AMERICAN NATIONAL BANKSHARES INC.
Form 10-Q
November 09, 2015
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2015.
o	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: 0-12820

AMERICAN NATIONAL BANKSHARES INC.
(Exact name of registrant as specified in its charter)

VIRGINIA	54-1284688
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

628 Main Street	
Danville, Virginia	24541
(Address of principal executive offices)	(Zip Code)

(434) 792-5111
(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 x No o

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.

Yes x No o

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

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

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

At November 5, 2015, the Company had 8,636,842 shares of Common Stock outstanding, $1 par value.

AMERICAN NATIONAL BANKSHARES INC.
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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
American National Bankshares Inc.
Consolidated Balance Sheets
(Dollars in thousands, except per share data)

Assets	(Unaudited) September 30, 2015	(*) December 31, 2014
Cash and due from banks	$19,280	$29,272
Interest-bearing deposits in other banks	46,637	38,031
Securities available for sale, at fair value	358,306	344,716
Restricted stock, at cost	5,308	4,367
Loans held for sale	2,998	616
Loans, net of unearned income	980,984	840,925
Less allowance for loan losses	(12,611)	(12,427)
Net loans	968,373	828,498
Premises and equipment, net	23,854	23,025
Other real estate owned, net of valuation allowance $359 in 2015 and $2,971 in 2014	1,333	2,119
Goodwill	44,333	39,043
Core deposit intangibles, net	2,983	2,045
Bank owned life insurance	17,491	15,193
Accrued interest receivable and other assets	21,541	19,567
Total assets	$1,512,437	$1,346,492
Liabilities		
Demand deposits -- noninterest bearing	$305,110	$254,458
Demand deposits -- interest bearing	220,562	193,432
Money market deposits	191,534	174,000
Savings deposits	108,992	90,130
Time deposits	400,323	363,817
Total deposits	1,226,521	1,075,837
Customer repurchase agreements	43,579	53,480
Long-term borrowings	9,952	9,935
Junior subordinated debt	27,597	27,521
Accrued interest payable and other liabilities	8,337	5,939
Total liabilities	1,315,986	1,172,712
Shareholders' equity		
Preferred stock, $5 par, 2,000,000 shares authorized, none outstanding	—	—
Common stock, $1 par, 20,000,000 shares authorized, 8,630,329 shares outstanding at September 30, 2015 and 7,873,474 shares outstanding at December 31, 2014	8,611	7,872
Capital in excess of par value	75,524	57,650

Retained earnings	109,030	104,594
Accumulated other comprehensive income, net	3,286	3,664
Total shareholders' equity	196,451	173,780
Total liabilities and shareholders' equity	$1,512,437	$1,346,492

(*) - Derived from audited consolidated financial statements.

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

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American National Bankshares Inc.
Consolidated Statements of Income
(Dollars in thousands, except share and per share data) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Interest and Dividend Income:				
Interest and fees on loans	$11,474	$9,864	$35,011	$29,398
Interest on federal funds sold	1	—	6	—
Interest and dividends on securities:				
Taxable	1,052	918	3,021	2,850
Tax-exempt	899	966	2,799	3,017
Dividends	91	72	258	221
Other interest income	25	32	123	100
Total interest and dividend income	13,542	11,852	41,218	35,586
Interest Expense:				
Interest on deposits	1,205	1,120	3,583	3,510
Interest on short-term borrowings	2	4	7	8
Interest on long-term borrowings	82	82	243	243
Interest on junior subordinated debt	192	186	564	555
Total interest expense	1,481	1,392	4,397	4,316
Net Interest Income	12,061	10,460	36,821	31,270
Provision for Loan Losses	—	—	700	150
Net Interest Income After Provision for Loan Losses	12,061	10,460	36,121	31,120
Noninterest Income:				
Trust fees	1,006	992	2,963	3,131
Service charges on deposit accounts	521	441	1,543	1,285
Other fees and commissions	592	479	1,787	1,416
Mortgage banking income	376	342	987	880
Gains on sales of securities	6	315	553	504
Other	554	412	1,636	1,168
Total noninterest income	3,055	2,981	9,469	8,384
Noninterest Expense:				
Salaries	4,179	3,714	12,634	10,890
Employee benefits	1,029	799	3,215	2,621
Occupancy and equipment	1,094	933	3,290	2,779
FDIC assessment	185	157	565	486
Bank franchise tax	220	216	675	669
Core deposit intangible amortization	300	227	901	888
Data processing	366	361	1,311	1,054
Software	290	248	850	745
Other real estate owned, net	(126)	141	60	148
Acquisition related expense	87	268	1,948	268
Other	1,764	1,763	5,628	5,067

Total noninterest expense	9,388	8,827	31,077	25,615
Income Before Income Taxes	5,728	4,614	14,513	13,889
Income Taxes	1,691	1,446	4,081	4,038
Net Income	$4,037	$3,168	$10,432	$9,851
Net Income Per Common Share:				
Basic	$0.47	$0.40	$1.20	$1.25
Diluted	$0.47	$0.40	$1.20	$1.25
Weighted Average Common Shares Outstanding:				
Basic	8,668,618	7,841,078	8,698,394	7,871,016
Diluted	8,676,571	7,851,735	8,706,870	7,881,441

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

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American National Bankshares Inc.
Consolidated Statements of Comprehensive Income
(Dollars in thousands) (Unaudited)

	Three Months Ended September 30,	
	2015	2014
Net income	$4,037	$3,168
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	1,365	(343)
Income tax (expense) benefit	(478)	121
Reclassification adjustment for gains on sales of securities	(6)	(315)
Income tax expense	3	110
Other comprehensive income (loss)	884	(427)
Comprehensive income	$4,921	$2,741

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

American National Bankshares Inc.
Consolidated Statements of Comprehensive Income
(Dollars in thousands) (Unaudited)

	Nine Months Ended September 30,	
	2015	2014
Net income	$10,432	$9,851
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	(29)	3,888
Income tax (expense) benefit	10	(1,360)
Reclassification adjustment for gains on sales of securities	(553)	(504)
Income tax expense	194	176
Other comprehensive income (loss)	(378)	2,200
Comprehensive income	$10,054	$12,051

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

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American National Bankshares Inc.
Consolidated Statements of Changes in Shareholders' Equity
(Dollars in thousands except per share data) (Unaudited)

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2013	$7,891	$58,050	$99,090	$2,520	$167,551
Net income	—	—	9,851	—	9,851
Other comprehensive income	—	—	—	2,200	2,200
Stock repurchased and retired	(70)	(1,438)	—	—	(1,508)
Equity based compensation	22	475	—	—	497
Cash dividends paid, $0.69 per share	—	—	(5,426)	—	(5,426)
Balance, September 30, 2014	$7,843	$57,087	$103,515	$4,720	$173,165
Balance, December 31, 2014	$7,872	$57,650	$104,594	$3,664	$173,780
Net income	—	—	10,432	—	10,432
Other comprehensive loss	—	—	—	(378)	(378)
Issuance of common stock	826	19,657	—	—	20,483
Stock repurchased and retired	(122)	(2,686)	—	—	(2,808)
Stock options exercised	22	377	—	—	399
Equity based compensation	13	526	—	—	539
Cash dividends paid, $0.69 per share	—	—	(5,996)	—	(5,996)
Balance, September 30, 2015	$8,611	$75,524	$109,030	$3,286	$196,451

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

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American National Bankshares Inc.
Consolidated Statements of Cash Flows
(Dollars in thousands) (Unaudited)

	Nine Months Ended September 30,	
	2015	2014
Cash Flows from Operating Activities:		
Net income	$10,432	$9,851
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	700	150
Depreciation	1,357	1,274
Net accretion of purchase accounting adjustments	(2,790)	(2,064)
Core deposit intangible amortization	901	888
Net amortization (accretion) of securities	2,062	1,916
Net gains on sale or call of securities	(553)	(504)
Net gain on sale of loans held for sale	(771)	(686)
Proceeds from sales of loans held for sale	42,691	40,813
Originations of loans held for sale	(44,302)	(38,178)
Net gain on other real estate owned	(199)	(100)
Valuation allowance on other real estate owned	86	46
Net loss on sale of premises and equipment	5	—
Equity based compensation expense	539	497
Net change in bank owned life insurance	(343)	(297)
Deferred income tax expense	1,482	396
Net change in interest receivable	491	(619)
Net change in other assets	107	450
Net change in interest payable	3	(29)
Net change in other liabilities	(606)	153
Net cash provided by operating activities	11,292	13,957
Cash Flows from Investing Activities:		
Proceeds from sales of securities available for sale	7,429	13,667
Proceeds from maturities, calls and paydowns of securities available for sale	70,759	52,901
Purchases of securities available for sale	(75,069)	(47,006)
Net change in restricted stock	(354)	360
Net increase in loans	(23,786)	(20,276)
Proceeds from sale of premises and equipment	42	—
Purchases of premises and equipment	(1,203)	(685)
Proceeds from sales of other real estate owned	1,993	1,498
Cash paid in bank acquisition	(5,935)	—
Cash acquired in bank acquisition	18,173	—
Net cash (used in) provided by investing activities	(7,951)	459
Cash Flows from Financing Activities:		
Net change in demand, money market, and savings deposits	31,727	23,792
Net change in time deposits	(18,148)	(30,407)
Net change in customer repurchase agreements	(9,901)	12,467
Net change in long-term borrowings	—	(38)
Common stock dividends paid	(5,996)	(5,426)

Repurchase of stock	(2,808)	(1,508)
Proceeds from exercise of stock options	399	—
Net cash used in financing activities	(4,727)	(1,120)
Net Increase (Decrease) in Cash and Cash Equivalents	(1,386)	13,296
Cash and Cash Equivalents at Beginning of Period	67,303	67,681
Cash and Cash Equivalents at End of Period	$65,917	$80,977

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

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AMERICAN NATIONAL BANKSHARES INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Accounting Policies

The consolidated financial statements include the accounts of American National Bankshares Inc. (the "Company") and its wholly owned subsidiary, American National Bank and Trust Company (the "Bank"). The Bank offers a wide variety of retail, commercial, secondary market mortgage lending, and trust and investment services which also include non-deposit products such as mutual funds and insurance policies.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of foreclosed real estate, goodwill and intangible assets, the valuation of deferred tax assets, other-than-temporary impairments of securities, and acquired loans with specific credit-related deterioration.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the AMNB Trust and the MidCarolina Trusts, as detailed in Note 9.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the results of the interim periods. The results of operations for the interim periods are not necessarily indicative of the results that may occur for the year ending December 31, 2015. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These reclassifications did not have an impact on net income and were considered immaterial.

