Virginia National Bankshares Corp
Form 10-Q
November 13, 2014

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

FORM 10-Q

(Mark One)

[X]	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended September 30, 2014
[ ]	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	**46-2331578**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
404 People Place, Charlottesville, Virginia	**22911**
(Address of principal executive offices)	**(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. x Yes ¨ No

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

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of November 7, 2014:

Class of Stock	Shares Outstanding
Common Stock, Par Value $2.50	2,699,836

VIRGINIA NATIONAL BANKSHARES CORPORATION

FORM 10-Q

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

VIRGINIA NATIONAL BANKSHARES CORPORATION
CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except share data)

	September 30, 2014	December 31, 2013
ASSETS	(Unaudited)	
Cash and due from banks	$ 14,505	$ 12,871
Federal funds sold	33,912	27,201
Securities:		
Available for sale, at fair value	142,627	133,027
Restricted securities, at cost	1,501	1,645
Total securities	144,128	134,672
Total loans	289,621	300,034
Allowance for loan losses	(3,094)	(3,360)
Total loans, net	286,527	296,674
Premises and equipment, net	9,513	9,824
Other real estate owned, net of valuation allowance	1,507	2,372
Bank owned life insurance	12,923	12,595
Accrued interest receivable and other assets	4,996	16,785
Total assets	$ 508,011	$ 512,994
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Demand deposits:		
Noninterest-bearing	$ 140,037	$ 140,911
Interest-bearing	81,282	80,832
Money market deposit accounts	91,119	84,555
Certificates of deposit and other time deposits	120,092	124,162
Total deposits	432,530	430,460
Securities sold under agreements to repurchase	14,102	16,297
Accrued interest payable and other liabilities	1,238	8,281
Total liabilities	447,870	455,038
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; 2,699,836 and 2,690,320 issued and outstanding at September 30, 2014 and December 31, 2013, respectively (including 288 non-vested shares at September 30, 2014 and December 31, 2013)	6,749	6,725
Capital surplus	28,121	27,915
Retained earnings	25,542	24,747
Accumulated other comprehensive loss	(271)	(1,431)
Total shareholders' equity	60,141	57,956
Total liabilities and shareholders' equity	$ 508,011	$ 512,994

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 September 30, 2014	For the three months ended September 30, 2013	For the nine months ended September 30, 2014	For the nine months ended September 30, 2013
Interest and dividend income:				
Loans, including fees	$ 3,100	$ 3,257	$ 9,396	$ 9,777
Federal funds sold	23	18	64	55
Investment securities:				
Taxable	545	459	1,595	1,346
Tax exempt	118	114	358	330
Dividends	20	19	62	58
Other	6	4	12	10
Total interest and dividend income	3,812	3,871	11,487	11,576
Interest expense:				
Demand and savings deposits	53	52	152	171
Certificates and other time deposits	173	180	511	578
Federal funds purchased and securities sold under agreements to repurchase	9	7	27	10
Total interest expense	235	239	690	759
Net interest income	3,577	3,632	10,797	10,817
(Recovery of) provision for loan losses	-	-	(118)	265
Net interest income after provision for (recovery of) loan losses	3,577	3,632	10,915	10,552
Noninterest income:				
Trust income	444	756	1,404	2,168
Customer service fees	217	231	656	695
Debit/credit card and ATM fees	186	188	543	543
Earnings/increase in value of bank owned life insurance	112	114	328	336
Gains on sales of securities	-	34	16	50
Other	196	152	435	295
Total noninterest income	1,155	1,475	3,382	4,087
Noninterest expense:				
Salaries and employee benefits	2,357	2,004	6,949	6,013
Net occupancy	495	510	1,478	1,532
Equipment	126	133	393	465
Other	1,278	1,170	3,875	3,505
Total noninterest expense	4,256	3,817	12,695	11,515
Income before income taxes	476	1,290	1,602	3,124
Provision for income taxes	94	365	269	845
Net income	$ 382	$ 925	$ 1,333	$ 2,279
Earnings per share, basic	$ 0.14	$ 0.35	$ 0.49	$ 0.85
Earnings per share, diluted	$ 0.14	$ 0.35	$ 0.49	$ 0.85

See Notes to Consolidated Financial Statements.

