is as follows:

	December 31, 2017	December 31, 2016
Demand		
Noninterest bearing	$ 74,102	$ 62,135
Interest bearing	205,131	187,870
Savings	102,856	108,078
Time, $250,000 or more (1)	42,507	38,865
Other time	142,897	126,164
	$567,493	$523,112

(1) Includes brokered certificates of deposit of $20,064 as of December 31, 2017 and $22,044 as of December 31, 2016.

At December 31, 2017, maturities of time deposits are scheduled as follows:

Year Ending December 31,	Amount
2018	$ 98,050
2019	39,486
2020	25,057
2021	10,232
2022	12,579
	$185,404

The Bank held deposits from the Company’s officers, directors and their related interests of $8,404 and $10,167 at December 31, 2017 and 2016, respectively.

Note 9 – Business Segments

The Company has two reportable business segments: (i) a traditional full service community banking segment and, (ii) a mortgage loan origination business. The community banking business segment includes Bank of the James which provides loans, deposits, investments and insurance to retail and commercial customers throughout Region 2000. The mortgage segment provides a variety of mortgage loan products principally within Region 2000. Mortgage loans are originated and sold in the secondary market through purchase commitments from investors. Because of the pre-arranged purchase commitments, there is minimal risk to the Company.

(dollars in thousands, except per share data)

Note 9—Business Segments (continued)

Both of the Company's reportable segments are service based. The mortgage business is a fee-based business while the Bank's primary source of revenue is net interest income. The Bank also provides a referral network for the mortgage origination business. The mortgage business may also be in a position to refer its customers to the Bank for banking services when appropriate.

Information about reportable business segments and reconciliation of such information to the consolidated financial statements for years ended December 31, 2017 and 2016 was as follows:

Business Segments

	Community Banking	Mortgage	Total
For the year ended December 31, 2017			
Net interest income	$ 20,672	$ —	$ 20,672
Provision for loan losses	993	—	993
Net interest income after provision for loan losses	19,679	—	19,679
Noninterest income	2,293	2,434	4,727
Noninterest expenses	17,127	1,919	19,046
Income before income taxes	4,845	515	5,360
Income tax expense	2,263	175	2,438
Net income	$ 2,582	$ 340	$ 2,922
Total assets	$ 623,547	$ 2,794	$626,341
For the year ended December 31, 2016			
Net interest income	$ 19,224	$ —	$ 19,224
Provision for loan losses	1,612	—	1,612
Net interest income after provision for loan losses	17,612	—	17,612
Noninterest income	2,338	2,457	4,795
Noninterest expenses	15,695	1,899	17,594
Income before income taxes	4,255	558	4,813
Income tax expense	1,337	190	1,527
Net income	$ 2,918	$ 368	$ 3,286
Total assets	$ 570,181	$ 4,014	$574,195

Note 10—Capital notes

On January 25, 2017, Financial closed a private placement of unregistered debt securities (the "2017 Offering") pursuant to which Financial issued $5,000,000 in principal of notes (the "2017 Notes"). The 2017 Notes bear interest at the rate of 4% per year with interest payable quarterly in arrears. The 2017 Notes are to mature on January 24, 2022, but are subject to prepayment in whole or in part on or after January 24, 2018 at Financial's sole discretion on 30 days written notice to the holders. A portion of the proceeds from the sale of the 2017 Notes will be used to provide additional capital to the Bank.

(dollars in thousands, except per share data)

Note 11—Other borrowings

Other borrowings consisted of the following at December 31, 2017 and 2016:

	As of December 31,	
Short Term:	**2017**	**2016**
Federal funds purchased		
Balance at end of year	$ —	$ —
Maximum month-end outstanding balance	—	6,265
Average outstanding balance during the year	1	371
Average interest rate during the year	0.00%	1.08%
Average interest rate at end of year	N/A	N/A
Reverse repurchase agreements		
Balance at end of year	$ —	$ —
Maximum month-end outstanding balance	5,000	—
Average outstanding balance during the year	795	—
Average interest rate during the year	1.76%	N/A
Average interest rate at end of year	N/A	N/A

Short-term borrowings may consist of securities sold under agreements to repurchase, which are secured transactions with customers and generally mature the day following the date sold. Short-term borrowings may also include Federal funds purchased, which are unsecured overnight borrowings from other financial institutions.

Unsecured federal fund lines and their respective limits are maintained with the following institutions: Community Bankers' Bank, $13,000, Zions Bank, $4,000, PNC Bank, $6,000 and Suntrust Bank, $3,000. In addition, the Bank maintains a $5,000 reverse repurchase agreement with Suntrust whereby securities may be pledged as collateral in exchange for funds for a minimum of 30 days with a maximum of 90 days. The Bank also maintains a secured federal funds line with Community Bankers' Bank whereby it may pledge securities as collateral with no specified minimum or maximum amount or term. The current amount available on the secured line based on the securities currently pledged is $3,151.

The Bank is also a member of the Federal Home Loan Bank of Atlanta ("FHLBA"). The Bank's available credit through the FHLBA was $156,641 as of December 31, 2017, the most recent calculation. The Bank must pledge collateral in order to access the FHLBA available credit. Currently the Bank has pledged to the FHLBA approximately $43,600 in 1-4 family residential mortgages which, after adjustments for the loan-to-value requirements by the FHLBA, would allow the Bank to access up to $29,132 in credit without pledging any additional collateral.

As of December 31, 2017, and 2016 there are no outstanding balances on any of the credit facilities mentioned above.

Note 12—Income taxes

The Company files income tax returns in the U.S. federal jurisdiction and the state of Virginia. With few exceptions, the Company is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2014.

