

AMERICAN NATIONAL BANKSHARES INC.  
Form 10-Q  
August 09, 2013

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2013.

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 (I.R.S. Employer  
incorporation or organization) 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.

YesxNo

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.

YesxNo

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  Accelerated filer  Non-accelerated filer   
Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

At August 6, 2013, the Company had 7,875,250 shares of Common Stock outstanding, \$1 par value.

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## Part I. Financial Information

## Item 1. Financial Statements

## American National Bankshares Inc. and Subsidiaries

## Consolidated Balance Sheets

(Dollars in thousands, except share data)

	(Unaudited) June 30, 2013	(Audited) December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 18,994	\$ 20,435
Interest-bearing deposits in other banks	37,720	27,007
Securities available for sale, at fair value	340,135	335,246
Restricted stock, at cost	4,880	5,287
Loans held for sale	4,098	13,852
Loans, net of unearned income	794,045	788,705
Less allowance for loan losses	(12,676 )	(12,118 )
Net loans	781,369	776,587
Premises and equipment, net	24,269	24,543
Other real estate owned, net	5,569	6,193
Goodwill	39,043	39,043
Core deposit intangibles, net	3,819	4,660
Bank owned life insurance	14,495	14,289
Accrued interest receivable and other assets	19,626	16,545
Total assets	\$ 1,294,017	\$ 1,283,687
<b>Liabilities</b>		
<b>Liabilities:</b>		
Demand deposits -- noninterest bearing	\$ 213,123	\$ 217,275
Demand deposits -- interest bearing	169,204	153,578
Money market deposits	173,696	166,111
Savings deposits	84,489	81,135
Time deposits	405,882	409,568
Total deposits	1,046,394	1,027,667
Customer repurchase agreements	41,972	49,942
Long-term borrowings	10,015	10,079
Trust preferred capital notes	27,368	27,317
Accrued interest payable and other liabilities	5,332	5,436
Total liabilities	1,131,081	1,120,441
<b>Shareholders' equity</b>		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	-	-
Common stock, \$1 par, 20,000,000 shares authorized, 7,872,250 shares outstanding at June 30, 2013 and 7,846,912 shares outstanding at December 31, 2012	7,872	7,847
Capital in excess of par value	57,581	57,211
Retained earnings	95,333	90,591

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Accumulated other comprehensive income, net	2,150	7,597
Total shareholders' equity	162,936	163,246
Total liabilities and shareholders' equity	\$1,294,017	\$ 1,283,687

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

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American National Bankshares Inc. and Subsidiaries

Consolidated Statements of Income

(Dollars in thousands, except share and per share data) (Unaudited)

	Three Months Ended	
	June 30	
	2013	2012
Interest and Dividend Income:		
Interest and fees on loans	\$ 11,358	\$ 12,683
Interest and dividends on securities:		
Taxable	851	1,056
Tax-exempt	1,045	1,077
Dividends	54	52
Other interest income	39	18
Total interest and dividend income	13,347	14,886
Interest Expense:		
Interest on deposits	1,369	1,729
Interest on short-term borrowings	14	51
Interest on long-term borrowings	82	84
Interest on trust preferred capital notes	189	206
Total interest expense	1,654	2,070
Net Interest Income	11,693	12,816
Provision for Loan Losses	-	733
Net Interest Income After Provision for Loan Losses	11,693	12,083
Noninterest Income:		
Trust fees	944	966
Service charges on deposit accounts	429	413
Other fees and commissions	463	445
Mortgage banking income	531	519
Securities gains, net	1	160
Other	318	297
Total noninterest income	2,686	2,800
Noninterest Expense:		
Salaries	3,503	3,809
Employee benefits	867	799
Occupancy and equipment	872	1,048
FDIC assessment	161	213
Bank franchise tax	185	182
Core deposit intangible amortization	421	546
Foreclosed real estate, net	193	171
Merger related expenses	-	(202)
Other	2,226	2,267
Total noninterest expense	8,428	8,833
Income Before Income Taxes	5,951	6,050
Income Taxes	1,741	1,776

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Net Income	\$4,210	\$4,274
Net Income Per Common Share:		
Basic	\$0.54	\$0.55
Diluted	\$0.53	\$0.54
Average Common Shares Outstanding:		
Basic	7,867,222	7,832,162
Diluted	7,876,969	7,849,142