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

	For the three months ended September 30, 2014	September 30, 2013	For the nine months ended September 30, 2014	September 30, 2013
Net income	$ 382	$ 925	$ 1,333	$ 2,279
Other comprehensive income (loss)				
Unrealized gain (loss) on securities, net of tax of $28 and $604 for the three and nine months ended September 30, 2014; and net of tax of ($39) and ($1,185) for the three and nine months ended September 30, 2013	52	(74)	1,171	(2,299)
Adjustment to unrealized income on securities due to the transfer of the held-to-maturity securities to available-for-sale, net of tax of $12 for the three and nine months ended September 30, 2013	-	22	-	22
Reclassification adjustment net of tax of $0 and ($5) for the three and nine months ended September 30, 2014; and net of tax of ($12) and ($17) for the three and nine months ended September 30, 2013	-	(22)	(11)	(33)
Total other comprehensive income (loss)	52	(74)	1,160	(2,310)
Total comprehensive income (loss)	$ 434	$ 851	$ 2,493	$ (31)

See Notes to Consolidated Financial Statements.

VIRGINIA NATIONAL BANKSHARES CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
For the Nine Months Ended September 30, 2014 and 2013
(dollars in thousands)
(Unaudited)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2013	$ 6,725	$ 27,915	$ 24,747	$ (1,431)	$ 57,956
Cash dividends ($0.20 per share)	-	-	(538)	-	(538)
Stock options exercised	24	165	-	-	189
Stock option/grant expense	-	41	-	-	41
Net income	-	-	1,333	-	1,333
Other comprehensive income	-	-	-	1,160	1,160
Balance, September 30, 2014	$ 6,749	$ 28,121	$ 25,542	$ (271)	$ 60,141
Balance, December 31, 2012	$ 6,724	$ 27,809	$ 18,254	$ 1,152	$ 53,939
Cash dividends ($0.10 per share)	-	-	(269)	-	(269)
Stock option/grant expense	-	84	-	-	84
Net income	-	-	2,279	-	2,279
Other comprehensive loss	-	-	-	(2,310)	(2,310)
Balance, September 30, 2013	$ 6,724	$ 27,893	$ 20,264	$ (1,158)	$ 53,723

See Notes to Consolidated Financial Statements.

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

	For the nine months ended	
	September 30, 2014	**September 30, 2013**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,333	$ 2,279
Adjustments to reconcile net income to net cash provided by operating activities:		
(Recovery of) provision for loan losses	(118)	265
Net amortization and accretion of securities	547	670
Gains on sales of securities	(16)	(50)
Gains on sales of assets	(44)	-
Earnings/increase in value of bank owned life insurance	(328)	(336)
Depreciation and amortization	860	982
Deferred tax benefit	(63)	-
Stock option/stock grant expense	41	84
Writedown of other real estate owned	64	-
Loss on sale of other real estate owned	13	-
Decrease in accrued interest receivable and other assets	11,286	7,260
Decrease in accrued interest payable and other liabilities	(7,043)	(3,282)
Net cash provided by operating activities	6,532	7,872
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(34,444)	(54,568)
Net decrease in restricted securities	144	84
Proceeds from maturities, calls and principal payments of available for sale securities	19,582	23,887
Proceeds from maturities, calls and principal payments of held-to-maturity securities	-	1,275
Proceeds from sale of available for sale securities	6,490	14,842
Proceeds from sale of held-to-maturity securities	-	2,013
Net decrease (increase) in loans	10,021	(13,566)
Proceeds from sale of other real estate owned	1,032	-
Proceeds from sale of bank premises and equipment	11	2
Purchase of bank premises and equipment	(549)	(297)
Net cash provided by (used in) investing activities	2,287	(26,328)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in demand deposits, NOW accounts, and money market accounts	6,140	(24,031)
Net decrease in certificates of deposit and other time deposits	(4,070)	(3,833)
Net (decrease) increase in securities sold under agreements to repurchase	(2,195)	7,697
Stock options exercised	189	-
Cash dividends paid	(538)	(269)
Net cash used in financing activities	(474)	(20,436)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ 8,345	$ (38,892)
CASH AND CASH EQUIVALENTS:		
Beginning of period	$ 40,072	$ 71,778
End of period	$ 48,417	$ 32,886
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash payments for:		
Interest	$ 702	$ 787
Taxes	$ 2,438	$ 2,428
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Unrealized gain (loss) on available for sale securities	$ 1,759	$ (3,500)
Transfer of loans to other real estate owned	$ 244	$ 804
Transfer of held-to-maturity securities to available-for-sale	$ -	$ 2,699

See Notes to Consolidated Financial Statements.