(dollars in thousands, except per share data)

Note 12—Income taxes (continued)

Income tax expense attributable to income before income tax expense is summarized as follows:

	December 31, 2017	December 31, 2016
Current federal income tax expense	$1,674	$1,983
Deferred federal income tax (benefit) expense	764	(456)
Income tax expense	$2,438	$1,527

Income tax expense differed from amounts computed by applying the U.S. Federal income tax rate of 34% to income before income tax expense as a result of the following:

	2017	2016
Computed "expected" income tax expense	$1,822	$1,636
Increase (reduction) in income tax resulting from:		
Non-taxable income	(127)	(113)
Non-deductible expenses	18	16
Other	(146)	(12)
Change in net deferred tax asset/liability due to rate change	871	—
Income tax expense	$2,438	$1,527

The results for the year ended December 31, 2017 include the effect of the Tax Cuts and Jobs Act (the Act), which was signed into law on December 22, 2017. Among other things, the Act permanently lowers the federal corporate income tax rate to 21% from the maximum rate prior to the passage of the Act of 35%, effective January 1, 2018. As a result of the reduction of the federal corporate income tax rate, U.S. GAAP requires companies to re-measure their deferred tax assets and deferred tax liabilities, including those accounted for in accumulated other comprehensive income, as of the date of the Act's enactment and record the corresponding effects in income tax expense in the further quarter of 2017. As a result of the permanent reduction in the corporate income tax rate, the Company recognized a $871,000 reduction in the value of its net deferred tax asset and recorded a corresponding incremental income tax expense of $871,000 in the Company's consolidated results of operations for the fourth quarter of 2017. The Company's evaluation of the effect of the Act is subject to refinement for up to one year after enactment.

(dollars in thousands, except per share data)

Note 12—Income taxes (continued)

The tax effects of temporary differences result in deferred tax assets and liabilities as presented below:

	2017	2016
Deferred tax assets		
Allowance for loan losses	$ 790	$1,353
Unrealized loss on available-for-sale securities	391	824
OREO	100	141
Non-accrual interest	263	403
Deferred Compensation	70	78
Other	10	—
Gross deferred tax assets	1,624	2,799
Deferred tax liabilities		
Depreciation	130	130
Other	76	295
Gross deferred tax liabilities	206	425
Net deferred tax asset	$1,418	$2,374

(dollars in thousands, except per share data)

Note 13—Earnings per common share (EPS)

Basic EPS excludes dilution and is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, or resulted in the issuance of common stock that then shared in the earnings of the entity.

The basic and diluted earnings per share calculations are as follows:

	2017	2016
Numerator:		
Net income available to stockholders	$ 2,922	$ 3,286
Basic EPS weighted average shares outstanding	4,378,436	4,378,436
Effect of dilutive securities:		
Incremental shares attributable to stock options	85	6
Diluted EPS weighted-average shares outstanding	4,378,521	4,378,442
Basic earnings per common share	$ 0.67	$ 0.75
Diluted earnings per common share	$ 0.67	$ 0.75

No option shares were excluded from the 2017 and 2016 earnings per share calculations because they are anti-dilutive.

Note 14—Retirement plans

Defined contribution benefit plan. The Company adopted a 401(k) defined contribution plan on October 1, 2000, which is administered by the Virginia Bankers' Association. Participants have the right to contribute up to a maximum of 19% of pretax annual compensation or the maximum allowed under Section 401(g) of the Internal Revenue Code, whichever is less. The Company contributed $270 and $253 to the plan on behalf of the employees for the years ended December 31, 2017 and 2016, respectively.

Supplemental Executive Retirement Plan . A Supplemental Executive Retirement Plan (SERP) was established to provide participating executives (as determined by the Company's Board of Directors) with benefits that cannot be provided under the 401(k) as a result of limitations imposed by the Internal Revenue Code. The SERP will also provide benefits to eligible employees or their survivors, as applicable, if they die, retire, or are terminated under certain circumstances. SERP expense totaled $331 and $230 for the years ended December 31, 2017 and 2016, respectively.

The Company funds the plan through a modified endowment contract. Income recorded for the plan represents life insurance income as recorded based on the projected increases in cash surrender values of life insurance policies. As of December 31, 2017 and 2016, the life insurance policies had cash surrender values of approximately $13,018 and $12,673, respectively.

(dollars in thousands, except per share data)

Note 15—Stock option plan

On October 21, 1999, the Board of Directors adopted the "1999 Stock Option Plan" for officers and employees. The ability to grant shares under the 1999 Stock Option Plan expired on October 21, 2009. The plan expired with 25,832 shares not granted.

Stock option plan activity for the year ended December 31, 2017 is summarized below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Intrinsic Value
Options outstanding, January 1, 2017	636	$ 12.79		
Granted	—	—		
Exercised	—	—		
Forfeited	—	—		
Options outstanding, December 31, 2017	636	12.79	0.42	$ 1
Options exercisable, December 31, 2017	636	$ 12.79	0.42	$ 1

No options were exercised in 2017 and 2016.

The following is summarized information concerning currently outstanding and exercisable options as adjusted for all stock dividends previously declared and paid:

Options Outstanding and Exercisable			
Exercise Price ($)	**Number of Options**	**Remaining Contractual Life**	**Weighted Average Exercise Price ($)**
12.79	636	0.42 years	12.79

Note 16—Dividend Reinvestment Plan

The Company has in effect a Dividend Reinvestment Plan (DRIP) which provides an automatic conversion of dividends into common stock for enrolled shareholders. The Company may issue common shares to the DRIP or purchase common shares on the open market. Common shares are purchased on the open market at a price that based on the weighted average price of all shares purchased by the broker-dealer on the open market from each aggregate order placed by the Plan Administrator.