These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

Recent Accounting Pronouncements

In June 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("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. Early adoption is not permitted. The adoption of the new guidance did not have a material impact on the Company’s 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 the Company's 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 a material impact on its consolidated financial statements.

In November 2014, the FASB issued ASU No. 2014-16, "Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity." The amendments in this ASU do not change the current criteria in GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. The amendments clarify how current GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features, including the embedded derivative feature being evaluated for bifurcation, in evaluating the nature of the host contract. Furthermore, the amendments clarify that no single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument. The amendments in this ASU also clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (i.e., the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption, including adoption in an interim period, is permitted. The Company does not expect the adoption of ASU 2014-16 to have a material impact on its consolidated financial statements.

In January 2015, the FASB issued ASU No. 2015-01, "Income Statement-Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items." The amendments in this ASU eliminate from GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. If an event or transaction meets the criteria for extraordinary classification, an entity is required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also is required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company does not expect the adoption of ASU 2015-01 to have a material impact on its consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis." The amendments in this ASU are intended to improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). In addition to reducing the number of consolidation models from four to two, the new standard simplifies the FASB Accounting Standards Codification and improves current GAAP by placing more emphasis on risk of loss when determining a controlling financial interest, reducing the frequency of the application of related-party guidance when determining a controlling financial interest in a variable interest entity ("VIE"), and changing consolidation conclusions for public and private

companies in several industries that typically make use of limited partnerships or VIEs. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. ASU 2015-02 may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. The Company does not expect the adoption of ASU 2015-02 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, “Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs.” The amendments in this ASU are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. The amendments in this ASU are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously

issued. The Company does not expect the adoption of ASU 2015-03 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement.” The amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments do not change the accounting for a customer’s accounting for service contracts. As a result of the amendments, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets. The amendments in this ASU are effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. An entity can elect to adopt the amendments either: (1) prospectively to all arrangements entered into or materially modified after the effective date; or (2) retrospectively. The Company is currently assessing the impact that ASU 2015-05 will have on its consolidated financial statements.

In May 2015, the FASB issued ASU No. 2015-08, “Business Combinations (Topic 805): Pushdown Accounting - Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115.” The amendments in ASU 2015-08 amend various Securities and Exchange Commission ("SEC") paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 115, Topic 5: Miscellaneous Accounting, regarding various pushdown accounting issues, and did not have a material impact on the Company’s consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-12, “Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), and Health and Welfare Benefit Plans (Topic 965) - 1. Fully Benefit-Responsive Investment Contracts, 2. Plan Investment Disclosures, and 3. Measurement Date Practical Expedient.” The amendments within this ASU are in 3 parts. Among other things, Part 1 amendments designate contract value as the only required measure for fully benefit-responsive investment contracts; Part 2 amendments eliminate the requirement that plans disclose: (a) individual investments that represent 5 percent or more of net assets available for benefits; and (b) the net appreciation or depreciation for investments by general type requirements for both participant-directed investments and nonparticipant-directed investments. Part 3 amendments provide a practical expedient to permit plans to measure investments and investment-related accounts (e.g., a liability for a pending trade with a broker) as of a month-end date that is closest to the plan’s fiscal year-end, when the fiscal period does not coincide with month-end. The amendments in Parts 1 and 2 of this ASU are effective on a retrospective basis and Part 3 is effective on a prospective basis, for fiscal years beginning after December 15, 2015. Early adoption is permitted. The Company is currently assessing the impact that ASU 2015-12 will have on its consolidated financial statements.

In August 2015, the FASB issued ASU No. 2015-14, “Revenue from Contracts with Customers (Topic 606): Deferral of Effective Date.” The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to an annual reporting period beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to an annual reporting period beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. All other entities may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities also may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which the entity first applies

the guidance in ASU 2014-09. The Company does not expect the adoption of ASU 2015-14 to have a material impact on its consolidated financial statements.

In August 2015, the FASB issued ASU 2015-15, “Interest - Imputation of Interest (Subtopic 835-30) - Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting).” On April 7, 2015, the FASB issued ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The guidance in ASU 2015-03 (see paragraph 835-30-45-1A) does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff stated that they would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding

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borrowings on the line-of-credit arrangement. ASU 2015-15 adds these SEC comments to the "S" section of the Codification. The Company does not expect the adoption of ASU 2015-15 to have a material impact on its consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, "Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments." The amendments in ASU 2015-16 require that an acquirer recognize adjustments to estimated amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the estimated amounts, calculated as if the accounting had been completed at the acquisition date. The amendments also require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the estimated amounts had been recognized as of the acquisition date. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date with earlier application permitted for financial statements that have not been issued. The Company does not expect the adoption of ASU 2015-16 to have a material impact on its consolidated financial statements.

Note 2 – Acquisition of MainStreet

On January 1, 2015, the Company completed its acquisition of MainStreet BankShares, Inc. ("MainStreet"). The merger of MainStreet with and into the Company was effected pursuant to the terms and conditions of the Agreement and Plan of Reorganization, dated as of August 24, 2014, between the Company and MainStreet, and a related Plan of Merger. Immediately after the merger, Franklin Community Bank, N.A., MainStreet's wholly owned bank subsidiary, merged with and into the Bank. Pursuant to the MainStreet merger agreement, holders of shares of MainStreet common stock received $3.46 in cash and 0.482 shares of the Company's common stock for each share of MainStreet common stock held immediately prior to the effective date of the merger, plus cash in lieu of fractional shares. Each option to purchase shares of MainStreet common stock that was outstanding immediately prior to the effective date of the merger vested upon the merger and was converted into an option to purchase shares of the Company's common stock, adjusted based on a 0.643 exchange ratio. Each share of the Company's common stock outstanding immediately prior to the merger remained outstanding and was unaffected by the merger. The cash portion of the merger consideration was funded through a cash dividend of $6,000,000 from the Bank to the Company, and no borrowing was incurred by the Company or the Bank in connection with the merger. Replacement stock option awards representing 43,086 shares of the Company's common stock were granted in conjunction with the MainStreet acquisition. The value of the consideration transferred with the replacement awards did not result in any goodwill.

The transaction was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed, and consideration exchanged were recorded at estimated fair values on the acquisition date. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition.

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In connection with the merger, the consideration paid, and the fair value of identifiable assets acquired and liabilities assumed as of the merger date are summarized in the following table (dollars in thousands):

Consideration Paid:	
Common shares issued (825,586)	$20,483
Cash paid to shareholders	5,935
Value of consideration	26,418
Assets acquired:	
Cash and cash equivalents	18,173
Investment securities	18,800
Restricted stock	587
Loans	115,050
Premises and equipment	1,030
Deferred income taxes	2,773
Core deposit intangible	1,839
Other real estate owned	168
Banked owned life insurance	1,955
Other assets	1,077
Total assets	161,452
Liabilities assumed:	
Deposits	137,323
Other liabilities	3,001
Total liabilities	140,324
Net assets acquired	21,128
Goodwill resulting from merger with MainStreet	$5,290

The following table details the changes in fair value of net assets acquired and liabilities assumed from the amounts originally reported in the Form 10-Q for the quarterly period ended June 30, 2015 (dollars in thousands):

Goodwill at June 30, 2015	$5,167	
Effect of adjustments to:		
Loans	(353	)
Premises and equipment	289	
Other Assets	187	
Goodwill at September 30, 2015	$5,290	

The increase in goodwill made during the third quarter of 2015 was due to a reevaluation of the loan portfolio, fair value appraisals of premises, and a change in estimated tax refunds due to MainStreet. As a part of the reevaluation, numerous loans were transferred to the purchased credit impaired portfolio primarily because of concerns over underlying collateral values, repayment terms and debt service coverage. The transfer resulted in a reduction in goodwill and accretion income of $353,000.

In many cases, the fair values of assets acquired and liabilities assumed were determined by estimating the cash flows expected to result from those assets and liabilities and discounting them at appropriate market rates. The most significant category of assets for which this procedure was used was that of acquired loans. The Company acquired the $122,447,000 loan portfolio at a fair value discount of $7,397,000. The estimated fair value of the performing portion of the portfolio was $87,803,000. The excess of expected cash flows above the fair value of the performing

portion of loans will be accreted to interest income over the remaining lives of the loans in accordance with FASB Accounting Standards Codification ("ASC") 310-20.

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Certain loans, those for which specific credit-related deterioration since origination was identified, are recorded at fair value, reflecting the present value of the amounts expected to be collected. Income recognition on these loans is based on reasonable expectations about the timing and amount of cash flows to be collected. Acquired loans deemed impaired and considered collateral dependent, with the timing of the sale of loan collateral indeterminate, remain on non-accrual status and have no accretable yield.