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

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American National Bankshares Inc. and Subsidiaries

Consolidated Statements of Income

(Dollars in thousands, except share and per share data) (Unaudited)

	Six Months Ended	
	June 30	
	2013	2012
Interest and Dividend Income:		
Interest and fees on loans	\$22,753	\$25,803
Interest and dividends on securities:		
Taxable	1,729	2,135
Tax-exempt	2,097	2,159
Dividends	109	103
Other interest income	68	28
Total interest and dividend income	26,756	30,228
Interest Expense:		
Interest on deposits	2,805	3,566
Interest on short-term borrowings	35	94
Interest on long-term borrowings	164	168
Interest on trust preferred capital notes	377	412
Total interest expense	3,381	4,240
Net Interest Income	23,375	25,988
Provision for Loan Losses	294	1,466
Net Interest Income After Provision for Loan Losses	23,081	24,522
Noninterest Income:		
Trust fees	1,532	1,848
Service charges on deposit accounts	838	901
Other fees and commissions	922	902
Mortgage banking income	1,249	1,050
Securities gains, net	199	160
Other	716	1,173
Total noninterest income	5,456	6,034
Noninterest Expense:		
Salaries	6,942	7,920
Employee benefits	1,766	1,877
Occupancy and equipment	1,788	2,013
FDIC assessment	322	446
Bank franchise tax	372	365
Core deposit intangible amortization	841	1,093
Foreclosed real estate, net	436	18
Merger related expenses	-	49
Other	4,279	4,979
Total noninterest expense	16,746	18,760
Income Before Income Taxes	11,791	11,796
Income Taxes	3,430	3,347

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Net Income	\$8,361	\$8,449
Net Income Per Common Share:		
Basic	\$1.06	\$1.08
Diluted	\$1.06	\$1.08
Average Common Shares Outstanding:		
Basic	7,862,719	7,827,195
Diluted	7,872,351	7,839,364

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

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Consolidated Statements of Comprehensive Income (Loss)  
(Dollars in thousands) (Unaudited)

	Three Months Ended June 30	
	2013	2012
Net income	\$ 4,210	\$ 4,274
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	(7,299 )	1,285
Income tax benefit (expense)	2,554	(450 )
Reclassification adjustment for (gains) on securities	(1 )	(160 )
Income tax expense	1	56
Other comprehensive income (loss)	(4,745 )	731
Comprehensive income (loss)	\$ (535 )	\$ 5,005
	Six Months Ended June 30	
	2013	2012
Net income	\$ 8,361	\$ 8,449
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available for sale	(8,181 )	608
Income tax benefit (expense)	2,863	(213 )
Reclassification adjustment for (gains) on securities	(199 )	(160 )
Income tax expense	70	56
Other comprehensive income (loss)	(5,447 )	291
Comprehensive income	\$ 2,914	\$ 8,740

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

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American National Bankshares Inc. and Subsidiaries  
 Consolidated Statements of Changes in Shareholders' Equity  
 Six Months Ended June 30, 2013 and 2012  
 (Dollars in thousands) (Unaudited)

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2011	\$ 7,807	\$ 56,395	\$ 81,797	\$ 6,830	\$ 152,829
Net income	-	-	8,449	-	8,449
Other comprehensive income	-	-	-	291	291
Stock options exercised	3	42	-	-	45
Equity based compensation	26	388	-	-	414
Cash dividends declared, \$0.46 per share	-	-	(3,604 )	-	(3,604 )
Balance, June 30, 2012	\$ 7,836	\$ 56,825	\$ 86,642	\$ 7,121	\$ 158,424
Balance, December 31, 2012	\$ 7,847	\$ 57,211	\$ 90,591	\$ 7,597	\$ 163,246
Net income	-	-	8,361	-	8,361
Other comprehensive loss	-	-	-	(5,447 )	(5,447 )
Stock options exercised	6	96	-	-	102
Equity based compensation	19	274	-	-	293
Cash dividends declared, \$0.46 per share	-	-	(3,619 )	-	(3,619 )
Balance, June 30, 2013	\$ 7,872	\$ 57,581	\$ 95,333	\$ 2,150	\$ 162,936

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

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American National Bankshares Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Six Months Ended June 30, 2013 and 2012