The DRIP was not in effect in 2016. In 2017, all shares purchased through the DRIP were purchased on the open market and consequently the Company issued no common shares to the DRIP during the year ended December 31, 2017.

Note 17—Stockholders' equity

The Bank is subject to certain legal and regulatory restrictions on the amount of cash dividends it may declare. Financial is a legal entity, separate and distinct from the Bank. Financial currently does not have any significant sources of revenue other than cash dividends paid to it by its subsidiaries. Both Financial and the Bank are subject to laws and regulations that limit the payment of cash dividends, including requirements to maintain capital at or above regulatory minimums.

Note 18—Regulatory matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital to average assets (as defined). Management believes, as of December 31, 2017 that the Bank meets all capital adequacy requirements to which it is subject. The Bank's actual regulatory capital amounts and ratios for December 31, 2017 and 2016 are also presented in the table below.

On June 7, 2012, the Federal Reserve issued a series of proposed rules that would revise and strengthen its risk-based and leverage capital requirements and its method for calculating risk-weighted assets. The rules were proposed to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. On July 2, 2013, the Federal Reserve approved certain revisions to the proposals and finalized new capital requirements for banking organizations.

Effective January 1, 2015, the final rules required Financial and the Bank to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1

Note 18—Regulatory matters (continued)

capital ratio of 6.0% of risk-weighted assets (increased from the previous requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from previous requirement); and (iv) a leverage ratio of 4.0% of total assets. These are the initial capital requirements, which will be phased in over a five-year period. When fully phased in on January 1, 2019, the rules will require Financial and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets.

The capital conservation buffer requirement was phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

With respect to the Bank, the rules also revised the “prompt corrective action” regulations pursuant to Section 38 of the FDIA by (i) introducing a common equity Tier 1 capital ratio requirement at each level (other than critically undercapitalized), with the required ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum ratio for well-capitalized status being 8.0% (as compared to the previous 6.0% as of December 31, 2014); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3.0% Tier 1 leverage ratio and still be well-capitalized.

The new capital requirements also include changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status, a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital, and increased risk-weights (from 0% to up to 600%) for equity exposures.

As of December 31, 2017, the most recent notification from the Federal Reserve Bank of Richmond categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

(dollars in thousands, except per share data)

Note 18—Regulatory matters (continued)

To be categorized as well capitalized, the Bank must maintain minimum total risk-based, CET1, Tier I risk-based and Tier I leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

The capital ratios for the Bank for 2017 and 2016 are set forth in the following table:

	December 31, 2017					
	Actual		Minimum Capital Requirement		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio (1)	Amount	Ratio
Total capital						
(to risk-weighted assets)	$61,888	12.05%	$53,909	>10.500%	$51,342	> 10.00%
Tier I capital						
(to risk-weighted assets)	$57,136	11.13%	$43,641	>8.50%	$41,074	> 8.00%
Common Equity Tier 1 capital						
(to risk-weighted assets)	$57,136	11.13%	$35,939	>7.00%	$33,372	>6.50%
Tier I capital (leverage)						
(to average assets)	$57,136	9.12%	$25,057	> 4.00%	$31,321	> 5.00%

(1) Includes capital conservation buffer after full phase-in where applicable.

	December 31, 2016					
	Actual		Minimum Capital Requirement		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio (1)	Amount	Ratio
Total capital						
(to risk-weighted assets)	$56,365	11.54%	$51,304	>10.500%	$48,861	> 10.00%
Tier I capital						
(to risk-weighted assets)	$50,649	10.37%	$41,532	>8.50%	$39,089	> 8.00%
Common Equity Tier 1 capital						
(to risk-weighted assets)	$50,649	10.37%	$34,202	>7.00%	$31,759	>6.50%
Tier I capital (leverage)						
(to average assets)	$50,649	8.94%	$22,656	> 4.00%	$28,320	> 5.00%

(1) Includes capital conservation buffer after full phase-in where applicable.

Note 18—Regulatory matters (continued)

The above tables set forth the capital position and analysis for the Bank only. Because total assets on a consolidated basis are less than $1,000,000, Financial is not subject to the consolidated capital requirements imposed by the Bank Holding Company Act. Consequently, Financial does not calculate its financial ratios on a consolidated basis. If calculated, the capital ratios for the Company on a consolidated basis would no longer be comparable to the capital ratios of the Bank because the proceeds of the private placement do not qualify as equity capital on a consolidated basis.

Note 19—Contingent liabilities

The Bank rents, under non-cancelable leases, six of its banking facilities and one commercial loan production office. The original lease for 615 Church Street expired on July 31, 2009. On August 1, 2009, the Bank elected to enter into a new 10 year lease for this property. The Bank has 1.5 years remaining on this lease.

The Bank entered into a lease agreement for 828 Main Street with Jamesview Investments, LLC, a related party which is wholly-owned by William C. Bryant III, a member of the Board of Directors of both Financial and the Bank. The initial term of the lease was 10 years with two five year renewal options for a total of 20 years. The Bank has 6.5 years remaining on this lease including option periods. The total expense to be incurred by the Bank over the remaining course of the lease, including options to extend, is estimated to be $1,543.

In December 2005, the Bank entered into a lease agreement for 4935 Boonsboro Road. The initial term of the lease was five years with two five-year renewal options for a total of 15 years. The Bank has 3 years remaining on this lease and no remaining option periods.

In September 2013, the Bank entered into a lease agreement for 1430 Rolkin Court in Charlottesville, VA. Lease payments did not begin on the property until the upfit was completed on January 1, 2014. The initial term of the lease was five years with one five-year renewal option for a total of 10 years. The Bank has 6 years remaining on this lease including the one option period.

