

AMERICAN NATIONAL BANKSHARES INC.

Form 10-K

March 12, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2013

Commission file number 0-12820

AMERICAN NATIONAL BANKSHARES INC.

(Exact name of registrant as specified in its charter)

Virginia 54-1284688

(State of incorporation) (I.R.S. Employer Identification No.)

628 Main Street, Danville, VA 24541

(Address of principal executive offices) (Zip Code)

434-792-5111

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class         | Name of Exchange on Which Registered |
|-----------------------------|--------------------------------------|
| Common Stock, \$1 par value | NASDAQ Global Select Market          |

Securities registered pursuant to section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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 Act.) Yes  No   
The aggregate market value of the voting stock held by non-affiliates of the registrant at June 30, 2013, based on the closing price, was \$168,548,449.

The number of shares of the registrant's common stock outstanding on March 7, 2014 was 7,893,699.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held on May 20, 2014, are incorporated by reference in Part III of this report.

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\*Certain information required by Item 10 is incorporated herein by reference to the information that appears under the headings "Election of Directors," "Election of Directors – Board Members Serving on Other Publicly Traded Company Boards of Directors," "Election of Directors – Board of Directors and Committees - The Audit and Compliance Committee," "Section 16(a) Beneficial Ownership Reporting Compliance," "Report of the Audit and Compliance Committee," and "Code of Conduct" in the Registrant's Proxy Statement for the 2014 Annual Meeting of Shareholders. The information required by Item 401 of Regulation S-K on executive officers is disclosed herein.

The information required by Item 11 is incorporated herein by reference to the information that appears under the headings "Compensation Discussion and Analysis," "Compensation Committee Interlocks and Insider Participation," and "Compensation Committee Report" in the Registrant's Proxy Statement for the 2014 Annual Meeting of Shareholders.

The information required by Item 12 is incorporated herein by reference to the information that appears under the heading "Security Ownership" in the Registrant's Proxy Statement for the 2014 Annual Meeting of Shareholders. The information required by Item 201(d) of Regulation S-K is disclosed herein. See Item 5, "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities."

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The information required by Item 13 is incorporated herein by reference to the information that appears under the headings "Related Party Transactions" and "Election of Directors – Board Independence" in the Registrant's Proxy Statement for the 2014 Annual Meeting of Shareholders.

The information required by Item 14 is incorporated herein by reference to the information that appears under the heading "Independent Public Accountants" in the Registrant's Proxy Statement for the 2014 Annual Meeting of Shareholders.

## PART I

### 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, 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, acquisitions, and other expansion activities.

## ITEM 1 – BUSINESS

American National Bankshares Inc. is a one-bank holding company organized under the laws of the Commonwealth of Virginia in 1984. On September 1, 1984, the Company acquired all of the outstanding capital stock of American National Bank and Trust Company, a national banking association chartered in 1909 under the laws of the United States. American National Bank and Trust Company is the only banking subsidiary of the Company. In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the "AMNB Trust") and a wholly owned subsidiary of the Company Inc., 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"). In April 2006, the Company finalized the acquisition of Community First and acquired 100% of its preferred and common stock through a merger transaction. Community First was a bank holding company headquartered in Lynchburg, Virginia, and through its subsidiary, Community First Bank, operated four banking offices serving the city of Lynchburg and Bedford, Nelson, and Amherst Counties.

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

The operations of the Company are conducted at twenty-five banking offices and two loan production offices in Roanoke, Virginia and Raleigh, North Carolina. American National Bank provides a full array of financial products and services, including commercial, mortgage, and consumer banking; trust and investment services; and insurance. Services are also provided through thirty-one ATMs, "Online Banking," and "Telephone Banking."

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### Competition and Markets

Vigorous competition exists in the Company's service areas. The Company competes not only with national, regional, and community banks, but also with other types of financial institutions including savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, and mortgage companies.

The Company has the second largest deposit market share in the City of Danville and Pittsylvania County, combined. The Company had a deposit market share in the Danville Metropolitan Statistical Area ("MSA") of 29.3% at June 30, 2013, based on Federal Deposit Insurance Corporation ("FDIC") data.

The Southern Virginia market, in which the Company has a significant presence, continues to experience slow economic growth, like much of the country. The region's economic base continues to be weighted toward the manufacturing sector. Although the region was negatively impacted by the elimination of many textile plant closings over several decades, the area has experienced some new manufacturing plant openings as well as job growth in the technology area. Other important industries include farming, tobacco processing and sales, food processing, furniture manufacturing and sales, specialty glass manufacturing, and packaging tape production.

The Company's new market areas are Alamance County and Guilford County, North Carolina, where there is strong competition in attracting deposits and making loans. Its most direct competition for deposits comes from commercial banks, savings institutions and credit unions located in the market area, including large financial institutions that have greater financial and marketing resources available to them. The Company had a deposit market share in Alamance County of 13.9% and a deposit market share in Guilford County of 0.8% at June 30, 2013, based on FDIC data.

### Supervision and Regulation

The Company and the Bank are extensively regulated under federal and state law. The following information describes certain aspects of that regulation applicable to the Company and the Bank and does not purport to be complete. Proposals to change the laws and regulations governing the banking industry are frequently raised in U.S. Congress, in state legislatures, and before the various bank regulatory agencies. The likelihood and timing of any changes and the impact such changes might have on the Company and the Bank are impossible to determine with any certainty. A change in applicable laws or regulations, or a change in the way such laws or regulations are interpreted by regulatory agencies or courts, may have a material impact on the business, operations, and earnings of the Company and the Bank.

#### American National Bankshares Inc.

American National Bankshares Inc. is qualified as a bank holding company ("BHC") within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), and is registered as such with the Board of Governors of the Federal Reserve System (the "FRB"). As a bank holding company, American National Bankshares Inc. is subject to supervision, regulation and examination by the FRB and is required to file various reports and additional information with the FRB. American National Bankshares Inc. is also registered under the bank holding company laws of Virginia and is subject to supervision, regulation and examination by the Virginia State Corporation Commission (the "SCC").

Under the Gramm-Leach-Bliley Act, a BHC may elect to become a financial holding company and thereby engage in a broader range of financial and other activities than are permissible for traditional BHC's. In order to qualify for the election, all of the depository institution subsidiaries of the BHC must be well capitalized, well managed, and have achieved a rating of "satisfactory" or better under the Community Reinvestment Act (the "CRA"). Financial holding

companies are permitted to engage in activities that are "financial in nature" or incidental or complementary thereto as determined by the FRB. The Gramm-Leach-Bliley Act identifies several activities as "financial in nature," including insurance underwriting and sales, investment advisory services, merchant banking and underwriting, and dealing or making a market in securities. American National Bankshares Inc. has not elected to become a financial holding company, and has no plans to become a financial holding company.