(Dollars in thousands) (Unaudited)

	2013		2012
Cash Flows from			
Operating Activities:			
Net income	\$ 8,361		\$ 8,449
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	294		1,466
Depreciation	854		865
Net accretion of purchase accounting adjustments	(4,050 )		(5,306 )
Core deposit intangible amortization	841		1,093
Net amortization (accretion) of securities	1,617		1,667
Net gain on sale or call of securities	(199 )		(160 )
Gain on sale of loans held for sale	(1,099 )		(926 )
Proceeds from sales of loans held for sale	58,268		41,030
Originations of loans held for sale	(47,415 )		(42,989 )
Net gain on foreclosed real estate Valuation allowance on foreclosed real estate	(139 )		(381 )
	294		219
Net gain on sale of premises and equipment	-		(495 )
Equity based compensation expense	293		414
Deferred income tax expense (benefit)	(1,874 )		2,238
Net change in interest receivable	(99 )		(12 )
	1,619		(4,596 )

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Net change in other assets		
Net change in interest payable	(51 )	(71 )
Net change in other liabilities	(53 )	(597 )
Net cash provided by operating activities	17,462	1,908
Cash Flows from Investing Activities:		
Proceeds from sales of securities available for sale	2,627	4,209
Proceeds from maturities, calls and paydowns of securities available for sale	32,216	33,574
Purchases of securities available for sale	(49,530 )	(39,999 )
Net change in restricted stock	407	(249 )
Net (increase) decrease in loans	(2,222 )	19,186
Proceeds from sale of premises and equipment	-	563
Purchases of premises and equipment	(580 )	(573 )
Proceeds from sales of foreclosed real estate	1,518	3,489
Net cash (used in) provided by investing activities	(15,564 )	20,200
Cash Flows from Financing Activities:		
Net change in demand, money market, and savings deposits	22,413	(29,597 )
Net change in time deposits	(3,477 )	13,602
Net change in customer repurchase agreements	(7,970 )	538
Net change in other short-term	-	(3,000 )

borrowings				
Net change in long-term borrowings	(75	)	(76	)
Common stock dividends paid	(3,619	)	(3,604	)
Proceeds from exercise of stock options	102		45	
Net cash provided by (used in) financing activities	7,374		(22,092	)
Net Increase in Cash and Cash Equivalents	9,272		16	
Cash and Cash Equivalents at Beginning of Period	47,442		28,893	
Cash and Cash Equivalents at End of Period	\$ 56,714		\$ 28,909	

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

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AMERICAN NATIONAL BANKSHARES INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Basis of Presentation

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, pension obligations, the valuation of foreclosed real estate, goodwill and intangible assets, the valuation of deferred tax assets, other-than-temporary impairments of securities, acquired loans with specific credit-related deterioration, and the fair value of financial instruments.

In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the “AMNB Trust”) and a wholly owned subsidiary of the Company, was formed for the purpose of issuing preferred securities (the “Trust Preferred Securities”) in a private placement pursuant to an applicable exemption from registration. Proceeds from the securities were used to fund the acquisition of Community First Financial Corporation (“Community First”) which occurred in April 2006.

On July 1, 2011, the Company completed its merger with MidCarolina Financial Corporation (“MidCarolina”). MidCarolina was headquartered in Burlington, North Carolina, and engaged in banking operations through its subsidiary bank, MidCarolina Bank.

In July 2011, and in connection with its acquisition of MidCarolina, the Company assumed the liabilities of the MidCarolina I and MidCarolina Trust II, two separate Delaware statutory trusts (the “MidCarolina Trusts”), which were also formed for the purpose of issuing preferred securities. Refer to Note 9 for further details concerning these entities.

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 Company’s financial position as of June 30, 2013; the consolidated statements of income for the three and six months ended June 30, 2013 and 2012; the consolidated statements of comprehensive income (loss) for the three and six months ended June 30, 2013 and 2012; the consolidated statements of changes in shareholders’ equity for the six months ended June 30, 2013 and 2012; and the consolidated statements of cash flows for the six months ended June 30, 2013 and 2012. Operating results for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results that may occur for the year ending December 31, 2013. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company’s Form 10-K for the year ended December 31, 2012.