In July 2015, the Bank entered into a lease agreement for 225 Merchant Walk Avenue, Charlottesville, VA. Lease payments did not begin on the property until the upfit was completed in November 2016. The initial term of the lease was 10 years with two five-year renewal options for a total of 20 years. The Bank has 19 years remaining on this lease including the two option periods.

In November 2016, the Bank entered into a lease agreement for 3564 Electric Road, Roanoke, VA. Lease payments did not begin on the property until February 1, 2017. The initial term of the lease was five years with two five year renewal options for a total of 15 years. The Bank has 14 years remaining on this lease including the two option periods.

Rental expenses under operating leases were $692 and $569 for the years ended December 31, 2017 and 2016, respectively.

(dollars in thousands, except per share data)

Note 19—Contingent liabilities (continued)

The current minimum annual rental commitments under the non-cancelable leases in effect at December 31, 2017 are as follows:

Year Ending	Amount
2018	$ 643
2019	430
2020	173
2021	116
2022	82
Thereafter	302
	$ 1,746

Note 20—Financial instruments with off-balance-sheet risk

The Bank is not a party to derivative financial instruments with off-balance-sheet risks such as futures, forwards, swaps and options. The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These instruments may involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets. The contract amounts of these instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

Credit risk is defined as the possibility of sustaining a loss because the other party to a financial instrument fails to perform in accordance with the terms of the contract. The Bank's maximum exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of the instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

The Bank requires collateral or other security to support financial instruments when it is deemed necessary. The Bank evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Types of collateral vary but may include marketable securities, accounts receivable, inventory, and property, plant and equipment.

At December 31, 2017, the Bank had rate lock commitments to originate mortgage loans through its Mortgage Division amounting to approximately $8,329 and loans held for sale of $2,626. The Bank has entered into corresponding commitments with third party investors to sell each of these loans that close. No other obligation exists. As a result of these contractual relationships with these investors, the Bank is not exposed to losses nor will it realize gains related to its rate lock commitments due to changes in interest rates.

(dollars in thousands, except per share data)

Note 20—Financial instruments with off-balance-sheet risk (continued)

Financial instruments whose contract amounts represent credit risk are as follows:

	Contract Amounts at December 31,	
	2017	2016
Commitments to extend credit	$115,152	$93,247
Standby letters of credit	$ 2,770	$ 3,466

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

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements. The credit risk involved in issuing standby letters of credit is generally less than that involved in extending loans to customers because the Bank generally holds deposits equal to the commitment. Management does not anticipate any material losses as a result of these transactions.

Note 21—Concentration of credit risk

The Bank has a diversified loan portfolio consisting of commercial, real estate and consumer (installment) loans. Substantially all of the Bank's customers are residents or operate business ventures in its market area consisting primarily of the Lynchburg metropolitan area. Therefore, a substantial portion of its debtors' ability to honor their contracts and the Bank's ability to realize the value of any underlying collateral, if needed, is influenced by the economic conditions in this market area.

The Bank maintains a significant portion of its cash balances with one financial institution. Uninsured cash balances as of December 31, 2017 were approximately $3,081 which consisted of the total balances in one account at the Federal Home Loan Bank of Atlanta (FHLBA) and the balances (net of $250 FDIC coverage) held in one account at Community Bankers' Bank, one account at Suntrust, and one account at Zions Bank. Uninsured cash balances as of December 31, 2016 were approximately $3,670 which consisted of the total balances in the same accounts referenced for 2017 above.

Note 22—Fair value measurements

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurements and Disclosures topic of FASB ASC, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

Securities

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow.

(dollars in thousands, except per share data)

Note 22—Fair value measurements (continued)

Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. Currently, all of the Company's securities are considered to be Level 2 securities.

The following table summarizes the Company's financial assets that were measured at fair value on a recurring basis during the period.

		Fair Value at December 31, 2017		
Description	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasuries	$ 1,858	$	$ 1,858	$
U.S. agency obligations	23,850	—	23,850	—
Mortgage-backed securities	13,388	—	13,388	—
Municipals	12,274	—	12,274	—
Corporates	3,942	—	3,942	—
Total available-for-sale securities	$ 55,312	$ —	$ 55,312	$ —

		Fair Value at December 31, 2016		
Description	Balance as of December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasuries	$ 1,833	$	$ 1,833	
U.S. agency obligations	13,113	—	13,113	$ —
Mortgage-backed securities	12,005	—	12,005	—
Municipals	9,947	—	9,947	—
Corporates	3,878	—	3,878	—
Total available-for-sale securities	$ 40,776	$ —	$ 40,776	$ —

Note 22—Fair value measurements (continued)

Loans held for sale

Loans held for sale are measured at lower of cost or fair value. Under ASC 820, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. Because quotes and bids on loans held for sale are available in active markets, loans held for sale are considered to be Level 2.

Impaired loans

ASC 820 applies to loans measured for impairment at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected when due. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The 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 Bank using observable market data. 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. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. The carrying values of all impaired loans are considered to be Level 3.

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of ASC 820.

Real estate acquired through foreclosure is transferred to other real estate owned ("OREO"). The measurement of loss associated with OREO is based on the fair value of the collateral less anticipated selling costs compared to the unpaid loan balance. The value of OREO collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data.

(dollars in thousands, except per share data)

Note 22—Fair value measurements (continued)

Any fair value adjustments are recorded in the period incurred and expensed against current earnings. The carrying values of all OREO are considered to be Level 3.

The following table summarizes the Company's impaired loans and OREO measured at fair value on a nonrecurring basis during the period.