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American National Bank and Trust Company

American National Bank and Trust Company is a federally chartered national bank and is a member of the Federal Reserve System. It is subject to federal regulation by the Office of the Comptroller of the Currency (the "OCC"), the FRB, and the FDIC.

Depository institutions, including the Bank, are subject to extensive federal and state regulations that significantly affect their business and activities. Regulatory bodies have broad authority to implement standards and initiate proceedings designed to prohibit depository institutions from engaging in unsafe and unsound banking practices. The standards relate generally to operations and management, asset quality, interest rate exposure, and capital. The bank regulatory agencies are authorized to take action against institutions that fail to meet such standards.

As with other financial institutions, the earnings of the Bank are affected by general economic conditions and by the monetary policies of the FRB. The FRB exerts a substantial influence on interest rates and credit conditions, primarily through open market operations in U.S. Government securities, setting the reserve requirements of member banks, and establishing the discount rate on member bank borrowings. The policies of the FRB have a direct impact on loan and deposit growth and the interest rates charged and paid thereon. They also impact the source, cost of funds, and the rates of return on investments. Changes in the FRB's monetary policies have had a significant impact on the operating results of the Bank and other financial institutions and are expected to continue to do so in the future; however, the exact impact of such conditions and policies upon the future business and earnings cannot accurately be predicted.

Regulatory Reform – The Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act significantly restructures the financial regulatory regime in the United States and has a broad impact on the financial services industry as a result of the significant regulatory and compliance changes required under the act. While significant rulemaking under the Dodd-Frank Act has occurred, certain of the act's provisions require additional rulemaking by the federal bank regulatory agencies, a process which will take years to fully implement. The Company believes that short- and long-term compliance costs for the Company will be greater because of the Dodd-Frank Act.

A summary of certain provisions of the Dodd-Frank Act is set forth below:

Increased Capital Standards. The federal banking agencies are required to establish minimum leverage and risk-based capital requirements for banks and bank holding companies. See "Capital Requirements – Basel III Capital Requirements" below. Among other things, the Dodd-Frank Act provides for new capital standards that eliminate the treatment of trust preferred securities as Tier 1 capital. Existing trust preferred securities are grandfathered for banking entities with less than \$15 billion of assets, such as the Company.

Deposit Insurance. The Dodd-Frank Act makes permanent the \$250,000 deposit insurance limit for insured deposits. Amendments to the Federal Deposit Insurance Act also revise the assessment base against which an insured depository institution's deposit insurance premiums paid to the Deposit Insurance Fund (the "DIF") will be calculated. Under the amendments, the assessment base will no longer be the institution's deposit base, but rather its average consolidated total assets less its average tangible equity during the assessment period. Additionally, the Dodd-Frank Act makes changes to the minimum designated reserve ratio of the DIF, increasing the minimum from 1.15% to 1.35% of the estimated amount of total insured deposits and eliminating the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds. The Dodd-Frank Act also provides that, effective one year after the date of enactment, depository institutions may pay interest on demand deposits.

Enhanced Lending Limits. The Dodd-Frank Act strengthens the existing limits on a depository institution's credit exposure to one borrower. Current banking law limits a depository institution's ability to extend credit to one person (or group of related persons) in an amount exceeding certain thresholds.

The Consumer Financial Protection Bureau ("CFPB"). The Dodd-Frank Act creates the CFPB within the FRB. The CFPB is charged with establishing rules and regulations under certain federal consumer protection laws with respect to the conduct of providers of certain consumer financial products and services.

Compensation Practices. The Dodd-Frank Act provides that the appropriate federal regulators must establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company or bank that provides an insider or other employee with "excessive compensation" or could lead to a material financial loss to such firm. In June 2010, prior to the Dodd-Frank Act, the federal bank regulatory agencies promulgated the Interagency Guidance on Sound Incentive Compensation Policies, which requires that financial institutions establish metrics for measuring the impact of activities to achieve incentive compensation with the related risk to the financial institution of such behavior.

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Although a significant number of the rules and regulations mandated by the Dodd-Frank Act have been finalized, certain of the act's requirements have yet to be implemented. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the federal bank regulatory agencies in the future, the full extent of the impact such requirements will have on the operations of the Company and the Bank is unclear. The changes resulting from the Dodd-Frank Act may affect the profitability of business activities, require changes to certain business practices, impose more stringent regulatory requirements or otherwise adversely affect the business and financial condition of the Company and the Bank. These changes may also require the Company to invest significant management attention and resources to evaluate and make necessary changes to comply with new statutory and regulatory requirements.

## Deposit Insurance

The deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund of the FDIC and are subject to deposit insurance assessments to maintain the DIF. On April 1, 2011, the deposit insurance assessment base changed from total deposits to average total assets minus average tangible equity, pursuant to a rule issued by the FDIC as required by the Dodd-Frank Act.

The Federal Deposit Insurance Act (the "FDIA"), as amended by the Federal Deposit Insurance Reform Act and the Dodd-Frank Act, requires the FDIC to set a ratio of deposit insurance reserves to estimated insured deposits of at least 1.35%. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank's capital level and supervisory rating. On February 27, 2009, the FDIC introduced three possible adjustments to an institution's initial base assessment rate: (i) a decrease of up to five basis points for long-term unsecured debt, including senior unsecured debt (other than debt guaranteed under the Temporary Liquidity Guarantee Program) and subordinated debt and, for small institutions, a portion of Tier 1 capital; (ii) an increase not to exceed 50% of an institution's assessment rate before the increase for secured liabilities in excess of 25% of domestic deposits; and (iii) for non-Risk Category I institutions, an increase not to exceed 10 basis points for brokered deposits in excess of 10% of domestic deposits. In 2013 and 2012, the Company paid only the base assessment rate for "well capitalized" institutions, which totaled \$647,000 and \$692,000, respectively, in regular deposit insurance assessments.

On May 22, 2009, the FDIC issued a final rule that levied a special assessment applicable to all insured depository institutions totaling 5 basis points of each institution's total assets less Tier 1 capital as of June 30, 2009, not to exceed 10 basis points of domestic deposits. The special assessment was part of the FDIC's efforts to rebuild the DIF. Deposit insurance expense during 2009 for the Bank included an additional \$1.2 million recognized in the second quarter related to the special assessment. On November 12, 2009, the FDIC issued a rule that required all insured depository institutions, with limited exceptions, to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. In December 2009, the Bank paid \$2.9 million in prepaid risk-based assessments, which amount was expensed in the appropriate periods through December 31, 2012. The remaining balance of \$1.7 million in prepaid risk-based assessments was refunded in 2013.

In addition, all FDIC insured institutions are required to pay assessments to the FDIC at an annual rate of approximately one basis point of insured deposits to fund interest payments on bonds issued by the Financing Corporation, an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments will continue until the Financing Corporation bonds mature in 2017 through 2019.

