

Virginia National Bankshares Corp
Form 10-Q
May 16, 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 March 31, 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 May 12, 2016:

| Class of Stock | Shares Outstanding |
|--------------------------------|--------------------|
| Common Stock, Par Value \$2.50 | 2,358,777 |

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)

| | March 31, 2016 (UNAUDITED) | December 31, 2015 * |
|---|-------------------------------|---------------------|
| ASSETS | | |
| Cash and due from banks | \$ 9,786 | \$ 14,200 |
| Federal funds sold | 23,857 | 29,327 |
| Securities: | | |
| Available for sale, at fair value | 71,436 | 74,801 |
| Restricted securities, at cost | 1,708 | 1,681 |
| Total securities | 73,144 | 76,482 |
| Loans | 424,588 | 423,664 |
| Allowance for loan losses | (3,440) | (3,567) |
| Loans, net | 421,148 | 420,097 |
| Premises and equipment, net | 8,445 | 8,668 |
| Bank owned life insurance | 13,585 | 13,476 |
| Goodwill | 372 | - |
| Other intangible assets, net | 756 | - |
| Accrued interest receivable and other assets | 4,749 | 5,241 |
| Total assets | \$ 555,842 | \$ 567,491 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Demand deposits: | | |
| Noninterest-bearing | \$ 172,431 | \$ 184,574 |
| Interest-bearing | 87,402 | 90,100 |
| Money market deposit accounts | 103,109 | 103,175 |
| Certificates of deposit and other time deposits | 115,851 | 108,618 |
| Total deposits | 478,793 | 486,467 |
| Securities sold under agreements to repurchase | 18,519 | 23,156 |
| Accrued interest payable and other liabilities | 1,951 | 1,571 |
| Total liabilities | 499,263 | 511,194 |
| Shareholders' equity: | | |
| 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; 2,358,777 and 2,412,589 issued and outstanding at March 31, 2016 and December 31, 2015, respectively | 5,897 | 6,031 |
| Capital surplus | 21,117 | 22,214 |
| Retained earnings | 29,289 | 28,170 |
| Accumulated other comprehensive income (loss) | 276 | (118) |
| Total shareholders' equity | 56,579 | 56,297 |
| Total liabilities and shareholders' equity | \$ 555,842 | \$ 567,491 |

*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 | |
|--|----------------------------|----------------|
| | March 31, 2016 | March 31, 2015 |
| Interest and dividend income: | | |
| Loans, including fees | \$ 4,333 | \$ 3,262 |
| Federal funds sold | 31 | 23 |
| Investment securities: | | |
| Taxable | 280 | 582 |
| Tax exempt | 84 | 116 |
| Dividends | 21 | 21 |
| Other | 4 | 7 |
| Total interest and dividend income | 4,753 | 4,011 |
| Interest expense: | | |
| Demand and savings deposits | 67 | 57 |
| Certificates and other time deposits | 160 | 167 |
| Federal funds purchased and securities sold under agreements to repurchase | 12 | 12 |
| Total interest expense | 239 | 236 |
| Net interest income | 4,514 | 3,775 |
| Provision for (recovery of) loan losses | (120) | 317 |
| Net interest income after provision for (recovery of) loan losses | 4,634 | 3,458 |
| Noninterest income: | | |
| Trust income | 388 | 449 |
| Customer service fees | 219 | 234 |
| Debit/credit card and ATM fees | 198 | 180 |
| Earnings on bank owned life insurance | 109 | 108 |
| Gains (losses) on sales of assets | (25) | - |
| Gains on sales of securities | 8 | 22 |
| Royalty income | - | 45 |
| Fees on mortgage sales | 48 | 37 |
| Other | 179 | 109 |
| Total noninterest income | 1,124 | 1,184 |
| Noninterest expense: | | |
| Salaries and employee benefits | 1,918 | 2,316 |
| Net occupancy | 476 | 496 |
| Equipment | 135 | 130 |
| Other | 1,268 | 1,176 |
| Total noninterest expense | 3,797 | 4,118 |
| Income before income taxes | 1,961 | 524 |
| Provision for income taxes | 606 | 109 |
| Net income | \$ 1,355 | \$ 415 |
| Earnings per common share, basic | \$ 0.57 | \$ 0.15 |
| Earnings per common share, diluted | \$ 0.57 | \$ 0.15 |

See Notes to Consolidated Financial Statements

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

| | For the three months ended | |
|---|----------------------------|----------------|
| | March 31, 2016 | March 31, 2015 |
| Net income | \$ 1,355 | \$ 415 |
| Other comprehensive income | | |
| Unrealized gain on securities, net of tax of \$205 and \$380 for the three months ended March 31, 2016 and 2015 | 399 | 738 |
| Reclassification adjustment for realized gains on sales of securities, net of tax of (\$3) and (\$7) for the three months ended March 31, 2016 and 2015 | (5) | (15) |
| Total other comprehensive income | 394 | 723 |
| Total comprehensive income | \$ 1,749 | \$ 1,138 |

See Notes to Consolidated Financial Statements

VIRGINIA NATIONAL BANKSHARES CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2016 AND 2015
(dollars in thousands, except per share data)
(unaudited)

| | Common Stock | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|--|-----------------|--------------------|----------------------|--|-----------|
| Balance, December 31, 2014 | \$ 6,721 | \$ 27,889 | \$ 25,978 | \$ 44 | \$ 60,632 |
| Stock options exercised | 3 | 20 | - | - | 23 |
| Stock purchased under stock repurchase plan | (2) | (16) | - | - | (18) |
| Stock option expense | - | 9 | - | - | 9 |
| Cash dividend declared (\$0.075 per share) | - | - | (201) | - | (201) |
| Net income | - | - | 415 | - | 415 |
| Other comprehensive income | - | - | - | 723 | 723 |
| Balance, March 31, 2015 | \$ 6,722 | \$ 27,902 | \$ 26,192 | \$ 767 | \$ 61,583 |
| Balance, December 31, 2015 | \$ 6,031 | \$ 22,214 | \$ 28,170 | \$ (118) | \$ 56,297 |
| Stock options exercised | 3 | 19 | - | - | 22 |
| Stock purchased under stock repurchase plan | (137) | (1,123) | - | - | (1,260) |
| Stock option expense | - | 7 | - | - | 7 |
| Cash dividend declared (\$0.10 per share) | - | - | (236) | - | (236) |
| Net income | - | - | 1,355 | - | 1,355 |
| Other comprehensive income | - | - | - | 394 | 394 |
| Balance, March 31, 2016 | \$ 5,897 | \$ 21,117 | \$ 29,289 | \$ 276 | \$ 56,579 |