		Fair Value at December 31, 2017		
Description	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans*	$ 2,523	$ —	$ —	$ 2,523
Loans held for sale	$ 2,626	$ —	$ 2,626	$ —
Other real estate	$ 2,650	$ —	$ —	$ 2,650

* Includes loans charged down to the net realizable value of the collateral.

		Fair Value at December 31, 2016		
Description	Balance as of December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans*	$ 2,830	$ —	$ —	$ 2,830
Loans held for sale	$ 3,833	$ —	$ 3,833	$ —
Other real estate	$ 2,370	$ —	$ —	$ 2,370

* Includes loans charged down to the net realizable value of the collateral.

The following table sets forth information regarding the quantitative inputs used to value assets classified as Level 3:

Note 22—Fair value measurements (continued)

Quantitative information about Level 3 Fair Value Measurements for December 31, 2017 *(dollars in thousands)*

	Fair Value	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Impaired loans	$2,523	Discounted appraised value	Selling cost	0% - 10% (8%)
			Discount for lack of marketability and age of appraisal	0% - 20% (6%)
OREO	$2,650	Discounted appraised value	Selling cost	0% - 10% (6%)
			Discount for lack of marketability and age of appraisal	0% - 25% (15%)

Quantitative information about Level 3 Fair Value Measurements for December 31, 2016 *(dollars in thousands)*

	Fair Value	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Impaired loans	$2,830	Discounted appraised value	Selling cost	5% - 10% (6%)
			Discount for lack of marketability and age of appraisal	0% - 25% (15%)
OREO	$2,370	Discounted appraised value	Selling cost	5% - 10% (6%)
			Discount for lack of marketability and age of appraisal	0% - 25% (15%)

Financial Instruments

Cash, cash equivalents and federal funds sold

The carrying amounts of cash and short-term instruments approximate fair values.

Securities

Fair values of securities, excluding restricted investments in Federal Reserve Bank stock, Federal Home Loan Bank stock, and Community Bankers' Bank stock are based on quoted prices available in an active market. If quoted prices are available, these securities are classified within Level 1 of the valuation hierarchy. Level 1

Note 22—Fair value measurements (continued)

securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow.

Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. Currently, all of the Company's securities are considered to be Level 2 securities.

Restricted securities are classified as such because their ownership is restricted to certain types of entities and there is no established market for their resale. When the stock is repurchased, the shares are repurchased at the stock's book value; therefore, the carrying amount of restricted securities approximate fair value. Restricted securities are considered to be Level 2.

Loans

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for certain fixed rate loans are based on quoted market prices of similar loans adjusted for differences in loan characteristics. Fair values for other loans such as commercial real estate and commercial and industrial loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values of impaired loans are estimated as described above. The carrying values of all loans are considered to be Level 3.

Loans held for sale are measured at the lower of cost or fair value. Fair values of loans held for sale are estimated as described above. The carrying values of all loans held for sale are considered to be Level 2.

Bank owned life insurance (BOLI)

The carrying amount approximates fair value. The carrying values of all BOLI is considered to be Level 2.

Deposits

Fair values disclosed for demand deposits (e.g., interest and noninterest checking, savings, and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed rate certificates of deposit are estimated using discounted cash flow analyses that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits. The carrying values of all deposits are considered to be Level 2.

FHLB borrowings

The fair value of FHLB borrowings is estimated using discounted cash flow analysis based on the rates currently offered for borrowings of similar remaining maturities and collateral requirements. The carrying values of all FHLB borrowings are considered to be Level 2.

Note 22—Fair value measurements (continued)

Short-term borrowings

The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate fair value. The carrying values of all short term borrowings are considered to be Level 2.

Capital notes

Fair values of capital notes are based on market prices for debt securities having similar maturity and interest rate characteristics. The carrying values of all capital notes are considered to be Level 2.

Accrued interest

The carrying amounts of accrued interest approximate fair value. The carrying values of all accrued interest is considered to be Level 2.

Off-balance sheet credit-related instruments

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties’ credit standing. Fair value of off-balance sheet credit-related instruments were deemed to be immaterial at December 31, 2017 and 2016 and therefore are not included in the table below.

(dollars in thousands, except per share data)

Note 22—Fair value measurements (continued)

The estimated fair values, and related carrying or notional amounts, of Financial's financial instruments are as follows:

	Carrying Amounts	Fair Value Measurements at December 31, 2017 using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance
Assets					
Cash and due from banks	$ 20,267	$ 20,267	$ —	$ —	$ 20,267
Fed funds sold	16,751	16,751	—	—	16,751
Securities					
Available-for-sale	55,312	—	55,312	—	55,312
Held-to-maturity	5,713	—	5,619	—	5,619
Restricted stock	1,505	—	1,505	—	1,505
Loans, net	491,022	—	—	492,397	492,397
Loans held for sale	2,626	—	2,626	—	2,626
Interest receivable	1,713	—	1,713	—	1,713
BOLI	13,018	—	13,018	—	13,018
Liabilities					
Deposits	$567,493	$ —	$568,224	$ —	$568,224
Capital notes	5,000	—	5,310	—	5,310
Interest payable	111	—	111	—	111

	Carrying Amounts	Fair Value Measurements at December 31, 2016 using: (Level 1)	(Level 2)	(Level 3)	Balance
Assets					
Cash and due from banks	$ 16,938	$ 16,938	$ —	$ —	$ 16,938
Fed funds sold	11,745	11,745			11,745
Securities					
Available-for-sale	40,776	—	40,776	—	40,776
Held-to-maturity	3,299	—	3,273	—	3,273
Restricted stock	1,373	—	1,373	—	1,373
Loans, net	464,353	—	—	468,393	468,393
Loans held for sale	3,833	—	3,833	—	3,833
Interest receivable	1,378	—	1,378	—	1,378
BOLI	12,673	—	12,673	—	12,673
Liabilities					
Deposits	$523,112	$ —	$524,222	$ —	$524,222
Interest payable	88	—	88	—	88

Note 22—Fair value measurements (continued)

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Bank's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment, and therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on-balance-sheet and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets that are not considered financial assets include deferred income taxes and bank premises and equipment; a significant liability that is not considered a financial liability is accrued post-retirement benefits. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

Financial 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 Financial's financial instruments will change when interest rate levels change, and that change may be either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. 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 rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Company's overall interest rate risk.