## Capital Requirements

Current Capital Requirements. The FRB, the OCC and the FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to all banks and bank holding companies. In addition, those regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels because of its

financial condition or actual or anticipated growth. Under the current risk-based capital requirements of these federal bank regulatory agencies, American National Bankshares Inc. and American National Bank are required to maintain a minimum ratio of total capital (which is defined as core capital and supplementary capital less certain specified deductions from total capital such as reciprocal holdings of depository institution capital instruments and equity investments) to risk-weighted assets of at least 8.0%. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet activities, recourse obligations, residual interests and direct credit substitutes, are multiplied by a risk-weight factor assigned by the capital regulation based on the risks believed inherent in the type of asset. At least half of the total capital is required to be "Tier 1 capital," which consists principally of common and certain qualifying preferred shareholders' equity (including trust preferred securities), less certain intangibles and other adjustments. The remainder ("Tier 2 capital") consists of cumulative preferred stock, long-term perpetual preferred stock, a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments) and a limited amount of the general loan loss allowance. The Tier 1 and total capital to risk-weighted asset ratios of the American National Bankshares Inc. were 16.88% and 18.14%, respectively, as of December 31, 2013, thus exceeding the minimum requirements. The Tier 1 and total capital to risk-weighted asset ratios of American National Bank were 16.33% and 17.59%, respectively, as of December 31, 2013 also exceeding the minimum requirements.

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Each of the federal bank regulatory agencies also has established a minimum leverage capital ratio of Tier 1 capital to average adjusted assets ("Tier 1 leverage ratio"). These guidelines provide for a minimum Tier 1 leverage ratio of 3.0% for bank holding companies and national banks that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk. All other bank holding companies and national banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. In addition, for a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%. The FRB has not advised the Company, and the OCC has not advised the Bank, of any specific minimum leverage ratio applicable to either entity. The Tier 1 leverage ratio of American National Bankshares Inc. as of December 31, 2013 was 11.81%, which is above the minimum requirements.

Basel III Capital Requirements. On June 7, 2012, the FRB issued a series of proposed rules that would revise and strengthen its risk-based and leverage capital requirements and its method for calculating risk-weighted assets. The rules were proposed to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. On July 2, 2013, the Federal Reserve approved certain revisions to the proposals and finalized new capital requirements for banking organizations.

Effective January 1, 2015, the final rules require the Company and the Bank to comply with the following new minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6% of risk-weighted assets (increased from the current requirement of 4%); (iii) a total capital ratio of 8% of risk-weighted assets (unchanged from current requirement); and (iv) a leverage ratio of 4% of total assets. These are the initial capital requirements, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The capital conservation buffer requirement will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing each year until fully implemented at 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

With respect to the Bank, the rules also revised the "prompt corrective action" regulations pursuant to Section 38 of the FDIA by (i) introducing a common equity Tier 1 capital ratio requirement at each level (other than critically undercapitalized), with the required ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum ratio for well-capitalized status being 8.0% (as compared to the current 6.0%); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3.0% Tier 1 leverage ratio and still be well-capitalized.

The new capital requirements also include changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status, a 20% (up from 0%) credit conversion factor for the unused portion of a commitment

with an original maturity of one year or less that is not unconditionally cancellable, a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital, and increased risk-weights (from 0% to up to 600%) for equity exposures.

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Based on management's understanding and interpretation of the new capital rules, it believes that, as of December 31, 2013, the Company and the Bank would meet all capital adequacy requirements under such rules on a fully phased-in basis as if such requirements were in effect as of such date.

## Dividends

The Company's principal source of cash flow, including cash flow to pay dividends to its shareholders, is dividends it receives from the Bank. Statutory and regulatory limitations apply to the Bank's payment of dividends to the Company. As a general rule, the amount of a dividend may not exceed, without prior regulatory approval, the sum of net income in the calendar year to date and the retained net earnings of the immediately preceding two calendar years. A depository institution may not pay any dividend if payment would cause the institution to become "undercapitalized" or if it already is "undercapitalized." The OCC may prevent the payment of a dividend if it determines that the payment would be an unsafe and unsound banking practice. The OCC also has advised that a national bank should generally pay dividends only out of current operating earnings.

## Permitted Activities

As a bank holding company, American National Bankshares Inc. is limited to managing or controlling banks, furnishing services to or performing services for its subsidiaries, and engaging in other activities that the FRB determines by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is permissible, the FRB must consider whether the performance of such an activity reasonably can be expected to produce benefits to the public that outweigh possible adverse effects. Possible benefits include greater convenience, increased competition, and gains in efficiency. Possible adverse effects include undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. Despite prior approval, the FRB may order a bank holding company or its subsidiaries to terminate any activity or to terminate ownership or control of any subsidiary when the FRB has reasonable cause to believe that a serious risk to the financial safety, soundness or stability of any bank subsidiary of that bank holding company may result from such an activity.

## Banking Acquisitions; Changes in Control

The BHC Act requires, among other things, the prior approval of the FRB in any case where a bank holding company proposes to (i) acquire direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank or bank holding company (unless it already owns a majority of such voting shares), (ii) acquire all or substantially all of the assets of another bank or bank holding company, or (iii) merge or consolidate with any other bank holding company. In determining whether to approve a proposed bank acquisition, the FRB will consider, among other factors, the effect of the acquisition on competition, the public benefits expected to be received from the acquisition, the projected capital ratios and levels on a post-acquisition basis, and the acquiring institution's performance under the Community Reinvestment Act of 1977 (the "CRA") and its compliance with fair housing and other consumer protection laws.

Subject to certain exceptions, the BHC Act and the Change in Bank Control Act, together with the applicable regulations, require FRB approval (or, depending on the circumstances, no notice of disapproval) prior to any person or company acquiring "control" of a bank or bank holding company. A conclusive presumption of control exists if an individual or company acquires the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25% or more of any class of voting securities of any insured depository institution. A rebuttable presumption of control exists if a person or company acquires 10% or more but less than 25% of any class of voting securities of an insured depository institution and either the institution has registered its securities with the Securities and Exchange Commission under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or no other person will own a greater percentage of that class of voting securities immediately after the acquisition.

The Company's common stock is registered under Section 12 of the Exchange Act.

In addition, Virginia law requires the prior approval of the SCC for (i) the acquisition of more than 5% of the voting shares of a Virginia bank or any holding company that controls a Virginia bank, or (ii) the acquisition by a Virginia bank holding company of a bank or its holding company domiciled outside Virginia.