Note 2 – Merger with MidCarolina



On July 1, 2011, the Company completed its merger with MidCarolina Financial Corporation pursuant to the Agreement and Plan of Reorganization, dated December 15, 2010, between the Company and MidCarolina (the “merger agreement”). MidCarolina was headquartered in Burlington, North Carolina, and engaged in banking operations through its subsidiary bank, MidCarolina Bank. The transaction has significantly expanded the Company’s footprint in North Carolina, adding eight branches in Alamance and Guilford Counties.

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Pursuant to the terms of the merger agreement, as a result of the merger, the holders of shares of MidCarolina common stock received 0.33 shares of the Company's common stock for each share of MidCarolina common stock held immediately prior to the effective date of the merger. Each option to purchase a share of MidCarolina common stock outstanding immediately prior to the effective date of the merger was converted into an option to purchase shares of Company common stock, adjusted for the 0.33 exchange ratio. Additionally, the holders of shares of noncumulative perpetual Series A preferred stock of MidCarolina received one share of a newly authorized noncumulative perpetual Series A preferred stock of the Company for each MidCarolina preferred share held immediately before the merger. The Company's Series A preferred stock was issued with terms, preferences, rights and limitations that are identical in all material respects to the MidCarolina Series A preferred stock.

The Company issued 1,626,157 shares of common stock in connection with the MidCarolina merger. MidCarolina Bank was merged with and into the Bank on July 1, 2011.

The merger with MidCarolina was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration paid were recorded at their estimated fair values as of the merger date. The excess of consideration paid over the fair value of net assets acquired was originally recorded as goodwill in the amount of approximately \$16.5 million, which will not be amortizable and is not deductible for tax purposes. The Company allocated the total balance of goodwill to its community banking segment. The Company also recorded \$6.6 million in core deposit intangibles which will be amortized over nine years using a declining balance method.

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 (1,626,157)	\$29,905
Cash paid to Shareholders	12
Fair Value of Options	132
Preferred shares issued (5,000)	5,000
Value of consideration	35,049
Assets acquired:	
Cash and cash equivalents	34,783
Investment securities	51,442
Loans held for sale	113
Loans, net of unearned income	328,123
Premises and equipment, net	5,708
Deferred income taxes	15,310
Core deposit intangible	6,556
Other real estate owned	3,538
Other assets	13,535
Total assets	459,108
Liabilities assumed:	
Deposits	420,248
FHLB advances	9,858
Other borrowings	6,546
Other liabilities	3,982
Total liabilities	440,634
Net assets acquired	18,474

Goodwill resulting from merger with MidCarolina \$16,575

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 \$367.4 million loan portfolio at a fair value discount of \$39.9 million. The estimated fair value of the performing portion of the portfolio was \$286.5 million. 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 Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 310-20 (formerly SFAS 91).

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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 (formerly Statement of Position (“SOP”) 03-3) as of July 1, 2011 (in thousands).

Contractually required principal and interest at acquisition	\$56,681
Contractual cash flows not expected to be collected (nonaccretable difference)	17,472
Expected cash flows at acquisition	39,209
Interest component of expected cash flows (accretable discount)	1,663
Fair value of acquired loans accounted for under FASB ASC 310-30	\$37,546

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

In connection with the merger with MidCarolina, the Company acquired an investment portfolio with a fair value of \$51.4 million. The fair value of the investment portfolio was determined by taking into account market prices obtained from independent valuation sources.

In connection with the merger with MidCarolina, the Company recorded a deferred income tax asset of \$15.3 million related to MidCarolina’s valuation allowance on foreclosed real estate and bad debt expenses, as well as other tax attributes of the acquired company, along with the effects of fair value adjustments resulting from applying the acquisition method of accounting.

In connection with the merger with MidCarolina, the Company acquired other real estate owned with a fair value of \$3.5 million. Other real estate owned was measured at fair value less estimated cost to sell.

In connection with the merger with MidCarolina, the Company acquired premises and equipment with a fair value of \$5.7 million. Property appraisals for all owned locations were obtained. The fair value adjustment will be amortized as expense over the remaining lives of the properties. The Company also acquired several lease obligations in connection with the merger. The unfavorable lease position will be amortized over the remaining lives of the leases.