Note 23—Impact of recently issued accounting standards

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606." This ASU revised guidance for the recognition, measurement, and disclosure of revenue from contracts with customers. The original guidance has been amended through subsequent accounting standard updates that resulted in technical corrections, improvements, and a one-year deferral of the effective date to January 1, 2018. The guidance, as amended, is applicable to all entities and, once effective, will replace significant portions of existing industry and transaction-specific revenue recognition rules with a more principles-based recognition model. Most revenue associated with financial instruments, including interest income, loan origination fees, and credit card fees, is outside the scope of the guidance. Gains and losses on investment securities, derivatives, and sales of financial instruments are similarly excluded from the scope. Entities can elect to adopt the guidance either on a full or modified retrospective basis. Full retrospective adoption will require a cumulative effect adjustment to retained earnings as of the beginning of the earliest comparative period presented. Modified retrospective adoption will require a cumulative effect adjustment to retained earnings as of the beginning of the reporting period in which the entity first applies the new guidance. The Company plans to adopt this guidance on the effective date, January 1, 2018 via the modified retrospective approach. The Company has completed its assessment of the adoption of this ASU, noting the standard will result in expanded disclosures related to non-interest income and enhance the qualitative disclosures on the revenues within the scope of the new guidance. The

Note 23—Impact of recently issued accounting standards (continued)

Company has concluded the adoption of ASU 2014-09 will not have a material impact on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of ASU 2016-01 to have a material impact on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements. The Company has gathered and is in the process of analyzing lease data to determine the impact that ASU2016-02 will have on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements. This guidance may result in material changes to the Company's accounting for credit losses on financial instruments. The Company has been in discussions with its core processor to coordinate its plans for implementation.

Note 23—Impact of recently issued accounting standards (continued)

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments", to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business". The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Company does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment". The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

In March 2017, the FASB issued ASU 2017-07, "Compensation — Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." The amendments in this ASU require an employer that offers defined benefit pension plans, other postretirement benefit plans, or

Note 23—Impact of recently issued accounting standards (continued)

other types of benefits accounted for under Topic 715 to report the service cost component of net periodic benefit cost in the same line item(s) as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented in the income statement separately from the service cost component. If the other components of net periodic benefit cost are not presented on a separate line or lines, the line item(s) used in the income statement must be disclosed. In addition, only the service cost component will be eligible for capitalization as part of an asset, when applicable. The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted. The Company does not expect the adoption of ASU 2017-07 to have a material impact on its consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company is currently assessing the impact that ASU 2017-08 will have on its consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, “Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting.” The amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. The Company is currently assessing the impact that ASU 2017-09 will have on its consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.” The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted, including adoption in any interim period. The Company does not expect the adoption of ASU 2017-12 to have a material impact on its consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, “Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” The amendments provide financial statement preparers with an option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed

Note 23—Impact of recently issued accounting standards (continued)

amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company has elected to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act in the consolidated financial statements for the period ending December 31, 2017. The amount of this reclassification in 2017 was $241.

(dollars in thousands, except per share data)

Note 24—Condensed financial statements of parent company

Financial information pertaining only to Bank of the James Financial Group, Inc. is as follows:

Balance Sheet

	December 31, 2017	December 31, 2016
Assets		
Cash	$ 859	$ 281
Taxes receivable	120	73
Investment in subsidiaries	55,668	49,049
Other assets	18	18
Total assets	$56,665	$49,421
Liabilities and stockholders' equity		
Capital notes	$ 5,000	$ —
Total Liabilities	$ 5,000	$ —
Common stock $2.14 par value	$ 9,370	$ 9,370
Additional paid-in-capital	31,495	31,495
Retained earnings	12,269	10,156
Accumulated other comprehensive (loss)	(1,469)	(1,600)
Total stockholders' equity	$51,665	$49,421
Total liabilities and stockholders' equity	$56,665	$49,421

(dollars in thousands, except per share data)

Note 24—Condensed financial statements of parent company (continued)

Statements of Income

	Years Ended December 31, 2017	2016
Income		
Dividends from subsidiary	$ —	$ 600
Operating expenses		
Interest on capital notes	187	8
Legal and professional fees	174	145
Other expense	131	126
Total expenses	492	279
Income tax (benefit)	(167)	(94)
(Loss) income before equity in undistributed income of subsidiaries	(325)	415
Equity in undistributed income of subsidiaries	3,247	2,871
Net income	$ 2,922	$ 3,286

(dollars in thousands, except per share data)

Note 24—Condensed financial statements of parent company (continued)