See Notes to Consolidated Financial Statements

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

| | For the three months ended | |
|---|----------------------------|--------------------|
| | March 31, 2016 | March 31, 2015 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 1,355 | \$ 415 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for (recovery of) loan losses | (120) | 317 |
| Net amortization and accretion of securities | 117 | 196 |
| Net gains on sales of securities | (8) | (22) |
| Net losses on sales of assets | 25 | - |
| Earnings on bank owned life insurance | (109) | (108) |
| Amortization of intangible assets | 17 | - |
| Depreciation and other amortization | 290 | 296 |
| Stock option/stock grant expense | 7 | 9 |
| Decrease in accrued interest receivable and other assets | 315 | 845 |
| Decrease in accrued interest payable and other liabilities | (85) | (529) |
| Net cash provided by operating activities | 1,804 | 1,419 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of available for sale securities | (6,982) | (26,770) |
| Net increase in restricted investments | (27) | (21) |
| Proceeds from maturities, calls and principal payments of available for sale securities | 8,804 | 11,533 |
| Proceeds from sales of available for sale securities | 2,030 | 3,302 |
| Net increase in organic loans | (4,709) | (15,228) |
| Net decrease (increase) in purchased loans | 3,778 | (12,240) |
| Cash payment for wealth management book of business | (700) | - |
| Purchase of bank premises and equipment | (92) | (166) |
| Net cash provided by (used in) investing activities | 2,102 | (39,590) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net (decrease) increase in demand deposits, NOW accounts, and money market accounts | (14,907) | 8,332 |
| Net increase (decrease) in certificates of deposit and other time deposits | 7,233 | (3,407) |
| Net (decrease) increase in securities sold under agreements to repurchase | (4,637) | 1,519 |
| Common stock repurchased | (1,260) | (18) |
| Proceeds from stock options exercised | 22 | 23 |
| Cash dividends | (241) | (201) |
| Net cash (used in) provided by financing activities | (13,790) | 6,248 |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | \$ (9,884) | \$ (31,923) |
| CASH AND CASH EQUIVALENTS: | | |
| Beginning of period | \$ 43,527 | \$ 54,107 |
| End of period | \$ 33,643 | \$ 22,184 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | |
| Cash payments for: | | |
| Interest | \$ 235 | \$ 243 |
| Taxes | \$ 454 | \$ 309 |
| SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES | | |
| Unrealized gain on available for sale securities | \$ 596 | \$ 1,096 |

VIRGINIA NATIONAL BANKSHARES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

March 31, 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-months ended March 31, 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.

Note 2. Securities

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

| March 31, 2016 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---------------------------------|----------------|------------------------|-------------------------|------------|
| U.S. Government agencies | \$ 11,243 | \$ 136 | \$ (9) | \$ 11,370 |
| Corporate bonds | 6,024 | 32 | - | 6,056 |
| Mortgage-backed securities/CMOs | 35,305 | 138 | (173) | 35,270 |
| Municipal bonds | 18,446 | 303 | (9) | 18,740 |
| | \$ 71,018 | \$ 609 | \$ (191) | \$ 71,436 |

| 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 |

Securities having carrying values of \$38.9 million at March 31, 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 three months ended March 31, 2016, proceeds from the sales of securities amounted to \$2.0 million, and realized gains on these securities were \$8 thousand. For the three months ended March 31, 2015, proceeds from the sales of securities amounted to \$3.3 million, with realized gains on these securities of \$18 thousand, and an additional \$5.4 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, totaling \$1.7 million as of March 31, 2016 and December 31, 2015. These restricted securities are carried at cost.

The following table summarizes all securities with unrealized losses, segregated by length of time in a continuous unrealized loss position, at March 31, 2016 and December 31, 2015 (dollars in thousands):

March 31, 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 | \$ 4,479 | \$ (3) | \$ 995 | \$ (6) | \$ 5,474 | \$ (9) |
| Mortgage-backed/CMOs | 7,150 | (27) | 10,838 | (146) | 17,988 | (173) |
| Municipal bonds | 1,816 | (9) | - | - | 1,816 | (9) |
| | \$ 13,445 | \$ (39) | \$ 11,833 | \$ (152) | \$ 25,278 | \$ (191) |

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) |

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| | | | | | | |
|----------------------|-----------|----------|-----------|----------|-----------|----------|
| 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) |

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As of March 31, 2016, there were \$25.3 million, or 25 issues of individual securities in a loss position. These securities have an unrealized loss of \$191 thousand and consisted of 19 mortgage-backed/CMOs, 3 municipal bonds, and 3 agency bonds.

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 March 31, 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 March 31, 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.

Note 3. Loans

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

| | March 31, 2016 | December 31, 2015 |
|--|-------------------|----------------------|
| Commercial | | |
| Commercial and industrial - organic | \$ 47,203 | \$ 47,215 |
| Commercial and industrial - syndicated | 20,615 | 23,653 |
| Total commercial and industrial | 67,818 | 70,868 |
| Real estate construction and land | | |
| Residential construction | 1,773 | 2,178 |
| Other construction and land | 16,590 | 16,733 |
| Total construction and land | 18,363 | 18,911 |
| Real estate mortgages | | |
| 1-4 family residential | 67,278 | 63,544 |
| Home equity lines of credit | 26,699 | 27,599 |
| Multifamily | 18,083 | 20,209 |
| Commercial owner occupied | 69,849 | 66,244 |
| Commercial non-owner occupied | 92,813 | 91,805 |
| Total real estate mortgage | 274,722 | 269,401 |
| Consumer | | |
| Consumer revolving credit | 16,922 | 17,174 |
| Consumer all other credit | 11,848 | 11,655 |
| Student loans purchased | 34,915 | 35,655 |
| Total consumer | 63,685 | 64,484 |
| Total loans | 424,588 | 423,664 |
| Less: Allowance for loan losses | (3,440) | (3,567) |
| Net loans | \$ 421,148 | \$ 420,097 |

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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.

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.

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.

Following is a breakdown by class of the loans classified as impaired loans as of March 31, 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 three months ended March 31, 2016 or the twelve months ended December 31, 2015. Interest income recognized is for the three months ended March 31, 2016 or the twelve months ended December 31, 2015. (Dollars below reported in thousands.)