VIRGINIA NATIONAL BANKSHARES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2014

Note 1. Significant Accounting Policies

Basis of Presentation

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

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

The preparation of financial statements in conformity with GAAP and the reporting guidelines prescribed by regulatory authorities requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred tax assets and other real estate owned. Operating results for the three-month and nine-month periods ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

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, 2013. If needed, certain previously reported amounts have been reclassified to conform to current period presentation. No such reclassifications were significant.

Subsequent Events

In preparing these financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through the date the financial statements were issued.

Recent Accounting Pronouncements

In January 2014, the FASB issued ASU 2014-04, Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force). The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. The Company is currently assessing the impact that ASU 2014-11 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-12, Compensation Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period . The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in Compensation Stock Compensation (Topic 718) should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company is currently assessing the impact that ASU 2014-12 will have on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-14, Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure . The amendments in this ASU apply to creditors that hold government-guaranteed mortgage loans and are intended to eliminate the diversity in practice related to the classification of these guaranteed loans upon foreclosure. The new guidance stipulates that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if (1) the loan has a government guarantee that is not separable from the loan prior to foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the other receivable should be measured on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2014. Entities may adopt the amendments on a prospective basis or modified retrospective basis as of the beginning of the annual period of adoption; however, the entity must apply the same method of transition as elected under ASU 2014-04. Early adoption is permitted provided the entity has already adopted ASU 2014-04. The Company is currently assessing the impact that ASU 2014-14 will have on its consolidated financial statements.

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 any impact on its consolidated financial statements.

Note 2. Securities

The amortized cost and fair values of securities available for sale as of September 30, 2014 and December 31, 2013 were as follows:

September 30, 2014 (dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized (Losses)**	**Fair Value**
U.S. Government agencies	$ 36,794	$ 458	$ (73)	$ 37,179
Corporate bonds	15,241	48	(73)	15,216
Asset-backed securities	2,138	-	(35)	2,103
Mortgage-backed securities/CMOs	65,370	157	(659)	64,868
Municipal bonds	23,494	82	(315)	23,261
	$ 143,037	$ 745	$ (1,155)	$ 142,627

December 31, 2013 (dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized (Losses)**	**Fair Value**
U.S. Government agencies	$ 43,268	$ 828	$ (91)	$ 44,005
Corporate bonds	9,066	37	(50)	9,053
Asset-backed securities	2,151	-	(51)	2,100
Mortgage-backed securities/CMOs	56,815	34	(1,252)	55,597
Municipal bonds	23,896	5	(1,629)	22,272
	$ 135,196	$ 904	$ (3,073)	$ 133,027

The Company s portfolio of securities available for sale is comprised of fixed rate and adjustable rate bonds, whose prices move inversely with interest rates. At the end of any accounting period, the portfolio may have both unrealized gains and losses. Unrealized losses within the Company s portfolio typically occur as market interest rates rise. Such unrealized losses are considered temporary in nature. 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 September 30, 2014, 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.

The following table summarizes all securities with unrealized losses, segregated by length of time in a continuous unrealized loss position, at September 30, 2014 and December 31, 2013:

September 30, 2014	**Less than 12 Months**		**12 Months or more**		**Total**	
(dollars in thousands)	**Estimated Fair Value**	**Unrealized (Losses)**	**Estimated Fair Value**	**Unrealized (Losses)**	**Estimated Fair Value**	**Unrealized (Losses)**
U.S. Government agencies	$ 5,455	$ (27)	$ 954	$ (46)	$ 6,409	$ (73)
Corporate bonds	7,038	(61)	3,040	(12)	10,078	(73)
Asset-backed securities	-	-	2,103	(35)	2,103	(35)
Mortgage-backed/CMOs	14,652	(61)	26,041	(598)	40,693	(659)
Municipal bonds	1,107	(9)	14,285	(306)	15,392	(315)
	$ 28,252	$ (158)	$ 46,423	$ (997)	$ 74,675	$ (1,155)