Statements of Cash Flows

	Years Ended December 31, 2017	Years Ended December 31, 2016
Cash flows from operating activities		
Net income	$ 2,922	$ 3,286
Adjustments to reconcile net income to net cash used in operating activities		
(Increase) decrease in income taxes receivable	(47)	259
Decrease in other assets	—	10
(Decrease) in other liabilities	—	(248)
Equity in undistributed net (income) of subsidiaries	(3,247)	(2,871)
Net cash (used in) provided by operating activities	$ (372)	$ 436
Cash flows from investing activities		
Capital contribution to subsidiary Bank of the James	$ (3,000)	$ —
Net cash (used in) provided by investing activities	$ (3,000)	$ —
Cash flows from financing activities		
Dividends paid to common stockholders	$ (1,050)	$ (1,050)
Retirement of capital notes	—	(10,000)
Proceeds from sale of 4% capital notes due 1/24/2022	5,000	—
Net cash provided by (used in) by financing activities	$ 3,950	$ (11,050)
Increase (decrease) in cash and cash equivalents	$ 578	$ (10,614)
Cash and cash equivalents at beginning of period	281	10,895
Cash and cash equivalents at end of period	$ 859	$ 281

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

There has been no change in the independent accountants engaged to audit the financial statements of the Company and its subsidiaries during the last two fiscal years ended December 31, 2017. There have been no disagreements with such independent accountants during the last two fiscal years ended December 31, 2017, on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure.

Item 9A. Controls and Procedures

Financial's management, including Financial's principal executive officer and principal financial officer, conducted an evaluation of the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act") as of December 31, 2017. Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, Financial's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that Financial files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC") (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that the Company's disclosure controls and procedures will detect or uncover every situation involving the failure of persons within the Company or its subsidiary to disclose material information required to be set forth in the Company's periodic reports.

Management's annual report on internal control over financial reporting is incorporated herein by reference to Financial's audited Consolidated Financial Statements set forth in Item 8 of this Annual Report on Form 10-K.

There have been no significant changes during the quarter ended December 31, 2017, in the Company's internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) or in other factors that could have significantly affected those controls subsequent to the date of our most recent evaluation of internal controls over financial reporting, including any corrective actions with regard to significant deficiencies and material weaknesses.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Part of the response to this Item will be included in the information set forth under the headings "Nominees and Continuing Directors," "Corporate Governance and the Board of Directors Matters," and "Section 16(a) Beneficial Ownership Reporting Compliance" in Financial's definitive Proxy Statement for its 2018 Annual Meeting of Shareholders, which Proxy Statement will be filed with the SEC within 120 days of the end of the Financial's 2017 fiscal year (the "2018 Proxy Statement"), and such information is hereby incorporated by reference

Financial has adopted a code of ethics that applies to Financial's directors, executive officers (including the principal financial officer, principal accounting officer or controller, or persons performing similar functions), and senior officers. The code of ethics has been posted under the "Investor Relations" section on Financial's website: www.bankofthejames.com.

Item 11. Executive Compensation

The response to this Item will be included in the information set forth under the headings "Compensation of Directors and Executive Officers," "Compensation of Directors and Executive Officers — Outstanding Equity Awards at Fiscal Year End," "Corporate Governance and the Board of Directors Matters," and "Committees of the Board of Directors of Financial" in the 2018 Proxy Statement and such information is hereby incorporated by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Certain information required by this Item 12 is included under "Securities Authorized for Issuance Under Equity Compensation Plans" in Part II, Item 5 of this annual report on Form 10-K. The information required by this Item will be included in the information set forth under the heading "Corporate Governance and the Board of Directors Matters – Independence of Directors" and "Security Ownership of Management" in the 2018 Proxy Statement and is hereby incorporated by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The response to this Item will be included in the information set forth under the heading "Transactions with Related Parties" in the 2018 Proxy Statement and is hereby incorporated by reference.

Item 14. Principal Accounting Fees and Services

The response to this Item will be included in the information set forth under the heading "Independent Registered Public Accounting Firm" in the 2018 Proxy Statement and is hereby incorporated by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) Financial Statements. Listed and included in Part II, Item 8.

(2) Financial Statement Schedules. Not applicable.

(3) Exhibits. The following exhibits are filed as a part of this Form 10-K:

No.	Description
2.1	Agreement and Plan of Share Exchange dated October 9, 2003 between Bank of the James Financial Group, Inc. and Bank of the James, dated as of October 9, 2003 (incorporated by reference to Exhibit 2.1 to Form 8-K12g-3 filed on January 13, 2004)
3.1	Amended and Restated Articles of Incorporation of Bank of the James Financial Group, Inc. (incorporated by reference to Exhibit 3(i) to Form 8-K filed on August 12, 2009)
3.2	Bylaws of Bank of the James (incorporated by reference to Exhibit 3.2 to Form 8-K filed August 24, 2012)
4.1	Specimen Common Stock Certificate of Bank of the James Financial Group, Inc. (incorporated by reference to Exhibit 4.1 to Form 10-KSB filed on March 26, 2004)
10.1	Amended and Restated Stock Option Plan (incorporated by reference to Form S-8 filed on August 14, 2004)