March 31, 2016

| | Recorded Investment | Unpaid Principal Balance | Associated Allowance | Average Recorded Investment | Interest Income Recognized |
|---|------------------------|--------------------------------|-------------------------|-----------------------------------|----------------------------------|
| Impaired loans without a valuation allowance: | | | | | |
| Other construction and land | 57 | 103 | - | 58 | - |
| 1-4 family residential mortgages | 491 | 518 | - | 493 | 4 |
| Commercial non-owner occupied real estate | 1,049 | 1,049 | - | 1,053 | 11 |
| Impaired loans with a valuation allowance | - | - | - | - | - |
| Total impaired loans | \$ 1,597 | \$ 1,670 | \$ - | \$ 1,604 | \$ 15 |

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 | \$ - |
| Other construction and land | 59 | 103 | - | 64 | - |
| 1-4 family residential mortgages | 499 | 524 | - | 685 | 23 |
| 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 |

Non-accrual loans are shown below by class (dollars in thousands):

| | March 31, 2016 | December 31, 2015 |
|----------------------------------|-------------------|----------------------|
| Other construction and land | \$ 57 | \$ 59 |
| 1-4 family residential mortgages | 128 | 132 |
| Total nonaccrual loans | \$ 185 | \$ 191 |

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) | March 31, 2016 | | December 31, 2015 | |
|---|----------------|---------------------|-------------------|---------------------|
| | No. of Loans | Recorded Investment | No. of Loans | Recorded Investment |
| Performing TDRs | | | | |
| 1-4 family residential mortgages | 2 | \$ 363 | 2 | \$ 366 |
| Commercial non-owner occupied real estate | 1 | 1,049 | 1 | 1,061 |
| Total performing TDRs | 3 | \$ 1,412 | 3 | \$ 1,427 |
| Nonperforming TDRs | | | | |
| Other construction and land | 1 | \$ 33 | 1 | \$ 34 |
| Total TDRs | 4 | \$ 1,445 | 4 | \$ 1,461 |

None of the TDRs reported above were modified under the terms of a TDR during the three months ended March 31, 2016 and 2015. Loans modified as TDRs that were fully paid down, charged-off, or foreclosed upon by period end are not reportable. Additionally, there were no loans modified as TDRs that subsequently defaulted during the three months ended March 31, 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 March 31, 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, trends in 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.

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the 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.

Loan Classes by Segments

Commercial loan segment:

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

Real estate construction and land loan segment:

- Residential construction
- Other construction and land

Real estate mortgage loan segment:

- 1-4 family residential
- Home equity lines of credit
- Multifamily
- Commercial owner occupied
- Commercial non-owner occupied

Consumer loan segment:

Consumer revolving credit
Consumer all other credit
Student loans purchased

Based on the internal risk ratings assigned to each credit, a historical loss factor is assigned to the balances for each class of loans, using a cumulative historical loss rate for the most recent twelve quarters. 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 Applied

Excellent

0% 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% applied, as these loans represent a low risk and are secured by marketable securities 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 acceptable risk loans which require more attention than normal servicing

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 March 31, 2016 and December 31, 2015 (dollars in thousands).

| March 31, 2016 | Excellent | Good | Pass | Special Mention | Sub- standard | Doubtful | TOTAL |
|--|-----------------|------------------|-------------------|--------------------|------------------|-------------|-------------------|
| Commercial | | | | | | | |
| Commercial and industrial - organic | \$ 1,181 | \$ 29,379 | \$ 16,619 | \$ 24 | \$ - | \$ - | \$ 47,203 |
| Commercial and industrial - syndicated | - | - | 17,660 | - | 2,955 | - | 20,615 |
| Real estate construction | | | | | | | |
| Residential construction | - | - | 1,773 | - | - | - | 1,773 |
| Other construction and land | - | - | 15,468 | 506 | 616 | - | 16,590 |
| Real estate mortgages | | | | | | | |
| 1-4 family residential | - | 1,500 | 64,706 | 429 | 643 | - | 67,278 |
| Home equity lines of credit | - | - | 26,616 | - | 83 | - | 26,699 |
| Multifamily | - | - | 18,083 | - | - | - | 18,083 |
| Commercial owner occupied | - | - | 69,849 | - | - | - | 69,849 |
| Commercial non-owner occupied | - | - | 91,702 | - | 1,111 | - | 92,813 |
| Consumer | | | | | | | |
| Consumer revolving credit | 76 | 16,211 | 630 | - | 5 | - | 16,922 |
| Consumer all other credit | 214 | 10,285 | 1,309 | - | 40 | - | 11,848 |
| Student loans purchased | - | - | 34,915 | - | - | - | 34,915 |
| Total Loans | \$ 1,471 | \$ 57,375 | \$ 359,330 | \$ 959 | \$ 5,453 | \$ - | \$ 424,588 |

| December 31, 2015 | Excellent | Good | Pass | Special Mention | Sub- standard | Doubtful | TOTAL |
|--|-----------------|------------------|-------------------|--------------------|------------------|-------------|-------------------|
| Commercial | | | | | | | |
| Commercial and industrial - organic | \$ 1,238 | \$ 30,221 | \$ 15,700 | \$ 25 | \$ 31 | \$ - | \$ 47,215 |
| Commercial and industrial - syndicated | - | - | 20,691 | - | 2,962 | - | 23,653 |
| Real estate construction | | | | | | | |
| Residential construction | - | - | 2,178 | - | - | - | 2,178 |
| Other construction and land | - | - | 15,591 | 515 | 627 | - | 16,733 |
| Real estate mortgages | | | | | | | |
| 1-4 family residential | - | 1,500 | 60,801 | 650 | 593 | - | 63,544 |
| Home equity lines of credit | - | - | 27,517 | - | 82 | - | 27,599 |
| Multifamily | - | - | 20,209 | - | - | - | 20,209 |
| Commercial owner occupied | - | - | 65,497 | - | 747 | - | 66,244 |
| Commercial non-owner occupied | - | - | 89,619 | 1,061 | 1,125 | - | 91,805 |
| Consumer | | | | | | | |
| Consumer revolving credit | 104 | 16,524 | 540 | - | 6 | - | 17,174 |
| Consumer all other credit | 232 | 10,063 | 1,319 | - | 41 | - | 11,655 |
| Student loans purchased | - | - | 35,655 | - | - | - | 35,655 |
| Total Loans | \$ 1,574 | \$ 58,308 | \$ 355,317 | \$ 2,251 | \$ 6,214 | \$ - | \$ 423,664 |

In addition to the historical factors, 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 four factors drive losses to a much greater extent than the last four factors; therefore, the first four factors are weighted more heavily.

Like the historical factors, qualitative factors are not assessed against loans rated excellent or rated good, since these are fully collateralized by cash, readily marketable collateral.

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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 six loans in the amount of \$1.6 million classified as impaired loans at March 31, 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.