December 31, 2013	**Less than 12 Months**		**12 Months or more**		**Total**	
(dollars in thousands)	**Estimated Fair Value**	**Unrealized (Losses)**	**Estimated Fair Value**	**Unrealized (Losses)**	**Estimated Fair Value**	**Unrealized (Losses)**
U.S. Government agencies	$ 2,889	$ (39)	$ 948	$ (52)	$ 3,837	$ (91)
Corporate bonds	5,016	(50)	-	-	5,016	(50)
Asset-backed securities	960	(36)	1,140	(15)	2,100	(51)
Mortgage-backed/CMOs	39,061	(1,079)	8,609	(173)	47,670	(1,252)
Municipal bonds	18,433	(1,451)	2,280	(178)	20,713	(1,629)
	$ 66,359	$ (2,655)	$ 12,977	$ (418)	$ 79,336	$ (3,073)

Securities having carrying values of $26,988,000 at September 30, 2014 were pledged as collateral to secure public deposits and securities sold under agreement to repurchase. At December 31, 2013, securities having carrying values of $17,547,000 were similarly pledged.

Restricted securities are securities with limited marketability and consist of stock in the Federal Reserve Bank of Richmond (FRB) and the Federal Home Loan Bank of Atlanta (FHLB) totaling $1,501,000 as of September 30, 2014 and $1,645,000 as of December 31, 2013. These restricted securities are carried at cost.

Note 3. Loans

The composition of the loan portfolio by loan classification at September 30, 2014 and December 31, 2013 appears below.

	September 30, 2014	December 31, 2013
	(dollars in thousands)	
Commercial & industrial	$ 48,621	$ 48,060
Real estate construction and land		
Residential construction	480	794
Other construction and land	12,648	17,667
Total construction and land	13,128	18,461
Real estate mortgage		
1-4 family residential	58,368	54,300
Home equity lines of credit	24,763	29,612
Multifamily	20,125	22,560
Commercial owner occupied	60,475	58,802
Commercial non-owner occupied	52,071	54,635
Total real estate mortgage	215,802	219,909
Consumer		
Consumer revolving credit	2,191	2,254
Consumer all other credit	9,879	11,350
Total consumer	12,070	13,604
Total loans	289,621	300,034
Less: Allowance for loan losses	(3,094)	(3,360)
Net loans	$ 286,527	$ 296,674

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 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 September 30, 2014 and December 31, 2013. 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 nine months ended September 30, 2014 or the twelve months ended December 31, 2013. Interest income recognized is for the nine months ended September 30, 2014 or the twelve months ended December 31, 2013.

September 30, 2014	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
	(dollars in thousands)				
Impaired loans without a valuation allowance:					
Other construction and land	$ 71	$ 109	$ -	$ 83	$ 1
1-4 family residential mortgages	431	544	-	412	11
Home equity lines of credit	89	169	-	47	3
Commercial owner occupied real estate	1,115	1,115	-	1,130	36
Commercial non-owner occupied real estate	-	-	-	61	-
Impaired loans with a valuation allowance	-	-	-	-	-
Total impaired loans	$ 1,706	$ 1,937	$ -	$ 1,733	$ 51

December 31, 2013	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
	(dollars in thousands)				
Impaired loans without a valuation allowance:					
Other construction and land	$ 77	$ 110	$ -	$ 81	$ -
1-4 family residential mortgages	285	380	-	293	11
Commercial owner occupied real estate	1,144	1,144	-	1,414	50
Commercial non-owner occupied real estate	230	274	-	202	-
Impaired loans with a valuation allowance	-	-	-	-	-
Total impaired loans	$ 1,736	$ 1,908	$ -	$ 1,990	$ 61

Non-accrual loans are shown below by class:

	September 30, 2014	**December 31, 2013**
	(dollars in thousands)	
Other construction and land	$ 71	$ 77
1-4 family residential mortgages	209	60
Home equity lines of credit	89	-
Commercial non-owner occupied real estate	-	230
Total non-accrual loans	$ 369	$ 367

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.

Troubled Debt Restructuring (TDRs)	**September 30, 2014**		**December 31, 2013**	
(dollars in thousands)	**No. of Loans**	**Recorded Investment**	**No. of Loans**	**Recorded Investment**
Performing TDRs				
1-4 family residential mortgages	1	$ 222	1	$ 225
Commercial owner occupied real estate	1	1,115	1	1,144
Total performing TDRs	2	$ 1,337	2	$ 1,369
Nonperforming TDRs				
Other construction and land	1	$ 40	-	$ -
Total TDRs	3	$ 1,377	2	$ 1,369

A summary of loans that were modified under the terms of a TDR during the three and nine months ended September 30, 2014 and 2013 is shown below by class. The Post-Modification Recorded Balance reflects the period end balances, inclusive of all partial principal pay downs and principal charge-offs since the modification date. Loans modified as TDRs that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