10.2	Lease between Jamesview Investments LLC and Bank of the James dated October 9, 2003 (incorporated by reference to Exhibit 10.6 to Form 10-KSB filed on March 26, 2004)
10.3	Form of Securities Purchase Agreement, made as of November 23, 2015, between Bank of the James Financial Group, Inc. and each institutional investor purchasing common shares of Bank of the James Financial Group, Inc. in the private placement that closed on December 3, 2015 (incorporated by reference to Exhibit 10.1 to Form 8-K filed on November 24, 2015)
10.4	Salary Continuation Agreement dated as of August 6, 2009 by and between the Bank and Robert R. Chapman III (incorporated by reference to Exhibit 10.7 to Form 8-K filed on August 12, 2009)
10.5	Salary Continuation Agreement dated as of August 6, 2009 by and between the Bank and J. Todd Scruggs (incorporated by reference to Exhibit 10.8 to Form 8-K filed on August 12, 2009)
10.6	Salary Continuation Agreement dated as of August 6, 2009 by and between the Bank and Harry P. Umberger (incorporated by reference to Exhibit 10.9 to Form 8-K filed on August 12, 2009)
10.7	First Amended Salary Continuation Agreement dated effective as of October 1, 2016 by and between the Bank and Robert R. Chapman III (incorporated by reference to Exhibit 10.1 to Form 8-K filed on October 21, 2016)
10.8	First Amended Salary Continuation Agreement dated effective as of October 1, 2016 by and between the Bank and J. Todd Scruggs (incorporated by reference to Exhibit 10.2 to Form 8-K filed on October 21, 2016)
10.9	First Amended Salary Continuation Agreement dated effective as of October 1, 2016 by and between the Bank and Harry P. Umberger (incorporated by reference to Exhibit 10.3 to Form 8-K filed on October 21, 2016)
10.10	2016 Salary Continuation Agreement dated effective as of October 1, 2016 by and between the Bank and Harry P. Umberger (incorporated by reference to Exhibit 10.4 to Form 8-K filed on October 21, 2016)
10.11	Dividend Reinvestment Plan (Incorporated by reference to Registration Statement on Form S-3, filed with the SEC on August 21, 2017)
21.1	List of subsidiaries (filed herewith)
23.1	Yount, Hyde and Barbour, PC, consent related to Form S-3 (Incorporated by reference to Registration Statement on Form S-3, filed with the SEC on August 21, 2017)
31.1	Certification pursuant to Rule 13a-14(a)/15d-14(a) (filed herewith)
31.2	Certification pursuant to Rule 13a-14(a)/15d-14(a) (filed herewith)
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act Of 2002 (filed herewith)

101 Pursuant to Rule 405 of Regulation S-T, the following materials from Bank of the James Financial Group, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2017, formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets as of December 31, 2017 and 2016; (ii) Consolidated Statements of Income For the Years ended December 31, 2017 and 2016; (iii) Consolidated Statements of Cash Flows for the Years ended December 31, 2017 and 2016 (iv) Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income For the Years ended December 31, 2017 and 2016; (v) Notes to Consolidated Financial Statements.

Item 16. Form 10–K Summary - Not required

EXHIBIT INDEX

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31.2	Certification pursuant to Rule 13a-14(a)/15d-14(a) (filed herewith)
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act Of 2002 (filed herewith)
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SIGNATURES

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities as of March 21, 2018.

Signature	Capacity
/S/ Robert R. Chapman III Robert R. Chapman III	President (Principal Executive Officer) and Director
/S/ J. Todd Scruggs J. Todd Scruggs	Secretary and Treasurer (Principal Financial Officer and Principal Accounting Officer) and Director
/S/ Thomas W. Pettyjohn, Jr. Thomas W. Pettyjohn, Jr.	Director, Chairman
/S/ Lewis C. Addison Lewis C. Addison	Director
John R. Alford, Jr.	Director
/S/ William C. Bryant III William C. Bryant III	Director
/S/ A. Douglas Dalton III A. Douglas Dalton III	Director
/S/ James F. Daly James F. Daly	Director
/S/ Julie P. Doyle Julie P. Doyle	Director
Watt R. Foster, Jr.	Director
/S/ Phillip C. Jamerson Phillip C. Jamerson	Director
/S/ Lydia K. Langley Lydia K. Langley	Director
/S/ Augustus A. Petticolas, Jr. Augustus A. Petticolas, Jr.	Director

Exhibit 21.1

List of Subsidiaries

Subsidiary	Jurisdiction or State of Incorporation	Names Under Which Subsidiary Does Business
Bank of the James	Virginia	Bank of the James Bank of the James Mortgage Bank of the James Mortgage, a Division of Bank of the James BOTJ Investment Services
BOTJ Insurance, Inc.	Virginia	BOTJ Insurance, Inc.
BOTJ Investment Group, Inc.	Virginia	Inactive

Exhibit 31.1

Certification—Principal Executive Officer

I, Robert R. Chapman III, President of Bank of the James Financial Group, Inc. certify that:

(1) I have reviewed this Form 10-K of Bank of the James Financial Group, Inc.;

(2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

(3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

(4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

(5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2018

By /S/ Robert R. Chapman III
Robert R. Chapman III
President (Principal Executive Officer) and Director

Certification—Principal Financial Officer and Principal Accounting Officer

I, J. Todd Scruggs, Secretary and Treasurer of Bank of the James Financial Group, Inc., certify that:

(1) I have reviewed this Form 10-K of Bank of the James Financial Group, Inc.;

(2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

(3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

(4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

(5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2018

By /S/ J. Todd Scruggs
J. Todd Scruggs
Secretary and Treasurer (Principal Financial Officer and Principal Accounting Officer) and Director

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Robert R. Chapman III, Chief Executive Officer of Bank of the James Financial Group, Inc., a Virginia corporation(the "Company") and J. Todd Scruggs, Secretary and Treasurer (Principal Financial Officer and Principal Accounting Officer), each certify in his capacity as an officer of the Company that he has reviewed the annual report on Form 10-K for the year ended December 31, 2017 (the "Report") and to the best of his knowledge:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of the Company as of the dates and for the periods covered by the Report.

BANK OF THE JAMES FINANCIAL GROUP, INC.

Date: March 21, 2018

By /S/ Robert R. Chapman III
Robert R. Chapman III
President and Director (Principal Executive Officer)

Date: March 21, 2018

By /S/ J. Todd Scruggs
J. Todd Scruggs
Secretary and Treasurer (Principal Financial Officer and Principal Accounting Officer)