

Virginia National Bankshares Corp  
Form 10-Q  
August 15, 2016

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

**FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2016

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-55117

**VIRGINIA NATIONAL BANKSHARES CORPORATION**

(Exact name of registrant as specified in its charter)

**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**46-2331578**  
(I.R.S. Employer  
Identification No.)

**404 People Place, Charlottesville, Virginia**  
(Address of principal executive offices)

**22911**  
(Zip Code)

**(434) 817-8621**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer

Accelerated filer

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Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of August 10, 2016:

Class of Stock	Shares Outstanding
Common Stock, Par Value \$2.50	2,368,777

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**VIRGINIA NATIONAL BANKSHARES CORPORATION**

**FORM 10-Q**

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

VIRGINIA NATIONAL BANKSHARES CORPORATION  
CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except share data)

	June 30, 2016 (UNAUDITED)	December 31, 2015 *
<b>ASSETS</b>		
Cash and due from banks	\$ 11,732	\$ 14,200
Federal funds sold	13,382	29,327
Securities:		
Available for sale, at fair value	69,545	74,801
Restricted securities, at cost	1,708	1,681
Total securities	71,253	76,482
Loans	424,593	423,664
Allowance for loan losses	(3,186)	(3,567)
Loans, net	421,407	420,097
Premises and equipment, net	8,294	8,668
Bank owned life insurance	13,696	13,476
Goodwill	372	-
Other intangible assets, net	731	-
Accrued interest receivable and other assets	4,811	5,241
<b>Total assets</b>	<b>\$ 545,678</b>	<b>\$ 567,491</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Demand deposits:		
Noninterest-bearing	\$ 168,402	\$ 184,574
Interest-bearing	87,147	90,100
Money market deposit accounts	102,474	103,175
Certificates of deposit and other time deposits	112,397	108,618
Total deposits	470,420	486,467
Securities sold under agreements to repurchase	15,719	23,156
Accrued interest payable and other liabilities	1,478	1,571
Total liabilities	487,617	511,194
<b>Shareholders' equity:</b>		
Preferred stock, \$2.50 par value, 2,000,000 shares authorized, no shares outstanding	-	-
Common stock, \$2.50 par value, 10,000,000 shares authorized; 2,360,007 and 2,412,589 issued and outstanding at June 30, 2016 and December 31, 2015, respectively	5,900	6,031
Capital surplus	21,140	22,214
Retained earnings	30,493	28,170
Accumulated other comprehensive income (loss)	528	(118)
<b>Total shareholders' equity</b>	<b>58,061</b>	<b>56,297</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 545,678</b>	<b>\$ 567,491</b>

\*Derived from audited Consolidated Financial Statements

See Notes to Consolidated Financial Statements



**VIRGINIA NATIONAL BANKSHARES CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(dollars in thousands, except per share data)  
**(UNAUDITED)**

	For the three months ended		For the six months ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
<b>Interest and dividend income:</b>				
Loans, including fees	\$ 4,294	\$ 3,529	\$ 8,627	\$ 6,791
Federal funds sold	25	6	56	29
<b>Investment securities:</b>				
Taxable	245	550	525	1,132
Tax exempt	80	109	164	225
Dividends	23	20	44	41
Other	-	6	4	13
<b>Total interest and dividend income</b>	<b>4,667</b>	<b>4,220</b>	<b>9,420</b>	<b>8,231</b>
<b>Interest expense:</b>				
Demand and savings deposits	68	58	135	115
Certificates and other time deposits	157	171	317	338
Federal funds purchased and securities sold under agreements to repurchase	12	13	24	25
<b>Total interest expense</b>	<b>237</b>	<b>242</b>	<b>476</b>	<b>478</b>
Net interest income	4,430	3,978	8,944	7,753
Provision for (recovery of) loan losses	(275)	-	(395)	317
<b>Net interest income after provision for (recovery of) loan losses</b>	<b>4,705</b>	<b>3,978</b>	<b>9,339</b>	<b>7,436</b>
<b>Noninterest income:</b>				
Trust income	398	445	786	894
Brokerage and insurance income	94	8	181	24
Royalty income	9	36	9	81
Customer service fees	227	233	446	467
Debit/credit card and ATM fees	232	219	430	399
Earnings/increase in value of bank owned life insurance	111	110	220	218
Fees on mortgage sales	67	57	115	94
Gains on sales of securities	-	24	8	46
Losses on sales of other assets	(2)	-	(27)	-
Other	114	123	206	216
<b>Total noninterest income</b>	<b>1,250</b>	<b>1,255</b>	<b>2,374</b>	<b>2,439</b>
<b>Noninterest expense:</b>				
Salaries and employee benefits	1,847	2,215	3,765	4,531
Net occupancy	472	483	948	979
Equipment	132	136	267	266
Other	1,308	1,341	2,576	2,517
<b>Total noninterest expense</b>	<b>3,759</b>	<b>4,175</b>	<b>7,556</b>	<b>8,293</b>
Income before income taxes	2,196	1,058	4,157	1,582
Provision for income taxes	686	291	1,292	400
Net income	\$ 1,510	\$ 767	\$ 2,865	\$ 1,182
Net income per common share, basic	\$ 0.64	\$ 0.30	\$ 1.21	\$ 0.45
Net income per common share, diluted	\$ 0.63	\$ 0.30	\$ 1.20	\$ 0.45

See Notes to Consolidated Financial Statements



**VIRGINIA NATIONAL BANKSHARES CORPORATION**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(dollars in thousands)  
(Unaudited)

	For the three months ended		For the six months ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Net income	\$ 1,510	\$ 767	\$ 2,865	\$ 1,182
Other comprehensive income (loss)				
Unrealized gain (loss) on securities, net of tax of \$130 and \$335 for the three and six months ended June 30, 2016; and net of tax of (\$576) and (\$196) for the three and six months ended June 30, 2015	252	(1,117)	651	(379)
Reclassification adjustment net of tax of (\$0) and (\$3) for the three and six months ended June 30, 2016; and net of tax of (\$8) and (\$15) for the three and six months ended June 30, 2015	-	(16 )	(5 )	(31 )
Total other comprehensive income (loss)	252	(1,133)	646	(410)
Total comprehensive income (loss)	\$ 1,762	\$ (366)	\$ 3,511	\$ 772

See Notes to Consolidated Financial Statements



**VIRGINIA NATIONAL BANKSHARES CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2016 AND 2015**  
(dollars in thousands, except per share data)  
(unaudited)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
<b>Balance, December 31, 2014</b>	\$ 6,721	\$ 27,889	\$ 25,978	\$ 44	\$ 60,632
Stock options exercised	3	20	-	-	23
Stock purchased under stock repurchase plan	(634)	(5,174)	-	-	(5,808)
Stock option expense	-	15	-	-	15
Cash dividend declared (\$0.175 per share)	-	-	(444)	-	(444)
Net income	-	-	1,182	-	1,182
Other comprehensive loss	-	-	-	(410)	(410)
<b>Balance, June 30, 2015</b>	\$ 6,090	\$ 22,750	\$ 26,716	\$ (366)	\$ 55,190
<b>Balance, December 31, 2015</b>	\$ 6,031	\$ 22,214	\$ 28,170	\$ (118)	\$ 56,297
Stock options exercised	6	35	-	-	41
Stock purchased under stock repurchase plan	(137)	(1,123)	-	-	(1,260)
Stock option expense	-	14	-	-	14
Cash dividend declared (\$0.23 per share)	-	-	(542)	-	(542)
Net income	-	-	2,865	-	2,865
Other comprehensive income	-	-	-	646	646
<b>Balance, June 30, 2016</b>	\$ 5,900	\$ 21,140	\$ 30,493	\$ 528	\$ 58,061

See Notes to Consolidated Financial Statements

**VIRGINIA NATIONAL BANKSHARES CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(dollars in thousands)

	For the six months ended	
	June 30, 2016	June 30, 2015
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 2,865	\$ 1,182
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for (recovery of) loan losses	(395)	317
Net amortization and accretion of securities	224	392
Realized gains on sales and calls of securities	(8)	(46)
Net losses on sales of assets	27	-
Earnings on bank owned life insurance	(220)	(218)
Amortization of intangible assets	42	-
Depreciation and other amortization	582	590
Stock option/stock grant expense	14	15
Decrease in accrued interest receivable and other assets	98	604
Decrease in accrued interest payable and other liabilities	(604)	(370)
Net cash provided by operating activities	2,625	2,466
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of available for sale securities	(9,481)	(26,770)
Net increase in restricted investments	(27)	(21)
Proceeds from maturities, calls and principal payments of available for sale securities	13,470	31,074
Proceeds from sales of available for sale securities	2,030	16,387
Proceeds from sales of other real estate owned	-	445
Net increase in organic loans	(6,029)	(31,392)
Net decrease (increase) in purchased loans	5,114	(22,466)
Cash payment for wealth management book of business	(700)	-
Purchase of bank premises and equipment	(235)	(263)
Net cash provided by (used in) investing activities	4,142	(33,006)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net decrease in demand deposits, NOW accounts, and money market accounts	(19,826)	(640)
Net increase in certificates of deposit and other time deposits	3,779	1,718
Net decrease in securities sold under agreements to repurchase	(7,437)	(1,887)
Common stock repurchased	(1,260)	(5,808)
Proceeds from stock options exercised	41	23
Cash dividends	(477)	(444)
Net cash used in financing activities	(25,180)	(7,038)
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>\$ (18,413)</b>	<b>\$ (37,578)</b>
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	\$ 43,527	\$ 54,107
End of period	\$ 25,114	\$ 16,529
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Cash payments for:		
Interest	\$ 477	\$ 479
Taxes	\$ 1,354	\$ 439
<b>SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES</b>		
Unrealized gain (loss) on available for sale securities	\$ 978	\$ (575)

See Notes to Consolidated Financial Statements



**VIRGINIA NATIONAL BANKSHARES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**June 30, 2016**

**Note 1. Significant Accounting Policies**

**Basis of Presentation**

The consolidated financial statements include the accounts of Virginia National Bankshares Corporation (the Company), its subsidiary Virginia National Bank (the Bank), and the Bank's subsidiary, VNBTrust, National Association which offers services under the name VNB Wealth Management (VNBTrust or VNB Wealth). All significant intercompany balances and transactions have been eliminated in consolidation.

The unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, the unaudited consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary for a fair presentation have been included.

The preparation of financial statements in conformity with GAAP and the reporting guidelines prescribed by regulatory authorities requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred tax assets and other real estate owned. Operating results for the three-month and six-month periods ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

The statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Form 10-K for the year ended December 31, 2015. If needed, certain previously reported amounts have been reclassified to conform to current period presentation. No such reclassifications were significant.

**Recent Accounting Pronouncements**

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to 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) require 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) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; 3) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables); and 4) eliminate 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

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effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have 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.

During March 2016, the FASB issued ASU No. 2016-05, Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. The amendments in this ASU clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria remain intact. The amendments are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-05 to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting. The amendments in this ASU eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. In addition, the amendments in this ASU require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early Adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

During March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Shares-Based Payment Accounting. The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently assessing the impact that ASU 2016-09 will have on its consolidated financial statements.

During 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. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

**Note 2. Securities**

The amortized cost and fair values of securities available for sale as of June 30, 2016 and December 31, 2015 were as follows (dollars in thousands):

June 30, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. Government agencies	\$ 11,250	\$ 147	\$ (6)	\$ 11,391
Corporate bonds	6,020	89	-	6,109
Mortgage-backed securities/CMOs	33,369	212	(78)	33,503
Municipal bonds	18,106	438	(2)	18,542
	\$ 68,745	\$ 886	\$ (86)	\$ 69,545

December 31, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. Government agencies	\$ 11,260	\$ 137	\$ (19)	\$ 11,378
Corporate bonds	6,027	-	(63)	5,964
Mortgage-backed securities/CMOs	37,077	60	(450)	36,687
Municipal bonds	20,615	250	(93)	20,772
	\$ 74,979	\$ 447	\$ (625)	\$ 74,801

As of June 30, 2016, there were \$13.3 million, or 14 issues of individual securities, in a loss position. These securities have an unrealized loss of \$86 thousand and consisted of 2 agency bonds, 11 mortgage-backed/CMOs, and 1 municipal bond. The following table summarizes all securities with unrealized losses, segregated by length of time in a continuous unrealized loss position, at June 30, 2016 and December 31, 2015 (dollars in thousands):

June 30, 2016	Less than 12 Months		12 Months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government agencies	\$ 1,993	\$ (4)	\$ 998	\$ (2)	\$ 2,991	\$ (6)
Mortgage-backed/CMOs	-	-	9,486	(78)	9,486	(78)
Municipal bonds	791	(2)	-	-	791	(2)
	\$ 2,784	\$ (6)	\$ 10,484	\$ (80)	\$ 13,268	\$ (86)

December 31, 2015	Less than 12 Months		12 Months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government agencies	\$ -	\$ -	\$ 980	\$ (19)	\$ 980	\$ (19)
Corporate bonds	5,964	(63)	-	-	5,964	(63)
Mortgage-backed/CMOs	21,003	(212)	9,504	(238)	30,507	(450)
Municipal bonds	2,788	(31)	1,908	(62)	4,696	(93)
	\$ 29,755	\$ (306)	\$ 12,392	\$ (319)	\$ 42,147	\$ (625)

The Company's securities portfolio is primarily made up of fixed rate bonds, whose prices move inversely with interest rates. Any unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. At the end of any accounting period, the portfolio may have both unrealized gains and losses. Management does not believe any of the securities in an unrealized loss position are impaired due to credit quality. Accordingly, as of June 30, 2016, management believes the impairments detailed in the table above are temporary, and no impairment loss has been realized in the Company's consolidated income statement.