The following table details the acquired loans that are accounted for in accordance with FASB ASC 310-30 as of January 1, 2015, after adjusting for the aforementioned reevaluation in the third quarter (dollars in thousands):

Contractually required principal and interest at acquisition	$33,066
Contractual cash flows not expected to be collected (nonaccretable difference)	1,828
Expected cash flows at acquisition	34,894
Interest component of expected cash flows (accretable yield)	7,647
Fair value of acquired loans accounted for under FASB ASC 310-30	$27,247

In accordance with GAAP, there was no carryover of the allowance for loan losses that had been previously recorded by MainStreet.

In connection with the acquisition of MainStreet, the Company acquired an investment portfolio with a fair value of $18,800,000. The fair value of the investment portfolio was determined by taking into account market prices obtained from independent valuation sources.

In connection with the acquisition of MainStreet, the Company recorded a deferred income tax asset of $2,773,000 related to tax attributes of MainStreet, along with the effects of fair value adjustments resulting from applying the acquisition method of accounting.

In connection with the acquisition of MainStreet, the Company acquired other real estate owned with a fair value of $168,000. Other real estate owned was measured at fair value less estimated cost to sell.

In connection with the acquisition of MainStreet, the Company acquired premises and equipment with a fair value of $1,030,000.

The fair value of savings and transaction deposit accounts acquired from MainStreet was assumed to approximate their carrying value as these accounts have no stated maturity and are payable on demand. Certificates of deposit accounts were valued by comparing the contractual cost of the portfolio to an identical portfolio bearing current market rates. The portfolio was segregated into pools based on segments: retail, individual retirement accounts, and brokered. For each segment, the projected cash flows from maturing certificates were then calculated based on contractual rates and prevailing market rates. The valuation adjustment for each segment is equal to the present value of the difference of these two cash flows, discounted at the assumed market rate for a certificate with a corresponding maturity. This valuation adjustment of $290,000 will be accreted to reduce interest expense over the average remaining maturities of the respective pools, which is estimated to be 12 months.

A core deposit intangible of $1,839,000 was recognized in connection with the acquisition of MainStreet. This intangible will be amortized over a 10 year period on an accelerated cost recovery basis.

Direct costs related to the acquisition were expensed as incurred. During 2015, the Company incurred $1,948,000 acquisition related expenses.

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The following table presents unaudited pro forma information as if the acquisition of MainStreet had occurred on January 1, 2014. This pro forma information gives effect to certain adjustments, including acquisition accounting fair value adjustments, amortization of core deposit intangible and related income tax effects. The pro forma information does not necessarily reflect the results of operations that would have occurred had the merger with MainStreet occurred in 2014. In particular, expected operational cost savings are not reflected in the pro forma amounts (dollars in thousands).

	Pro forma Nine Months Ended	
	September 30, 2015	September 30, 2014
Net interest income	$37,584	$37,302
Provision for loan loss	(700)	(150)
Non-interest income	9,469	9,055
Non-interest expense and income taxes	(35,660)	(34,644)
Net income	$10,693	$11,563

	Pro forma Three Months Ended	
	September 30, 2015	September 30, 2014
Net interest income	$12,378	$12,512
Provision for loan loss	—	—
Non-interest income	3,055	3,205
Non-interest expense and income taxes	(11,245)	(11,868)
Net income	$4,188	$3,849

Note 3 – Securities

The amortized cost and fair value of investments in debt and equity securities at September 30, 2015 and December 31, 2014 were as follows (dollars in thousands):

	September 30, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	$103,765	$510	$29	$104,246
Mortgage-backed and CMOs	54,687	1,086	74	55,699
State and municipal	179,761	6,623	28	186,356
Corporate	10,681	57	30	10,708
Equity securities	1,000	297	—	1,297
Total securities available for sale	$349,894	$8,573	$161	$358,306

	December 31, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	$81,958	$252	$104	$82,106
Mortgage-backed and CMOs	56,289	1,248	112	57,425
State and municipal	188,060	7,523	90	195,493
Corporate	8,416	16	53	8,379
Equity securities	1,000	313	—	1,313
Total securities available for sale	$335,723	$9,352	$359	$344,716

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Restricted Stock

Due to restrictions placed upon the Bank's common stock investment in the Federal Reserve Bank of Richmond ("FRB") and Federal Home Loan Bank of Atlanta ("FHLB"), these securities have been classified as restricted equity securities and carried at cost. The restricted securities are not subject to the investment security classification and are included as a separate line item on the Company's balance sheet. The FRB requires the Bank to maintain stock with a par value equal to 6.0% of its common stock and paid-in surplus. One-half of this amount is paid to the FRB and the remaining half is subject to call when deemed necessary by the Board of Governors of the Federal Reserve System. The FHLB requires the Bank to maintain stock in an amount equal to a specific percentage of the Bank's total assets and 4.5% of outstanding borrowings. The cost of restricted stock at September 30, 2015 and December 31, 2014 was as follows (dollars in thousands):

	September 30, 2015	December 31, 2014
FRB stock	$3,531	$2,742
FHLB stock	1,777	1,625
Total restricted stock	$5,308	$4,367

Temporarily Impaired Securities

The following table shows fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2015. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period (dollars in thousands).

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	$15,037	$29	$12,939	$27	$2,098	$2
Mortgage-backed and CMOs	8,281	74	6,243	54	2,038	20
State and municipal	8,457	28	8,457	28	—	—
Corporate	2,726	30	1,135	9	1,591	21
Total	$34,501	$161	$28,774	$118	$5,727	$43

Federal Agencies and GSE debt securities: The unrealized losses on the Company's investment in four government sponsored entities ("GSE") were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2015.

Mortgage-backed securities and CMOs: The unrealized losses on the Company's investment in 13 GSE mortgage-backed securities and collateralized mortgage obligations ("CMOs") were caused by interest rate increases. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2015.

State and municipal securities: The unrealized losses on 11 state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2015.

Corporate securities: The unrealized losses on three investments in corporate securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that

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the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2015.

Restricted stock: When evaluating restricted stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The company does not consider restricted stock to be other-than-temporarily impaired at September 30, 2015, and no impairment has been recognized.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position, at December 31, 2014 (dollars in thousands):

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	$28,979	$104	$21,449	$35	$7,530	$69
Mortgage-backed and CMOs	7,182	112	1,171	13	6,011	99
State and municipal	20,542	90	15,836	60	4,706	30
Corporate	5,032	53	2,273	4	2,759	49
Total	$61,735	$359	$40,729	$112	$21,006	$247

Other-Than-Temporary-Impaired Securities

As of September 30, 2015 and December 31, 2014, there were no securities classified as having other-than-temporary impairment.

Note 4 – Loans

Segments

Loans, excluding loans held for sale, as of September 30, 2015 and December 31, 2014, were comprised of the following (dollars in thousands):

	September 30, 2015	December 31, 2014
Commercial	$164,025	$126,981
Commercial real estate:		
Construction and land development	68,692	50,863
Commercial real estate	424,404	391,472
Residential real estate:		
Residential	219,415	175,293
Home equity	98,249	91,075
Consumer	6,199	5,241
Total loans	$980,984	$840,925

Acquired Loans

Interest income, including accretion income of $2,379,000, on loans acquired from MidCarolina Financial Corporation ("MidCarolina") and MainStreet for the nine months ended September 30, 2015 was approximately $11,333,000. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheets at September 30, 2015 and December 31, 2014 are as follows (dollars in thousands):

	September 30, 2015	December 31, 2014
Outstanding principal balance	$162,190	$84,892
Carrying amount	151,026	78,111

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The outstanding principal balance and related carrying amount of acquired impaired loans, for which the Company applies FASB ASC 310-30, to account for interest earned, at September 30, 2015 and December 31, 2014 are as follows (dollars in thousands):

	September 30, 2015	December 31, 2014
Outstanding principal balance	$43,325	$18,357
Carrying amount	35,569	14,933

The following table presents changes in the accretable yield on acquired impaired loans, for which the Company applies FASB ASC 310-30, for the nine months ended September 30, 2015 (dollars in thousands):

	Accretable Yield
Balance at December 31, 2014	$1,440
Additions from merger with MainStreet	7,647
Accretion	(1,437)
Other changes, net	(589)
Balance at September 30, 2015	$7,061

Past Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at September 30, 2015 (dollars in thousands):

	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing	Non-Accrual Loans	Total Past Due	Current	Total Loans
Commercial	$4	$—	$—	$103	$107	$163,918	$164,025
Commercial real estate:							
Construction and land development	84	—	—	263	347	68,345	68,692
Commercial real estate	137	598	—	2,651	3,386	421,018	424,404
Residential:							
Residential	709	235	—	1,368	2,312	217,103	219,415
Home equity	58	32	—	960	1,050	97,199	98,249
Consumer	3	34	—	14	51	6,148	6,199
Total	$995	$899	$—	$5,359	$7,253	$973,731	$980,984

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The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2014 (dollars in thousands):

	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing	Non-Accrual Loans	Total Past Due	Current	Total Loans
Commercial	$114	$165	$—	$—	$279	$126,702	$126,981
Commercial real estate:							
Construction and land development	44	269	—	279	592	50,271	50,863
Commercial real estate	257	—	—	3,010	3,267	388,205	391,472
Residential:							
Residential	390	325	—	560	1,275	174,018	175,293
Home equity	223	60	—	262	545	90,530	91,075
Consumer	1	42	—	1	44	5,197	5,241
Total	$1,029	$861	$—	$4,112	$6,002	$834,923	$840,925