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

As of and for the period ended March 31, 2016

| | Commercial Loans | Real Estate Construction and Land | Real Estate Mortgages | Consumer Loans | Total |
|---|---------------------|---|--------------------------|-------------------|------------|
| Allowance for Loan Losses: | | | | | |
| Balance as of January 1, 2016 | \$ 797 | \$ 159 | \$ 2,592 | \$ 19 | \$ 3,567 |
| Charge-offs | - | - | (12) | - | (12) |
| Recoveries | 4 | - | - | 1 | 5 |
| Provision for (recovery of) loan losses | (143) | (5) | (36) | 64 | (120) |
| Ending Balance | \$ 658 | \$ 154 | \$ 2,544 | \$ 84 | \$ 3,440 |
| Ending Balance: | | | | | |
| Individually evaluated for impairment | \$ - | \$ - | \$ - | \$ - | \$ - |
| Collectively evaluated for impairment | 658 | 154 | 2,544 | 84 | 3,440 |
| Loans: | | | | | |
| Individually evaluated for impairment | \$ - | \$ 57 | \$ 1,540 | \$ - | \$ 1,597 |
| Collectively evaluated for impairment | 67,818 | 18,306 | 273,182 | 63,685 | 422,991 |
| Ending Balance | \$ 67,818 | \$ 18,363 | \$ 274,722 | \$ 63,685 | \$ 424,588 |

As of and for the year ended December 31, 2015

| | Commercial Loans | Real Estate Construction and Land | Real Estate Mortgages | Consumer Loans | Total |
|---|---------------------|---|--------------------------|-------------------|------------|
| Allowance for Loan Losses: | | | | | |
| 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 |
| Ending Balance: | | | | | |
| Individually evaluated for impairment | \$ - | \$ - | \$ - | \$ - | \$ - |
| Collectively evaluated for impairment | 797 | 159 | 2,592 | 19 | 3,567 |
| Loans: | | | | | |
| 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 March 31, 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 March 31, 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 | | | | |
| Commercial loans | | | | | | | |
| Commercial and industrial - organic | \$ - | \$ - | \$ - | \$ - | \$ 47,203 | \$ 47,203 | \$ - |
| Commercial and industrial - syndicated | - | - | - | - | 20,615 | 20,615 | - |
| Real estate construction and land | | | | | | | |
| Residential construction | - | - | - | - | 1,773 | 1,773 | - |
| Other construction and land | - | - | - | - | 16,590 | 16,590 | - |
| Real estate mortgages | | | | | | | |
| 1-4 family residential | 71 | - | - | 71 | 67,207 | 67,278 | - |
| Home equity lines of credit | - | - | - | - | 26,699 | 26,699 | - |
| Multifamily | - | - | - | - | 18,083 | 18,083 | - |
| Commercial owner occupied | - | - | - | - | 69,849 | 69,849 | - |
| Commercial non-owner occupied | - | - | - | - | 92,813 | 92,813 | - |
| Consumer loans | | | | | | | |
| Consumer revolving credit | - | - | - | - | 16,922 | 16,922 | - |
| Consumer all other credit | 64 | - | - | 64 | 11,784 | 11,848 | - |
| Student loans purchased | 376 | 285 | 74 | 735 | 34,180 | 34,915 | 74 |
| Total Loans | \$ 511 | \$ 285 | \$ 74 | \$ 870 | \$ 423,718 | \$ 424,588 | \$ 74 |

| 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 | | | | |
| Commercial loans | | | | | | | |
| Commercial and industrial - organic | \$ 211 | \$ 40 | \$ - | \$ 251 | \$ 46,964 | \$ 47,215 | \$ - |
| Commercial and industrial - syndicated | - | - | - | - | 23,653 | 23,653 | - |
| Real estate construction and land | | | | | | | |
| Residential construction | - | - | - | - | 2,178 | 2,178 | - |
| Other construction and land | 7 | - | - | 7 | 16,726 | 16,733 | - |
| Real estate mortgages | | | | | | | |
| 1-4 family residential | 156 | 36 | - | 192 | 63,352 | 63,544 | - |
| Home equity lines of credit | - | - | - | - | 27,599 | 27,599 | - |
| Multifamily | - | - | - | - | 20,209 | 20,209 | - |
| Commercial owner occupied | - | - | - | - | 66,244 | 66,244 | - |
| Commercial non-owner occupied | - | - | - | - | 91,805 | 91,805 | - |
| Consumer loans | | | | | | | |
| 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 | - |
| Total Loans | \$ 1,245 | \$ 78 | \$ - | \$ 1,323 | \$ 422,341 | \$ 423,664 | \$ - |

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 market 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.

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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 |
|-------------------------------------|------------|------------------------------|--------------------------------|
| Identified Intangible Assets | | | |
| Non-Compete Agreement | \$ 103 | 9.0% | 3 years |
| Customer Relationships Intangible | 670 | 58.5% | 10 years |
| Total Identified Intangible Assets | \$ 773 | 67.5% | |
| Goodwill - Residual | \$ 372 | 32.5% | Indefinite |
| Total Intangible Assets | \$ 1,145 | 100.0% | |

For the quarter ended March 31, 2016, the Company recognized \$17 thousand in amortization expense from these identified intangible assets with a finite life. The net carrying value of \$756 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 March 31, 2016. (Dollars below reported in thousands.)

| | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
|-------------------------------------|----------------------|--------------------------|--------------------|
| Identified Intangible Assets | | | |
| Non-Compete Agreement | \$ 103 | \$ 6 | \$ 97 |
| Customer Relationships Intangible | 670 | 11 | 659 |
| Total Identified Intangible Assets | \$ 773 | \$ 17 | \$ 756 |

As of March 31, 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. Earnings 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 earnings per common share and the effect on weighted average number of shares of diluted potential common stock for the three months ended March 31, 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.)

| Three Months Ended | March 31, 2016 | | | March 31, 2015 | | |
|--------------------------|----------------|-------------------------|------------------|----------------|-------------------------|------------------|
| | Net Income | Weighted Average Shares | Per Share Amount | Net Income | Weighted Average Shares | Per Share Amount |
| Basic earnings per share | \$ 1,355 | 2,382,951 | \$ 0.57 | \$ 415 | 2,688,400 | \$ 0.15 |

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| | | | | | | |
|----------------------------------|----------|-----------|---------|--------|-----------|---------|
| Effect of dilutive stock options | - | 14,088 | - | - | 9,664 | - |
| Diluted earnings per share | \$ 1,355 | 2,397,039 | \$ 0.57 | \$ 415 | 2,698,064 | \$ 0.15 |

For the periods ended March 31, 2016 and March 31, 2015, option shares totaling 59,110 and 140,308, 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 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 market 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.

A summary of the shares issued and available under each of the Plans is shown below as of March 31, 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 |
| Grants issued and outstanding: | | | |
| Total vested and unvested shares | 30,214 | 102,829 | - |
| Fully vested shares | 30,214 | 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 a fair value on the date of grant and expensed based on that fair value over the applicable vesting period. For the three months ended March 31, 2016 and 2015, the Company recognized \$7 thousand and \$9 thousand, respectively, in compensation expense for stock options. As of March 31, 2016, there was \$29 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 | Weighted Average Exercise Price | Aggregate Intrinsic Value |
|---------------------------------------|-------------------|---------------------------------|---------------------------|
| Outstanding at January 1, 2016 | 152,118 | \$ 25.36 | \$ 354 |
| Exercised | (1,250) | \$ 18.10 | |
| Expired | (17,825) | \$ 32.43 | - |
| Outstanding at March 31, 2016 | 133,043 | \$ 24.48 | \$ 287 |
| Options exercisable at March 31, 2016 | 129,293 | \$ 24.69 | \$ 264 |

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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 three months of 2016 or during the twelve months of 2015.