An other-than-temporary impairment ( OTTI ) is considered to exist if any of the following conditions are met: it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, or the Company does not expect to recover the security's entire amortized cost basis (even if the Company does not intend to sell). In the event that a security would suffer impairment for a reason that was other than temporary, the Company would be expected to write down the security's value to its new fair value, and the amount of the write down would be included in earnings as a realized loss. As of June 30, 2016, management has concluded that none of its investment securities have an OTTI based upon the information available at this time. Additionally, management has the ability to hold any security with an unrealized loss until maturity or until such time as the value of the security has recovered from its unrealized loss position.

Securities having carrying values of \$37.7 million at June 30, 2016 were pledged as collateral to secure public deposits and securities sold under agreements to repurchase. At December 31, 2015, securities having carrying values of \$42.2 million were similarly pledged.

For the six months ended June 30, 2016, proceeds from the sales of securities amounted to \$2.0 million, and realized gains on these securities were \$8 thousand. For the six months ended June 30, 2015, proceeds from the sales of securities amounted to \$16.4 million, with realized gains on these securities of \$42 thousand, and an additional \$4.4 million in calls of securities accounted for the additional \$4 thousand in realized gains.

Restricted securities are securities with limited marketability and consist of stock in the Federal Reserve Bank of Richmond ( FRB ), the Federal Home Loan Bank of Atlanta ( FHLB ), and CBB Financial Corporation ( CBBFC ), the holding company for Community Bankers Bank. These restricted securities, totaling \$1.7 million as of June 30, 2016 and December 31, 2015, are carried at cost.



**Note 3. Loans**

The composition of the loan portfolio by loan classification at June 30, 2016 and December 31, 2015 appears below (dollars in thousands).

	June 30, 2016	December 31, 2015
<b>Commercial</b>		
Commercial and industrial - organic	\$ 43,644	\$ 47,215
Commercial and industrial - syndicated	19,994	23,653
Total commercial and industrial	63,638	70,868
<b>Real estate construction and land</b>		
Residential construction	2,935	2,178
Commercial construction	6,078	6,214
Land and land development	9,531	10,519
Total construction and land	18,544	18,911
<b>Real estate mortgages</b>		
1-4 family residential, first lien, investment	35,678	31,128
1-4 family residential, first lien, owner occupied	18,396	20,883
1-4 family residential, junior lien	3,329	3,770
Home equity lines of credit, first lien	9,545	11,930
Home equity lines of credit, junior lien	15,703	15,670
Farm	7,953	7,762
Multifamily	17,895	20,209
Commercial owner occupied	75,786	66,244
Commercial non-owner occupied	94,870	91,805
Total real estate mortgage	279,155	269,401
<b>Consumer</b>		
Consumer revolving credit	17,020	17,174
Consumer all other credit	12,036	11,655
Student loans purchased	34,200	35,655
Total consumer	63,256	64,484
Total loans	424,593	423,664
Less: Allowance for loan losses	(3,186)	(3,567)
Net loans	\$ 421,407	\$ 420,097

Accounting guidance requires certain disclosures about investments in impaired loans, the allowance for loan losses and interest income recognized on impaired loans. A loan is considered impaired when it is probable that the Company will be unable to collect all principal and interest amounts when due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, expected future cash flows, financial condition of the borrower, and current economic conditions.

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Following is a breakdown by class of the loans classified as impaired loans as of June 30, 2016 and December 31, 2015. These loans are reported at their recorded investment, which is the carrying amount of the loan as reflected on the Company's balance sheet, net of charge-offs and other amounts applied to reduce the net book balance. Average recorded investment in impaired loans is computed using an average of month-end balances for these loans for either the six months ended June 30, 2016 or the twelve months ended December 31, 2015. Interest income recognized is for the six months ended June 30, 2016 or the twelve months ended December 31, 2015. (Dollars below reported in thousands.)

**June 30, 2016**

	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Land and land development	\$ 55	\$ 102	\$ -	\$ 57	\$ -
1-4 family residential mortgages, first lien, owner occupied	124	152	-	127	-
1-4 family residential mortgages, junior lien	360	360	-	363	8
Commercial non-owner occupied real estate	1,039	1,039	-	1,048	23
Student loans purchased	713	713	-	119	22
Impaired loans with a valuation allowance	-	-	-	-	-
Total impaired loans	\$ 2,291	\$ 2,366	\$ -	\$ 1,714	\$ 53

**December 31, 2015**

	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial and industrial - organic	\$ -	\$ -	\$ -	\$ 4	\$ -
Land and land development	59	103	-	64	-
1-4 family residential mortgage, first lien, owner occupied	132	157	-	200	2
1-4 family residential mortgage, junior lien	367	367	-	485	21
Commercial non-owner occupied real estate	1,061	1,061	-	1,080	47
Impaired loans with a valuation allowance	-	-	-	-	-
Total impaired loans	\$ 1,619	\$ 1,688	\$ -	\$ 1,833	\$ 70

Included in the impaired loans above are non-accrual loans. Generally, loans are placed on non-accrual when a loan is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more. Any unpaid interest previously accrued on those loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other non-accrual loans is recognized only to the extent of interest payments received. Non-accrual loans are shown below by class (dollars in thousands):

	June 30, 2016	December 31, 2015
Land and land development	\$ 55	\$ 59
1-4 family residential mortgage, first lien, owner occupied	124	132
Total nonaccrual loans	\$ 179	\$ 191

Additionally, Troubled Debt Restructurings ( TDRs ) are considered impaired loans. TDRs occur when the Company agrees to modify the original terms of a loan by granting a concession that it would not otherwise consider due to the deterioration in the financial condition of the borrower. These concessions are done in an attempt to improve the paying capacity of the borrower, and in some cases to avoid foreclosure, and are made with the intent to restore the loan to a performing status once sufficient payment history can be demonstrated. These concessions could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions.

Based on newly issued regulatory guidance on Student Lending, the Company classified 38 of its student loans purchased as TDRs for a total of \$713 thousand during the quarter ended June 30, 2016. These borrowers that should have been in repayment have requested and been granted payment extensions or reductions exceeding the maximum lifetime allowable payment forbearance of twelve months (36 months lifetime allowance for military service), as permitted under the regulatory guidance, and are therefore considered restructurings. Student loan borrowers are allowed in-school deferments, plus an automatic six month grace period post in-school status, before repayment is scheduled to begin, and these deferments do not count toward the maximum allowable forbearance. As all student loans purchased are fully insured, the Company does not expect to experience a

loss on these loans and interest continues to accrue on these TDRs during any deferment and forbearance periods.

A summary of loans that were modified under the terms of a TDR during the three and six months ended June 30, 2016 and 2015 is shown below by class (dollars in thousands). The Post-Modification Recorded Balance reflects the period end balances, inclusive of all partial principal pay downs and principal charge-offs since the modification date. Loans modified as TDRs that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

	For three months ended June 30, 2016			For three months ended June 30, 2015		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance
<b>Loans modified at below market rates</b>						
Student loans purchased	38	\$ 713	\$ 713	0	\$ -	\$ -
Total loans modified during the period	38	\$ 713	\$ 713	0	\$ -	\$ -

	For six months ended June 30, 2016			For six months ended June 30, 2015		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance
<b>Loans modified at below market rates</b>						
Student loans purchased	38	\$ 713	\$ 713	0	\$ -	\$ -
Total loans modified during the period	38	\$ 713	\$ 713	0	\$ -	\$ -

The following provides a summary, by class, of TDRs that continue to accrue interest under the terms of the restructuring agreement, which are considered to be performing, and TDRs that have been placed in non-accrual status, which are considered to be nonperforming (dollars in thousands).

**Troubled debt restructuring (TDRs)**

	June 30, 2016		December 31, 2015	
	No. of Loans	Recorded Investment	No. of Loans	Recorded Investment
<b>Performing TDRs</b>				
1-4 family residential mortgages, junior lien	2	\$ 360	2	\$ 367
Commercial non-owner occupied real estate	1	1,039	1	1,061
Student loans purchased	38	713	-	-
Total performing TDRs	41	\$ 2,112	3	\$ 1,428
<b>Nonperforming TDRs</b>				
Land and land development	1	\$ 32	1	\$ 34
Total TDRs	42	\$ 2,144	4	\$ 1,462

There were no loans modified as TDRs that subsequently defaulted during the six months ended June 30, 2016 and 2015 that were modified as TDRs during the twelve months prior to default.

There were no loans secured by 1-4 family residential property that were in the process of foreclosure at either June 30, 2016 or December 31, 2015.

#### **Note 4. Allowance for Loan Losses**

The allowance for loan losses is maintained at a level which, in management's judgment, is adequate to absorb probable credit losses inherent in the loan portfolio. The amount of the allowance is based on management's quarterly evaluation of the collectability of the loan portfolio, credit concentrations, historical loss experience, specific impaired loans, and economic conditions. To determine the total allowance for loan losses, the Company estimates the reserves needed for each segment of the portfolio, including loans analyzed individually and loans analyzed on a pooled basis. Allowances for impaired loans are generally determined based on collateral values or the present value of estimated cash flows.

For purposes of determining the allowance for loan losses, the Company has segmented certain loans in the portfolio by product type. Within these segments, the Company has sub-segmented its portfolio by classes within the segments, based on the associated risks within these classes. As explained below, beginning with the quarter ended June 30, 2016, the classes have been expanded for more granularity in determining risks and losses inherent in the loan portfolio.

##### **Loan Classes by Segments**

###### Commercial loan segment:

- Commercial and industrial - organic
- Commercial and industrial - syndicated

###### Real estate construction and land loan segment:

- Residential construction
- Commercial construction
- Land and land development

###### Real estate mortgage loan segment:

- 1-4 family residential, first lien, investment
- 1-4 family residential, first lien, owner occupied
- 1-4 family residential, junior lien
- Home equity lines of credit, first lien
- Home equity lines of credit, junior lien
- Farm
- Multifamily
- Commercial owner occupied
- Commercial non-owner occupied

###### Consumer loan segment:

- Consumer revolving credit
- Consumer all other credit
- Student loans purchased

Beginning with the quarter ended June 30, 2016, management enhanced its methodology for determining the quantitative risk assigned to unimpaired loans in order to capture historical loss information at the loan level, track loss migration through risk grade deterioration, and increase efficiencies related to performing the calculations. Prior to June 30, 2016, under the Bank's allowance model, each loan class was assigned a quantitative loss factor that was primarily based on a rolling twelve-quarter look-back at historical losses for that class. As of June 30, 2016, the quantitative risk factor for each loan class primarily utilizes a migration analysis loss method based on loss history for the prior twelve quarters.

The migration analysis loss method is used for all loan classes except for the following:

Student loans purchased are fully insured for loss by a surety bond that the Company purchased at the same time that each package of loans was acquired in 2015, and the Company has not experienced any losses in this class to date. In addition to the insurance, the Company holds a deposit reserve account to offset any losses resulting from the breach of any representations or warranties by the seller. Qualitative factors are applied and the calculated reserve is net of any deposit reserve accounts.

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Commercial and industrial syndicated loans do not have an established loss history as the Company only began purchasing these loans late in 2014. Therefore, the S&P Credit Rating and Recovery Rating on the credit facilities are utilized to calculate a three-year weighted average historical default rate until the Company has enough history with these syndicated loans. Under the historical loss method, quarterly loss rates are calculated for each class by dividing the cumulative gross charge-offs for the past twelve quarters by the average balance for the past twelve quarters. Under the migration analysis method, average loss rates are calculated at the risk grade and class levels by dividing the twelve-quarter average net charge-off amount by the twelve-quarter average balance. Qualitative factors are combined with these quantitative factors to arrive at the overall general allowances.

In addition to the movement to the migration analysis method, the following other changes were implemented for the quarter ended June 30, 2016:

The number of classes increased from twelve to seventeen to provide greater loan level detail.