The fair value of savings and transaction deposit accounts acquired from MidCarolina 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 brokered, and Certificate of Deposit Account Registry Service® (often referred to as “CDARS”). 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 will be accreted to reduce interest expense over the remaining maturities of the respective pools.

The fair value of the Federal Home Loan Bank of Atlanta (“FHLB”) advances was determined based on the discounted cash flows of future payments. This adjustment to the face value of the borrowings will be amortized to increase interest expense over the remaining lives of the respective borrowings.

The fair value of junior subordinated debentures (Other Borrowings) was determined based on the fair value of similar debt or equity instruments with reasonably comparable terms. This adjustment to the face value of the borrowings will be amortized to increase interest expense over the remaining lives of the respective borrowings.

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Direct costs related to the acquisition were expensed as incurred. During the entire year of 2011, the Company incurred \$1,600,000 in merger and acquisition expenses. During 2012, the Company incurred \$251,000 in merger related expense. There were no merger related expenses in the three or six months ended June 30, 2013.

## Note 3 – Securities

The amortized cost and estimated fair value of investments in debt and equity securities at June 30, 2013 and December 31, 2012 were as follows:

(in thousands)	June 30, 2013			
	Amortized	Unrealized	Unrealized	Estimated
	Cost	Gains	Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$54,965	\$ 172	\$ 496	\$54,641
Mortgage-backed and CMOs	74,299	1,074	446	74,927
State and municipal	193,223	7,092	486	199,829
Corporate	10,952	2	216	10,738
Total securities available for sale	\$333,439	\$ 8,340	\$ 1,644	\$340,135

(in thousands)	December 31, 2012			
	Amortized	Unrealized	Unrealized	Estimated
	Cost	Gains	Losses	Fair Value
Securities available for sale:				
Federal agencies and GSE	\$42,458	\$ 306	\$ 5	\$42,759
Mortgage-backed and CMOs	81,585	1,829	106	83,308
State and municipal	189,810	12,935	14	202,731
Corporate	6,317	131	-	6,448
Total securities available for sale	\$320,170	\$ 15,201	\$ 125	\$335,246

## Temporarily Impaired Securities

The following table shows estimated 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 June 30, 2013. 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.

Available for sale securities that have been in a continuous unrealized loss position are as follows:

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Estimated	Unrealized	Estimated	Unrealized	Estimated	Unrealized
	Fair Value	Loss	Fair Value	Loss	Fair Value	Loss
Federal agencies and GSEs	\$39,222	\$ 496	\$39,222	\$ 496	\$-	\$ -
Mortgage-backed and CMOs	28,184	446	23,012	374	5,172	72
State and municipal	29,771	486	29,771	486	-	-
Corporate	8,582	216	8,582	216	-	-
Total	\$105,759	\$ 1,644	\$100,587	\$ 1,572	\$5,172	\$ 72

GSE debt securities: The unrealized losses on the Company's investment in 17 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 bases 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 bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2013.

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Mortgage-backed securities and CMOs: The unrealized losses on the Company's investment in 22 GSE mortgage-backed securities and 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 June 30, 2013.

State and municipal securities: The unrealized losses on 35 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 June 30, 2013.

Corporate securities: The unrealized losses on eight 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 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 June 30, 2013.

The Company's investment in FHLB stock totaled \$2,000,000 at June 30, 2013. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLB or member institutions. Therefore, when evaluating FHLB 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 this investment to be other-than-temporarily impaired at June 30, 2013 and no impairment has been recognized. FHLB stock is shown in restricted stock on the balance sheet and is not a part of the available for sale securities portfolio.

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, 2012.

(in thousands)	Total		Less than 12 Months		12 Months or More	
	Estimated		Estimated		Estimated	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	\$5,501	\$ 5	\$5,501	\$ 5	\$-	\$ -
Mortgage-backed and CMOs	16,353	106	12,941	42	3,412	64
State and municipal	4,329	14	4,329	14	-	-
Total	\$26,183	\$ 125	\$22,771	\$ 61	\$3,412	\$ 64

## Other-Than-Temporary-Impaired Securities

As of June 30, 2013 and December 31, 2012, there were no securities classified as having other-than-temporary impairment.