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Summary information pertaining to options outstanding at March 31, 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 | 44,514 | 4.1 Years | \$ 17.15 | 40,764 | \$ 17.15 |
| \$20.01 to 30.00 | 58,514 | 1.9 Years | 24.83 | 58,514 | 24.83 |
| \$30.01 to 36.74 | 30,015 | 0.7 Years | 34.67 | 30,015 | 34.67 |
| Total | 133,043 | 2.4 Years | \$ 24.48 | 129,293 | \$ 24.69 |

Restricted Stock

There were no restricted stock grants outstanding throughout 2015 or as of March 31, 2016. No restricted stock grants were awarded during 2015 or the first three 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 March 31, 2016 and December 31, 2015 (dollars in thousands):

| <u>Fair Value Measurements at March 31, 2016 Using:</u> | | | | |
|--|-----------|-----------|-------------|--------------|
| Description | Balance | Quoted | Significant | Significant |
| | | Prices in | Other | |
| | | Active | Observable | Unobservable |
| | | Markets | Inputs | Inputs |
| | | for | (Level 2) | (Level 3) |
| | | Identical | | |
| | | Assets | | |
| | | (Level 1) | | |
| Assets: | | | | |
| U.S. Government agencies | \$ 11,370 | \$ - | \$ 11,370 | \$ - |
| Corporate bonds | 6,056 | - | 6,056 | - |
| Mortgage-backed securities/CMOs | 35,270 | - | 35,270 | - |
| Municipal bonds | 18,740 | - | 18,740 | - |
| Total securities available for sale | \$ 71,436 | \$ - | \$ 71,436 | \$ - |

| <u>Fair Value Measurements at December 31, 2015 Using:</u> | | | | |
|---|-----------|-----------|-------------|--------------|
| Description | Balance | Quoted | Significant | Significant |
| | | Prices in | Other | |
| | | Active | Observable | Unobservable |
| | | Markets | Inputs | Inputs |
| | | for | (Level 2) | (Level 3) |
| | | Identical | | |
| | | Assets | | |
| | | (Level 1) | | |
| Assets: | | | | |
| 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.

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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).

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 \$1.6 million in impaired loans as of March 31, 2016 and December 31, 2015. 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 March 31, 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

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 March 31, 2016 and December 31, 2015 are as follows (dollars in thousands):

Fair Value Measurement at March 31, 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 |
|--|----------------|---|--|--|------------|
| Assets | | | | | |
| Cash and cash equivalent | \$ 33,643 | \$ 33,643 | \$ - | \$ - | \$ 33,643 |
| Available for sale securities | 71,436 | - | 71,436 | - | 71,436 |
| Loans, net | 421,148 | - | - | 418,966 | 418,966 |
| Bank owned life insurance | 13,585 | - | 13,585 | - | 13,585 |
| Accrued interest receivable | 1,542 | - | 351 | 1,191 | 1,542 |
| Liabilities | | | | | |
| Demand deposits and interest-bearing transaction and money market accounts | \$ 362,942 | \$ - | \$ 362,942 | \$ - | \$ 362,942 |
| Certificates of deposit | 115,851 | - | 115,767 | - | 115,767 |
| Securities sold under agreements to repurchase | 18,519 | - | 18,519 | - | 18,519 |
| Accrued interest payable | 110 | - | 110 | - | 110 |

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 |
|--|----------------|---|--|--|------------|
| Assets | | | | | |
| 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 |
| Liabilities | | | | | |
| 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 ended March 31, 2016 and 2015 (dollars in thousands):

| | Three Months Ended | |
|---------------------------------------|--------------------|----------------|
| | March 31, 2016 | March 31, 2015 |
| Available for sale securities | | |
| Realized gains on sales of securities | \$ 8 | \$ 22 |
| Tax effect | (3) | (7) |
| Realized gains, net of tax | \$ 5 | \$ 15 |

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 three months ended March 31, 2016 and March 31, 2015, management fees of \$25 thousand and \$34 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 months ended March 31, 2016 and 2015 is shown in the following tables (dollars in thousands):

| Three months ended March 31, 2016 | Bank | VNB Wealth | Consolidated |
|--|------------|------------|--------------|
| Net interest income | \$ 4,502 | \$ 12 | \$ 4,514 |
| Provision for (recovery of) loan losses | (120) | - | (120) |
| Noninterest income | 679 | 445 | 1,124 |
| Noninterest expense | 3,184 | 613 | 3,797 |
| Income (loss) before income taxes | 2,117 | (156) | 1,961 |
| Provision for (benefit of) income taxes | 659 | (53) | 606 |
| Net income (loss) | \$ 1,458 | \$ (103) | \$ 1,355 |
| Total assets | \$ 546,171 | \$ 9,671 | \$ 555,842 |
| | | | |
| Three months ended March 31, 2015 | Bank | VNB Wealth | Consolidated |
| Net interest income | \$ 3,769 | \$ 6 | \$ 3,775 |
| Provision for loan losses | 317 | - | 317 |
| Noninterest income | 690 | 494 | 1,184 |
| Noninterest expense | 3,381 | 737 | 4,118 |
| Income (loss) before income taxes | 761 | (237) | 524 |
| Provision for (benefit of) income taxes | 189 | (80) | 109 |
| Net income (loss) | \$ 572 | \$ (157) | \$ 415 |
| Total assets | \$ 533,916 | \$ 10,003 | \$ 543,919 |

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 ended March 31, 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.

For additional information regarding 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 significant changes in the Company's application of critical accounting policies related to the allowance for loan losses since December 31, 2015.

FINANCIAL CONDITION

Total assets

The total assets of the Company as of March 31, 2016 were \$555.8 million. This is an \$11.7 million decrease from the \$567.5 million total assets reported at December 31, 2015 and an \$11.9 million increase from the \$543.9 million reported at March 31, 2015. The year-over-year net growth in assets was funded largely by expansion within all deposit categories totaling \$17.2 million, while repurchase agreement sweep balances contracted by \$1.0 million over that period. Deposits and repurchase agreement sweep balances totaled \$497.3 million at March 31, 2016, up 3.4% from the \$481.1 million at March 31, 2015 and down 2.4% from the \$509.7 million at December 31, 2015.

Federal funds sold

The Company had overnight federal funds sold of \$23.9 million at March 31, 2016, compared to \$29.3 million at December 31, 2015. At March 31, 2015, the Company had overnight federal funds sold of \$8.8 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 March 31, 2016 totaled \$73.1 million, a decrease of \$3.4 million from the \$76.5 million reported at December 31, 2015 and a decrease of \$83.2 million from the \$156.3 million reported at March 31, 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 March 31, 2016, the investment securities holdings represented 13.2% of the Company's total assets, a decrease from the 13.5% and 28.7% of total assets at December 31, 2015 and March 31, 2015, respectively.