Previously the risk rating Watch was included in the Pass pool. The Watch risk rating was separated to account for the higher level of risk associated with this risk rating.

A minimum qualitative loss factor has been applied to the Good risk ratings in an abundance of caution. Previously a loan loss reserve had not been applied to loans risk rated Good; however, management deemed a nominal reserve as prudent. The following table represents the effect of the changes in methodology from that used in prior periods on the provision for (recovery of) loan losses through the six months ended June 30, 2016 (dollars in thousands):

	<b>Provision (Recovery) Based on New Methodology</b>	<b>Provision (Recovery) Based on Prior Methodology</b>	<b>Difference</b>
Commercial loans	\$ (295)	\$ (106)	\$ (189)
Real estate construction and land	(4)	-	(4)
Real estate mortgages	(275)	(41)	(234)
Consumer loans	179	42	137
<b>Total provision for (recovery of) loan losses</b>	<b>\$ (395)</b>	<b>\$ (105)</b>	<b>\$ (290)</b>

The Company's internal creditworthiness grading system is based on experiences with similarly graded loans. Higher risk-rated credits are reviewed quarterly by experienced senior lenders based on each borrower's situation. Additionally, internal monitoring and review of credits is conducted on an annual basis and a percentage of the loan portfolio is reviewed by an external loan review group.

Loans that trend upward on the risk ratings scale, toward more positive risk ratings, generally exhibit lower risk factor characteristics. Conversely, loans that migrate toward more negative ratings generally will result in a higher risk factor being applied to those related loan balances.

### **Risk Ratings and Historical Loss Factor Assigned**

#### **Excellent**

0% historical loss factor applied, as these loans are secured by cash and represent a minimal risk. The Company has never experienced a loss within this category.

#### **Good**

0% historical loss factor applied, as these loans represent a low risk and are secured by marketable collateral within margin. The Company has never experienced a loss within this category.

#### **Pass**

Historical loss factor for loans rated **Pass** is applied to current balances of like-rated loans, pooled by class. Loans with the following risk ratings are pooled by class and considered together as **Pass** :

**Satisfactory** - modest risk loans where the borrower has strong and liquid financial statements and more than adequate cash flow

**Average** average risk loans where the borrower has reasonable debt service capacity

**Marginal** acceptable risk loans where the borrower has acceptable financial statements but is leveraged

#### **Watch**

These loans have an acceptable risk but require more attention than normal servicing. Historical loss factor for loans rated **Watch** is applied to current balances of like-rated loans pooled by class.

#### **Special Mention**

These potential problem loans are currently protected but are potentially weak. Historical loss factor for loans rated **Special Mention** is applied to current balances of like-rated loans pooled by class.

#### **Substandard**

These problem loans are inadequately protected by the sound worth and paying capacity of the borrower and/or the value of any collateral pledged. These loans may be considered impaired and evaluated on an individual basis. Otherwise, a historical loss factor for loans rated **Substandard** is applied to current balances of all other **Substandard** loans pooled by class.

#### **Doubtful**

Loans with this rating have significant deterioration in the sound worth and paying capacity of the borrower and/or the value of any collateral pledged, making collection or liquidation of the loan in full highly questionable. These loans would be considered impaired and evaluated on an individual basis.



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The following represents the loan portfolio designated by the internal risk ratings assigned to each credit as of June 30, 2016 and December 31, 2015 (dollars in thousands). There were no loans rated Doubtful as of either period.

June 30, 2016	Excellent	Good	Pass	Watch	Special Mention	Sub-standard	TOTAL
<b>Commercial</b>							
Commercial and industrial - organic	\$ 1,103	\$ 25,246	\$ 16,863	\$ 28	\$ 234	\$ 170	\$ 43,644
Commercial and industrial - syndicated	-	-	17,046	-	-	2,948	19,994
<b>Real estate construction</b>							
Residential construction	-	-	2,935	-	-	-	2,935
Commercial construction	-	-	6,078	-	-	-	6,078
Land and land development	-	-	8,422	6	495	608	9,531
<b>Real estate mortgages</b>							
1-4 family residential, first lien, investment	-	-	33,343	1,860	231	244	35,678
1-4 family residential, first lien, owner occupied	-	-	16,951	330	-	1,115	18,396
1-4 family residential, junior lien	-	-	2,652	337	195	145	3,329
Home equity lines of credit, first lien	-	-	9,506	39	-	-	9,545
Home equity lines of credit, junior lien	-	-	15,592	-	-	111	15,703
Farm	-	-	7,953	-	-	-	7,953
Multifamily	-	-	17,895	-	-	-	17,895
Commercial owner occupied	-	-	74,742	1,044	-	-	75,786
Commercial non-owner occupied	-	-	92,734	1,039	-	1,097	94,870
<b>Consumer</b>							
Consumer revolving credit	71	16,335	609	-	-	5	17,020
Consumer all other credit	205	10,411	1,381	1	-	38	12,036
Student loans purchased	-	-	33,487	713	-	-	34,200
<b>Total Loans</b>	<b>\$ 1,379</b>	<b>\$ 51,992</b>	<b>\$ 358,189</b>	<b>\$ 5,397</b>	<b>\$ 1,155</b>	<b>\$ 6,481</b>	<b>\$ 424,593</b>
<b>December 31, 2015</b>	<b>Excellent</b>	<b>Good</b>	<b>Pass</b>	<b>Watch</b>	<b>Special Mention</b>	<b>Sub-standard</b>	<b>TOTAL</b>
<b>Commercial</b>							
Commercial and industrial - organic	\$ 1,238	\$ 30,221	\$ 15,599	\$ 101	\$ 25	\$ 31	\$ 47,216
Commercial and industrial - syndicated	-	-	20,691	-	-	2,962	23,653
<b>Real estate construction</b>							
Residential construction	-	-	2,178	-	-	-	2,178
Commercial construction	-	-	6,214	-	-	-	6,214
Land and land development	-	-	9,369	8	515	627	10,519
<b>Real estate mortgages</b>							
1-4 family residential, first lien, investment	-	-	28,832	1,885	232	179	31,128
1-4 family residential, first lien, owner occupied	-	1,500	18,796	335	-	252	20,883
1-4 family residential, junior lien	-	-	3,060	130	418	162	3,770
Home equity lines of credit, first lien	-	-	11,890	40	-	-	12,130
Home equity lines of credit, junior lien	-	-	15,588	-	-	82	15,670
Farm	-	-	7,762	-	-	-	7,762
Multifamily	-	-	20,209	-	-	-	20,209
Commercial owner occupied	-	-	61,803	3,694	-	747	66,244
Commercial non-owner occupied	-	-	89,619	-	1,061	1,125	91,805
<b>Consumer</b>							
Consumer revolving credit	104	16,524	540	-	-	6	17,174
Consumer all other credit	232	10,063	1,317	2	-	41	11,655
Student loans purchased	-	-	35,655	-	-	-	35,655
<b>Total Loans</b>	<b>\$ 1,574</b>	<b>\$ 58,308</b>	<b>\$ 349,122</b>	<b>\$ 6,195</b>	<b>\$ 2,251</b>	<b>\$ 6,214</b>	<b>\$ 423,564</b>

In addition, the adequacy of the Company's allowance for loan losses is evaluated through reference to eight qualitative factors, listed below and ranked in order of importance:

- 1) Changes in national and local economic conditions, including the condition of various market segments
- 2) Changes in the value of underlying collateral
- 3) Changes in volume of classified assets, measured as a percentage of capital
- 4) Changes in volume of delinquent loans
- 5) The existence and effect of any concentrations of credit and changes in the level of such concentrations
- 6) Changes in lending policies and procedures, including underwriting standards
- 7) Changes in the experience, ability and depth of lending management and staff
- 8) Changes in the level of policy exceptions

It has been the Company's experience that the first five factors drive losses to a much greater extent than the last three factors; therefore, the first five factors are weighted more heavily. Qualitative factors are not assessed against loans rated "Excellent" since these are fully collateralized by cash. Beginning in the second quarter of 2016, a nominal qualitative factor has been assigned to loans rated "Good," as discussed above.

For each segment and class of loans, management must exercise significant judgment to determine the estimation method that fits the credit risk characteristics of its various segments. Although this evaluation is inherently subjective, qualified management utilizes its significant knowledge and experience related to both the market and history of the Company's loan losses.

Impaired loans are individually evaluated and, if deemed appropriate, a specific allocation is made for these loans. In reviewing the loans classified as impaired loans totaling \$2.3 million at June 30, 2016, there was no specific valuation allowance on any of these loans after consideration was given for each borrowing as to the fair value of the collateral on the loan or the present value of expected future cash flows from the borrower.

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A summary of the transactions in the Allowance for Loan Losses by loan portfolio segment for the six months ended June 30, 2016 and the year ended December 31, 2015 appears below (dollars in thousands):

**As of and for the period ended June 30, 2016**

	Commercial Loans	Real Estate Construction and Land	Real Estate Mortgages	Consumer Loans	Total
<b>Allowance for Loan Losses:</b>					
Balance as of January 1, 2016	\$ 797	\$ 159	\$ 2,592	\$ 19	\$ 3,567
Charge-offs	-	-	(12)	-	(12)
Recoveries	20	-	2	4	26
Provision for (recovery of) loan losses	(295)	(4)	(275)	179	(395)
Ending Balance	\$ 522	\$ 155	\$ 2,307	\$ 202	\$ 3,186
<b>Ending Balance:</b>					
Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -
Collectively evaluated for impairment	522	155	2,307	202	3,186
<b>Loans:</b>					
Individually evaluated for impairment	\$ -	\$ 55	\$ 1,523	\$ 713	\$ 2,291
Collectively evaluated for impairment	63,638	18,489	277,632	62,543	422,302
Ending Balance	\$ 63,638	\$ 18,544	\$ 279,155	\$ 63,256	\$ 424,593

**As of and for the year ended December 31, 2015**

	Commercial Loans	Real Estate Construction and Land	Real Estate Mortgages	Consumer Loans	Total
<b>Allowance for Loan Losses:</b>					
Balance as of January 1, 2015	\$ 674	\$ 102	\$ 2,360	\$ 28	\$ 3,164
Charge-offs	(126)	-	(12)	(3)	(141)
Recoveries	35	-	46	-	81
Provision for (recovery of) loan losses	214	57	198	(6)	463
Ending Balance	\$ 797	\$ 159	\$ 2,592	\$ 19	\$ 3,567
<b>Ending Balance:</b>					
Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -
Collectively evaluated for impairment	797	159	2,592	19	3,567
<b>Loans:</b>					
Individually evaluated for impairment	\$ -	\$ 59	\$ 1,560	\$ -	\$ 1,619
Collectively evaluated for impairment	70,868	18,852	267,841	64,484	422,045
Ending Balance	\$ 70,868	\$ 18,911	\$ 269,401	\$ 64,484	\$ 423,664

As previously mentioned, one of the major factors that the Company uses in evaluating the adequacy of its allowance for loan losses is changes in the volume of delinquent loans. Management monitors payment activity on a regular basis. For all classes of loans, the Company considers the entire balance of the loan to be contractually delinquent if the minimum payment is not received by the due date. Interest and fees continue to accrue on past due loans until they are changed to non-accrual status.

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The following tables show the aging of past due loans as of June 30, 2016 and December 31, 2015. Also included are loans that are 90 or more days past due but still accruing, because they are well secured and in the process of collection. (Dollars below reported in thousands.)