	For three and nine months ended September 30, 2014			**For three and nine months ended September 30, 2013**		
	Number of Loans	**Pre-Modification Recorded Balance**	**Post-Modification Recorded Balance**	**Number of Loans**	**Pre-Modification Recorded Balance**	**Post-Modification Recorded Balance**
Loans modified at below market rates		(dollars in thousands)			(dollars in thousands)	
Other construction and land	1	$ 40	$ 40	0	$ -	$ -
Total loans modified during the period	1	$ 40	$ 40	0	$ -	$ -

The following tables present, by class of loans, information related to loans modified as TDRs that subsequently defaulted during the nine months ended September 30, 2014 and 2013 and were modified as TDRs during the twelve months prior to default:

(dollars in thousands)	**For nine months ended September 30, 2014**		**For nine months ended September 30, 2013**	
	No. of Loans	Recorded Investment	No. of Loans	Recorded Investment
1-4 family residential mortgages	-	$ -	1	$ 65
Commercial owner occupied real estate	-	-	1	183
Total	-	$ -	2	$ 248

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 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

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

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 forty-five percent 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 are secured by marketable securities within margin and represent a low risk. 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, an 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.

The following represents the loan portfolio designated by the internal risk ratings assigned to each credit as of September 30, 2014 and December 31, 2013.

Internal Risk Rating Grades as of September 30, 2014 (dollars in thousands)	Excellent	Good	Pass	Special Mention	Sub-standard	Doubtful	Total
Commercial and industrial	$ 3,846	$ 22,829	$ 21,504	$ 4	$ 438	$ -	$ 48,621
Real estate construction							
Residential construction	-	-	480	-	-	-	480
Other construction and land	-	-	12,064	513	71	-	12,648
Real estate mortgages							
1-4 family residential	-	1,916	55,383	411	658	-	58,368
Home equity lines of credit	-	-	24,592	-	171	-	24,763
Multifamily	-	-	20,125	-	-	-	20,125
Commercial owner occupied	-	-	58,578	-	1,897	-	60,475
Commercial non-owner occupied	-	-	52,071	-	-	-	52,071
Consumer							
Consumer revolving credit	17	1,852	313	-	9	-	2,191
Consumer all other credit	206	7,783	1,839	-	51	-	9,879
Total Loans	$ 4,069	$ 34,380	$ 246,949	$ 928	$ 3,295	$ -	$ 289,621

Internal Risk Rating Grades as of December 31, 2013 (dollars in thousands)	Excellent	Good	Pass	Special Mention	Sub-standard	Doubtful	Total
Commercial and industrial	$ 4,056	$ 19,464	$ 24,015	$ 5	$ 520	$ -	$ 48,060
Real estate construction							
Residential construction	-	-	794	-	-	-	794
Other construction and land	-	-	17,031	530	106	-	17,667
Real estate mortgages							
1-4 family residential	-	1,934	50,945	593	828	-	54,300
Home equity lines of credit	-	-	29,367	-	245	-	29,612
Multifamily mortgages	-	-	22,560	-	-	-	22,560
Commercial owner occupied	-	-	56,668	-	2,134	-	58,802
Commercial non-owner occupied	-	-	51,884	567	2,184	-	54,635
Consumer							
Consumer revolving credit	-	1,926	319	-	9	-	2,254
Consumer all other credit	371	8,772	2,153	-	54	-	11,350
Total Loans	$ 4,427	$ 32,096	$ 255,736	$ 1,695	$ 6,080	$ -	$ 300,034

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. Although the markets served by the Company remain stronger than the national economy as a whole, management continues to pay close attention on a case-by-case basis for any yet unforeseen potential ripple effects of the housing downturn and the related financial market fallout.

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

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 seven loans in the amount of $1,706,000 classified as impaired loans at September 30, 2014, 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.