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Note 4 - Loans

Segments

Loans, excluding loans held for sale, were comprised of the following:

(in thousands)	June 30, 2013	December 31, 2012
Commercial	\$ 130,721	\$ 126,192
Commercial real estate:		
Construction and land development	44,029	48,812
Commercial real estate	354,323	355,433
Residential real estate:		
Residential	168,965	161,033
Home equity	89,688	91,313
Consumer	6,319	5,922
Total loans	\$ 794,045	\$ 788,705

Acquired Loans

Interest income, including accretion, on loans acquired from MidCarolina for the six months ended June 30, 2013 was approximately \$9.5 million. This included \$3.9 million in accretion income of which \$976,000 was related to loan pay-offs and renewals. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at June 30, 2013 and December 31, 2012 are as follows:

(in thousands)	June 30, 2013	December 31, 2012
Outstanding principal balance	\$ 173,073	\$ 219,569
Carrying amount	160,672	203,981

The outstanding principal balance and related carrying amount of acquired impaired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), to account for interest earned, at June 30, 2013 and December 31, 2012 are as follows:

(in thousands)	June 30, 2013	December 31, 2012
Outstanding principal balance	\$ 23,672	\$ 26,349
Carrying amount	17,999	20,182

The following table presents changes in the accretable discount on acquired impaired loans, for which the Company applies ASC 310-30 (formerly SOP 03-3), for the six months ended June 30, 2013. The accretion reflected below includes \$976,000 related to loan payoffs.

(in thousands)	Accretable Discount
Balance at December 31, 2012	\$ 2,165

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Accretion	(1,222 )
Reclassification from nonaccretable difference	1,026
Balance at June 30, 2013	\$ 1,969

IndexPast Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at June 30, 2013.

At June 30, 2013

			90 Days +		Total		Total Loans
	30- 59 Days Past Due	60-89 Days Past Due	Past Due and Still Accruing	Non- Accrual Loans	Past Due	Current	
(in thousands)							
Commercial	\$78	\$-	\$ -	\$ 19	\$97	\$130,624	\$130,721
Commercial real estate:							
Construction and land development	-	6	-	1,056	1,062	42,967	44,029
Commercial real estate	-	13	-	2,561	2,574	351,749	354,323
Residential:							
Residential	215	291	-	1,804	2,310	166,655	168,965
Home equity	103	36	-	379	518	89,170	89,688
Consumer	11	-	-	9	20	6,299	6,319
Total	\$407	\$346	\$ -	\$5,828	\$6,581	\$787,464	\$794,045

The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2012.

			90 Days +		Total		Total Loans
	30- 59 Days Past Due	60-89 Days Past Due	Past Due and Still Accruing	Non- Accrual Loans	Past Due	Current	
(in thousands)							
Commercial	\$219	\$-	\$ -	\$ 52	\$271	\$125,921	\$126,192
Commercial real estate:							
Construction and land development	417	-	-	1,208	1,625	47,187	48,812
Commercial real estate	1,120	-	-	1,526	2,646	352,787	355,433
Residential:							
Residential	672	168	-	2,130	2,970	158,063	161,033
Home equity	144	-	-	397	541	90,772	91,313
Consumer	33	-	-	3	36	5,886	5,922
Total	\$2,605	\$168	\$ -	\$5,316	\$8,089	\$780,616	\$788,705

IndexImpaired Loans

The following table presents the Company's impaired loan balances by portfolio segment, excluding loans acquired with deteriorated credit quality, at June 30, 2013.

(in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<u>With no related allowance recorded:</u>					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial real estate:					
Construction and land development	825	837	-	939	-
Commercial real estate	333	334	-	327	7
Residential:					
Residential	261	539	-	265	-
Home equity	10	10	-	11	-
Consumer	-	-	-	-	-
	\$ 1,429	\$ 1,720	\$ -	\$ 1,542	\$ 7
<u>With a related allowance recorded:</u>					
Commercial	10	10	7	10	-
Commercial real estate:					
Construction and land development	890	929	82	988	-
Commercial real estate	959	959	331	959	-
Residential:					
Residential	90	90	15	90	-
Home equity	-	-	-	-	-
Consumer	19	19	19	20	-
	\$ 1,968	\$ 2,007	\$ 454	\$ 2,067	\$ -
<u>Total:</u>					
Commercial	\$ 10	\$ 10	\$ 7	\$ 10	\$ -
Commercial real estate:					
Construction and land development	1,715	1,766	82	1,927	-
Commercial real estate	1,292	1,293	331	1,286	7
Residential:					
Residential	351	629	15	355	-
Home equity	10	10	-	11	-
Consumer	19	19	19	20	-
	\$ 3,397	\$ 3,727	\$ 454	\$ 3,609	\$ 7

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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, 2012.