Past Due Aging as of June 30, 2016	30-59	60-89	90 Days or	Total Past Due	Current	Total Loans	90 Days Past Due and Still Accruing
	Days Past Due	Days Past Due	More Past Due				
<b>Commercial loans</b>							
Commercial and industrial - organic	\$ -	\$ 6	\$ -	\$ 6	\$ 43,638	\$ 43,644	\$ -
Commercial and industrial - syndicated	-	-	-	-	19,994	19,994	-
<b>Real estate construction and land</b>							
Residential construction	-	-	-	-	2,935	2,935	-
Commercial construction	-	-	-	-	6,078	6,078	-
Other construction and land	24	-	-	24	9,507	9,531	-
<b>Real estate mortgages</b>							
1-4 family residential, first lien, investment	-	-	-	-	35,678	35,678	-
1-4 family residential, first lien, owner occupied	-	21	-	21	18,375	18,396	-
1-4 family residential, junior lien	-	-	-	-	3,329	3,329	-
Home equity lines of credit, first lien	-	-	-	-	9,545	9,545	-
Home equity lines of credit, junior lien	-	-	-	-	15,703	15,703	-
Farm	-	-	-	-	7,953	7,953	-
Multifamily	-	-	-	-	17,895	17,895	-
Commercial owner occupied	-	-	-	-	75,786	75,786	-
Commercial non-owner occupied	-	-	-	-	94,870	94,870	-
<b>Consumer loans</b>							
Consumer revolving credit	-	-	-	-	17,020	17,020	-
Consumer all other credit	-	1	-	1	12,035	12,036	-
Student loans purchased	260	88	206	554	33,646	34,200	206
<b>Total Loans</b>	<b>\$ 284</b>	<b>\$ 116</b>	<b>\$ 206</b>	<b>\$ 606</b>	<b>\$ 423,987</b>	<b>\$ 424,593</b>	<b>\$ 206</b>

Past Due Aging as of December 31, 2015	30-59	60-89	90 Days or	Total Past Due	Current	Total Loans	90 Days Past Due and Still Accruing
	Days Past Due	Days Past Due	More Past Due				
<b>Commercial loans</b>							
Commercial and industrial - organic	\$ 211	\$ 40	\$ -	\$ 251	\$ 46,964	\$ 47,215	\$ -
Commercial and industrial - syndicated	-	-	-	-	23,653	23,653	-
<b>Real estate construction and land</b>							
Residential construction	-	-	-	-	2,178	2,178	-
Commercial construction	-	-	-	-	6,214	6,214	-
Other construction and land	7	-	-	7	10,512	10,519	-
<b>Real estate mortgages</b>							
1-4 family residential, first lien, investment	-	-	-	-	31,128	31,128	-
1-4 family residential, first lien, owner occupied	93	-	-	93	20,790	20,883	-
1-4 family residential, junior lien	63	36	-	99	3,671	3,770	-
Home equity lines of credit, first lien	-	-	-	-	11,930	11,930	-
Home equity lines of credit, junior lien	-	-	-	-	15,670	15,670	-
Farm	-	-	-	-	7,762	7,762	-
Multifamily	-	-	-	-	20,209	20,209	-
Commercial owner occupied	-	-	-	-	66,244	66,244	-
Commercial non-owner occupied	-	-	-	-	91,805	91,805	-
<b>Consumer loans</b>							
Consumer revolving credit	-	-	-	-	17,174	17,174	-
Consumer all other credit	58	1	-	59	11,596	11,655	-
Student loans purchased	813	1	-	814	34,841	35,655	-
<b>Total Loans</b>	<b>\$ 1,245</b>	<b>\$ 78</b>	<b>\$ -</b>	<b>\$ 1,323</b>	<b>\$ 422,341</b>	<b>\$ 423,664</b>	<b>\$ -</b>



**Note 5. Intangible Assets**

On February 1, 2016 (the Effective Date), VNB Wealth purchased the book of business, including interest in the client relationships, ( Purchased Relationships ), from a current officer (the Seller ) of VNB Wealth pursuant to an employment and asset purchase agreement (the Purchase Agreement ). Prior to becoming an employee of VNB Wealth and until the Effective Date of the sale, the Seller provided services to these Purchased Relationships as a sole proprietor. As of January 15, 2016, the fair value of the assets under management associated with the Purchased Relationships totaled \$31.5 million. Under the terms of the Purchase Agreement, the Company will receive all future revenue for brokerage, investment management, advisory, insurance, consulting, trust and related services performed for the Purchased Relationships.

The purchase price of \$1.2 million will be paid over a five year period. During the first quarter of 2016, the Company recognized goodwill and other intangible assets arising from this purchase. As required under ASC Topic 805, Business Combinations, using the acquisition method of accounting, below is a summary of the net asset values, as determined by an independent third party, based on the fair value measurements and the purchase price. The intangible assets identified below will be amortized using a straight line method over the estimated useful life, and the amortized cost will be shown as noninterest expense. In accordance with ASC 350, Intangibles-Goodwill and Other, the Company will review the carrying value of indefinite lived goodwill at least annually or more frequently if certain impairment indicators exist. (Dollars below reported in thousands.)

	Fair Value	% of Total Intangible Assets	Estimated Economic Useful Life
<b>Identified Intangible Assets</b>			
Non-Compete Agreement	\$ 103	9.0%	3 years
Customer Relationships Intangible	670	58.5%	10 years
Total Identified Intangible Assets	\$ 773	67.5%	
Goodwill	\$ 372	32.5%	Indefinite
Total Intangible Assets	\$ 1,145	100.0%	

Through the six months ended June 30, 2016, the Company recognized \$42 thousand in amortization expense from these identified intangible assets with a finite life. The net carrying value of \$731 thousand will be recognized as amortization expense in future reporting periods through 2026. The following shows the gross and net balance of these intangible assets as of June 30, 2016. (Dollars below reported in thousands.)

	Gross Carrying Value	Net Accumulated Amortization	Net Carrying Value
<b>Identified Intangible Assets</b>			
Non-Compete Agreement	\$ 103	\$ 14	\$ 89
Customer Relationships Intangible	670	28	642
Total Identified Intangible Assets	\$ 773	\$ 42	\$ 731

As of June 30, 2016, the Company carried a contingent liability of \$445 thousand, representing the net of the fair value of the purchase price, less the initial payment made on the Effective Date to the Seller. The remaining four annual payments as delineated in the Purchase Agreement will be paid from this liability.

**Note 6. Net Income Per Share and Stock Repurchase Program**

On September 22, 2014, the Company announced the approval by its Board of Directors of a stock repurchase program authorizing repurchase of up to 400,000 shares of the Company's common shares through September 18, 2015. The Company announced on September 21, 2015 that its Board of Directors extended the program for another year. A total of 343,559 shares at a weighted average price of \$22.89 per share have been repurchased since the beginning of the program, with the remaining 56,441 shares available for purchase through September 18, 2016 under the extended program.

The following shows the weighted average number of shares used in computing net income per common share and the effect on the weighted average number of shares of diluted potential common stock for the three and six months ended June 30, 2016 and 2015. Potential dilutive common stock equivalents have no effect on net income available to common shareholders. (Dollars below reported in thousands except per share data.)

	June 30, 2016			June 30, 2015		
	Net Income	Weighted Average Shares	Per Share Amount	Net Income	Weighted Average Shares	Per Share Amount
Basic net income per share	\$ 1,510	2,359,101	\$ 0.64	\$ 767	2,577,424	\$ 0.30
Effect of dilutive stock options	-	15,139	-	-	9,357	-
Diluted net income per share	\$ 1,510	2,374,240	\$ 0.63	\$ 767	2,586,781	\$ 0.30

	June 30, 2016			June 30, 2015		
	Net Income	Weighted Average Shares	Per Share Amount	Net Income	Weighted Average Shares	Per Share Amount
Basic net income per share	\$ 2,865	2,371,026	\$ 1.21	\$ 1,182	2,632,605	\$ 0.45
Effect of dilutive stock options	-	14,635	-	-	9,510	-
Diluted net income per share	\$ 2,865	2,385,661	\$ 1.20	\$ 1,182	2,642,115	\$ 0.45

For the periods ended June 30, 2016 and June 30, 2015, option shares totaling 59,110 and 134,654, respectively, were considered anti-dilutive and were excluded from this calculation.

**Note 7. Stock Incentive Plans**

At the Annual Shareholders Meeting on May 21, 2014, shareholders approved the Virginia National Bankshares Corporation 2014 Stock Incentive Plan ( 2014 Plan ). The 2014 Plan makes available up to 250,000 shares of the Company's common stock to be issued to plan participants. Similar to the Company's 2003 Stock Incentive Plan ( 2003 Plan ) and 2005 Stock Incentive Plan ( 2005 Plan ), the 2014 Plan provides for granting of both incentive and nonqualified stock options, as well as restricted stock and other stock based awards. No new grants will be issued under the 2003 Plan or the 2005 Plan as these plans have expired.

For all of the Company's stock incentive plans (the Plans ), the option price of incentive stock options will not be less than the fair value of the stock at the time an option is granted. Nonqualified stock options may be granted at prices established by the Board of Directors, including prices less than the fair value on the date of grant. Outstanding stock options generally expire in ten years from the grant date. Stock options generally vest by the fourth or fifth anniversary of the date of the grant.

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A summary of the shares issued and available under each of the Plans is shown below as of June 30, 2016. Although the 2003 Plan and 2005 Plan have expired and no new grants will be issued under these plans, there were shares issued before the plans expired which are still outstanding as shown below.

	2003 Plan	2005 Plan	2014 Plan
Aggregate shares issuable	128,369	230,000	250,000
Options issued, net of forfeited and expired options	(108,054)	(106,722)	-
Cancelled due to Plan expiration	(20,315)	(123,278)	-
Remaining available for grant	-	-	250,000
<b>Grants issued and outstanding:</b>			
Total vested and unvested shares	28,984	102,829	-
Fully vested shares	28,984	99,079	-
Exercise price range	\$15.65 to \$18.26	\$11.74 to \$36.74	N/A

The Company accounts for all of its stock incentive plans under recognition and measurement accounting principles which require that the compensation cost relating to stock-based payment transactions be recognized in the financial statements. Stock-based compensation arrangements include stock options and restricted stock. All stock-based payments to employees are required to be valued at fair value on the date of grant and expensed based on that fair value over the applicable vesting period. For the six months ended June 30, 2016 and 2015, the Company recognized \$14 thousand and \$15 thousand, respectively, in compensation expense for stock options. As of June 30, 2016, there was \$22 thousand in unamortized compensation expense remaining to be recognized in future reporting periods through 2017.

### Stock Options

Changes in the stock options outstanding related to all of the Plans are summarized as follows (dollars in thousands except per share data):

	Number of Options	June 30, 2016	
		Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at January 1, 2016	152,118	\$ 25.36	\$ 354
Exercised	(2,480)	\$ 16.89	
Expired	(17,825)	32.43	-
Outstanding at June 30, 2016	131,813	\$ 24.56	\$ 369
Options exercisable at June 30, 2016	128,063	\$ 24.78	\$ 341

The fair value of any grant is estimated at the grant date using the Black-Scholes pricing model. There were no stock option grants during the first six months of 2016 or during the twelve months ended December 31, 2015.



Summary information pertaining to options outstanding at June 30, 2016 is as follows:

Exercise Price	Options Outstanding			Options Exercisable	
	Number of Options	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price
\$11.74 to 20.00	43,284	3.9 Years	\$ 17.19	39,534	\$ 17.20
\$20.01 to 30.00	58,514	1.7 Years	24.83	58,514	24.83
\$30.01 to 36.74	30,015	0.5 Years	34.67	30,015	34.67
Total	131,813	2.1 Years	\$ 24.56	128,063	\$ 24.78

### Restricted Stock

There were no restricted stock grants outstanding throughout 2015 or as of June 30, 2016. No restricted stock grants were awarded during 2015 or the first six months of 2016.

### Note 8. Fair Value Measurements

#### Determination of Fair Value

The Company follows ASC 820, Fair Value Measurements and Disclosures, to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. This codification clarifies that 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 Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market

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The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the consolidated financial statements:

### **Securities available for sale**

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2).

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The following tables present the balances measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015 (dollars in thousands):

**Fair Value Measurements at June 30, 2016 Using:**

Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other	Significant
			Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
<b>Assets:</b>				
U.S. Government agencies	\$ 11,391	\$ -	\$ 11,391	\$ -
Corporate bonds	6,109	-	6,109	-
Mortgage-backed securities/CMOs	33,503	-	33,503	-
Municipal bonds	18,542	-	18,542	-
Total securities available for sale	\$ 69,545	\$ -	\$ 69,545	\$ -

**Fair Value Measurements at December 31, 2015 Using:**

Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other	Significant
			Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
<b>Assets:</b>				
U.S. Government agencies	\$ 11,378	\$ -	\$ 11,378	\$ -
Corporate bonds	5,964	-	5,964	-
Mortgage-backed securities/CMOs	36,687	-	36,687	-
Municipal bonds	20,772	-	20,772	-
Total securities available for sale	\$ 74,801	\$ -	\$ 74,801	\$ -

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write downs of individual assets. The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the consolidated financial statements:

**Impaired Loans**

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. 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 Company using observable market data (Level 2). However, if the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Company because of marketability, then the fair value is considered Level 3.

The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business financial statements if not considered significant. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3).

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Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. The Company had \$2.3 million and \$1.6 million in impaired loans as of June 30, 2016 and December 31, 2015, respectively. None of these impaired loans required a valuation allowance after consideration was given for each borrowing as to the fair value of the collateral on the loan or the present value of expected future cash flows from the customer.

### **Other Real Estate Owned**

Other real estate owned ( OREO ) is measured at fair value less cost to sell, based on an appraisal conducted by an independent, licensed appraiser outside of the Company. If the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Company because of marketability, then the fair value is considered Level 3. OREO is measured at fair value on a nonrecurring basis. Any initial fair value adjustment is charged against the Allowance for Loan Losses. Subsequent fair value adjustments are recorded in the period incurred and included in other noninterest expense on the Consolidated Statements of Income. As of June 30, 2016 and December 31, 2015, the Company had no OREO property.