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Source of Strength

FRB policy has historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. The Dodd-Frank Act codified this policy as a statutory requirement. Under this requirement, the Company is expected to commit resources to support the Bank, including at times when the Company may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to depositors and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Safety and Soundness

There are a number of obligations and restrictions imposed on bank holding companies and their subsidiary banks by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the FDIC insurance fund in the event of a depository institution default. For example, under the Federal Deposit Insurance Corporation Improvement Act of 1991, to avoid receivership of an insured depository institution subsidiary, a bank holding company is required to guarantee the compliance of any subsidiary bank that may become "undercapitalized" with the terms of any capital restoration plan filed by such subsidiary with its appropriate federal bank regulatory agency up to the lesser of (i) an amount equal to 5% of the institution's total assets at the time the institution became undercapitalized or (ii) the amount that is necessary (or would have been necessary) to bring the institution into compliance with all applicable capital standards as of the time the institution fails to comply with such capital restoration plan.

Under the FDIA, the federal bank regulatory agencies have adopted guidelines prescribing safety and soundness standards. These guidelines establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines.

The Federal Deposit Insurance Corporation Improvement Act

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), the federal bank regulatory agencies possess broad powers to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution is "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized," as defined by the law. Under current regulations established by the federal bank regulatory agencies a "well capitalized" institution must have a Tier 1 capital ratio of at least 6%, a total capital ratio of at least 10%, and a leverage ratio of at least 5%, and not be subject to a capital directive order. An "adequately capitalized" institution must have a Tier 1 capital ratio of at least 4%, a total capital ratio of at least 8%, and a leverage ratio of at least 4%, or 3% in some cases. Management believes, as of December 31, 2013 and 2012, that the Company met the requirements for being classified as "well capitalized."

As required by FDICIA, the federal bank regulatory agencies also have adopted guidelines prescribing safety and soundness standards relating to, among other things, internal controls and information systems, internal audit systems, loan documentation, credit underwriting, and interest rate exposure. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. In addition, the agencies adopted regulations that authorize, but do not require, an institution which has been notified that it is not in compliance with safety and soundness standard to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the

prompt corrective action provisions described above.

### Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, as amended (the "Interstate Banking Act"), generally permits well capitalized bank holding companies to acquire banks in any state, and preempts all state laws restricting the ownership by a bank holding company of banks in more than one state. The Interstate Banking Act also permits a bank to merge with an out-of-state bank and convert any offices into branches of the resulting bank if both states have not opted out of interstate branching; and permits a bank to acquire branches from an out-of-state bank if the law of the state where the branches are located permits the interstate branch acquisition. Under the Dodd-Frank Act, a bank holding company or bank must be well capitalized and well managed to engage in an interstate acquisition. Bank holding companies and banks are required to obtain prior FRB approval to acquire more than 5% of a class of voting securities, or substantially all of the assets, of a bank holding company, bank or savings association. The Interstate Banking Act and the Dodd-Frank Act permit banks to establish and operate de novo interstate branches to the same extent a bank chartered by the host state may establish branches.

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### Transactions with Affiliates

Pursuant to Sections 23A and 23B of the Federal Reserve Act and Regulation W, the authority of the Bank to engage in transactions with related parties or "affiliates" or to make loans to insiders is limited. Loan transactions with an affiliate generally must be collateralized and certain transactions between the Bank and its affiliates, including the sale of assets, the payment of money or the provision of services, must be on terms and conditions that are substantially the same, or at least as favorable to the Bank, as those prevailing for comparable nonaffiliated transactions. In addition, the Bank generally may not purchase securities issued or underwritten by affiliates.

Loans to executive officers, directors or to any person who directly or indirectly, or acting through or in concert with one or more persons, owns, controls or has the power to vote more than 10% of any class of voting securities of a bank (a "10% Shareholders"), are subject to Sections 22(g) and 22(h) of the Federal Reserve Act and their corresponding regulations (Regulation O) and Section 13(k) of the Exchange Act relating to the prohibition on personal loans to executives (which exempts financial institutions in compliance with the insider lending restrictions of Section 22(h) of the Federal Reserve Act). Among other things, these loans must be made on terms substantially the same as those prevailing on transactions made to unaffiliated individuals and certain extensions of credit to those persons must first be approved in advance by a disinterested majority of the entire board of directors. Section 22(h) of the Federal Reserve Act prohibits loans to any of those individuals where the aggregate amount exceeds an amount equal to 15% of an institution's unimpaired capital and surplus plus an additional 10% of unimpaired capital and surplus in the case of loans that are fully secured by readily marketable collateral, or when the aggregate amount on all of the extensions of credit outstanding to all of these persons would exceed the Bank's unimpaired capital and unimpaired surplus. Section 22(g) of the Federal Reserve Act identifies limited circumstances in which the Bank is permitted to extend credit to executive officers.

### Community Reinvestment Act and Consumer Protection Laws

In connection with its lending activities, the Company is subject to a number of federal laws designed to protect borrowers and promote lending to various sectors of the economy and population. These include the Equal Credit Opportunity Act, the Truth-in-Lending Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the Community Reinvestment Act of 1977.

The CRA requires the appropriate federal banking agency, in connection with its examination of a bank, to assess the bank's record in meeting the credit needs of the communities served by the bank, including low and moderate income neighborhoods. Furthermore, such assessment is also required of banks that have applied, among other things, to merge or consolidate with or acquire the assets or assume the liabilities of an insured depository institution, or to open or relocate a branch. In the case of a BHC applying for approval to acquire a bank or BHC, the record of each subsidiary bank of the applicant BHC is subject to assessment in considering the application. Under the CRA, institutions are assigned a rating of "outstanding," "satisfactory," "needs to improve," or "substantial non-compliance." The Company was rated "outstanding" in its most recent CRA evaluation.

### Anti-Money Laundering Legislation

The Company is subject to the Bank Secrecy Act and other anti-money laundering laws and regulations, including the USA Patriot Act of 2001. Among other things, these laws and regulations require the Company to take steps to prevent the use of the Company for facilitating the flow of illegal or illicit money, to report large currency transactions, and to file suspicious activity reports. The Company is also required to carry out a comprehensive anti-money laundering compliance program. Violations can result in substantial civil and criminal sanctions. In addition, provisions of the USA Patriot Act require the federal bank regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and BHC acquisitions.

## Privacy Legislation

Several recent laws, including the Right to Financial Privacy Act, and related regulations issued by the federal bank regulatory agencies, also provide new protections against the transfer and use of customer information by financial institutions. A financial institution must provide to its customers information regarding its policies and procedures with respect to the handling of customers' personal information. Each institution must conduct an internal risk assessment of its ability to protect customer information. These privacy provisions generally prohibit a financial institution from providing a customer's personal financial information to unaffiliated parties without prior notice and approval from the customer.

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Incentive Compensation

In June 2010, the federal bank regulatory agencies issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of financial institutions do not undermine the safety and soundness of such institutions by encouraging excessive risk-taking. The Interagency Guidance on Sound Incentive Compensation Policies, which covers all employees that have the ability to materially affect the risk profile of a financial institutions, either individually or as part of a group, is based upon the key principles that a financial institution's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the institution's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the financial institution's board of directors.