The Company's investment securities portfolio included restricted securities totaling \$1.7 million as of March 31, 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

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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.

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At March 31, 2016, the unrestricted securities portfolio totaled \$71.4 million. The following table summarizes the Company's available for sale securities by type as of March 31, 2016 and December 31, 2015 (dollars in thousands):

| | March 31, 2016 Balance | Percent of Total | December 31, 2015 Balance | Percent of Total |
|--|---------------------------|---------------------|---------------------------------|---------------------|
| U.S. Government agencies | \$ 11,370 | 15.92% | \$ 11,378 | 15.21% |
| Corporate bonds | 6,056 | 8.48% | 5,964 | 7.97% |
| Mortgage-backed securities/CMOs | 35,270 | 49.37% | 36,687 | 49.05% |
| Municipal bonds | 18,740 | 26.23% | 20,772 | 27.77% |
| Total available for sale securities | \$ 71,436 | 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 is Charlottesville, Albemarle County, Orange County, Winchester, Frederick County, Fauquier County and adjacent counties.

As of March 31, 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 \$84.0 million from the \$340.6 million at March 31, 2015. Loans as a percentage of total assets at March 31, 2016 were 76.4%, compared to 62.6% as of March 31, 2015. Loans as a percentage of deposits at March 31, 2016 were 88.7%, a 14.9 percentage point improvement over the 73.8% 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 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 \$924 thousand during the first quarter 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 into 2016. Management does not expect loan balances to continue to grow at the same pace as seen in 2015 but does still expect meaningful growth in the loan portfolio in 2016. To achieve this goal, we will continue to evaluate loan purchase transactions to supplement organic loan growth, from time to time.

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

| | March 31, 2016 Balance | Percent of Total | December 31, 2015 Balance | Percent of Total | March 31, 2015 Balance | Percent of Total |
|------------------------------------|---------------------------|---------------------|------------------------------|---------------------|---------------------------|---------------------|
| Commercial and industrial | \$ 67,818 | 16.0% | \$ 70,868 | 16.7% | \$ 74,339 | 21.8% |
| Real estate - commercial | 180,745 | 42.6% | 178,258 | 42.1% | 154,578 | 45.4% |
| Real estate - residential mortgage | 93,977 | 22.1% | 91,143 | 21.5% | 85,703 | 25.2% |
| Real estate - construction | 18,363 | 4.3% | 18,911 | 4.5% | 12,641 | 3.7% |
| Consumer installment and other | 63,685 | 15.0% | 64,484 | 15.2% | 13,384 | 3.9% |
| Total loans | \$ 424,588 | 100.0% | \$ 423,664 | 100.0% | \$ 340,645 | 100.0% |

Loan quality

Non-accrual loans remained low and totaled \$185 thousand at March 31, 2016, compared to the \$191 thousand and \$211 thousand reported at December 31, 2015 and March 31, 2015, respectively.

At March 31, 2016 and December 31, 2015, the Company had six loans in the amount of \$1.6 million classified as impaired loans. Of this total, \$1.4 million were Troubled Debt Restructurings (TDRs) which are still accruing interest. At March 31, 2015, the Company had eight loans in the amount of \$2.2 million classified as impaired loans. Of this total, \$2.0 million were TDRs which are still accruing interest.

The Company had loans totaling \$74 thousand that were past due ninety or more days and still accruing interest in its portfolio as of March 31, 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 March 31, 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

The allowance for loan losses as a percentage of total loans at March 31, 2016 was 0.81% compared to 0.84% at December 31, 2015 and 1.00% at March 31, 2015.

The following is a summary of the changes in the allowance for loan losses for the three months ended March 31, 2016 and March 31, 2015 (dollars in thousands):

| | 2016 | 2015 |
|---|----------|----------|
| Allowance for loan losses, January 1 | \$ 3,567 | \$ 3,164 |
| Chargeoffs | (12) | (86) |
| Recoveries | 5 | 9 |
| Provision for (recovery of) loan losses | (120) | 317 |
| Allowance for loan losses, March 31 | \$ 3,440 | \$ 3,404 |

A recovery of provision for loan losses of \$120 thousand was recorded in the first quarter of 2016, while a provision for loan losses of \$317 thousand was recognized for the first quarter of 2015. Net loan charge-offs for the first three months of 2016 totaled \$7 thousand, compared to net charge-offs totaling \$77 thousand during the first three months of 2015.

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

| | March 31, 2016 | December 31, 2015 | March 31, 2015 |
|--|-------------------|-------------------------|-------------------|
| Loans held for investment at period-end | \$ 424,588 | \$ 423,664 | \$ 340,645 |
| Allowance for loan losses | \$ 3,440 | \$ 3,567 | \$ 3,404 |
| Allowance as a percent of period-end loans | 0.81% | 0.84% | 1.00% |

The decreased balance in the allowance relative to total loans compared to the prior periods is reflective of the continued improvement in the historical loss rate, as well as a favorable shift in the mix of loans toward categories requiring minimal or no reserve, such as student loans that are insured by a surety bond and loans secured by readily-marketable collateral. 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

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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

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 management details the rollforward of the allowance by loan portfolio segments. The 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 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 March 31, 2016.

Premises and equipment

The Company's premises and equipment, net of depreciation, as of March 31, 2016 totaled \$8.4 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 March 31, 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 Bank also had a loan production office in Warrenton, Virginia.

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 March 31, 2016 were \$478.8 million, down \$7.7 million compared to the balances of \$486.5 million at December 31, 2015 and \$17.2 million or 3.7% higher than the \$461.6 million total as of March 31, 2015.

Noninterest-bearing demand deposits on March 31, 2016 were \$172.4 million, representing 36.0% of total deposits. Interest-bearing transaction and money market accounts totaled \$190.5 million, and represented 39.8% of total deposits at March 31, 2016. Collectively, noninterest-bearing and interest-bearing transaction and money market accounts represented 75.8% of total deposit accounts at March 31, 2016. These account types are an excellent source of low-cost funding for the Company.

Certificates of deposit and other time deposit accounts totaled \$115.9 million at March 31, 2016 and \$108.6 million at December 31, 2015. Included in this deposit total are Certificate of Deposit Account Registry Service CDs, known as CDARSTM, whereby depositors can obtain FDIC deposit insurance on account balances of up to \$50 million. CDARS deposits totaled \$17.1 million and \$17.2 million as of March 31, 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 March 31, 2016 were \$18.5 million, compared to \$23.2 million at December 31, 2015 and \$19.5 million as of March 31, 2015.