ASC 825, Financial Instruments , requires disclosures about fair value of financial instruments for interim periods and excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

### **Cash and cash equivalents**

For those short-term instruments, including cash, due from banks, federal funds sold and interest-bearing deposits maturing within ninety days, the carrying amount is a reasonable estimate of fair value.

### **Securities**

Fair values for securities, excluding restricted securities, are based on third party vendor pricing models. The carrying value of restricted securities consists of stock in FRB, FHLB, and CBBFC and is based on the redemption provisions of each entity and therefore excluded from the following table.

### **Loans**

The fair value of performing loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar remaining maturities. This calculation ignores loan fees and certain factors affecting the interest rates charged on various loans, such as the borrower s creditworthiness and compensating balances and dissimilar types of real estate held as collateral. The fair value of impaired loans is measured as described within the Impaired Loans section of this note.

### **Bank owned life insurance**

The carrying amounts of bank owned life insurance approximate fair value.

### **Accrued interest**

The carrying amounts of accrued interest approximate fair value.

### **Deposit liabilities**

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

### **Securities sold under agreements to repurchase**

The carrying amounts of securities sold under agreements to repurchase approximate fair value.

### **Off-balance sheet financial instruments**

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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. For the reporting period, the fair value of unfunded loan commitments and standby letters of credit were deemed to be immaterial and therefore, they have not been included in the following tables.

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The carrying values and estimated fair values of the Company's financial instruments as of June 30, 2016 and December 31, 2015 are as follows (dollars in thousands):

Fair Value Measurement at June 30, 2016 Using:

	Carrying value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
<b>Assets</b>					
Cash and cash equivalent	\$ 25,114	\$ 25,114	\$ -	\$ -	\$ 25,114
Available for sale securities	69,545	-	69,545	-	69,545
Loans, net	421,407	-	-	419,881	419,881
Bank owned life insurance	13,696	-	13,696	-	13,696
Accrued interest receivable	1,428	-	299	1,129	1,428
<b>Liabilities</b>					
Demand deposits and interest-bearing transaction and money market accounts	\$ 358,023	\$ -	\$ 358,023	\$ -	\$ 358,023
Certificates of deposit	112,397	-	112,460	-	112,460
Securities sold under agreements to repurchase	15,719	-	15,719	-	15,719
Accrued interest payable	105	-	105	-	105

Fair Value Measurement at December 31, 2015 Using:

	Carrying value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
<b>Assets</b>					
Cash and cash equivalent	\$ 43,527	\$ 43,527	\$ -	\$ -	\$ 43,527
Available for sale securities	74,801	-	74,801	-	74,801
Loans, net	420,097	-	-	418,774	418,774
Bank owned life insurance	13,476	-	13,476	-	13,476
Accrued interest receivable	1,611	-	369	1,242	1,611
<b>Liabilities</b>					
Demand deposits and interest-bearing transaction and money market accounts	\$ 377,849	\$ -	\$ 377,849	\$ -	\$ 377,849
Certificates of deposit	108,618	-	108,578	-	108,578
Securities sold under agreements to repurchase	23,156	-	23,156	-	23,156
Accrued interest payable	106	-	106	-	106

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The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Company'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 9. Other Comprehensive Income**

A component of the Company's other comprehensive income, in addition to net income from operations, is the recognition of the unrealized gains and losses on available for sale securities, net of income taxes. Reclassifications of realized gains and losses on available for sale securities are reported in the income statement as Gains on sales of securities with the corresponding income tax effect reflected as a component of income tax expense. Amounts reclassified out of accumulated other comprehensive income are presented below for the three and six months ended June 30, 2016 and 2015 (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Available for sale securities				
Realized gains on sales of securities	\$ -	\$ 24	\$ 8	\$ 46
Tax effect	-	(8)	(3)	(15)
Realized gains, net of tax	\$ -	\$ 16	\$ 5	\$ 31

**Note 10. Segment Reporting**

Virginia National Bankshares Corporation has two reportable segments, the Bank and VNB Wealth.

Commercial banking involves making loans and generating deposits from individuals and businesses. Loan fee income, service charges from deposit accounts, and other non-interest-related fees such as fees for debit cards and ATM usage and fees for treasury management services generate additional income for this segment.

The VNB Wealth segment includes (a) trust income from the investment management, wealth advisory and trust and estate services offered by VNBTrust, comprised of both management fees and performance fees, and (b) brokerage and insurance income from retail brokerage, investment advisory, annuity and insurance services offered under the name of VNB Investment Services.

A management fee for administrative and technology support services provided by the Bank is charged to VNB Wealth. For the six months ended June 30, 2016 and June 30, 2015, management fees of \$50 thousand and \$68 thousand, respectively, were charged to VNB Wealth and eliminated in consolidated totals. The VNB Wealth total assets as shown in the following tables represent the assets of VNB Wealth and should not be confused with client assets under management.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies provided earlier in this report. Each reportable segment is a strategic business unit that offers different products and services. They are managed separately, because each segment appeals to different markets and, accordingly, require different technology and marketing strategies.

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Segment information for the three and six months ended June 30, 2016 and 2015 is shown in the following tables (dollars in thousands):

<b>Three months ended June 30, 2016</b>	Bank	VNB Wealth	Consolidated
Net interest income	\$ 4,419	\$ 11	\$ 4,430
Provision for (recovery of) loan losses	(275)	-	(275)
Noninterest income	744	506	1,250
Noninterest expense	3,170	589	3,759
Income (loss) before income taxes	2,268	(72)	2,196
Provision for (benefit of) income taxes	710	(24)	686
Net income (loss)	\$ 1,558	\$ (48)	\$ 1,510
Total assets	\$ 536,061	\$ 9,617	\$ 545,678

<b>Three months ended June 30, 2015</b>	Bank	VNB Wealth	Consolidated
Net interest income	\$ 3,971	\$ 7	\$ 3,978
Provision for loan losses	-	-	-
Noninterest income	774	481	1,255
Noninterest expense	3,413	762	4,175
Income (loss) before income taxes	1,332	(274)	1,058
Provision for (benefit of) income taxes	383	(92)	291
Net income (loss)	\$ 949	\$ (182)	\$ 767
Total assets	\$ 520,442	\$ 9,990	\$ 530,432

<b>Six months ended June 30, 2016</b>	Bank	VNB Wealth	Consolidated
Net interest income	\$ 8,921	\$ 23	\$ 8,944
Provision for (recovery of) loan losses	(395)	-	(395)
Noninterest income	1,422	952	2,374
Noninterest expense	6,353	1,203	7,556
Income (loss) before income taxes	4,385	(228)	4,157
Provision for (benefit of) income taxes	1,369	(77)	1,292
Net income (loss)	\$ 3,016	\$ (151)	\$ 2,865

<b>Six months ended June 30, 2015</b>	Bank	VNB Wealth	Consolidated
Net interest income	\$ 7,740	\$ 13	\$ 7,753
Provision for loan losses	317	-	317
Noninterest income	1,464	975	2,439
Noninterest expense	6,795	1,498	8,293
Income (loss) before income taxes	2,092	(510)	1,582
Provision for (benefit of) income taxes	571	(171)	400
Net income (loss)	\$ 1,521	\$ (339)	\$ 1,182

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

The following discussion should be read in conjunction with Virginia National Bankshares Corporation's consolidated financial statements, and notes thereto, for the year ended December 31, 2015, included in the Company's 2015 Form 10-K. Operating results for the three and six months ended June 30, 2016 are not necessarily indicative of the results for the year ending December 31, 2016 or any future period.

### **FORWARD-LOOKING STATEMENTS AND FACTORS THAT COULD AFFECT FUTURE RESULTS**

Certain statements contained or incorporated by reference in this quarterly report on Form 10-Q, including but not limited to, statements concerning future results of operations or financial position, borrowing capacity and future liquidity, future investment results, future credit exposure, future loan losses and plans and objectives for future operations, change in laws and regulations applicable to the Company and its subsidiaries, adequacy of funding sources, actuarial expected benefit payment, valuation of foreclosed assets, regulatory requirements, economic environment and other statements contained herein regarding matters that are not historical facts, are forward-looking statements as defined in the Securities Exchange Act of 1934. Such statements are often characterized by use of qualified words such as expect, believe, estimate, project, anticipate, intend, will, should, similar meaning or other statements concerning the opinions or judgment of the Company and its management about future events. These statements are not historical facts but instead are subject to numerous assumptions, risks and uncertainties, and represent only our belief regarding future events, many of which, by their nature, are inherently uncertain and outside our control. Any forward-looking statements made by the Company speak only as of the date on which such statements are made. Our actual results and financial position may differ materially from the anticipated results and financial condition indicated in or implied by these forward-looking statements. The Company makes no commitment to update or revise forward-looking statements in order to reflect new information or subsequent events or changes in expectations.

Factors that could cause our actual results to differ materially from those in the forward-looking statements include, but are not limited to, the following: inflation, interest rates, market and monetary fluctuations; geopolitical developments including acts of war and terrorism and their impact on economic conditions; the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board; changes, particularly declines, in general economic conditions and in the local economies in which the Company operates; the financial condition of the Company's borrowers; competitive pressures on loan and deposit pricing and demand; changes in technology and their impact on the marketing of new products and services and the acceptance of these products and services by new and existing customers; the willingness of customers to substitute competitors' products and services for the Company's products and services; the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities and insurance); changes in accounting principles, policies and guidelines; other risks and uncertainties described from time to time in press releases and other public filings; and the Company's performance in managing the risks involved in any of the foregoing. The foregoing list of important factors is not exclusive, and the Company will not update any forward-looking statement, whether written or oral, that may be made from time to time.

### **APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The accounting and reporting policies followed by the Company conform, in all material respects, to GAAP and to general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. While the Company bases estimates on historical experience, current information and other factors deemed to be relevant, actual results could differ from those estimates.

The Company considers accounting estimates to be critical to reported financial results if (i) the accounting estimate requires management to make assumptions about matters that are highly uncertain; and (ii) different estimates that management reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, could have a material impact on the Company's consolidated financial statements. The Company's accounting policies are fundamental to understanding management's discussion and analysis of financial condition and results of operations.

As discussed earlier under Allowance for Loan Losses in Note 4 of the Notes to Consolidated Financial Statements, beginning with the second quarter of 2016, the Company made significant changes related to determining the allowance for loan losses. The Company's movement from a historical loss rate methodology to the more complex loss migration analysis, which is a more robust method, will better equip the bank to comply with upcoming regulatory changes. Concurrent with the change in the methodology used, the loan portfolio was further segmented by loan classes and by risk ratings to provide greater loan level detail. For additional

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information regarding other critical accounting policies, refer to the Application of Critical Accounting Policies and Critical Accounting Estimates section under Item 7 in the 2015 Form 10-K. There have been no other significant changes in the Company's application of critical accounting policies since December 31, 2015.

**FINANCIAL CONDITION**Total assets

The total assets of the Company as of June 30, 2016 were \$545.7 million. This is a \$21.8 million decrease from the \$567.5 million total assets reported at December 31, 2015 and a \$15.3 million increase from the \$530.4 million reported at June 30, 2015. Demand deposits and repurchase agreement sweep balances declined \$16.2 million and \$7.4 million, respectively, accounting for the majority of the decrease in funding as of June 30, 2016 compared to December 31, 2015 balances. The year-over-year net growth in assets was funded largely by expansion within all core deposit categories totaling \$19.0 million, while time deposits and repurchase agreement sweep balances contracted by \$6.8 million over that period. Total deposits and repurchase agreement sweep balances totaled \$486.1 million at June 30, 2016, up 2.6% from the \$473.9 million at June 30, 2015 and down 4.6% from the \$509.7 million at December 31, 2015.

Federal funds sold

The Company had overnight federal funds sold of \$13.4 million at June 30, 2016, compared to \$29.3 million at December 31, 2015. At June 30, 2015, the Company had overnight federal funds sold of \$4.3 million. Any excess funds are sold on a daily basis in the federal funds market. The Company intends to maintain sufficient liquidity at all times to meet its funding commitments.

The Company continues to participate in the Federal Reserve Bank of Richmond's Excess Balance Account (EBA). The EBA is a limited-purpose account at the Federal Reserve Bank for the maintenance of excess cash balances held by financial institutions. The Federal Reserve Bank requires the Company to have its participation in the EBA program managed by a pass-through correspondent bank. The Company's pass-through correspondent is Community Bankers Bank of Midlothian, Virginia. The EBA eliminates the potential of concentration risk that comes with depositing excess balances with one or multiple correspondent banks. Balances on deposit in the EBA are considered to be on deposit with the Federal Reserve Bank, with the correspondent bank acting as agent. Balances in the EBA cannot be used to satisfy reserve balance requirements or contractual clearing agreements with the Federal Reserve Bank.