(in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<u>With no related allowance recorded:</u>					
Commercial	\$ 39	\$ 39	\$ -	\$ 276	\$ 11
Commercial real estate:					
Construction and land development	2,302	2,335	-	1,562	-
Commercial real estate	305	306	-	557	8
Residential:					
Residential	270	541	-	861	15
Consumer:					
Consumer	-	-	-	-	-
	\$ 2,916	\$ 3,221	\$ -	\$ 3,256	\$ 34
<u>With a related allowance recorded:</u>					
Commercial	\$ 110	\$ 110	\$ 107	\$ 35	\$ -
Commercial real estate:					
Construction and land development					-
Commercial real estate					-
Residential:					
Residential					-
Home equity	-	-	-	-	-
Consumer	21	21	21	10	-
Consumer	-	-	-	-	-
	\$ 131	\$ 131	\$ 128	\$ 45	\$ -
<u>Total:</u>					
Commercial	\$ 149	\$ 149	\$ 107	\$ 311	\$ 11
Commercial real estate:					
Construction and land development	2,302	2,335	-	1,562	-
Commercial real estate	305	306	-	557	8
Residential:					
Residential	270	541	-	861	15
Home equity	-	-	-	-	-
Consumer:					
Consumer	21	21	21	10	-
	\$ 3,047	\$ 3,352	\$ 128	\$ 3,301	\$ 34

There were no loans modified as a troubled debt restructuring ("TDR") for the three or six months ended June 30, 2013.

The following table shows the detail of loans modified as TDRs during the three and six months ended June 30, 2012 included in the impaired loan balances.

(dollars in thousands)	Loans Modified as a TDR for the Three Months Ended June 30, 2012	
	Pre-Modification	Post-Modification
	Number of Outstanding Recorded Contracts	Number of Outstanding Recorded Investment
Commercial	1 \$ 11	\$ 11

Commercial real estate:

Construction and land development	2	1,411	1,411
Home Equity	-	-	-
Commercial real estate	1	4	4
Consumer	-	-	-
Total	4	\$ 1,426	\$ 1,426

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(dollars in thousands)	Loans Modified as a TDR for the Six Months Ended June 30, 2012	
	Pre-Modification Number of Outstanding Recorded Contract Investment	Post-Modification Outstanding Recorded Investment
Commercial	1	\$ 11
Commercial real estate:		
Construction and land development	7	2,188
Home Equity	-	-
Commercial real estate	1	4
Consumer	-	-
Total	9	\$ 2,203
		\$ 2,096

None of the loans modified as a TDR within the previous twelve months have subsequently defaulted during the three or six month periods ending June 30, 2013 and 2012.

Risk Grades

The following table shows the Company's commercial loan portfolio broken down by internal risk grading as of June 30, 2013.

(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	\$ 129,226	\$ 35,940	\$ 341,474	\$ 155,507	\$ 86,850
Special Mention	1,414	1,635	6,349	10,192	1,777
Substandard	81	6,454	6,500	3,266	1,061
Doubtful	-	-	-	-	-
Total	\$ 130,721	\$ 44,029	\$ 354,323	\$ 168,965	\$ 89,688

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

Consumer	
Performing	\$ 6,307
Nonperforming	12
Total	\$ 6,319

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The following table shows the Company's commercial loan portfolio broken down by internal risk grading as of December 31, 2012.