The FRB will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of financial institutions, such as the Company, that are not "large, complex banking organizations." These reviews will be tailored to each financial institution based on the scope and complexity of the institution's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the institution's supervisory ratings, which can affect the institution's ability to make acquisitions and take other actions. Enforcement actions may be taken against a financial institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the institution's safety and soundness and the financial institution is not taking prompt and effective measures to correct the deficiencies. At December 31, 2013, the Company had not been made aware of any instances of non-compliance with the final guidance.

Volcker Rule

The Dodd-Frank Act prohibits insured depository institutions and their holding companies from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of 3% of Tier 1 capital in private equity and hedge funds (known as the "Volcker Rule"). On December 10, 2013, the federal bank regulatory agencies adopted final rules implementing the Volcker Rule. These final rules prohibit banking entities from (i) engaging in short-term proprietary trading for their own accounts, and (ii) having certain ownership interests in and relationships with hedge funds or private equity funds. The final rules are intended to provide greater clarity with respect to both the extent of those primary prohibitions and of the related exemptions and exclusions. The final rules also require each regulated entity to establish an internal compliance program that is consistent with the extent to which it engages in activities covered by the Volcker Rule, which must include (for the largest entities) making regular reports about those activities to regulators. Although the final rules provide some tiering of compliance and reporting obligations based on size, the fundamental prohibitions of the Volcker Rule apply to banking entities of any size, including the Company and the Bank. The final rules are effective April 1, 2014, but the conformance period has been extended from its statutory end date of July 21, 2014 until July 21, 2015. The Company has evaluated the implications of the final rules on its investments and does not expect any material financial implications.

Under the final rules implementing the Volcker Rule, banking entities would have been prohibited from owning certain collateralized debt obligations ("CDOs") backed by trust preferred securities ("TruPS") as of July 21, 2015, which could have forced banking entities to recognize unrealized market losses based on the inability to hold any such investments to maturity. However, on January 14, 2014, the federal bank regulatory agencies issued an interim rule, effective April 1, 2014, exempting TruPS CDOs from the Volcker Rule if (i) the CDO was established prior to May 19, 2010, (ii) the banking entity reasonably believes that the offering proceeds of the CDO were used to invest primarily in TruPS issued by banks with less than \$15 billion in assets, and (iii) the banking entity acquired the CDO on or before December 10, 2013. The Company currently does not have any impermissible holdings of TruPS CDOs under the interim rule, and therefore, will not be required to divest of any such investments or change the accounting

treatment. However, regulators are soliciting comments to the Interim Rule, and this exemption could change prior to its effective date.

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### Ability-to-Repay and Qualified Mortgage Rule

Pursuant to the Dodd-Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate "qualified mortgages," which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are "higher-priced" (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g. prime loans) are given a safe harbor of compliance. The Company is predominantly an originator of compliant qualified mortgages.

### Effect of Governmental Monetary Policies

The Company's operations are affected not only by general economic conditions, but also by the policies of various regulatory authorities. In particular, the FRB regulates money and credit conditions and interest rates to influence general economic conditions. These policies have a significant impact on overall growth and distribution of loans, investments and deposits; they affect interest rates charged on loans or paid for time and savings deposits. FRB monetary policies have had a significant effect on the operating results of commercial banks, including the Company, in the past and are expected to do so in the future. As a result, the Company is unable to predict the effects of possible changes in monetary policies upon its future operating results.

### Employees

At December 31, 2013, the Company employed 290 full-time equivalent persons. In the opinion of the management of the Company, the relationship with employees of the Company and the Bank is good.

### Internet Access to Company Documents

The Company provides access to its Securities and Exchange Commission (the "SEC") filings through a link on the Investor Relations page of the Company's website at [www.amnb.com](http://www.amnb.com). Reports available include the annual report 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 Annual Report on Form 10-K 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](http://www.sec.gov).

### Executive Officers of the Company

The following table lists, as of December 31, 2013, the executive officers of the Company, their ages, and their positions:

| Name | Age | Position |
|------|-----|----------|
|------|-----|----------|

|                     |    |   |
|---------------------|----|---|
| Charles H. Majors   | 68 | Executive Chairman of the Company and the Bank since January 2013; prior thereto, Chairman and Chief Executive Officer of the Company since January 2012; Chairman of the Bank since January 2012; prior thereto, President and Chief Executive Officer of the Company; Chairman and Chief Executive Officer of the Bank from June 2010 to December 2011, prior thereto, Chief Executive Officer and President of the Bank.   |
| Jeffrey V. Haley    | 53 | President and Chief Executive Officer of the Company and Bank since January 2013; prior thereto, President of the Company and Chief Executive Officer of the Bank since January 2012; prior thereto, Executive Vice President of the Company from June 2010 to December 2011; prior thereto, Senior Vice President of the Company from July 2008 to May 2010; President of the Bank since June 2010; prior thereto, Executive Vice President of the Bank, as well as President of Trust and Financial Services from July 2008 to May 2010; prior thereto, Executive Vice President and Chief Operating Officer of the Bank from November 2005 to June 2007. |
| William W. Traynham | 58 | Senior Vice President, Chief Financial Officer, Treasurer and Secretary of the Company since April 2009; Executive Vice President, Chief Financial Officer, and Cashier of the Bank since April 2009; prior thereto, President and Chief Financial Officer of Community Bankshares Inc. and Chief Financial Officer of Community Resource Bank, NA from 1992 until the sale of the company in 2008.   |



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ITEM 1A – RISK FACTORS

Risks Related to the Company's Business

The Company's business is subject to interest rate risk, and variations in interest rates may negatively affect financial performance.

Changes in the interest rate environment may reduce the Company's profits. It is expected that the Company will continue to realize income from the spread between the interest earned on loans, securities, and other interest earning assets, and interest paid on deposits, borrowings and other interest bearing liabilities. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest earning assets and interest bearing liabilities. In addition, loan volume and yields are affected by market interest rates on loans, and the current interest rate environment encourages extreme competition for new loan originations from qualified borrowers. Management cannot ensure that it can minimize the Company's interest rate risk. While an eventual increase in the general level of interest rates may increase the loan yield and the net interest margin, it may adversely affect the ability of certain borrowers with variable rate loans to pay the interest and principal of their obligations. Accordingly, changes in levels of market interest rates could materially and adversely affect the net interest spread, asset quality, loan origination volume, and overall profitability of the Company.

The Company faces strong competition from financial services companies and other companies that offer banking and other financial services, which could negatively affect the Company's business.

The Company encounters substantial competition from other financial institutions in its market area. Ultimately, the Company may not be able to compete successfully against current and future competitors. Many competitors offer the same banking services that the Company offers. These competitors include national, regional, and community banks. The Company also faces competition from many other types of financial institutions, including savings banks, finance companies, mutual and money market fund providers, brokerage firms, insurance companies, credit unions, financial subsidiaries of certain industrial corporations, and mortgage companies. In particular, competitors include several major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and ATMs and conduct extensive promotional and advertising campaigns. Increased competition may result in reduced business for the Company.

Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the credit needs of larger customers. Areas of competition include interest rates for loans and deposits, efforts to obtain loans and deposits, and range and quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances enable more companies to provide financial services. If the Company is unable to attract and retain banking customers, it may be unable to continue to grow loan and deposit portfolios and its results of operations and financial condition may be adversely affected.

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Changes in economic conditions could materially and negatively affect the Company's business.

The Company's business is directly impacted by economic, political, and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government monetary and fiscal policies, and inflation, all of which are beyond the Company's control. A deterioration in economic conditions, whether caused by global, national or local events, especially within the Company's market area, could result in potentially negative material consequences such as the following, among others: loan delinquencies increasing; problem assets and foreclosures increasing; demand for products and services decreasing; low cost or noninterest bearing deposits decreasing; and collateral for loans, especially real estate, declining in value, in turn reducing customers' borrowing power, and reducing the value of assets and collateral associated with existing loans. Each of these consequences may have a material adverse effect on the Company's financial condition and results of operations.

Trust division income is a major source of non-interest income for the Company. Trust and Investment Services fee revenue is largely dependent on the fair market value of assets under management and on trading volumes in the brokerage business. General economic conditions and their subsequent effect on the securities markets tend to act in correlation. When general economic conditions deteriorate, securities markets generally decline in value, and the Company's Trust and Investment Service revenues are negatively impacted as asset values and trading volumes decrease.

The Company's credit standards and its on-going credit assessment processes might not protect it from significant credit losses.

The Company takes credit risk by virtue of making loans and extending loan commitments and letters of credit. The Company manages credit risk through a program of underwriting standards, the review of certain credit decisions and an on-going process of assessment of the quality of the credit already extended. The Company's exposure to credit risk is managed through the use of consistent underwriting standards that emphasize local lending while avoiding highly leveraged transactions as well as excessive industry and other concentrations. The Company's credit administration function employs risk management techniques to help ensure that problem loans are promptly identified. While these procedures are designed to provide the Company with the information needed to implement policy adjustments where necessary and to take appropriate corrective actions, and have proven to be reasonably effective to date, there can be no assurance that such measures will be effective in avoiding future undue credit risk.

The Company's focus on lending to small to mid-sized community-based businesses may increase its credit risk.

Most of the Company's commercial business and commercial real estate loans are made to small business or middle market customers. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities and have a heightened vulnerability to economic conditions. If general economic conditions in the market areas in which the Company operates negatively impact this important customer sector, the Company's results of operations and financial condition may be adversely affected. Moreover, a portion of these loans have been made by the Company in recent years and the borrowers may not have experienced a complete business or economic cycle. The deterioration of the borrowers' businesses may hinder their ability to repay their loans with the Company, which could have a material adverse effect on the Company's financial condition and results of operations.

The Company depends on the accuracy and completeness of information about clients and counterparties, and its financial condition could be adversely affected if it relies on misleading information.

In deciding whether to extend credit or to enter into other transactions with clients and counterparties, the Company may rely on information furnished to it by or on behalf of clients and counterparties, including financial statements and other financial information, which the Company does not independently verify. The Company also may rely on representations of clients and counterparties as to the accuracy and completeness of that information and, with respect

to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to clients, the Company may assume that a customer's audited financial statements conform with accounting principles generally accepted in the United States and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. The Company's financial condition and results of operations could be negatively impacted to the extent it relies on financial statements that do not comply with GAAP or are materially misleading.

The allowance for loan losses may not be adequate to cover actual losses.

In accordance with accounting principles generally accepted in the United States, an allowance for loan losses is maintained to provide for loan losses. The allowance for loan losses may not be adequate to cover actual credit losses, and future provisions for credit losses could materially and adversely affect operating results. The allowance for loan losses is based on prior experience, as well as an evaluation of the risks in the current portfolio. The amount of future losses is susceptible to changes in economic, operating, and other outside forces and conditions, including changes in interest rates, all of which are beyond the Company's control; and these losses may exceed current estimates. Federal bank regulatory agencies, as a part of their examination process, review the Company's loans and allowance for loan losses. While management believes that the allowance for loan losses is adequate to cover current losses, it cannot make assurances that it will not further increase the allowance for loan losses or that regulators will not require it to increase this allowance. Either of these occurrences could adversely affect earnings.

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Nonperforming assets take significant time to resolve and adversely affect the Company's results of operations and financial condition.

The Company's nonperforming assets adversely affect its net income in various ways. Until economic and market conditions stabilize, the Company expects to continue to incur additional losses relating to volatility in nonperforming loans. The Company does not record interest income on nonaccrual loans, which adversely affects its income and increases credit administration costs. When the Company receives collateral through foreclosures and similar proceedings, it is required to mark the related asset to the then fair market value of the collateral less estimated selling costs, which may, and often does, result in a loss. An increase in the level of nonperforming assets also increases the Company's risk profile and may impact the capital levels regulators believe are appropriate in light of such risks. The Company utilizes various techniques such as workouts, restructurings and loan sales to manage problem assets. Increases in or negative adjustments in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect the Company's business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and staff, which can be detrimental to the performance of their other responsibilities, including generation of new loans. There can be no assurance that the Company will avoid further increases in nonperforming loans in the future.

The continued weak condition of, or downturn in, the local real estate market could materially and negatively affect the Company's business.

The Company offers a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity lines of credit, consumer and other loans. Many of these loans are secured by real estate (both residential and commercial) located in the Company's market area. The continued weakness of, or downturn in, the real estate market in the areas in which the Company conducts its operations could negatively affect the Company's business because significant portions of its loans are secured by real estate. At December 31, 2013, the Company had approximately \$795 million in loans, of which approximately \$666 million (83.8%) were secured by real estate. The ability to recover on defaulted loans by selling the real estate collateral could then be diminished and the Company would be more likely to suffer losses.

Substantially all of the Company's real property collateral is located in its market area. If there is a continued decline in real estate values, especially in the Company's market area, the collateral for loans would deteriorate and provide significantly less security.

The Company relies upon independent appraisals to determine the value of the real estate which secures a significant portion of its loans, and the values indicated by such appraisals may not be realizable if the Company is forced to foreclose upon such loans.

A significant portion of the Company's loan portfolio consists of loans secured by real estate. The Company relies upon independent appraisers to estimate the value of such real estate. Appraisals are only estimates of value and the independent appraisers may make mistakes of fact or judgment which adversely affect the reliability of their appraisals. In addition, events occurring after the initial appraisal may cause the value of the real estate to increase or decrease. As a result of any of these factors, the real estate securing some of the Company's loans may be more or less valuable than anticipated at the time the loans were made. If a default occurs on a loan secured by real estate that is less valuable than originally estimated, the Company may not be able to recover the outstanding balance of the loan and will suffer a loss.