Deposit accounts

| (dollars in thousands) | March 31, 2016 | | December 31, 2015 | | March 31, 2015 | |
|---|-------------------|---------------------|-------------------|---------------------|-------------------|---------------------|
| | Balance | % of Total Deposits | Balance | % of Total Deposits | Balance | % of Total Deposits |
| No cost and low cost deposits | | | | | | |
| Noninterest demand deposits | \$ 172,431 | 36.0% | \$ 184,574 | 37.9% | \$ 163,556 | 35.5% |
| Interest checking accounts | 87,402 | 18.3% | 90,100 | 18.5% | 83,253 | 18.0% |
| Money market deposit accounts | 103,109 | 21.5% | 103,175 | 21.3% | 101,148 | 21.9% |
| Total noninterest and low cost deposit accounts | \$ 362,942 | 75.8% | \$ 377,849 | 77.7% | \$ 347,957 | 75.4% |
| Time deposit accounts | | | | | | |
| Certificates of deposit | \$ 98,736 | 20.6% | \$ 91,459 | 18.8% | \$ 96,085 | 20.8% |
| CDARS deposits | 17,115 | 3.6% | 17,159 | 3.5% | 17,602 | 3.8% |
| Total certificates of deposit and other time deposits | \$ 115,851 | 24.2% | \$ 108,618 | 22.3% | \$ 113,687 | 24.6% |
| Total deposit account balances | \$ 478,793 | 100.0% | \$ 486,467 | 100.0% | \$ 461,644 | 100.0% |

Securities sold under agreements to repurchase

| (dollars in thousands) | March 31, 2016 Balance | December 31, 2015 Balance | March 31, 2015 Balance |
|--|---------------------------|------------------------------|---------------------------|
| Securities sold under agreements to repurchase | \$ 18,519 | \$ 23,156 | \$ 19,514 |

Shareholders' equity and regulatory capital ratios

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

| | |
|---|-----------|
| Equity, December 31, 2015 | \$ 56,297 |
| Net income | 1,355 |
| Other comprehensive income | 394 |
| Cash dividends declared | (236) |
| Stock purchased under stock repurchase plan | (1,260) |
| Stock options exercised | 22 |
| Equity increase due to expensing of stock options | 7 |
| Equity, March 31, 2016 | \$ 56,579 |

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 March 31, 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 12.28% 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 13.04% of its risk-weighted assets and leverage ratio of 9.91% 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 March 31, 2016 was \$1.4 million compared to the \$415 thousand reported for the three months ended March 31, 2015. Earnings per share (basic and diluted) were \$0.57 per share for the quarter ended March 31, 2016 compared to \$0.15 per share for the same quarter in the prior year. The \$940 thousand increase in net income for the first quarter of 2016 when compared to the same period of 2015 is attributable to an increase in net interest income of \$739 thousand, a decrease of \$437 thousand in the provision for loan losses and a decrease in noninterest expenses of \$321 thousand. Partially offsetting the increase was a decrease in noninterest income of \$60 thousand and an increase of \$497 thousand in the provision for income taxes.

Net interest income

Net interest income for the three months ended March 31, 2016 was \$4.5 million, a \$739 thousand increase compared to net interest income of \$3.8 million for the three months ended March 31, 2015. Net interest income is computed as the difference between the interest income on earning assets and the interest expense on deposits and other interest-bearing liabilities. Net interest income represents the principal source of revenue for the Company.

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 3.48% for the three months ended March 31, 2016 was 14 basis points higher than the net interest margin of 3.34% from the quarter ended December 31, 2015 and 48 basis points higher than the 3.00% for the quarter ended March 31, 2015.

Total interest income of \$4.8 million for the quarter ended March 31, 2016 was \$742 thousand higher than the \$4.0 million earned in the same quarter of 2015. For the quarter ended March 31, 2016, average earning assets were \$526.6 million or \$9.0 million higher than the \$517.6 million in average earning assets for the first quarter of 2015. Total interest income was positively impacted by an improved mix in earning assets as average loans increased \$98.4 million while the average balances in lower yielding investments and fed funds contracted \$89.6 million in a year-over-year comparison. The improvement in the earnings mix resulted in an earning asset yield, adjusted to a tax equivalent basis, for the three months ended March 31, 2016 of 3.66% or 47 basis points above the tax equivalent earning asset yield of 3.19% for the three months ended March 31, 2015.

Interest expense of \$239 thousand for the three months ended March 31, 2016 was fairly level with \$236 thousand for the three months ended March 31, 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 both the three months ended March 31, 2016 and March 31, 2015.

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The following table details the average balance sheet, including an analysis of net interest income for earning assets and interest bearing liabilities, for the three months ended March 31, 2016 and 2015. The table also includes a rate/volume analysis for these same periods (dollars in thousands).

Consolidated Average Balance Sheet And Analysis of Net Interest Income

| (dollars in thousands) | For the three months ended | | | | | | Change in Interest Income/ Expense | | Total Increase/ (Decrease) |
|---|----------------------------|-------------------------------|---------------------------|--------------------|-------------------------------|---------------------------|---------------------------------------|-------|----------------------------------|
| | March 31, 2016 | | | March 31, 2015 | | | Change Due to: ⁴ | | |
| | Average Balance | Interest Income Expense | Average Yield/ Cost | Average Balance | Interest Income Expense | Average Yield/ Cost | Volume | Rate | |
| ASSETS | | | | | | | | | |
| Interest Earning Assets: | | | | | | | | | |
| Securities | | | | | | | | | |
| Taxable Securities | \$ 63,074 | \$ 302 | 1.92% | \$ 130,059 | \$ 604 | 1.86% | \$ (320) | \$ 18 | \$ (302) |
| Tax Exempt Securities ¹ | 14,945 | 127 | 3.40% | 19,990 | 174 | 3.48% | (43) | (4) | (47) |
| Total Securities ¹ | 78,019 | 429 | 2.20% | 150,049 | 778 | 2.07% | (363) | 14 | (349) |
| Total Loans | 421,477 | 4,333 | 4.13% | 322,820 | 3,262 | 4.10% | 1,013 | 58 | 1,071 |
| Fed Funds Sold | 25,905 | 30 | 0.47% | 42,258 | 23 | 0.22% | (11) | 18 | 7 |
| Other Interest Bearing Deposits | 1,249 | 4 | 1.29% | 2,498 | 7 | 1.14% | (4) | 1 | (3) |
| Total Earning Assets | 526,650 | 4,796 | 3.66% | 517,625 | 4,070 | 3.19% | 635 | 91 | 726 |
| Less: Allowance for Loan Losses | (3,563) | | | (3,222) | | | | | |
| Total Non-Earning Assets | 37,420 | | | 39,010 | | | | | |
| Total Assets | \$ 560,507 | | | \$ 553,413 | | | | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | | | |
| Interest Bearing Liabilities: | | | | | | | | | |
| Interest Bearing Deposits: | | | | | | | | | |
| Interest Checking | \$ 91,809 | \$ 11 | 0.05% | \$ 82,320 | \$ 10 | 0.05% | \$ 1 | \$- | \$ 1 |
| Money Market Deposits | 105,988 | 56 | 0.21% | 95,802 | 47 | 0.20% | 5 | 4 | 9 |
| Time Deposits | 116,460 | 160 | 0.55% | 115,868 | 167 | 0.58% | 1 | (8) | (7) |
| Total Interest-Bearing Deposits | 314,257 | 227 | 0.29% | 293,990 | 224 | 0.31% | 7 | (4) | 3 |
| Securities Sold Under Agreement to Repurchase | 21,476 | 12 | 0.22% | 19,798 | 12 | 0.25% | 1 | (1) | - |
| Total Interest-Bearing Liabilities | 335,733 | 239 | 0.29% | 313,788 | 236 | 0.31% | 8 | (5) | 3 |
| Non-Interest-Bearing Liabilities: | | | | | | | | | |
| Demand deposits | 166,441 | | | 176,864 | | | | | |
| Other liabilities | 1,616 | | | 1,385 | | | | | |
| Total Liabilities | 503,790 | | | 492,037 | | | | | |
| Shareholders' Equity | 56,717 | | | 61,376 | | | | | |
| Total Liabilities & Shareholders' Equity | \$ 560,507 | | | \$ 553,413 | | | | | |
| Net Interest Income (Tax Equivalent) | | \$ 4,557 | | | \$ 3,834 | | \$ 627 | \$ 96 | \$ 723 |
| Interest Rate Spread ² | | | 3.37% | | | 2.88% | | | |
| Interest Expense as a Percentage of Average Earning Assets | | | 0.18% | | | 0.18% | | | |
| Net Interest Margin ³ | | | 3.48% | | | 3.00% | | | |