Securities

The Company's investment securities portfolio as of June 30, 2016 totaled \$71.3 million, a decrease of \$5.2 million from the \$76.5 million reported at December 31, 2015 and a decrease of \$50.4 million from the \$121.7 million reported at June 30, 2015. Management continues to focus on maximizing the earning capacity of the Company. As loan funding needs have increased over the past year, lower earning securities have been sold in order to deploy these funds to higher earning loans. At June 30, 2016, the investment securities holdings represented 13.1% of the Company's total assets, a decrease from the 13.5% and 23.0% of total assets at December 31, 2015 and June 30, 2015, respectively.

The Company's investment securities portfolio included restricted securities totaling \$1.7 million as of June 30, 2016 and December 31, 2015. These securities represent stock in the Federal Reserve Bank of Richmond (FRB-R), the Federal Home Loan Bank of Atlanta (FHLB-A), and CBB Financial Corporation (CBBFC), the holding company for Community Bankers Bank. The level of FRB-R and FHLB-A stock that the Company is required to hold is determined in accordance with membership guidelines provided by the Federal Reserve Bank Board of Governors or the Federal Home Loan Bank of Atlanta. Stock ownership in the bank holding company for Community Bankers Bank provides the Bank with several benefits that are not available to non-shareholder correspondent banks. None of these restricted securities are traded on the open market and can only be redeemed by the respective issuer.

At June 30, 2016, the unrestricted securities portfolio totaled \$69.6 million. The following table summarizes the Company's available for sale securities by type as of June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016 Balance	Percent of Total	December 31, 2015 Balance	Percent of Total
U.S. Government agencies	\$ 11,391	16.38%	\$ 11,378	15.21%
Corporate bonds	6,109	8.78%	5,964	7.97%
Mortgage-backed securities/CMOs	33,503	48.18%	36,687	49.05%
Municipal bonds	18,542	26.66%	20,772	27.77%
Total available for sale securities	\$ 69,545	100.00%	\$ 74,801	100.00%

Loan portfolio

A management objective is to grow loan balances while maintaining the asset quality of the loan portfolio. The Company seeks to achieve this objective by maintaining rigorous underwriting standards coupled with regular evaluation of the creditworthiness of and the designation of lending limits for each borrower. The portfolio strategies include seeking industry, loan size, and loan type diversification in order to minimize credit exposure and originating loans in markets with which the Company is familiar. The predominant market area for loans includes Charlottesville, Albemarle County, Orange County, Winchester, Frederick County and areas in the Commonwealth of Virginia that are within a 75 mile radius of any Virginia National Bank office.

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As of June 30, 2016, total loans were \$424.6 million, an increase of \$0.9 million from the balance of \$423.7 million as of December 31, 2015 and an increase of \$57.5 million from the \$367.1 million at June 30, 2015. Loans as a percentage of total assets at June 30, 2016 were 77.8%, compared to 69.2% as of June 30, 2015. Loans as a percentage of deposits at June 30, 2016 were 90.3%, a 10.1 percentage point improvement over the 80.2% ratio as of the year prior.

From the \$289.6 million outstanding at September 30, 2014, gross loans have increased \$135.0 million, or 46.6%, due to approximately \$71.6 million in net organic loan growth, supplemented by purchases of \$27.0 million in syndicated loans and \$36.4 million in student loans. The purchase of loans is considered a secondary strategy, which allows the Company to supplement organic loan growth and enhance earnings. Syndicated loans represent shared national credits in leveraged lending transactions and are included in the commercial and industrial portfolio. The Company has developed policies to limit overall credit exposure to the syndicated market, as well as limits by industry and amount per borrower. The first package of student loans totaling \$10.8 million was purchased late in the second quarter of 2015. The purchase of a second student loan package totaling \$25.6 million closed in the fourth quarter of 2015. Along with the purchase of these student loans, the Company purchased a surety bond that fully insures this portion of the Company's consumer portfolio.

While the increase in loan balances slowed to a modest \$929 thousand during the first two quarters of 2016, after experiencing significant loan growth in each of the prior five quarters, the benefit from the expansion in these higher yielding assets should continue to strengthen earnings in 2016.

The following table summarizes the Company's loan portfolio by type of loan as of June 30, 2016, December 31, 2015, and June 30, 2015 (dollars in thousands):

	June 30, 2016	Percent of Total	December 31, 2015	Percent of Total	June 30, 2015	Percent of Total
	Balance		Balance		Balance	
Commercial and industrial	\$ 63,638	15.0%	\$ 70,868	16.7%	\$ 76,825	20.9%
Real estate - commercial	188,551	44.4%	178,258	42.1%	161,008	43.9%
Real estate - residential mortgage	90,604	21.3%	91,143	21.5%	88,158	24.0%
Real estate - construction	18,544	4.4%	18,911	4.5%	16,026	4.4%
Consumer installment and other	63,256	14.9%	64,484	15.2%	25,068	6.8%
Total loans	\$ 424,593	100.0%	\$ 423,664	100.0%	\$ 367,085	100.0%

### Loan quality

Non-accrual loans remained low and totaled \$179 thousand at June 30, 2016, compared to the \$191 thousand and \$205 thousand reported at December 31, 2015 and June 30, 2015, respectively.

At June 30, 2016, the Company had loans in the amount of \$2.3 million classified as impaired loans. Of this total, \$2.1 million were Troubled Debt Restructurings (TDRs) which are still accruing interest. Based on newly issued regulatory guidance on Student Lending, the Company classified 38 of its student loans purchased as TDRs for a total of \$713 thousand during the quarter ended June 30, 2016. These borrowers that should have been in repayment have requested and been granted payment extensions or reductions exceeding the maximum lifetime allowable payment forbearance of twelve months (36 months lifetime allowance for military service), as permitted under the regulatory guidance, and are therefore considered restructurings. Student loan borrowers are allowed in-school deferments, plus an automatic six month grace period post in-school status, before repayment is scheduled to begin, and these deferments do not count toward the maximum allowable forbearance. As all student loans purchased are fully insured, the Company does not expect to experience a loss on these loans and interest continues to accrue on these TDRs during any deferment and forbearance periods.

At December 31, 2015, the Company had loans totaling \$1.6 million classified as impaired loans, of which, \$1.4 million were TDRs which are still accruing interest. At June 30, 2015, the Company had loans in the amount of \$1.8 million classified as impaired loans, of which, \$1.6 million were TDRs which are still accruing interest.

The Company had loans totaling \$206 thousand that were past due ninety or more days and still accruing interest in its portfolio as of June 30, 2016. The Company had no loans past due ninety or more days and still accruing interest in its portfolio as of December 31, 2015 and as of June 30, 2015.

Management identifies potential problem loans through its periodic loan review process and defines potential problem loans as those loans classified as special mention, substandard, or doubtful.



Allowance for loan losses

In general, the Company determines the adequacy of its allowance for loan losses by considering the risk classification and delinquency status of loans and other factors. Management may also establish specific allowances for loans which management believes require allowances greater than those allocated according to their risk classification. The purpose of the allowance is to provide for losses inherent in the loan portfolio. Since risks to the loan portfolio include general economic trends as well as conditions affecting individual borrowers, the allowance is an estimate. The Company is committed to determining, on an ongoing basis, the adequacy of its allowance for loan losses. The Company applies historical loss rates to various pools of loans based on risk rating classifications. In addition, the adequacy of the allowance is further evaluated by applying estimates of loss that could be attributable to any one of the following eight qualitative factors:

- National and local economic trends;
- Underlying collateral values;
- Loan delinquency status and trends;
- Loan risk classifications;
- Industry concentrations;
- Lending policies;
- Experience, ability and depth of lending staff; and
- Levels of policy exceptions

As discussed earlier, beginning with the second quarter of 2016, the Company moved from a historical loss rate method to a loss migration model. Migration analysis uses loan level attributes to track the movement of loans through various risk classifications in order to estimate the percentage of losses likely in the portfolio. Concurrent with the change in the methodology used, the loan portfolio was further segmented by loan classes and by risk ratings to provide greater loan level detail. Management believes that this new methodology together with greater data granularity will more accurately reflect the potential risks and losses inherent in the loan portfolio.

The relationship of the allowance for loan losses to total loans at June 30, 2016, December 31, 2015, and June 30, 2015 appears below (dollars in thousands):

	June 30, 2016	December 31, 2015	June 30, 2015
Loans held for investment at period-end	\$ 424,593	\$ 423,664	\$ 367,085
Allowance for loan losses	\$ 3,186	\$ 3,567	\$ 3,454
Allowance as a percent of period-end loans	0.75%	0.84%	0.94%

The allowance for loan losses as a percentage of total loans at June 30, 2016 of 0.75% was 19 basis points lower than the 0.94% at June 30, 2015 and is reflective of both a continued improvement in asset quality and as a result of the Company's movement to the migration loss analysis.

A recovery of provision for loan losses totaling \$395 thousand was recorded in the first six months of 2016, while a provision for loan losses of \$317 thousand was recognized for the first six months of 2015. The following is a summary of the changes in the allowance for loan losses for the six months ended June 30, 2016 and June 30, 2015 (dollars in thousands):

	2016	2015
Allowance for loan losses, January 1	\$ 3,567	\$ 3,164
Chargeoffs	(12)	(88)
Recoveries	26	61
Provision for (recovery of) loan losses	(395)	317
Allowance for loan losses, June 30	\$ 3,186	\$ 3,454

For additional insight into management's approach and methodology in estimating the allowance for loan losses, please refer to the earlier discussion of Allowance for Loan Losses in Note 4 of the Notes to Consolidated Financial Statements, where an analysis shows the effect of the changes in methodology from that used in prior periods on the recovery of the provision for loan losses. In

addition, Note 4 includes details regarding the rollforward of the allowance by loan portfolio segments. The rollforward tables indicate the activity for loans that are charged-off, amounts received from borrowers as recoveries of previously charged-off loan balances, and the allocation by loan portfolio segment of the provision made during the period. The events that can positively impact the amount of allowance in a given loan segment include any one or all of the following: the recovery of a previously charged-off loan balance; the decline in the amount of classified or delinquent loans in a loan segment from the previous period, which most commonly occurs when these loans are repaid or are foreclosed; or when there are improvements in the ratios used to estimate the probability of loan losses. Improvements to the ratios could include lower historical loss rates, improvements to any of the qualitative factors mentioned above, or reduced loss expectations for individually-classified loans.

Management reviews the adequacy of the Allowance for Loan Losses on a quarterly basis to ensure it is adequate based upon the calculated potential losses inherent in the portfolio. Management believes the allowance for loan losses was adequately provided for as of June 30, 2016.

#### Premises and equipment

The Company's premises and equipment, net of depreciation, as of June 30, 2016 totaled \$8.3 million compared to the December 31, 2015 amount of \$8.7 million. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed by the straight-line method based on the estimated useful lives of assets. Expenditures for repairs and maintenance are charged to expense as incurred. The costs of major renewals and betterments are capitalized and depreciated over their estimated useful lives. Upon disposition, assets and related accumulated depreciation are removed from the books, and any resulting gain or loss is charged to income.

As of June 30, 2016, the Company and its subsidiaries occupied seven full-service banking facilities in the cities of Charlottesville and Winchester, as well as the counties of Albemarle and Orange in Virginia. The Company's lease for the Loudoun Mall banking office located at 186 North Loudoun Street, Winchester, Virginia is expiring, and the Company will permanently close that office on or about October 28, 2016. Upon its closure, the Loudoun Mall deposit and loan accounts will automatically be transferred to the Creekside Office, located at 3119 Valley Avenue, Winchester, Virginia, and the Loudoun Mall staff will relocate to the Creekside Office. The Company is continuing to search for at least one new branch office location in Winchester.

The multi-story office building at 404 People Place in Charlottesville also serves as the Company's corporate headquarters and operations center, as well as the principal offices of VNB Wealth.

The Arlington Boulevard and People Place facilities also contain office space that is currently under lease to tenants.

#### Deposits and securities sold under agreement to repurchase

Depository accounts represent the Company's primary source of funds and are comprised of demand deposits, interest-bearing checking accounts, money market deposit accounts and time deposits. These deposits have been provided predominantly by individuals, professionals, small businesses and organizations in the Charlottesville/Albemarle area, the Orange County area, and the Winchester area. Total deposits as of June 30, 2016 were \$470.4 million, down \$16.1 million compared to the balances of \$486.5 million at December 31, 2015 and \$12.6 million higher than the \$457.8 million total as of June 30, 2015.

Noninterest-bearing demand deposits on June 30, 2016 were \$168.4 million, representing 35.8% of total deposits. Interest-bearing transaction and money market accounts totaled \$189.6 million, and represented 40.3% of total deposits at June 30, 2016. Collectively, noninterest-bearing and interest-bearing transaction and money market accounts represented 76.1% of total deposit accounts at June 30, 2016. These account types are an excellent source of low-cost funding for the Company.