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Impaired Loans

The following table presents the Company's impaired loan balances by portfolio segment, excluding loans acquired with deteriorated credit quality, at September 30, 2015 (dollars in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$107	$108	$—	$203	$—
Commercial real estate:					
Construction and land development	249	306	—	382	—
Commercial real estate	1,108	1,425	—	1,524	—
Residential:					
Residential	920	921	—	626	—
Home equity	803	803	—	695	—
Consumer	15	15	—	34	1
	$3,202	$3,578	$—	$3,464	$1
With a related allowance recorded:					
Commercial	—	—	—	—	—
Commercial real estate:					
Construction and land development	413	413	2	484	21
Commercial real estate	249	249	6	254	12
Residential					
Residential	379	379	24	333	10
Home equity	106	106	2	24	—
Consumer	—	—	—	—	—
	$1,147	$1,147	$34	$1,095	$43
Total:					
Commercial	$107	$108	$—	$203	$—
Commercial real estate:					
Construction and land development	662	719	2	866	21
Commercial real estate	1,357	1,674	6	1,778	12
Residential:					
Residential	1,299	1,300	24	959	10
Home equity	909	909	2	719	—
Consumer	15	15	—	34	1
	$4,349	$4,725	$34	$4,559	$44

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The following table presents the Company's impaired loan balances by portfolio segment, excluding loans acquired with deteriorated credit quality, at December 31, 2014 (dollars in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$7	$7	$—	$12	$1
Commercial real estate:					
Construction and land development	280	325	—	448	—
Commercial real estate	1,520	1,797	—	1,844	—
Residential:					
Residential	603	603	—	723	8
Home equity	256	256	—	316	—
Consumer	1	1	—	2	—
	$2,667	$2,989	$—	$3,345	$9
With a related allowance recorded:					
Commercial	$—	$—	$—	$—	$—
Commercial real estate:					
Construction and land development	576	577	12	593	34
Commercial real estate	1,275	1,422	149	1,297	8
Residential:					
Residential	4	4	1	4	—
Home equity	—	—	—	—	—
Consumer	15	15	3	17	1
	$1,870	$2,018	$165	$1,911	$43
Total:					
Commercial	$7	$7	$—	$12	$1
Commercial real estate:					
Construction and land development	856	902	12	1,041	34
Commercial real estate	2,795	3,219	149	3,141	8
Residential:					
Residential	607	607	1	727	8
Home equity	256	256	—	316	—
Consumer	16	16	3	19	1
	$4,537	$5,007	$165	$5,256	$52

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The following tables show the detail of loans modified as troubled debt restructurings ("TDRs") during the three and nine months ended September 30, 2015 included in the impaired loan balances (dollars in thousands):

Loan Type	Loans Modified as a TDR for the Three Months Ended September 30, 2015		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	2	$ 52	$ 31
Commercial real estate	—	—	—
Construction and land development	—	—	—
Home Equity	1	106	106
Residential real estate	1	382	294
Consumer	—	—	—
Total	4	$ 540	$ 431

Loan Type	Loans Modified as a TDR for the Nine Months Ended September 30, 2015		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	2	$ 52	$ 31
Commercial real estate	3	256	249
Construction and land development	—	—	—
Home Equity	1	106	106
Residential real estate	5	776	680
Consumer	—	—	—
Total	11	$ 1,190	$ 1,066

The following tables show the detail of loans modified as TDRs during the three and nine months ended September 30, 2014 included in the impaired loan balances (dollars in thousands):

Loan Type	Loans Modified as a TDR for the Three Months Ended September 30, 2014		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	—	$ —	$ —
Commercial real estate	—	—	—
Construction and land development	—	—	—
Home Equity	—	—	—
Residential real estate	—	—	—
Consumer	—	—	—
Total	—	$ —	$ —

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Loan Type	Loans Modified as a TDR for the Nine Months Ended September 30, 2014		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	—	$—	$ —
Commercial real estate	1	182	179
Construction and land development	—	—	—
Home Equity	1	8	8
Residential real estate	2	121	115
Consumer	—	—	—
Total	4	$311	$ 302

During the three and nine months ended September 30, 2015 and September 30, 2014, the Company had one loan that subsequently defaulted within twelve months of modification as a TDR. The credit is a commercial real estate loan which became over 90 days past due during the third quarter of 2015, after being restructured in the second quarter of 2015. The Company defines defaults as one or more payments that occur more than 90 days past the due date, charge-off or foreclosure subsequent to modification.

Residential Real Estate in Process of Foreclosure

The Company had $386,000 in residential real estate in the process of foreclosure and $131,000 in residential other real estate owned at September 30, 2015.

Risk Grades

The following table shows the Company's loan portfolio broken down by internal risk grading as of September 30, 2015 (dollars in thousands):

Commercial and Consumer Credit Exposure

Credit Risk Profile by Internally Assigned Grade

	Commercial	Commercial Real Estate Construction	Commercial Real Estate Other	Residential	Home Equity
Pass	$162,525	$63,538	$411,483	$198,067	$95,351
Special Mention	1,362	1,579	6,179	16,268	1,528
Substandard	138	3,575	6,742	5,080	1,370
Doubtful	—	—	—	—	—
Total	$164,025	$68,692	$424,404	$219,415	$98,249

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

	Consumer
Performing	$6,148
Nonperforming	51
Total	$6,199

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The following table shows the Company's loan portfolio broken down by internal risk grading as of December 31, 2014 (dollars in thousands):

Commercial and Consumer Credit Exposure
Credit Risk Profile by Internally Assigned Grade

	Commercial	Commercial Real Estate Construction	Commercial Real Estate Other	Residential	Home Equity
Pass	$125,405	$45,534	$382,607	$165,367	$88,646
Special Mention	1,569	569	4,889	6,709	1,801
Substandard	7	4,760	3,976	3,217	628
Doubtful	—	—	—	—	—
Total	$126,981	$50,863	$391,472	$175,293	$91,075

Consumer Credit Exposure
Credit Risk Profile Based on Payment Activity

	Consumer
Performing	$5,240
Nonperforming	1
Total	$5,241

Loans classified in the Pass category typically are fundamentally sound and risk factors are reasonable and acceptable. Loans classified in the Special Mention category typically have been criticized internally, by loan review or the loan officer, or by external regulators under the current credit policy regarding risk grades. Loans classified in the Substandard category typically have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are typically characterized by the possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Loans classified in the Doubtful category typically have all the weaknesses inherent in loans classified as substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur that may salvage the debt.

Consumer loans are classified as performing or nonperforming. A loan is nonperforming when payments of interest and principal are past due 90 days or more, or payments are less than 90 days past due, but there are other good reasons to doubt that payment will be made in full.

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Note 5 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments as of the indicated dates and periods are presented below (dollars in thousands).

The reserve for unfunded loan commitments is included in other liabilities.

	Nine Months Ended September 30, 2015	Year Ended December 31, 2014	Nine Months Ended September 30, 2014
Allowance for Loan Losses			
Balance, beginning of period	$12,427	$12,600	$12,600
Provision for loan losses	700	400	150
Charge-offs	(883)	(964)	(398)
Recoveries	367	391	268
Balance, end of period	$12,611	$12,427	$12,620
Reserve for Unfunded Lending Commitments			
Balance, beginning of period	$163	$210	$210
Provision for (recovery of) loan losses	26	(47)	(55)
Charge-offs	—	—	—
Balance, end of period	$189	$163	$155

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The following table presents changes in the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment as of and for the nine months ended September 30, 2015 (dollars in thousands):

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Allowance for Loan Losses						
Balance as of December 31, 2014:	$1,818	$6,814	$3,715	$80	$—	$12,427
Charge-offs	(164)	(486)	(58)	(175)	—	(883)
Recoveries	26	114	122	105	—	367
Provision for loan losses	383	386	(131)	62	—	700
Balance as of September 30, 2015:	$2,063	$6,828	$3,648	$72	$—	$12,611
Balance as of September 30, 2015:						
Allowance for Loan Losses						
Individually evaluated for impairment	$—	$8	$26	$—	$—	$34
Collectively evaluated for impairment	2,056	6,603	3,386	60	—	12,105
Loans acquired with deteriorated credit quality	7	217	236	12	—	472
Total	$2,063	$6,828	$3,648	$72	$—	$12,611
Loans						
Individually evaluated for impairment	$107	$2,019	$2,208	$15	$—	$4,349
Collectively evaluated for impairment	163,346	474,196	297,674	5,849	—	941,065
Loans acquired with deteriorated credit quality	572	16,881	17,782	335	—	35,570
Total	$164,025	$493,096	$317,664	$6,199	$—	$980,984

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The following table presents changes in the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment as of and for the year ended December 31, 2014 (dollars in thousands):

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Allowance for Loan Losses						
Balance as of December 31, 2013:	$1,810	$6,819	$3,690	$99	$182	$12,600
Charge-offs	(101)	(510)	(258)	(95)	—	(964)
Recoveries	51	66	191	83	—	391
Provision for loan losses	58	439	92	(7)	(182)	400
Balance as of December 31, 2014:	$1,818	$6,814	$3,715	$80	$—	$12,427
Balance as of December 31, 2014:						
Allowance for Loan Losses						
Individually evaluated for impairment	$—	$161	$1	$3	$—	$165
Collectively evaluated for impairment	1,815	6,400	3,424	77	—	11,716
Loans acquired with deteriorated credit quality	3	253	290	—	—	546
Total	$1,818	$6,814	$3,715	$80	$—	$12,427
Loans						
Individually evaluated for impairment	$7	$3,651	$863	$16	$—	$4,537
Collectively evaluated for impairment	126,774	429,660	259,796	5,225	—	821,455
Loans acquired with deteriorated credit quality	200	9,024	5,709	—	—	14,933
Total	$126,981	$442,335	$266,368	$5,241	$—	$840,925

The allowance for loan losses is allocated to loan segments based upon historical loss factors, risk grades on individual loans, portfolio analysis of smaller balance, homogenous loans, and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers and other lending staff; national, regional, and local economic trends and conditions; legal, regulatory and collateral factors; and concentrations of credit.