Allowance for Credit Losses Rollforward by Portfolio Segment
For the nine months ended September 30, 2014

(dollars in thousands)	Commercial Loans	Real Estate Construction	Real Estate Mortgages	Consumer Loans	Total
Allowance for Credit Losses:					
Balance as of January 1, 2014	$ 340	$ 198	$ 2,788	$ 34	$ 3,360
Charge-offs	(70)	-	(116)	-	(186)
Recoveries	23	-	7	8	38
Provision for (recovery of) loan losses	60	(77)	(86)	(15)	(118)
Ending Balance	$ 353	$ 121	$ 2,593	$ 27	$ 3,094
Ending Balance:					
Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -
Collectively evaluated for impairment	353	121	2,593	27	3,094
Financing Receivables:					
Ending Balance:					
Individually evaluated for impairment	$ -	$ 71	$ 1,635	$ -	$ 1,706
Collectively evaluated for impairment	48,621	13,057	214,167	12,070	287,915
	$ 48,621	$ 13,128	$ 215,802	$ 12,070	$ 289,621

Allowance for Credit Losses Rollforward by Portfolio Segment
For the year ended December 31, 2013

(dollars in thousands)	Commercial Loans	Real Estate Construction	Real Estate Mortgages	Consumer Loans	Total
Allowance for Credit Losses:					
Balance as of January 1, 2013	$ 303	$ 168	$ 2,750	$ 46	$ 3,267
Charge-offs	(22)	-	(139)	-	(161)
Recoveries	22	-	48	24	94
Provision for (recovery of) loan losses	37	30	129	(36)	160
Ending Balance	$ 340	$ 198	$ 2,788	$ 34	$ 3,360
Ending Balance:					
Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -
Collectively evaluated for impairment	340	198	2,788	34	3,360
Financing Receivables:					
Ending Balance:					
Individually evaluated for impairment	$ -	$ 77	$ 1,659	$ -	$ 1,736
Collectively evaluated for impairment	48,060	18,384	218,250	13,604	298,298
	$ 48,060	$ 18,461	$ 219,909	$ 13,604	$ 300,034

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.

The following tables show the aging of past due loans as of September 30, 2014 and December 31, 2013. 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.

Past Due Aging as of September 30, 2014 (dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due and Still Accruing
Commercial and industrial	$ 216	$ -	$ -	$ 216	$ 48,405	$ 48,621	$ -
Real estate construction							
Residential construction	-	-	-	-	480	480	-
Other construction and land	-	-	-	-	12,648	12,648	-
Real estate mortgages							
1-4 family residential	-	39	56	95	58,273	58,368	-
Home equity lines of credit	-	-	89	89	24,674	24,763	-
Multifamily	-	-	-	-	20,125	20,125	-
Commercial owner occupied	-	-	-	-	60,475	60,475	-
Commercial non-owner occupied	-	-	-	-	52,071	52,071	-
Consumer loans							
Consumer revolving credit	1	-	-	1	2,190	2,191	-
Consumer all other credit	-	-	-	-	9,879	9,879	-
Total Loans	$ 217	$ 39	$ 145	$ 401	$ 289,220	$ 289,621	$ -

Past Due Aging as of December 31, 2013 (dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due and Still Accruing
Commercial and industrial	$ 123	$ 35	$ -	$ 158	$ 47,902	$ 48,060	$ -
Real estate construction							
Residential construction	-	-	-	-	794	794	-
Other construction and land	34	-	29	63	17,604	17,667	29
Real estate mortgages							
1-4 family residential	60	26	149	235	54,065	54,300	149
Home equity lines of credit	-	-	-	-	29,612	29,612	-
Multifamily	-	-	-	-	22,560	22,560	-
Commercial owner occupied	-	-	-	-	58,802	58,802	-
Commercial non-owner occupied	-	139	91	230	54,405	54,635	-
Consumer loans							
Consumer revolving credit	-	-	-	-	2,254	2,254	-
Consumer all other credit	93	30	-	123	11,227	11,350	-
Total Loans	$ 310	$ 230	$ 269	$ 809	$ 299,225	$ 300,034	$ 178

Note 5. Earnings Per Share

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of diluted potential common stock for the three and nine months ended September 30, 2014 and 2013. Potential dilutive common stock has no effect on income available to common shareholders.