The Company is dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect the Company's operations and prospects.

The Company currently depends on the services of a number of key management personnel. The loss of key personnel could materially and adversely affect the results of operations and financial condition. The Company's success also depends in part on the ability to attract and retain additional qualified management personnel. Competition for such personnel is strong and the Company may not be successful in attracting or retaining the personnel it requires.

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The inability of the Company to successfully manage its growth or implement its growth strategy may adversely affect the Company's results of operations and financial condition.

The Company may not be able to successfully implement its growth strategy if it is unable to identify attractive markets, locations or opportunities to expand in the future. In addition, the ability to manage growth successfully depends on whether the Company can maintain adequate capital levels, cost controls and asset quality, and successfully integrate any businesses acquired into the Company.

As the Company continues to implement its growth strategy by opening new branches or acquiring branches or banks, it expects to incur increased personnel, occupancy and other operating expenses. In the case of new branches, the Company must absorb those higher expenses while it begins to generate new deposits; there is also further time lag involved in redeploying new deposits into attractively priced loans and other higher yielding earning assets. The Company's plans to expand could depress earnings in the short run, even if it efficiently executes a branching strategy leading to long-term financial benefits.

Difficulties in combining the operations of acquired entities with the Company's own operations may prevent the Company from achieving the expected benefits from acquisitions.

The Company may not be able to achieve fully the strategic objectives and operating efficiencies expected in an acquisition. Inherent uncertainties exist in integrating the operations of an acquired entity. In addition, the markets and industries in which the Company and its potential acquisition targets operate are highly competitive. The Company may lose customers or the customers of acquired entities as a result of an acquisition; the Company may lose key personnel, either from the acquired entity or from itself; and the Company may not be able to control the incremental increase in noninterest expense arising from an acquisition in a manner that improves its overall operating efficiencies. These factors could contribute to the Company's not achieving the expected benefits from its acquisitions within desired time frames, if at all. Future business acquisitions could be material to the Company and it may issue additional shares of common stock to pay for those acquisitions, which would dilute current shareholders' ownership interests. Acquisitions also could require the Company to use substantial cash or other liquid assets or to incur debt; the Company could therefore become more susceptible to economic downturns and competitive pressures.

The Company is subject to extensive regulation which could adversely affect its business.

The Company's operations as a publicly traded corporation, a bank holding company, and an insured depository institution are subject to extensive regulation by federal, state, and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of the Company's operations. Because the Company's business is highly regulated, the laws, rules, and regulations applicable to it are subject to frequent and sometimes extensive change. Such changes could include higher capital requirements, increased insurance premiums, increased compliance costs, reductions of non-interest income and limitations on services that can be provided. Actions by regulatory agencies or significant litigation against the Company could cause it to devote significant time and resources to defend itself and may lead to liability or penalties that materially affect the Company and its shareholders. Any future changes in the laws, rules or regulations applicable to the Company may negatively affect the Company's business and results of operations.

The Dodd-Frank Act substantially changes the regulation of the financial services industry and it could have a material adverse effect upon the Company.

The Dodd-Frank Act provides wide-ranging changes in the way banks and financial services firms generally are regulated and affects the way the Company and its customers and counterparties do business with each other. Among other things, it requires increased capital and regulatory oversight for banks and their holding companies, changes the deposit insurance assessment system, changes responsibilities among regulators, establishes the new Consumer

Financial Protection Bureau, and makes various changes in the securities laws and corporate governance that affect public companies, including the Company. The Dodd-Frank Act also requires numerous studies and regulations related to its implementation. The Company is continually evaluating the effects of the Dodd-Frank Act, together with implementing the regulations that have been proposed and adopted. The ultimate effects of the Dodd-Frank Act and the resulting rulemaking cannot be predicted at this time, but it has increased the Company's operating and compliance costs in the short-term, and it could have a material adverse effect on the Company's results of operation and financial condition.

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Recently enacted capital standards may have an adverse effect on the Company's profitability, lending, and ability to pay dividends on the Company's securities.

In July 2013, the FRB released its final rules which will implement in the U. S the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. Under the final rules, minimum requirements will increase for both the quality and quantity of capital held by banking organizations. Consistent with the international Basel framework, the rule includes a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised financial institutions. The rule also, among other things, raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. We must begin transitioning to the new rules effective January 1, 2015. The potential impact of the new capital rules includes, but is not limited to, reduced lending and negative pressure on profitability and return on equity due to the higher capital requirements. To the extent the Company is required to increase capital in the future to comply with the new capital rules, its ability to pay dividends on its securities may be reduced.

New regulations issued by the Consumer Financial Protection Bureau could adversely the Company's earnings. The CFPB has broad rulemaking authority to administer and carry out the provisions of the Dodd-Frank Act with respect to financial institutions that offer covered financial products and services to consumers. Pursuant to the Dodd-Frank Act, the CFPB issued a final rule effective January 10, 2014, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms, or to originate "qualified mortgages" that meet specific requirements with respect to terms, pricing and fees. The new rule also contains new disclosure requirements at mortgage loan origination and in monthly statements. These requirements could limit the Company's ability to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could adversely impact the Company's profitability.

The Company's exposure to operational, technological and organizational risk may adversely affect the Company. The Company is exposed to many types of operational risks, including reputation, legal, and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, clerical or record-keeping errors, and errors resulting from faulty or disabled computer or telecommunications systems.

Negative public opinion can result from the actual or alleged conduct in any number of activities, including lending practices, corporate governance, and acquisitions, and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect the Company's ability to attract and retain customers and can expose it to litigation and regulatory action.

Certain errors may be repeated or compounded before they are discovered and successfully rectified. The Company's necessary dependence upon automated systems to record and process its transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. The Company may also be subject to disruptions of its operating systems arising from events that are wholly or partially beyond its control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. The Company is further exposed to the risk that its external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as is the Company) and to the risk that the Company's (or its vendors') business continuity and data security systems prove to be inadequate.

Changes in accounting standards could impact reported earnings.

From time to time, with seeming increasing frequency, there are changes in the financial accounting and reporting standards that govern the preparation of the Company's financial statements. These changes can materially impact how the Company records and reports its financial condition and results of operations. In some instances, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of prior



period financial statements.

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Failure to maintain effective systems of internal and disclosure control could have a material adverse effect on the Company's results of operation and financial condition.

Effective internal and disclosure controls are necessary for the Company to provide reliable financial reports and effectively prevent fraud and to operate successfully as a public company. If the Company cannot provide reliable financial reports or prevent fraud, its reputation and operating results would be harmed. As part of the Company's ongoing monitoring of internal control, it may discover material weaknesses or significant deficiencies in its internal control that require remediation. A "material weakness" is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of a company's annual or interim financial statements will not be prevented or detected on a timely basis.