Note 6 – Goodwill and Other Intangible Assets

The Company records as goodwill the excess of the purchase price over the fair value of the identifiable net assets acquired. Impairment testing is performed annually, as well as when an event triggering impairment may have occurred. The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No

indicators of impairment were identified as of June 30, 2015.
Core deposit intangibles resulting from the MidCarolina acquisition in July 2011 were $3,112,000 and are being amortized on an accelerated basis over 120 months. Core deposit intangibles resulting from the MainStreet acquisition in January 2015 were $1,839,000 and are being amortized on an accelerated basis over 120 months.

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The changes in the carrying amount of goodwill and intangibles for the nine months ended September 30, 2015, are as follows (dollars in thousands):

	Goodwill	Intangibles
Balance as of December 31, 2014	$39,043	$2,045
Additions	5,290	1,839
Amortization	—	(901)
Impairment	—	—
Balance as of September 30, 2015	$44,333	$2,983

Note 7 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies or GSEs. They mature daily. The interest rates may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. Other short-term borrowings consist of overnight advances which contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. There were no customer repurchase agreements acquired in the MainStreet acquisition. Short-term borrowings consisted of the following at September 30, 2015 and December 31, 2014 (dollars in thousands):

	September 30, 2015	December 31, 2014
Customer repurchase agreements	$43,579	$53,480
	$43,579	$53,480

Note 8 – Long-term Borrowings

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans, home equity lines of credit, and commercial real estate loans. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of September 30, 2015, $424,020,000 in eligible collateral was pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long-term advances as of September 30, 2015 and December 31, 2014 (dollars in thousands):

September 30, 2015			December 31, 2014		
Due by	Advance Amount	Weighted Average Rate	Due by	Advance Amount	Weighted Average Rate
November 2017	9,952	2.98 %	November 2017	9,935	2.98 %
	$9,952	2.98 %		$9,935	2.98 %

The advance due in November 2017 is net of a fair value discount of $48,000. The original discount recorded on July 1, 2011, was a result of the merger with MidCarolina. The adjustment to the face value is being amortized into interest expense over the life of the borrowing. There were no long-term borrowings acquired in the MainStreet acquisition and no borrowings were incurred to fund the acquisition.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At September 30, 2015, the Bank's public deposits totaled $132,451,000. The Company is required to provide collateral to secure the deposits that exceed the insurance coverage provided by the Federal Deposit Insurance Corporation. This collateral can be provided in the form of certain types of government or agency bonds or letters of credit from the FHLB. At September 30, 2015, the Company had $70,000,000 in letters of credit with the FHLB outstanding, as well as $132,653,000 in agency, state, and municipal securities pledged to provide collateral for such deposits.

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Note 9 – Junior Subordinated Debt

On April 7, 2006, AMNB Statutory Trust I (the "AMNB Trust I"), a Delaware statutory trust and a wholly owned subsidiary of the Company, issued $20,000,000 of preferred securities (the "Trust Preferred Securities") in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on June 30, 2036, but may be redeemed at the Company's option (which option became effective beginning on September 30, 2011). Initially, the securities required quarterly distributions by the AMNB Trust I to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective September 30, 2011, the rate resets quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to 20 consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities.

The proceeds of the Trust Preferred Securities received by the AMNB Trust I, along with proceeds of $619,000 received by the trust from the issuance of common securities by the trust to the Company, were used to purchase $20,619,000 of the Company's junior subordinated debt securities (the "Junior Subordinated Debt"), issued pursuant to junior subordinated debentures entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Junior Subordinated Debt were used to fund the cash portion of the merger consideration to the former shareholders of Community First Financial Corporation in connection with the Company's acquisition of that company, and for general corporate purposes. On July 1, 2011, in connection with the MidCarolina merger, the Company assumed $8,764,000 in junior subordinated debt to MidCarolina Trust I and MidCarolina Trust II, two separate Delaware statutory trusts (the "MidCarolina Trusts"), to fully and unconditionally guarantee the preferred securities issued by the MidCarolina Trusts. These long-term obligations, which currently qualify as Tier 1 capital, constitute a full and unconditional guarantee by the Company of the MidCarolina Trusts' obligations. Neither the AMNB Trust I nor the MidCarolina Trusts were consolidated in the Company's financial statements.

In accordance with FASB ASC 810-10-15-14, the Company did not eliminate through consolidation the Company's $619,000 equity investment in AMNB Trust I or the $264,000 equity investment in the MidCarolina Trusts. Instead, the Company reflected this equity investment in the "Accrued interest receivable and other assets" line item in the consolidated balance sheets.

A description of the junior subordinated debt outstanding payable to the trusts is shown below as of September 30, 2015 and December 31, 2014 (dollars in thousands):

Issuing Entity	Date Issued	Interest Rate	Maturity Date	Principal Amount September 30, 2015	Principal Amount December 31, 2014
AMNB Trust I	4/7/2006	Libor plus 1.35 %	6/30/2036	$ 20,619	$ 20,619
MidCarolina Trust I	10/29/2002	Libor plus 3.45 %	11/7/2032	4,196	4,154
MidCarolina Trust II	12/3/2003	Libor plus 2.95 %	10/7/2033	2,782	2,748
				$ 27,597	$ 27,521

The principal amounts reflected above for the MidCarolina Trusts (I and II) are net of fair value adjustments of $959,000 and $827,000, respectively at September 30, 2015. The original fair value adjustments of $1,197,000 and $1,021,000 were recorded as a result of the acquisition of MidCarolina on July 1, 2011, and are being amortized into interest expense over the remaining lives of the respective borrowings.

Note 10 – Stock Based Compensation

The Company's 2008 Stock Incentive Plan ("2008 Plan") was adopted by the Board of Directors of the Company on February 19, 2008, and approved by shareholders on April 22, 2008, at the Company's 2008 Annual Meeting of Shareholders. The 2008 Plan provides for the granting of restricted stock awards and incentive and non-statutory

options to employees and directors on a periodic basis, at the discretion of the Board of Directors or a Board designated committee. The 2008 Plan authorizes the issuance of up to 500,000 shares of common stock. The 2008 Plan replaced the Company's stock option plan that was approved by the shareholders at the 1997 Annual Meeting. The prior stock option plan was terminated in 2006.

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Stock Options

Accounting guidance requires that compensation cost relating to share-based payment transactions be recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued.

A summary of stock option transactions for the nine months ended September 30, 2015 is as follows:

	Option Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at December 31, 2014	110,947	$26.08		
Acquired in acquisition	43,086	20.02		
Granted	—	—		
Exercised	22,074	18.06		
Forfeited	—	—		
Expired	—	—		
Outstanding at September 30, 2015	131,959	25.44	1.66 years	$156
Exercisable at September 30, 2015	131,959	$25.44	1.66 years	$156

Replacement stock option awards representing 43,086 shares of the Company's common stock were granted in conjunction with the MainStreet acquisition. The value of the consideration transferred with the replacement awards was evaluated during the quarter ended September 30, 2015, but did not result in an adjustment to the amount of goodwill recorded.

The fair value of options is estimated at the date of grant using the Black-Scholes option pricing model and expensed over the options' vesting period. As of September 30, 2015, there was no unrecognized compensation expenses related to nonvested stock option grants.

Restricted Stock

The Company from time-to-time grants shares of restricted stock to key employees and non-employee directors. These awards help align the interests of these employees and directors with the interests of the shareholders of the Company by providing economic value directly related to increases in the value of the Company's common stock. The value of the stock awarded is established as the fair market value of the stock at the time of the grant. The Company recognizes expense, equal to the total value of such awards, ratably over the vesting period of the stock grants. Restricted stock granted cliff vests over 24 to 36 months based on the term of the award.

Nonvested restricted stock activity for the nine months ended September 30, 2015 is summarized in the following table.

Restricted Stock	Shares	Weighted Average Grant Date Value
Nonvested at December 31, 2014	41,562	$21.39
Granted	19,155	21.81
Vested	15,536	19.51
Forfeited	1,112	22.49
Nonvested at September 30, 2015	44,069	$22.21

As of September 30, 2015 and December 31, 2014 there was $471,000 and $327,000 in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. The weighted average period over which this cost is expected to be recognized is 1.30 years. The share based compensation expense for nonvested restricted stock was $249,000 and $267,000 during the first nine months of 2015 and 2014, respectively.

Starting in 2010, the Company began offering its outside directors alternatives with respect to director compensation. The regular monthly board retainer can be received in the form of either (i) $1,000 in cash or (ii) shares of

immediately vested, but restricted stock with a market value of $1,563. Monthly meeting fees can also be received as $600 per meeting in cash or $750 in immediately vested, but restricted stock. For 2015, all 13 outside directors have elected to receive stock in lieu of cash for

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either all or part of their quarterly retainer or meeting fees. Only outside directors receive board fees. The Company issued 8,630 and 10,239 shares and recognized share based compensation expense of $195,000 and $230,000 during the first nine months of 2015 and 2014, respectively.

During the nine months ended September 30, 2015, 4,158 shares with a market value of $95,000 were issued to a retired director as payment for cumulative deferred director compensation.