(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	\$ 125,072	\$ 39,417	\$ 340,094	\$ 146,875	\$ 89,066
Special Mention	922	2,287	10,321	10,731	1,060
Substandard	198	7,108	5,018	3,427	1,187
Doubtful	-	-	-	-	-
Total	\$ 126,192	\$ 48,812	\$ 355,433	\$ 161,033	\$ 91,313

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

Consumer

Performing	\$ 5,856
Nonperforming	66
Total	\$ 5,922

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 distinct 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 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:

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

(in thousands)	Six Months Ended June 30, 2013	Year Ended December 31, 2012	Six Months Ended June 30, 2012
Allowance for Loan Losses			
Balance, beginning of period	\$12,118	\$10,529	\$10,529
Provision for loan losses	294	2,133	1,466
Charge-offs	(467 )	(2,086 )	(1,068 )
Recoveries	731	1,542	1,172
Balance, end of period	\$12,676	\$12,118	\$12,099

Reserve for Unfunded Lending Commitments			
Balance, beginning of period	\$201	\$200	\$200
Provision for loan losses	2	1	6
Charge-offs	-	-	-
Balance, end of period	\$203	\$201	\$206

The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at June 30, 2013.

(in thousands)	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Total
Allowance for Loan Losses					
Balance as of December 31, 2012	\$1,450	\$6,822	\$3,638	\$208	\$12,118
Charge-offs	(109 )	(23 )	(230 )	(105 )	(467 )
Recoveries	241	268	145	77	731
Provision for loan losses	35	166	88	5	294
Balance as of June 30, 2013	\$1,617	\$7,233	\$3,641	\$185	\$12,676

## Balance as of June 30, 2013

Allowance for Loan Losses					
Individually evaluated for impairment	\$7	\$413	\$15	\$19	\$454
Collectively evaluated for impairment	1,610	6,506	3,577	166	11,859
Loans acquired with deteriorated credit quality	-	314	49	-	363
Total	\$1,617	\$7,233	\$3,641	\$185	\$12,676

## Loans

Individually evaluated for impairment	\$10	\$3,007	\$361	\$19	\$3,397
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Collectively evaluated for impairment	130,431	383,541	251,511	6,300	771,783
Loans acquired with deteriorated credit quality	280	11,804	6,781	-	18,865
Total	\$ 130,721	\$ 398,352	\$ 258,653	\$ 6,319	\$ 794,045

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The following table presents the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at December 31, 2012.

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Total
(in thousands)					
<u>Allowance for Loan Losses</u>					
Balance as of December 31, 2011	\$ 1,236	\$ 5,719	\$ 3,412	\$ 162	\$10,529
Charge-offs	(748 )	(572 )	(694 )	(72 )	(2,086 )
Recoveries	707	475	279	81	1,542
Provision	255	1,200	641	37	2,133
Balance as of December 31, 2012	\$ 1,450	\$ 6,822	\$ 3,638	\$ 208	\$12,118

Balance as of December 31, 2012:

<u>Allowance for Loan Losses</u>					
Individually evaluated for impairment	\$ 107	\$ -	\$ -	\$ 21	\$128
Collectively evaluated for impairment	1,343	6,376	3,609	187	11,515
Loans acquired with deteriorated credit quality	-	446	29	-	475
Total	\$ 1,450	\$ 6,822	\$ 3,638	\$ 208	\$12,118

Loans

Individually evaluated for impairment	\$ 149	\$ 2,607	\$ 270	\$ 21	\$3,047
Collectively evaluated for impairment	125,707	388,495	245,373	5,901	765,476
Loans acquired with deteriorated credit quality	336	13,143	6,703	-	20,182
Total	\$ 126,192	\$ 404,245	\$ 252,346	\$ 5,922	\$788,705

Balances at December 31, 2011:

<u>Allowance for Loan Losses</u>					
Balance as of December 31, 2010	\$ 751	\$ 4,631	\$ 2,921	\$ 117	\$8,420
Charge-offs	(163 )	(702 )	(871 )	(127 )	(1,863 )
Recoveries	373	306	50	73	802
Provision	275	1,484	1,312	99	3,170
Balance as of December 31, 2011	\$ 1,236	\$ 5,719	\$ 3,412	\$ 162	\$10,529

Allowance for Loan Losses

Individually evaluated for impairment	\$ -	\$ 129	\$ 1	\$ -	\$130
Collectively evaluated for impairment	1,236	5,590	3,411	162	10,399
Total	\$ 1,236	\$ 5,719	\$ 3,412	\$ 162	\$10,529

Loans

Individually evaluated for impairment	\$ -	\$ 1,894	\$ 1,295	\$ 49	\$3,238
Collectively evaluated for impairment	131,755	381,175	266,421	8,142	787,493
Loans acquired with deteriorated credit quality	2,411	23,325	8,291	-	34,027
Total	\$				