Certificates of deposit and other time deposit accounts totaled \$112.4 million at June 30, 2016 and \$108.6 million at December 31, 2015. Included in this deposit total are Certificate of Deposit Account Registry Service CDs, known as CDARS<sup>TM</sup>, whereby depositors can obtain FDIC deposit insurance on account balances of up to \$50 million. CDARS deposits totaled \$17.8 million and \$17.2 million as of June 30, 2016 and December 31, 2015, respectively.

Securities sold under agreement to repurchase are an additional source of funding for the Company and are available to non-individual accountholders on an overnight term through the Company's investment sweep product. Under the agreements to repurchase, invested funds are fully collateralized by security instruments that are pledged on behalf of customers utilizing this product. Total balances in securities sold under agreement to repurchase as of June 30, 2016 were \$15.7 million, compared to \$23.2 million at December 31, 2015 and \$16.1 million as of June 30, 2015.

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**Deposit accounts**

(dollars in thousands)	June 30, 2016		December 31, 2015		June 30, 2015	
	% of Total		% of Total		% of Total	
	Balance	Deposits	Balance	Deposits	Balance	Deposits
<b>No cost and low cost deposits:</b>						
Noninterest demand deposits	\$ 168,402	35.8%	\$ 184,574	37.9%	\$ 160,577	35.1%
Interest checking accounts	87,147	18.5%	90,100	18.5%	81,004	17.7%
Money market deposit accounts	102,474	21.8%	103,175	21.3%	97,404	21.2%
Total noninterest and low cost deposit accounts	358,023	76.1%	377,849	77.7%	338,985	74.0%
<b>Time deposit accounts:</b>						
Certificates of deposit	94,636	20.1%	91,459	18.8%	102,792	22.5%
CDARS deposits	17,761	3.8%	17,159	3.5%	16,020	3.5%
Total certificates of deposit and other time deposits	112,397	23.9%	108,618	22.3%	118,812	26.0%
<b>Total deposit account balances</b>	<b>\$ 470,420</b>	<b>100.0%</b>	<b>\$ 486,467</b>	<b>100.0%</b>	<b>\$ 457,797</b>	<b>100.0%</b>

**Securities sold under agreements to repurchase**

(dollars in thousands)	June 30, 2016	December 31, 2015	June 30, 2015
	Balance	Balance	Balance
Securities sold under agreements to repurchase	\$ 15,719	\$ 23,156	\$ 16,108

Shareholders' equity and regulatory capital ratios

The following table displays the changes in shareholders' equity for the Company from December 31, 2015 to June 30, 2016 (dollars in thousands):

Equity, December 31, 2015	\$ 56,297
Net income	2,865
Other comprehensive income	646
Cash dividends declared	(542)
Stock purchased under stock repurchase plan	(1,260)
Stock options exercised	41
Equity increase due to expensing of stock options	14
Equity, June 30, 2016	\$ 58,061

Effective January 1, 2015, the final rules adopted by the federal bank regulatory agencies to implement the Basel III regulatory capital rules required the Company and its subsidiaries to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.50% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6% of risk-weighted assets (increased from the prior requirement of 4.00%); (iii) a total capital ratio of 8.00% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4.00% of total assets (unchanged from the prior requirement). These were the initial capital requirements.

Beginning January 1, 2016 a capital conservation buffer requirement began to be phased in over a four-year period, beginning at 0.625% of risk-weighted assets and increasing annually to 2.50% at January 1, 2019. Therefore, for the calendar year 2016, this initial 0.625% buffer effectively results in the minimum (i) common equity Tier 1 capital ratio of 5.125% of risk-weighted assets; (ii) Tier 1 capital ratio of 6.625% of risk-weighted assets; and (iii) total capital ratio of 8.625% of risk-weighted assets. The minimum leverage ratio remains at 4.00%. For additional information regarding the new capital requirements, refer to the Supervision and Regulation section, under Item 1. Business, found in the Company's Form 10-K Report for December 31, 2015.

Using the new capital requirements, the Company's capital ratios remain well above the levels designated by bank regulators as "well capitalized" at June 30, 2016. Under the current risk-based capital guidelines of federal regulatory authorities, the Company's common equity Tier 1 capital ratio and Tier 1 capital ratio are both at 12.51% of its risk-weighted assets and are well in excess of the minimum capital requirements of 6.50% and 8.00%, respectively. Additionally, the Company has a total capital ratio of 13.21%

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of its risk-weighted assets and leverage ratio of 10.37% of total assets, which are both well in excess of the minimum 10.00% and 5.00% level designated by bank regulators under well capitalized capital guidelines.

### Stock repurchase program

On September 22, 2014, the Company announced the approval by its Board of Directors of a stock repurchase program authorizing repurchase of up to 400,000 shares of the Company's common shares through the open market or in privately negotiated transactions through September 18, 2015. The Company announced on September 21, 2015 that its Board of Directors had extended the program for another year. A total of 343,559 shares at a weighted average price of \$22.89 per share have been repurchased since the beginning of the program, with the remaining 56,441 shares available for purchase through September 18, 2016 under the extended program. The repurchase program does not obligate the Company to repurchase any shares and may be suspended or terminated at any time.

## **RESULTS OF OPERATIONS**

### Net income

Net income for the three months ended June 30, 2016 was \$1.5 million, a 96.9% increase compared to the \$767 thousand reported for the three months ended June 30, 2015. Net income per diluted share was \$0.63 for the quarter ended June 30, 2016 compared to \$0.30 per diluted share for the same quarter in the prior year. The \$743 thousand increase in net income for the second quarter of 2016 when compared to the same period of 2015 is attributable to an increase in net interest income of \$452 thousand, a decrease of \$275 thousand in the provision for loan losses and a decrease in noninterest expenses of \$416 thousand. Partially offsetting the increase was a decrease in noninterest income of \$5 thousand and an increase of \$395 thousand in the provision for income taxes.

Net income for the first six months of 2016 was \$2.9 million, or 142.4% higher than the reported net income of \$1.2 million during the same period in 2015. Net income per diluted share for the first half of 2016 was \$1.20, or \$0.75 higher than the \$0.45 per diluted share reported in the first half of 2015. The \$1.7 million increase in net income during the first six months of 2016 from the first six months of 2015 is attributable to several positive factors, including an increase of \$1.2 million in net interest income, a decrease of \$712 thousand in the provision for loan losses, and a decrease of \$737 thousand in noninterest expense. Partially offsetting the net increase was a decrease of \$65 thousand in noninterest income and an increase of \$892 thousand in provision for income taxes.

### Net interest income

Net interest income for the three months ended June 30, 2016 was \$4.4 million, a \$452 thousand increase compared to net interest income of \$4.0 million for the three months ended June 30, 2015. Net interest income was positively impacted by an improved mix in earning assets as average loans for the second quarter of 2016 were \$69.8 million higher than the average loans for the second quarter of 2015, while the quarterly average balances in lower yielding investments and fed funds contracted \$64.8 million in the year-over-year comparison.

Net interest margin is the ratio of taxable-equivalent net interest income to average earning assets for the period. The level of interest rates, together with the volume and mix of earning assets and interest-bearing liabilities, impact net interest income and net interest margin. The net interest margin of 3.50% for the three months ended June 30, 2016 was 32 basis points higher than the 3.18% for the quarter ended June 30, 2015.

For the six months ended June 30, 2016, the Company recorded \$8.9 million in net interest income, or 15.4% more than the \$7.8 million recorded for the same six months a year ago. The Bank's tax-equivalent net interest margin for the first half of 2016 was 3.49% or 40 basis points higher than the 3.09% reported for the same period in 2015.

Total interest income was \$1.2 million higher than the prior year, accounting for the year-to-date increase in net interest income. On average, loan balances comprised 80.8% of the earning assets for the first half of 2016, an improvement from the 65.5% for the first half of 2015. This shift resulted in an earning asset yield, as computed on a tax-equivalent basis, of 3.67% on average earning asset balances of \$520.4 million for the six months ended June 30, 2016. The earning asset yield, as computed on a tax-equivalent basis, was 3.28% on average earning asset balances of \$513.4 million for the six months ended June 30, 2015.

The Company's net interest income continues to benefit from having one of the lowest cost of funds among community banks in the country. A table showing the mix of no cost and low cost deposit accounts is shown under Financial Condition - Deposits and securities sold under agreement to repurchase earlier in this report. Interest expense as a percentage of average earning assets was 0.18% for the three and six months ended June 30, 2016 and 0.19% for the three and six months ended June 30, 2015.

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The following tables detail the average balance sheet, including an analysis of net interest income for earning assets and interest bearing liabilities, for the three and six months ended June 30, 2016 and 2015. These tables also include a rate/volume analysis for these same periods (dollars in thousands).

## Consolidated Average Balance Sheet And Analysis of Net Interest Income

	For the three months ended						Change in Interest		Total
	June 30, 2016			June 30, 2015			Income/Expense		
	Average	Interest	Average	Average	Interest	Average	Change Due to: <sup>4</sup>		Increase/ (Decrease)
(dollars in thousands)	Balance	Income/ Expense	Yield/ Cost	Balance	Income/ Expense	Yield/ Cost	Volume	Rate	
<b>ASSETS</b>									
Interest Earning Assets:									
Securities									
Taxable Securities	\$ 57,850	\$ 268	1.85%	\$ 126,930	\$ 570	1.80%	\$ (319)	\$ 17	\$ (302)
Tax Exempt Securities <sup>1</sup>	14,310	121	3.38%	18,825	165	3.51%	(38)	(6)	(44)
Total Securities <sup>1</sup>	72,160	389	2.16%	145,755	735	2.02%	(357)	11	(346)
Total Loans	419,429	4,294	4.12%	349,612	3,529	4.05%	714	51	765
Fed Funds Sold	21,425	25	0.47%	11,893	6	0.20%	7	12	19
Other Interest Bearing Deposits	1,148	-	0.00%	1,918	6	1.25%	(2)	(4)	(6)
Total Earning Assets	514,162	4,708	3.68%	509,178	4,276	3.37%	362	70	432
Less: Allowance for Loan Losses	(3,411)			(3,480)					
Total Non-Earning Assets	37,523			37,710					
Total Assets	\$ 548,274			\$ 543,408					
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>									
Interest Bearing Liabilities:									
Interest Bearing Deposits:									
Interest Checking	\$ 86,673	\$ 11	0.05%	\$ 82,315	\$ 10	0.05%	\$ 1	\$ -	\$ 1
Money Market Deposits	108,917	57	0.21%	95,018	48	0.20%	7	2	9
Time Deposits	112,772	156	0.56%	117,107	171	0.59%	(6)	(9)	(15)
Total Interest-Bearing Deposits	308,362	224	0.29%	294,440	229	0.31%	2	(7)	(5)
Securities Sold Under Agreement to Repurchase	19,260	11	0.23%	20,355	13	0.26%	(1)	(1)	(2)
Total Interest-Bearing Liabilities	327,622	235	0.29%	314,795	242	0.31%	1	(8)	(7)
Non-Interest-Bearing Liabilities:									
Demand deposits	161,583			168,216					
Other liabilities	1,626			1,041					
Total Liabilities	490,831			484,052					
Shareholders Equity	57,443			59,356					
Total Liabilities & Shareholders Equity	\$ 548,274			\$ 543,408					
Net Interest Income (Tax Equivalent)		\$ 4,473			\$ 4,034		\$ 361	\$ 78	\$ 439
Interest Rate Spread <sup>2</sup>			3.39%			3.06%			
Interest Expense as a Percentage of Average Earning Assets			0.18%			0.19%			
Net Interest Margin <sup>3</sup>			3.50%			3.18%			

- (1) Tax-exempt income for investment securities has been adjusted to a fully tax-equivalent basis (FTE), using a Federal income tax rate of 34%.
- (2) Interest spread is the average yield earned on earning assets less the average rate paid on interest-bearing liabilities.
- (3) Net interest margin is net interest income expressed as a percentage of average earning assets.
- (4) The impact on the net interest income resulting from changes in average balances and average rates is shown for the period indicated. The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.