Note 11 – Earnings Per Share

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 potentially dilutive common stock. Potentially dilutive common stock had no effect on income available to common shareholders. The following tables present basic and diluted earnings per share for the three and nine months period ended September 30, 2015 and 2014.

	Three Months Ended September 30,			
	2015		2014	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	8,668,618	$0.47	7,841,078	$0.40
Effect of dilutive securities - stock options	7,953	—	10,657	—
Diluted	8,676,571	$0.47	7,851,735	$0.40

	Nine Months Ended September 30,			
	2015		2014	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic	8,698,394	1.20	7,871,016	1.25
Effect of dilutive securities - stock options	8,476	—	10,425	—
Diluted	8,706,870	1.20	7,881,441	1.25

Stock options on common stock which were not included in computing diluted earnings per share for the nine month periods ended September 30, 2015 and 2014, because their effects were anti-dilutive, averaged 78,127 and 120,277 shares, respectively. Nonvested restricted stock is included in calculating basic earnings per share because the holder has voting rights and shares in non-forfeitable dividends during the vesting period.

Note 12 – Employee Benefit Plans

The following information for the nine months ended September 30, 2015 and September 30, 2014 pertains to the Company's non-contributory defined benefit pension plan which was frozen in 2009. If lump sum payments exceed the service cost plus interest cost, an additional settlement charge will apply (dollars in thousands):

Components of Net Periodic Benefit Cost	Nine months ended September 30,	
	2015	2014
Service cost	$—	$—
Interest cost	222	228
Expected return on plan assets	(345)	(351)
Recognized net actuarial loss	462	54
Net periodic (benefit) cost	$339	$(69)

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Note 13 – Fair Value of Financial Instruments

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the fair value measurements and disclosures topic of FASB ASC 820, "Fair Value Measurement and Disclosures", the fair value of an 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 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 assets and 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 assets and liabilities recorded at fair value on a recurring basis in the 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). If no observable market data is available, valuations are based upon third party model based techniques (Level 3).

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The following table presents the balances of assets and liabilities measured at fair value on a recurring basis at the dates indicated (dollars in thousands):

	Fair Value Measurements at September 30, 2015 Using			
	Balance at September 30,	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Description	2015	Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	$104,246	$—	$104,246	$—
Mortgage-backed and CMOs	55,699	—	55,699	—
State and municipal	186,356	—	186,356	—
Corporate	10,708	—	10,708	—
Equity	1,297	—	—	1,297
Total	$358,306	$—	$357,009	$1,297

	Fair Value Measurements at December 31, 2014 Using			
	Balance at December 31,	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Description	2014	Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	$82,106	$2,995	$79,111	$—
Mortgage-backed and CMOs	57,425	—	57,425	—
State and municipal	195,493	1,172	194,321	—
Corporate	8,379	—	8,379	—
Equity	1,313	—	—	1,313
Total	$344,716	$4,167	$339,236	$1,313

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					
		Total Realized / Unrealized Gains (Losses) Included in				
	Balances as of January 1, 2015	Net Income	Other Comprehensive Income	Purchases, Sales, Issuances and Settlements, Net	Transfer In (Out) of Level 3	Balances as of September 30, 2015
Securities available for sale:						
Equity	$1,313	$—	$(16)	$—	$—	$1,297

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.

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

Loans held for sale: Loans held for sale are carried at estimated fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the nine month period ended September 30, 2015 or the year ended December 31, 2014. Gains and losses on the sale of loans are recorded within mortgage banking income on the Consolidated Statements of Income.

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 agreements will not be collected. In addition, the impairment of a loan may be measured using a present value of future cash flows analysis (Level 3). Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable 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.

Other real estate owned: Measurement for fair values for other real estate owned are the same as real estate collateral discussed with impaired loans.

The following table summarizes the Company's assets that were measured at fair value on a nonrecurring basis at the dates indicated (dollars in thousands):

	Fair Value Measurements at September 30, 2015 Using			
	Balance at September 30,	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Description	2015	Level 1	Level 2	Level 3
Assets:				
Loans held for sale	$2,998	$—	$2,998	$—
Impaired loans, net of valuation allowance	1,113	—	—	1,113
Other real estate owned	1,333	—	—	1,333

	Fair Value Measurements at December 31, 2014 Using			
	Balance at December 31,	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs

Description	2014	Level 1	Level 2	Level 3
Assets:				
Loans held for sale	$616	$—	$616	$—
Impaired loans, net of valuation allowance	1,705	—	—	1,705
Other real estate owned	2,119	—	—	2,119

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The following tables summarize the Company's quantitative information about Level 3 fair value measurements at the dates indicated:

Quantitative Information About Level 3 Fair Value Measurements at September 30, 2015

Assets	Valuation Technique	Unobservable Input	Weighted Rate	
Securities available for sale	Consideration of equity conversion options	Stock price in different rate environments	30	%
Impaired loans	Discounted appraised value	Selling cost	6	%
	Discounted cash flows	Market rate for borrower (discount rate)	6	%
Other real estate owned	Discounted appraised value	Selling cost	6	%

Quantitative Information About Level 3 Fair Value Measurements at December 31, 2014

Assets	Valuation Technique	Unobservable Input	Weighted Rate	
Securities available for sale	Consideration of equity conversion options	Stock price in different rate environments	31	%
Impaired loans	Discounted appraised value	Selling cost	6	%
	Discounted cash flows	Market rate for borrower (discount rate)	4	%
Other real estate owned	Discounted appraised value	Selling cost	6	%

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

	Fair Value Measurements at September 30, 2015 Using				
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value
	Carrying Value	Level 1	Level 2	Level 3	Balance
Financial Assets:					
Cash and cash equivalents	$65,917	$65,917	$—	$—	$65,917
Securities available for sale	358,306	—	357,009	1,297	358,306
Restricted stock	5,308	—	5,308	—	5,308
Loans held for sale	2,998	—	2,998	—	2,998
Loans, net of allowance	968,373	—	—	976,432	976,432
Bank owned life insurance	17,491	—	17,491	—	17,491
Accrued interest receivable	4,462	—	4,462	—	4,462
Financial Liabilities:					
Deposits	$1,226,521	$—	$826,198	$402,079	$1,228,277
Repurchase agreements	43,579	—	43,579	—	43,579
Other borrowings	9,952	—	—	10,414	10,414
Trust preferred capital notes	27,597	—	—	22,475	22,475
Accrued interest payable	642	—	642	—	642

The carrying values and estimated fair values of the Company's financial instruments at December 31, 2014 are as follows (dollars in thousands):

	Fair Value Measurements at December 31, 2014 Using				
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value
	Carrying Value	Level 1	Level 2	Level 3	Balance
Financial Assets:					
Cash and cash equivalents	$67,303	$67,303	$—	$—	$67,303
Securities available for sale	344,716	4,167	339,236	1,313	344,716
Restricted stock	4,367	—	4,367	—	4,367
Loans held for sale	616	—	616	—	616
Loans, net of allowance	828,498	—	—	832,708	832,708
Bank owned life insurance	15,193	—	15,193	—	15,193
Accrued interest receivable	4,534	—	4,534	—	4,534
Financial Liabilities:					
Deposits	$1,075,837	$—	$712,020	$365,309	$1,077,329
Repurchase agreements	53,480	—	53,480	—	53,480
Other borrowings	9,935	—	—	10,432	10,432
Trust preferred capital notes	27,521	—	—	22,009	22,009
Accrued interest payable	587	—	587	—	587

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The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and cash equivalents. The carrying amount is a reasonable estimate of fair value.
Securities. Fair values are based on quoted market prices or dealer quotes.
Loans held for sale. The carrying amount is a reasonable estimate of fair value.
Loans. For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated based upon discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable.
Bank owned life insurance. Bank owned life insurance represents insurance policies on officers, directors, and past directors of the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.
Accrued interest receivable. The carrying amount is a reasonable estimate of fair value.
Deposits. The fair value of demand deposits, savings deposits, and money market deposits equals the carrying value. The fair value of fixed-rate certificates of deposit is estimated by discounting the future cash flows using the current rates at which similar deposit instruments would be offered to depositors for the same remaining maturities.
Repurchase agreements. The carrying amount is a reasonable estimate of fair value.
Other borrowings. The fair values of other borrowings are estimated using discounted cash flow analyses based on the interest rates for similar types of borrowing arrangements.
Trust preferred capital notes. Fair value is calculated by discounting the future cash flows using the estimated current interest rates at which similar securities would be issued.
Accrued interest payable. The carrying amount is a reasonable estimate of fair value.
Off-balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2015 and December 31, 2014, the fair value of off-balance sheet instruments was deemed immaterial, and therefore was not included in the previous table.
The Company assumes interest rate risk (the risk that interest rates will change) in its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rates change and that change may be either favorable or unfavorable to the Company.

Note 14 – Segment and Related Information

The Company has two reportable segments, (i) community banking and (ii) trust and investment services.
Community banking involves making loans to and generating deposits from individuals and businesses. All assets and liabilities of the Company are allocated to community banking. Investment income from securities is also allocated to the community banking segment. Loan fee income, service charges from deposit accounts, and non-deposit fees such as automated teller machine fees and insurance commissions generate additional income for the community banking segment.
Trust and investment services include estate planning, trust account administration, investment management, and retail brokerage. Investment management services include purchasing equity, fixed income, and mutual fund investments for customer accounts. The trust and investment services segment receives fees for investment and administrative services.
Amounts shown in the "Other" column includes activities of the Company which are primarily debt service on trust preferred securities and corporate items. Intersegment eliminations primarily consist of the Company's investment in the Bank.