Three Months Ended (dollars in thousands, except per share data)	September 30, 2014			September 30, 2013		
	Net Income	Weighted Average Shares	Per Share Amount	Net Income	Weighted Average Shares	Per Share Amount
Basic earnings per share	$ 382	2,697,674	$ 0.14	$ 925	2,690,220	$ 0.35
Effect of dilutive stock options	-	14,875	-	-	317	-
Diluted earnings per share	$ 382	2,712,549	$ 0.14	$ 925	2,690,537	$ 0.35

Nine Months Ended (dollars in thousands, except per share data)	September 30, 2014			September 30, 2013		
	Net Income	Weighted Average Shares	Per Share Amount	Net Income	Weighted Average Shares	Per Share Amount
Basic earnings per share	$ 1,333	2,694,487	$ 0.49	$ 2,279	2,690,220	$ 0.85
Effect of dilutive stock options	-	10,870	-	-	159	-
Diluted earnings per share	$ 1,333	2,705,357	$ 0.49	$ 2,279	2,690,379	$ 0.85

For the three-month periods ended September 30, 2014 and September 30, 2013, option shares totaling 111,260 and 220,199, respectively, were considered anti-dilutive and were excluded from these calculations. For the nine-month periods ended September 30, 2014 and September 30, 2013, option shares totaling 137,607 and 226,701, respectively, were considered anti-dilutive and were likewise excluded from these calculations.

Note 6. Stock Compensation 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 Virginia National Bank 1998 Stock Incentive Plan (1998 Plan), 2003 Stock Incentive Plan (2003 Plan), and 2005 Stock Incentive Plan (2005 Plan), the 2014 Plan provides for granting of both incentive and nonqualified stock options, as well as restricted stock and other stock based awards. No new grants will be issued under the 1998 Plan or the 2003 Plan as both plans have expired. The 2005 Plan will expire on December 20, 2014.

For all Plans, the option price of incentive options will not be less than the fair market value of the stock at the time an option is granted. Nonqualified options may be granted at a price established by the Board of Directors, including prices less than the fair market value on the date of grant. Outstanding 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 Company s stock incentive plans (the Plans) is shown below as of September 30, 2014:

	1998 Plan	2003 Plan	2005 Plan	2014 Plan
Aggregate shares issuable	430,100	128,369	230,000	250,000
Options issued, net of forfeited and expired options	(381,089)	(110,278)	(149,751)	-
Cancelled due to Plan expiration	(49,011)	(18,091)	-	-
Remaining available for grant	-	-	80,249	250,000
Grants issued and outstanding:				
Total vested and unvested shares	1,150	32,438	148,358	-
Fully vested shares	1,150	32,438	137,881	-
Exercise price range	$23.30	$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 financial statements. Stock-based compensation arrangements include stock options and restricted stock. All stock-based payments to employees are required to be valued using a fair value method on the date of grant and expensed based on that fair value over the applicable vesting period. For the nine months ended September 30, 2014 and 2013, the Company recognized $41,000 and $84,000, respectively, in compensation expense for stock options and restricted stock grants. As of September 30, 2014, there was $75,000 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)	**September 30, 2014** Number of Options	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at January 1, 2014	226,424	$ 26.35	$ 44
Granted	5,000	18.10	
Exercised	(9,516)	19.90	$ 18
Expired	(9,200)	22.14	
Forfeited	(30,762)	31.30	
Outstanding at September 30, 2014	181,946	$ 25.84	$ 325
Options exercisable at September 30, 2014	171,469	$ 26.41	$ 254

The fair value of any grant is estimated at the grant date using the Black-Scholes pricing model. During both the first quarter of 2014 and 2013, there were stock option grants of 5,000 shares. The fair value on the grant issued in 2014 was estimated based on the assumptions noted in the following table:

	For the nine months ended September 30, 2014
Expected volatility[1]	29.20%
Expected dividends[2]	1.10%
Expected term (in years)[3]	6.25
Risk-free rate[4]	2.15%

[1] Based on the monthly historical volatility of the Company s stock price over the expected life of the options.

[2] Calculated as the ratio of historical dividends paid per share of common stock to the stock price on the date of grant.

[3] Based on the average of the contractual life and vesting period for the respective option.

[4] Based upon an interpolated US Treasury yield curve interest rate that corresponds to the contractual life of the option, in effect at the time of the grant.

Summary information pertaining to options outstanding at September 30, 2014 is as follows:

	Options Outstanding			Options Exercisable	
Exercise Price	Number of Options Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number of Options Exercisable	Weighted-Average Exercise Price
$11.74 to 20.00	49,238	5.8 Years	$ 17.25	38,762	$ 17.42
$20.01 to 30.00	64,168	3.4 Years	24.71	64,167	24.71
$30.01 to 36.74	68,540	1.7 Years	33.08	68,540	33.08
Total	181,946	3.4 Years	$ 25.84	171,469	$ 26.41

Restricted Stock

No restricted stock grants were awarded during 2013 or the first nine months of 2014. Changes in the restricted stock activity as of September 30, 2014 are summarized as follows:

(dollars in thousands, except per share data)	Number of Shares	Grant Date Fair Value	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Outstanding at January 1, 2014	288	$ 12.18		
Issued	-	-		
Vested	-	-		
Non-vested at September 30, 2014	288	$ 12.18	$ 7	0.1 Years

Note 7. 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

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:

<u>Securities available for sale</u>

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).