(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.

The impact on the net interest income resulting from changes in average balances and average rates is shown for the period indicated. The

(4) 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 \$120 thousand was recorded in the first quarter of 2016, while a provision for loan losses of \$317 thousand was recognized for the first quarter of 2015. This resulted in a positive impact to income of \$437 thousand when comparing year-over-year. Last year's loan loss provision was driven by the \$27.4 million in loan growth during the first quarter of 2015. In management's opinion, the allowance was adequately provided for at March 31, 2016. 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.

Noninterest income

Noninterest income for the quarter ended March 31, 2016 was \$1.1 million, a decrease of \$60 thousand from the \$1.2 million reported for the quarter ended March 31, 2015. The components of noninterest income - for the three months are shown below (dollars in thousands):

| | For the three months ended | |
|---|----------------------------|-------------------|
| | March 31, 2016 | March 31, 2015 |
| Noninterest income: | | |
| Trust income | \$ 388 | \$ 449 |
| Brokerage and insurance income | 87 | 16 |
| Customer service fees | 219 | 234 |
| Debit/credit card and ATM fees | 198 | 180 |
| Earnings on bank owned life insurance | 109 | 108 |
| Fees on mortgage sales | 48 | 37 |
| Gains on sales of securities | 8 | 22 |
| Gains (losses) on sales of other assets | (25) | - |
| Royalty income | - | 45 |
| Other | 92 | 93 |
| Total noninterest income | \$ 1,124 | \$ 1,184 |

Noninterest income was somewhat suppressed for the quarter due to timing. The purchase of the wealth management book of business, as discussed earlier under Note 5 Intangible Assets, increased the brokerage and insurance revenue by \$71 thousand from the same period last year, but this revenue was lower than anticipated as a result of a one month delay in the transaction's closing. Additionally, no royalty income was recognized in the first quarter of 2016 as accurate estimates of revenue stemming from ongoing referral fees were unavailable when closing out the quarter; however, \$45 thousand was recognized as royalty income in the first quarter of 2015. One-time losses realized on disposition of assets of \$25 thousand in the first quarter of this year further decreased noninterest income compared to the same period last year.

Noninterest expense

Noninterest expense for the first quarter of 2016 was \$3.8 million, a reduction of \$321 thousand from the \$4.1 million reported in the quarter ended March 31, 2015. The reduction year-over-year was driven by a \$398 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, 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 months are shown below (dollars in thousands):

| | For the three months ended | |
|--------------------------------------|-------------------------------|-------------------|
| | March 31, 2016 | March 31, 2015 |
| Noninterest expense: | | |
| Salaries and employee benefits | \$ 1,918 | \$ 2,316 |
| Net occupancy | 476 | 496 |
| Equipment | 135 | 130 |
| ATM, debit and credit card | 71 | 70 |
| Bank franchise tax | 106 | 92 |
| Computer software | 87 | 82 |
| Data processing | 289 | 260 |
| FDIC deposit insurance assessment | 84 | 92 |
| Marketing, advertising and promotion | 137 | 125 |
| Professional fees | 111 | 160 |
| Other | 383 | 295 |
| Total noninterest expense | \$ 3,797 | \$ 4,118 |

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 66.8% for the first quarter of 2016 compared favorably to the efficiency ratio of 82.1% for the first quarter 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.

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.

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 March 31, 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 March 31, 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 March 31, 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 |
| 1st quarter 2016 (by month): | | | | |
| January 1-31, 2016 | - | \$ - | 288,497 | 111,503 |
| February 1-29, 2016 | 55,062 | \$ 22.90 | 343,559 | 56,441 |
| March 1-31, 2016 | - | \$ - | 343,559 | 56,441 |
| Total January 1, 2016 to March 31, 2016 | 55,062 | \$ 22.90 | 343,559 | 56,441 |
| Total | 343,559 | \$ 22.89 | 343,559 | 56,441 |

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 ^a |
| 3.1 | Articles of Incorporation of Virginia National Bankshares Corporation, as amended and restated ^b |
| 3.2 | Bylaws of Virginia National Bankshares Corporation ^c |
| 10.1 | Virginia National Bank 2003 Stock Incentive Plan ^d |
| 10.2 | Virginia National Bank Amended and Restated 2005 Stock Incentive Plan ^e |
| 10.3 | Virginia National Bankshares Corporation 2014 Stock Incentive Plan ^f |
| 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 March 31, 2016 and December 31, 2015, (ii) the Consolidated Statements of Income for the three months ended March 31, 2016 and March 31, 2015, (iii) the Consolidated Statements of Comprehensive Income for the three months ended March 31, 2016 and March 31, 2015, (iv) the Consolidated Statements of Changes in Shareholders' Equity for the three months ended March 31, 2016 and March 31, 2015, (v) the Consolidated Statements of Cash Flows for the three months ended March 31, 2016 and March 31, 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.

^d 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.

^e 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.

^f 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: May 16, 2016

By: /s/ Vicki T. Miller
Vicki T. Miller
Senior Vice President and Controller
Date: May 16, 2016