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Segment information as of and for the three and nine months ended September 30, 2015 and 2014 (unaudited), is shown in the following tables (dollars in thousands):

	Three Months Ended September 30, 2015				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	$13,527	$—	$15	$—	$13,542
Interest expense	1,290	—	191	—	1,481
Noninterest income	1,788	1,262	5	—	3,055
Income (loss) before income taxes	5,160	803	(235)	—	5,728
Net income (loss)	3,626	566	(155)	—	4,037
Depreciation and amortization	772	3	—	—	775
Total assets	1,510,324	—	224,120	(222,007)	1,512,437
Goodwill	44,333	—	—	—	44,333
Capital expenditures	602	—	—	—	602

	Three Months Ended September 30, 2014				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	$11,837	$—	$15	$—	$11,852
Interest expense	1,206	—	186	—	1,392
Noninterest income	1,800	1,177	4	—	2,981
Income (loss) before income taxes	4,205	633	(224)	—	4,614
Net income (loss)	2,886	430	(148)	—	3,168
Depreciation and amortization	641	3	—	—	644
Total assets	1,317,189	—	200,757	(198,789)	1,319,157
Goodwill	39,043	—	—	—	39,043
Capital expenditures	419	—	—	—	419

	Nine Months Ended September 30, 2015				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	$41,173	$—	$45	$—	$41,218
Interest expense	3,834	—	563	—	4,397
Noninterest income	5,809	3,645	15	—	9,469
Income (loss) before income taxes	13,314	2,026	(827)	—	14,513
Net income (loss)	9,522	1,456	(546)	—	10,432
Depreciation and amortization	2,249	9	—	—	2,258
Total assets	1,510,324	—	224,120	(222,007)	1,512,437
Goodwill	44,333	—	—	—	44,333
Capital expenditures	1,182	21	—	—	1,203

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	Nine Months Ended September 30, 2014				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	$35,541	$—	$45	$—	$35,586
Interest expense	3,761	—	555	—	4,316
Noninterest income	4,770	3,600	14	—	8,384
Income (loss) before income taxes	12,355	2,284	(750)	—	13,889
Net income (loss)	8,726	1,620	(495)	—	9,851
Depreciation and amortization	2,154	8	—	—	2,162
Total assets	1,317,189	—	200,757	(198,789)	1,319,157
Goodwill	39,043	—	—	—	39,043
Capital expenditures	685	—	—	—	685

Note 15 – Supplemental Cash Flow Information

	Nine Months Ended September 30,	
	2015	2014
Supplemental Schedule of Cash and Cash Equivalents:		
Cash and due from banks	$19,280	$22,699
Interest-bearing deposits in other banks	46,637	58,278
Cash and Cash Equivalents	$65,917	$80,977
Supplemental Disclosure of Cash Flow Information:		
Cash paid for:		
Interest on deposits and borrowed funds	$4,341	$4,345
Income taxes	2,950	3,211
Noncash investing and financing activities:		
Transfer of loans to other real estate owned	926	386
Unrealized gain (loss) on securities available for sale	(582)	3,384
Non-cash transactions related to acquisitions:		
Assets acquired:		
Investment securities	18,800	—
Restricted stock	587	—
Loans	115,050	—
Premises and equipment	1,030	—
Deferred income taxes	2,773	—
Core deposit intangible	1,839	—
Other real estate owned	168	—
Bank owned life insurance	1,955	—
Other assets	1,077	—
Liabilities assumed:		
Deposits	137,323	—
Other liabilities	3,001	—
Consideration:		

Issuance of common stock	20,483	—

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Note 16 – Accumulated Other Comprehensive Income

Changes in each component of accumulated other comprehensive income ("AOCI") for the three and nine months ended September 30, 2015 and 2014 (unaudited) were as follows (dollars in thousands):

For the Three Months Ended	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income
Balance at June 30, 2014	$6,205	$(1,058)	$5,147
Net unrealized losses on securities available for sale, net of tax, $(121)	(222)	—	(222)
Reclassification adjustment for gains on securities, net of tax, $(110)	(205)	—	(205)
Balance at September 30, 2014	$5,778	$(1,058)	$4,720
Balance at June 30, 2015	$4,583	$(2,181)	$2,402
Net unrealized gains on securities available for sale, net of tax, $478	887	—	887
Reclassification adjustment for gains on securities, net of tax, $(3)	(3)	—	(3)
Balance at September 30, 2015	$5,467	$(2,181)	$3,286

For the Nine Months Ended	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income
Balance at December 31, 2013	$3,578	$(1,058)	$2,520
Net unrealized gains on securities available for sale, net of tax, $1,360	2,528	—	2,528
Reclassification adjustment for gains on securities, net of tax, $(176)	(328)	—	(328)
Balance at September 30, 2014	$5,778	$(1,058)	$4,720
Balance at December 31, 2014	$5,845	$(2,181)	$3,664
Net unrealized losses on securities available for sale, net of tax, $(10)	(19)	—	(19)
Reclassification adjustment for gains on securities, net of tax, $(194)	(359)	—	(359)

Balance at September 30, 2015	$5,467	$(2,181)	$3,286

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Reclassifications Out of Accumulated Other Comprehensive Income
For the three and nine months ended September 30, 2015
(dollars in thousands)

For the Three Months Ended September 30, 2015	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	$6	Securities gains, net
	(3)	Income tax expense
Total reclassifications	$3	Net of tax

For the Nine Months Ended September 30, 2015	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	$553	Securities gains, net
	(194)	Income tax expense
Total reclassifications	$359	Net of tax

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

The purpose of this discussion is to focus on important factors affecting the financial condition and results of operations of the Company. The discussion and analysis should be read in conjunction with the Consolidated Financial Statements.

Forward-Looking Statements

This report contains forward-looking statements with respect to the financial condition, results of operations and business of American National Bankshares Inc. (the "Company') and its wholly owned subsidiary, American National Bank and Trust Company (the "Bank"). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on information available to management at the time these statements and disclosures were prepared. Forward-looking statements are subject to numerous assumptions, estimates, risks, and uncertainties that could cause actual conditions, events, or results to differ materially from those stated or implied by such forward-looking statements.

A variety of factors, some of which are discussed in more detail in Item 1A – Risk Factors of the Company's Annual Report on Form 10-K for the year ended December 31, 2014, may affect the operations, performance, business strategy, and results of the Company. Those factors include but are not limited to the following:

- Financial market volatility, including the level of interest rates could affect the values of financial instruments and the amount of net interest income earned;
- General economic or business conditions, either nationally or in the market areas in which the Company does business, may be less favorable than expected, resulting in deteriorating credit quality, reduced demand for credit, or a weakened ability to generate deposits;
- Competition among financial institutions may increase and competitors may have greater financial resources and develop products and technology that enable those competitors to compete more successfully than the Company;
- Businesses that the Company is engaged in may be adversely affected by legislative or regulatory changes, including changes in accounting standards;
- The ability to retain key personnel;
- The failure of assumptions underlying the allowance for loan losses; and
- Risks associated with mergers and other acquisitions and other expansion activities.

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Reclassification
In certain circumstances, reclassifications have been made to prior period information to conform to the 2015 presentation. There were no material reclassifications.

CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principles ("GAAP") and they conform to general practices within the banking industry. The Company's critical accounting policies, which are summarized below, relate to (1) the allowance for loan losses, (2) mergers and acquisitions, (3) acquired loans with specific credit-related deterioration and (4) goodwill impairment. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements contained in the Form 10-K for the year ended December 31, 2014.
The financial information contained within the Company's financial statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset, or relieving a liability. In addition, GAAP itself may change from one previously acceptable method to another method.
Allowance for Loan Losses
The purpose of the allowance for loan losses ("ALLL") is to provide for probable losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.
The goal of the Company is to maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and the provision for loan loss expense.
The Company uses certain practices to manage its credit risk. These practices include (1) appropriate lending limits for loan officers, (2) a loan approval process, (3) careful underwriting of loan requests, including analysis of borrowers, cash flows, collateral, and market risks, (4) regular monitoring of the portfolio, including diversification by type and geography, (5) review of loans by the Loan Review department, which operates independently of loan production, (6) regular meetings of the Credit Committee to discuss portfolio and policy changes and make decisions on large or unusual loan requests, and (7) regular meetings of the Asset Quality Committee which reviews the status of individual loans.
Risk grades are assigned as part of the loan origination process. From time to time, risk grades may be modified as warranted by the facts and circumstances surrounding the credit.
Calculation and analysis of the ALLL is prepared quarterly by the Finance Department. The Company's Credit Committee, Capital Management Committee, Audit Committee, and the Board of Directors review the allowance for adequacy.
The Company's ALLL has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates and judgments.
The formula allowance uses historical loss experience as an indicator of future losses, along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries, trends in volume and terms of loans, effects of changes in underwriting standards, experience of lending staff, economic conditions, portfolio concentrations, regulatory, legal, competition, quality of loan review system, and value of underlying collateral. In the formula allowance for commercial and commercial real estate loans, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. Allowance calculations for residential real estate and consumer loans are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category.
The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. These include:

- The present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan);

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- The loan's observable market price, or
- The fair value of the collateral, net of estimated costs to dispose, if the loan is collateral dependent. The use of these computed values is inherently subjective and actual losses could be greater or less than the estimates.

No single statistic, formula, or measurement determines the adequacy of the allowance. Management makes subjective and complex judgments about matters that are inherently uncertain, and different amounts would be reported under different conditions or using different assumptions. For analytical purposes, management allocates a portion of the allowance to specific loan categories and specific loans. However, the entire allowance is used to absorb credit losses inherent in the loan portfolio, including identified and unidentified losses.