**Consolidated Average Balance Sheet And Analysis of Net Interest Income**

	For the three months ended						Change in Interest		Total
	June 30, 2016			June 30, 2015			Income/Expense		
	Average	Interest	Average	Average	Interest	Average	Change Due to:		Increase/
	Balance	Income/	Yield/	Balance	Income/	Yield/	Volume	Rate	(Decrease)
		Expense	Cost		Expense	Cost			
<b>(dollars in thousands)</b>									
<b>ASSETS</b>									
Interest Earning Assets:									
Securities									
Taxable Securities	\$ 60,146	\$ 569	1.89%	\$ 128,529	\$ 1,173	1.83%	\$ (645)	\$ 41	\$ (604)
Tax Exempt Securities (1)	14,943	248	3.32%	19,361	341	3.52%	(75)	(18)	(93)
Total Securities (1)	75,089	817	2.18%	147,890	1,514	2.05%	(720)	23	(697)
Total Loans	420,446	8,627	4.13%	336,290	6,791	4.07%	1,725	111	1,836
Fed Funds Sold	23,665	56	0.48%	26,992	29	0.22%	(4)	31	27
Other Interest Bearing Deposits	1,199	4	0.67%	2,206	13	1.19%	(5)	(4)	(9)
Total Earning Assets	520,399	9,504	3.67%	513,378	8,347	3.28%	996	161	1,157
Less: Allowance for Loan Losses	(3,487)			(3,352)					
Total Non-Earning Assets	37,478			38,357					
Total Assets	\$ 554,390			\$ 548,383					
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>									
Interest Bearing Liabilities:									
Interest Bearing Deposits:									
Interest Checking	\$ 89,241	\$ 22	0.05%	\$ 82,317	\$ 21	0.05%	\$ 2	\$ (1)	\$ 1
Money Market Deposits	107,452	113	0.21%	95,408	94	0.20%	12	7	19
Time Deposits	114,616	316	0.55%	116,491	338	0.59%	(5)	(17)	(22)
Total Interest-Bearing Deposits	311,309	451	0.29%	294,216	453	0.31%	9	(11)	(2)
Securities Sold Under Agreement to Repurchase	20,368	24	0.24%	20,109	25	0.25%	-	(1)	(1)
Total Interest-Bearing Liabilities	331,677	475	0.29%	314,325	478	0.31%	9	(12)	(3)
Non-Interest-Bearing Liabilities:									
Demand deposits	164,012			172,513					
Other liabilities	1,621			1,180					
Total Liabilities	497,310			488,018					
Shareholders Equity	57,080			60,365					
Total Liabilities & Shareholders Equity	\$ 554,390			\$ 548,383					
Net Interest Income (Tax Equivalent)		\$ 9,029			\$ 7,869		\$ 987	\$ 173	\$ 1,160
Interest Rate Spread (2)			3.38%			2.97%			
Interest Expense as a Percentage of Average Earning Assets			0.18%			0.19%			
Net Interest Margin (3)			3.49%			3.09%			

- (1) Tax-exempt income for investment securities has been adjusted to a fully tax-equivalent basis (FTE), using a Federal income tax rate of 34%.  
(2) Interest spread is the average yield earned on earning assets less the average rate paid on interest-bearing liabilities.  
(3) Net interest margin is net interest income expressed as a percentage of average earning assets.  
(4) The impact on the net interest income resulting from changes in average balances and average rates is shown for the period indicated. The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

Provision for loan losses

A recovery of the provision for loan losses of \$395 thousand was recorded in the first half of 2016, while a provision for loan losses of \$317 thousand was recognized for the first half of 2015. This resulted in a positive impact to income of \$712 thousand when comparing year-over-year. Last year's loan loss provision was driven by the \$53.8 million in loan growth during the first two quarters of 2015. As discussed earlier, beginning with the second quarter of 2016, the Company moved from a historical loss rate method to a loss migration model. The 2016 recovery of provision for loan loss is reflective of a continued improvement in asset quality, slower loan growth, and the Company's movement to the migration loss analysis. Further discussion of management's assessment of the allowance for loan losses is provided earlier in the report and in Note 4 Allowance for Loan Losses, found in the Notes to the Consolidated Financial Statements. In management's opinion, the allowance was adequately provided for at June 30, 2016.

Noninterest income

Noninterest income for the quarter ended June 30, 2016 of \$1.3 million was level with the amount recorded for the quarter ended June 30, 2015. On a year-to-date basis, noninterest income of \$2.4 million was recognized in the first six months of 2016, a decline of \$65 thousand from the same period in 2015.

The components of noninterest income for the three and six months are shown below (dollars in thousands):

	For the three months ended		For the six months ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
<b>Noninterest income:</b>				
Trust income	\$ 398	\$ 445	\$ 786	\$ 894
Brokerage and insurance income	94	8	181	24
Royalty income	9	36	9	81
Customer service fees	227	233	446	467
Debit/credit card and ATM fees	232	219	430	399
Earnings on bank owned life insurance	111	110	220	218
Fees on mortgage sales	67	57	115	94
Gains on sales of securities	-	24	8	46
Losses on sales of other assets	(2)	-	(27)	-
Other	114	123	206	216
<b>Total noninterest income</b>	<b>\$ 1,250</b>	<b>\$ 1,255</b>	<b>\$ 2,374</b>	<b>\$ 2,439</b>

The purchase of the wealth management book of business, as discussed earlier under Note 5 Intangible Assets, increased the brokerage and insurance revenue by \$157 thousand from the same six-month period last year. Offsetting this increase, VNB Wealth realized \$108 thousand less in trust income. Small downticks in other categories further suppressed noninterest income, accounting for the year-over-year contraction.

Noninterest expense

Noninterest expense for the second quarter of 2016 was \$3.8 million, a reduction of \$416 thousand from the \$4.2 million reported in the quarter ended June 30, 2015. For the first six months of 2016, noninterest expense contracted by 8.9% to \$7.6 million compared to the \$8.3 million recognized in the same period of 2015. The \$737 thousand reduction year-over-year was driven by a \$766 thousand decline in salaries and employee benefits as management continually takes advantage of opportunities to streamline operations and maximize the efficiency of staff. In addition, 2015 was the last year that the Company accrued for guaranteed bonuses which were strategically used to retain valued personnel to stabilize the VNB Wealth Management team during its planned transition. Other expense categories have been identified and are being evaluated for potential savings that would have a positive impact on net income on an ongoing basis.

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The components of noninterest expense for the three and six months are shown below (dollars in thousands):

	For the three months ended		For the six months ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
<b>Noninterest expense:</b>				
Salaries and employee benefits	\$ 1,847	\$ 2,215	\$ 3,765	\$ 4,531
Net occupancy	472	483	948	979
Equipment	132	136	267	266
ATM, debit and credit card	79	77	149	147
Bank franchise tax	109	96	215	188
Computer software	94	88	181	170
Data processing	298	285	587	544
FDIC deposit insurance assessment	71	94	155	186
Marketing, advertising and promotion	137	161	275	286
Professional fees	119	131	230	291
Other	401	409	784	705
<b>Total noninterest expense</b>	<b>\$ 3,759</b>	<b>\$ 4,175</b>	<b>\$ 7,556</b>	<b>\$ 8,293</b>

One of the ratios the Company examines in its evaluation of net income is the efficiency ratio, which measures the cost to produce one dollar of revenue. The Company computes its efficiency ratio by dividing noninterest expense by the sum of net interest income (on an FTE basis) and noninterest income. A lower ratio is an indicator of increased efficiency.

The efficiency ratio of 65.7% for the second quarter of 2016 reflected an improvement of 13.2 percentage points compared to the efficiency ratio of 78.9% for the same quarter of 2015.

The efficiency ratio of 66.3% for the first six months of 2016 compared favorably to the efficiency ratio of 80.5% for the first six months of 2015. The improved asset mix from the significant loan growth experienced last year added to the revenue stream, while cost reduction strategies lowered expenses.

### Provision for Income Taxes

For the three and six months ended June 30, 2016, the Company provided \$686 thousand and \$1.3 million for Federal income taxes, resulting in an effective income tax rate of 31.2% and 31.1%, respectively. For the three and six months ended June 30, 2015, the Company provided \$291 thousand and \$400 thousand for Federal income taxes, resulting in an effective income tax rate of 27.5% and 25.3%, respectively. The effective income tax rates differed from the U.S. statutory rate of 34% during the comparable periods primarily due to the effect of tax-exempt income from municipal bonds and life insurance policies. The tax benefits from the tax-exempt income in the first six months of 2016 and 2015 of \$133 thousand and \$150 thousand, respectively, remained fairly constant over the two periods. However, the higher effective tax rate for 2016 compared to the prior year was a result of significantly higher net income before taxes that was taxable at the full statutory rate.

### **OTHER SIGNIFICANT EVENTS**

None

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Not required

### **ITEM 4. CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed in reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and the Controller (Acting Principal Financial Officer), as appropriate, to allow timely decisions regarding required disclosure.

In designing and evaluating its disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

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Based on their evaluation as of the end of the period covered by this quarterly report on Form 10-Q, the Company's Chief Executive Officer and Controller (Acting Principal Financial Officer) have concluded that the disclosure controls and procedures were effective at the reasonable assurance level. There was no change in the internal control over financial reporting that occurred during the quarter ended June 30, 2016 that has materially affected, or is reasonably likely to materially affect, the internal control over financial reporting.

### PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS.

None

#### ITEM 1A. RISK FACTORS.

Not required

#### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

On September 22, 2014, the Company announced the approval by its Board of Directors of a stock repurchase program authorizing repurchase of up to 400,000 shares of the Company's common shares through the open market or in privately negotiated transactions. The Company announced on September 21, 2015 that its Board of Directors extended the program for another year. As of June 30, 2016, a total of 343,559 shares have been purchased since the beginning of this program, with the remaining 56,441 shares available for purchase through September 18, 2016 under the extended program (the "Stock Repurchase Program").

The table below represents the number of shares repurchased by quarter since the Stock Repurchase Program's inception on September 16, 2014 through June 30, 2016.

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced Plan	Maximum number of shares that may yet be purchased under the Plan
September 16, 2014 to September 30, 2014	-	\$ -	-	400,000
October 1, 2014 to December 31, 2014	11,500	\$ 22.75	11,500	388,500
January 1, 2015 to March 31, 2015	805	\$ 22.50	12,305	387,695
April 1, 2015 to June 30, 2015	252,907	\$ 22.90	265,212	134,788
July 1, 2015 to September 30, 2015	-	\$ -	265,212	134,788
October 1, 2015 to December 31, 2015	23,285	\$ 22.90	288,497	111,503
January 1, 2016 to March 31, 2016	55,062	\$ 22.90	343,559	56,441
April 1, 2016 to June 30, 2016	-	\$ -	343,559	56,441
<b>Total</b>	<b>343,559</b>	<b>\$ 22.89</b>	<b>343,559</b>	<b>56,441</b>

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None

ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable

ITEM 5. OTHER INFORMATION.

(a) Required 8-K disclosures.

None

(b) Changes in procedures for director nominations by security holders.

None

ITEM 6. EXHIBITS.

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
2.0	Reorganization Agreement and Plan of Share Exchange, dated as of March 6, 2013, between Virginia National Bank and Virginia National Bankshares Corporation <sup>a</sup>
3.1	Articles of Incorporation of Virginia National Bankshares Corporation, as amended and restated <sup>b</sup>
3.2	Bylaws of Virginia National Bankshares Corporation <sup>c</sup>
10.1	Virginia National Bank 2003 Stock Incentive Plan <sup>d</sup>
10.2	Virginia National Bank Amended and Restated 2005 Stock Incentive Plan <sup>e</sup>
10.3	Virginia National Bankshares Corporation 2014 Stock Incentive Plan <sup>f</sup>
31.1	302 Certification of Principal Executive Officer
31.2	302 Certification of Acting Principal Financial Officer
32.1	906 Certification
101.0	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets as of June 30, 2016 and December 31, 2015, (ii) the Consolidated Statements of Income for the three and six months ended June 30, 2016 and June 30, 2015, (iii) the Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2016 and June 30, 2015, (iv) the Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2016 and June 30, 2015, (v) the Consolidated Statements of Cash Flows for the six months ended June 30, 2016 and June 30, 2015 and (vi) the Notes to the Consolidated Financial Statements (furnished herewith).

a, b, c Incorporated herein by reference to Virginia National Bankshares Corporation's Current Report on Form 8-K, filed with the Securities and Exchange Commission on December 18, 2013.

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<sup>d</sup> Incorporated herein by reference to Virginia National Bank's Definitive Proxy Statement, filed with the Office of the Comptroller of the Currency on April 24, 2003. Virginia National Bankshares Corporation assumed this plan on December 16, 2013 upon consummation of the reorganization under the agreement referenced as Exhibit 2.0.

<sup>e</sup> Incorporated herein by reference to Virginia National Bank's Definitive Proxy Statement, filed with the Office of the Comptroller of the Currency on March 30, 2006. Virginia National Bankshares Corporation assumed this plan on December 16, 2013 upon consummation of the reorganization under the agreement referenced as Exhibit 2.0.

<sup>f</sup> Incorporated herein by reference to Virginia National Bankshares Corporation's Definitive Proxy Statement, filed with the Securities and Exchange Commission on April 10, 2014.



SIGNATURES

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

VIRGINIA NATIONAL BANKSHARES CORPORATION

(Registrant)

By: /s/ Glenn W. Rust  
Glenn W. Rust  
President and Chief Executive Officer

Date: August 15, 2016

By: /s/ Vicki T. Miller  
Vicki T. Miller  
Senior Vice President and Controller

Date: August 15, 2016