The following tables present the balances measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013:

(dollars in thousands)		Fair Value Measurements at September 30, 2014 Using:		
Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
U.S. Government agencies	$ 37,179	$ -	$ 37,179	$ -
Corporate bonds	15,216	-	15,216	-
Asset-backed securities	2,103	-	2,103	-
Mortgage-backed securities/CMOs	64,868	-	64,868	-
Municipal bonds	23,261	-	23,261	-
Total securities available for sale	$ 142,627	$ -	$ 142,627	$ -

(dollars in thousands)		Fair Value Measurements at December 31, 2013 Using:		
Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
U.S. Government agencies	$ 44,005	$ -	$ 44,005	$ -
Corporate bonds	9,053	-	9,053	-
Asset-backed securities	2,100	-	2,100	-
Mortgage-backed securities/CMOs	55,597	-	55,597	-
Municipal bonds	22,272	-	22,272	-
Total securities available for sale	$ 133,027	$ -	$ 133,027	$ -

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. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Company because of marketability, then the fair value is considered Level 3.

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

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 $1,706,000 and $1,736,000 in impaired loans as of September 30, 2014 and December 31, 2013, respectively. None of these impaired loans required a valuation allowance after consideration was given for each borrowing as to the fair value of the collateral on the loan or the present value of expected future cash flows from the customer.

Other Real Estate Owned

Other real estate owned (OREO) is measured at fair value less cost to sell, based on an appraisal conducted by an independent, licensed appraiser outside of the Company. If the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Company because of marketability, then the fair value is considered Level 3. OREO is measured at fair value on a nonrecurring basis. Any initial fair value adjustment is charged against the Allowance for Loan Losses. Subsequent fair value adjustments are recorded in the period incurred and included in other noninterest expense on the Consolidated Statements of Income.

The following table presents the Company s assets that were measured at fair value on a nonrecurring basis as of September 30, 2014 and December 31, 2013:

(dollars in thousands)		Fair Value Measurements at September 30, 2014 Using:		
Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Other Real Estate Owned	$ 1,507	$ -	$ -	$ 1,507

(dollars in thousands)		Fair Value Measurements at December 31, 2013 Using:		
Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Other Real Estate Owned	$ 2,372	$ -	$ -	$ 2,372

For the assets measured at fair value on a nonrecurring basis as of September 30, 2014, the following table displays quantitative information about Level 3 Fair Value Measurements:

(dollars in thousands)

Description	Fair Value	Valuation Technique	Unobservable Inputs	Weighted Average
Assets:				
Other Real Estate Owned	$ 1,507	Market comparables	Discount applied to market comparables *	5.8 %

* A discount percentage is applied based on age of independent appraisals, current market conditions, and cost to sell.

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 FRB and FHLB stock is based on the redemption provisions of each entity and is therefore excluded from the following table.

Loan receivables

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.

Certificates of deposit

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.

The carrying values and estimated fair values of the Company's financial instruments as of September 30, 2014 and December 31, 2013 are as follows:

		Fair Value Measurement at September 30, 2014 using:			
(dollars in thousands)		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	Carrying value	Level 1	Level 2	Level 3	Fair Value
Assets					
Cash and cash equivalent	$ 48,417	$ 48,417	$ -	$ -	$ 48,417
Securities	142,627	-	142,627	-	142,627
Loans, net	286,527	-	-	287,501	287,501
Bank owned life insurance	12,923	-	12,923	-	12,923
Accrued interest receivable	1,191	-	577	614	1,191
Liabilities					
Demand deposits and interest-bearing transaction and money market accounts	$ 312,438	$ -	$ 312,438	$ -	$ 312,438
Certificates of deposit	120,092	-	120,213	-	120,213
Securities sold under agreements to repurchase	14,102	-	14,102	-	14,102
Accrued interest payable	113	-	113	-	113

		Fair Value Measurement at December 31, 2013 using:		
(dollars in thousands)		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Carrying value	Level 1	Level 2	