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period as facts and circumstances evolve. Furthermore, management cannot provide assurance that in any particular period the Bank will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time.

Mergers and Acquisitions

Business combinations are accounted for under the Financial Accounting Standards Board (the "FASB") Accounting Standards Codification ("ASC") 805, Business Combinations, using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company will rely on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analysis or other valuation techniques. Under the acquisition method of accounting, the Company will identify the acquirer and the closing date and apply applicable recognition principles and conditions.

Acquisition-related costs are costs the Company incurs to effect a business combination. Those costs include advisory, legal, accounting, valuation, and other professional or consulting fees. Some other examples of costs to the Company include systems conversions, integration planning consultants and advertising costs. The Company will account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities will be recognized in accordance with other applicable GAAP. These acquisition-related costs have been and will be included within the Consolidated Statements of Income classified within the noninterest expense caption.

Acquired Loans with Specific Credit-Related Deterioration

Acquired loans with specific credit deterioration are accounted for by the Company in accordance with FASB ASC 310-30, Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality. Certain acquired loans, those for which specific credit-related deterioration, since origination, is identified, are recorded at fair value reflecting the present value of the amounts expected to be collected. Income recognition on these loans is based on a reasonable expectation about the timing and amount of cash flows to be collected. Acquired loans deemed impaired and considered collateral dependent, with the timing of the sale of loan collateral indeterminate, remain on non-accrual status and have no accretable yield.

Goodwill Impairment

The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified during the years ended December 31, 2014, 2013, and 2012.

Non-GAAP Presentations

Non-GAAP presentations are provided because the Company believes these may be valuable to investors. These include (1) the analysis of net interest income presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets and (2) the impact to net interest income and pretax income from accretable and amortizable fair value adjustments attributable to the merger with MidCarolina Financial

Corporation ("MidCarolina") in July 2011 and MainStreet BankShares, Inc. ("MainStreet") in January 2015.

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Internet Access to Corporate Documents
The Company provides access to its Securities and Exchange Commission ("SEC") filings through a link on the Investor Relations page of the Company's web site at www.amnb.com. Reports available include annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The information on the Company's website is not incorporated into this report or any other filing the Company makes with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

ACQUISITION OF MAINSTREET BANKSHARES, INC.
On January 1, 2015, the Company completed its acquisition of MainStreet. The merger of MainStreet with and into the Company was effected pursuant to the terms and conditions of the Agreement and Plan of Reorganization, dated as of August 24, 2014, between the Company and MainStreet, and a related Plan of Merger. Immediately after the merger of MainStreet into the Company, Franklin Community Bank, N.A., MainStreet's wholly-owned bank subsidiary, merged with and into the Bank.
Pursuant to the MainStreet merger agreement, the former holders of shares of MainStreet common stock received $3.46 in cash and 0.482 shares of the Company's common stock for each share of MainStreet common stock held immediately prior to the effective date of the merger, plus cash in lieu of fractional shares. Each option to purchase shares of MainStreet common stock that was outstanding immediately prior to the effective date of the merger vested upon the merger and was converted into an option to purchase shares of the Company's common stock, adjusted based on a 0.643 exchange ratio. Each share of the Company's common stock outstanding immediately prior to the merger remained outstanding and was unaffected by the merger. The cash portion of the merger consideration was funded through a cash dividend of $6,000,000 from the Bank to the Company, and no borrowing was incurred by the Company or the Bank in connection with the merger.
MainStreet was the holding company for Franklin Community Bank, N.A. As of January 1, 2015, MainStreet had net loans of approximately $121,000,000, total assets of approximately $165,000,000, and total deposits of approximately $137,000,000. Franklin Community Bank, N.A. provided banking services to its customers from three banking offices located in Rocky Mount, Hardy, and Union Hall, Virginia, which are now branch offices of the Bank.

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RESULTS OF OPERATIONS

Earnings Performance

Three months ended September 30, 2015 and 2014

For the quarter ended September 30, 2015, the Company reported net income of $4,037,000 compared to $3,168,000 for the comparable quarter in 2014. The $869,000 or 27.4% increase in earnings was primarily due to an increase in income resulting from the earning assets acquired in the acquisition of MainStreet, offset by increased noninterest expenses related to the transaction. Salaries and employee benefits expenses are the primary contributor to the increase in noninterest expenses for the quarterly period.

SUMMARY INCOME STATEMENT
(Dollars in thousands)

Three Months Ended September 30,	2015	2014	$ Change	% Change
Interest income	$13,542	$11,852	$1,690	14.3 %
Interest expense	(1,481)	(1,392)	(89)	6.4 %
Net interest income	12,061	10,460	1,601	15.3 %
Provision for loan losses	—	—	—	—
Noninterest income	3,055	2,981	74	2.5 %
Noninterest expense	(9,388)	(8,827)	(561)	6.4 %
Income tax expense	(1,691)	(1,446)	(245)	16.9 %
Net income	$4,037	$3,168	$869	27.4 %

For the nine month period ended September 30, 2015, the Company reported net income of $10,432,000 compared to $9,851,000 for the comparable period in 2014. The $581,000 or 5.9% increase in earnings was primarily due to an increase in income resulting from the earning assets acquired in the acquisition of MainStreet and an increase in noninterest income, reduced by an increase in noninterest expenses related to the transaction. Salaries and employee benefits and merger related costs are the primary contributors to the increase in noninterest expenses for the year to date period. Merger related costs were $1,948,000 for the nine months ended September 30, 2015.

SUMMARY INCOME STATEMENT
(Dollars in thousands)

Nine months ended September 30,	2015	2014	$ Change	% Change
Interest income	$41,218	$35,586	$5,632	15.8 %
Interest expense	(4,397)	(4,316)	(81)	1.9 %
Net interest income	36,821	31,270	5,551	17.8 %
Provision for loan losses	(700)	(150)	(550)	366.7 %
Noninterest income	9,469	8,384	1,085	12.9 %
Noninterest expense	(31,077)	(25,615)	(5,462)	21.3 %
Income tax expense	(4,081)	(4,038)	(43)	1.1 %
Net income	$10,432	$9,851	$581	5.9 %

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Net Interest Income

Net interest income is the difference between interest income on earning assets, primarily loans and securities, and interest expense on interest bearing liabilities, primarily deposits and other funding sources. Fluctuations in interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income. The following discussion of net interest income is presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets, such as certain state and municipal securities. A tax rate of 35% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent basis. Net interest income divided by average earning assets is referred to as the net interest margin. The net interest spread represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities.

Three months ended September 30, 2015 and 2014

Net interest income on a taxable equivalent basis increased $1,587,000 or 14.5%, for the third quarter of 2015 compared to the same quarter of 2014. This change was driven by an increase in average earning assets of $187,815,000 or 15.7%, primarily related to the acquisition of MainStreet.

For the third quarter of 2015, the Company's yield on interest-earning assets was 4.06%, compared to 4.14% for the third quarter of 2014. The cost of interest-bearing liabilities was 0.58% compared to 0.62%, mostly related to a five basis point decline in the cost of time deposits. The interest rate spread was 3.48% compared to 3.52%. The net interest margin, on a fully taxable equivalent basis, was 3.64% compared to 3.68%, a decrease of four basis points (0.04%).

Net interest income for the third quarters of 2015 and 2014 was positively impacted by acquisition related accretion income. For the third quarter of 2015, acquisition related accretion income was $549,000 or 4.6% of total net interest income. For the third quarter of 2014, acquisition related accretion income was $564,000 or 5.4% of net interest income.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the three months ended September 30, 2015 and 2014. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

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Net Interest Income Analysis (in thousands, except rates)
Three Months Ended September 30,

	Average Balance		Income/Expense		Yield/Rate	
	2015	2014	2015	2014	2015	2014
Loans:						
Commercial	$164,551	$126,340	$1,801	$1,339	4.34 %	4.20 %
Real estate	814,500	686,682	9,557	8,451	4.69	4.92
Consumer	6,034	4,540	150	85	9.86	7.43
Total loans	985,085	817,562	11,508	9,875	4.67	4.83
Securities:						
Federal agencies & GSEs	103,303	72,828	431	212	1.67	1.16
Mortgage-backed & CMOs	57,100	58,365	282	345	1.98	2.36
State and municipal	180,799	183,679	1,650	1,783	3.65	3.88
Other	16,225	14,583	140	114	3.45	3.13
Total securities	357,427	329,455	2,503	2,454	2.80	2.98
Federal funds sold	76	—	1	—	0.11	—
Deposits in other banks	37,988	45,744	25	32	0.26	0.28
Total interest-earning assets	1,380,576	1,192,761	14,037	12,361	4.06	4.14
Non-earning assets	130,888	116,359				
Total assets	$1,511,464	$1,309,120				
Deposits:						
Demand	$221,700	$189,208	20	15	0.04	0.03
Money market	191,689	167,777	63	51	0.13	0.12
Savings	109,919	88,456	13	10	0.05	0.04
Time	400,532	360,826	1,109	1,044	1.10	1.15
Total deposits	923,840	806,267	1,205	1,120	0.52	0.55
Customer repurchase agreements	45,444	45,725	2	2	0.02	0.02
Other short-term borrowings	57	2,215	—	2	0.35	0.36
Long-term borrowings	37,531	37,406	274	268	2.92	2.87
Total interest-bearing liabilities	1,006,872	891,613	1,481	1,392	0.58	0.62
Noninterest bearing demand deposits	299,488	238,646				
Other liabilities	9,444	6,368				
Shareholders' equity	195,660	172,493				
Total liabilities and shareholders' equity	$1,511,464	$				