The Company has in the past discovered, and may in the future discover, areas of its internal controls that need improvement. Even so, the Company is continuing to work to improve its internal controls. The Company cannot be certain that these measures will ensure that it implements and maintains adequate controls over its financial processes and reporting in the future. Any failure to maintain effective controls or to timely effect any necessary improvement of the Company's internal and disclosure controls could, among other things, result in losses from fraud or error, harm the Company's reputation or cause investors to lose confidence in the Company's reported financial information, all of which could have a material adverse effect on the Company's results of operation and financial condition.

The carrying value of goodwill may be adversely impacted.

When the Company completes an acquisition, generally goodwill is recorded on the date of acquisition as an asset. Current accounting guidance requires for goodwill to be tested for impairment, which the Company performs an impairment analysis at least annually, rather than amortizing it over a period of time. A significant adverse change in expected future cash flows or sustained adverse change in the Company's common stock could require the asset to become impaired. If impaired, the Company would incur a non-cash charge to earnings that would have a significant impact on the results of operations. The carrying value of goodwill was approximately \$39 million at December 31, 2013.

The Company may need to raise additional capital in the future to continue to grow, but may be unable to obtain additional capital on favorable terms or at all.

Federal and state banking regulators and safe and sound banking practices require the Company to maintain adequate levels of capital to support its operations. Although the Company currently has no specific plans for additional offices, its business strategy calls for it to continue to grow in its existing banking markets (internally and through additional offices and to expand into new markets as appropriate opportunities arise. Continued growth in the Company's earning assets, which may result from internal expansion and new branch offices, at rates in excess of the rate at which its capital is increased through retained earnings, will reduce the Company's capital ratios. If the Company's capital ratios fell below "well capitalized" levels, the FDIC deposit insurance assessment rate would increase until capital was restored and maintained at a "well capitalized" level. A higher assessment rate would cause an increase in the assessments the Company pays for federal deposit insurance, which would have an adverse effect on the Company's operating results.

Management of the Company believes that its current and projected capital position is sufficient to maintain capital ratios significantly in excess of regulatory requirements for the next several years and allow the Company flexibility in the timing of any possible future efforts to raise additional capital. However, if, in the future, the Company needs to increase its capital to fund additional growth or satisfy regulatory requirements, its ability to raise that additional capital will depend on conditions at that time in the capital markets, economic conditions, the Company's financial performance and condition, and other factors, many of which are outside its control. There is no assurance that the Company will be able to raise additional capital on terms favorable to it or at all. Any future inability to raise

additional capital on terms acceptable to the Company may have a material adverse effect on its ability to expand operations, and on its financial condition, results of operations and future prospects.

The Company relies on other companies to provide key components of the Company's business infrastructure.

Third parties provide key components of the Company's business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, Internet connections and network access. While the Company has selected these third party vendors carefully, it does not control their actions. Any problem caused by these third parties, including those resulting from disruptions in communication services provided by a vendor, failure of a vendor to handle current or higher volumes, failures of a vendor to provide services for any reason or poor performance of services, could adversely affect the Company's ability to deliver products and services to its customers and otherwise conduct its business. Financial or operational difficulties of a third party vendor could also hurt the Company's operations if those difficulties interface with the vendor's ability to serve the Company. Replacing these third party vendors could also create significant delay and expense. Accordingly, use of such third parties creates an unavoidable inherent risk to the Company's business operations.

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The Company's operations may be adversely affected by cyber security risks.

The Company relies heavily on communications and information systems to conduct business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in the Company's internet banking, deposit, loan, and other systems. While the Company has policies and procedures designed to prevent or limit the effect of such failure, interruption, or security breach of the Company's information systems, there can be no assurance that they will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failure, interruption or security breach of the Company's communications and information systems could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose the Company to civil litigation and possible financial liability. Additionally, the Company outsources its data processing to a third party. If the Company's third party provider encounters difficulties or if the Company has difficulty in communicating with such third party, it will significantly affect the Company's ability to adequately process and account for customer transactions, which would significantly affect its business operations.

In the ordinary course of business, the Company collects and stores sensitive data, including proprietary business information and personally identifiable information of its customers and employees in systems and on networks. The secure processing, maintenance and use of this information is critical to operations and the Company's business strategy. The Company has invested in accepted technologies, and annually reviews processes and practices that are designed to protect its networks, computers and data from damage or unauthorized access. Despite these security measures, the Company's computer systems and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged or disclosed. A breach in security could result in legal claims, regulatory penalties, disruption in operations, and damage to the Company's reputation, which could adversely affect the Company's business.

Consumers may increasingly decide not to use the Bank to complete their financial transactions, which would have a material adverse impact on the Company's financial condition and operations.

Technology and other changes are allowing parties to complete financial transactions through alternative methods that historically have involved banks. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts, mutual funds or general-purpose reloadable prepaid cards. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost of deposits as a source of funds could have a material adverse effect on the Company's financial condition and results of operations.

The Company is subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to the performance of the Company's fiduciary responsibilities. Whether customer claims and legal action related to the performance of the Company's fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Company, they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services, as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on the Company's financial condition and results of operations.

### Risks Related to the Company's Common Stock

While the Company's common stock is currently traded on the NASDAQ Global Select Market, it has less liquidity than stocks for larger companies quoted on a national securities exchange.

The trading volume in the Company's common stock on the NASDAQ Global Select Market has been relatively low when compared with larger companies listed on the NASDAQ Global Select Market or other stock exchanges. There is no assurance that a more active and liquid trading market for the common stock will exist in the future.

Consequently, shareholders may not be able to sell a substantial number of shares for the same price at which shareholders could sell a smaller number of shares. In addition, we cannot predict the effect, if any, that future sales of the Company's common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of the common stock.

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Future issuances of the Company's common stock could adversely affect the market price of the common stock and could be dilutive.

The Company is not restricted from issuing additional shares of common stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, shares of common stock. Issuances of a substantial number of shares of common stock, or the expectation that such issuances might occur, including in connection with acquisitions by the Company, could materially adversely affect the market price of the shares of the common stock and could be dilutive to shareholders. Because the Company's decision to issue common stock in the future will depend on market conditions and other factors, it cannot predict or estimate the amount, timing or nature of possible future issuances of its common stock. Accordingly, the Company's shareholders bear the risk that future issuances will reduce the market price of the common stock and dilute their stock holdings in the Company.

The primary source of the Company's income from which it pays cash dividends is the receipt of dividends from its subsidiary bank.

The availability of dividends from the Company is limited by various statutes and regulations. It is possible, depending upon the financial condition of the Bank and other factors, that the OCC could assert that payment of dividends or other payments is an unsafe or unsound practice. In the event the Bank was unable to pay dividends to the Company, or be limited in the payment of such dividends, the Company would likely have to reduce or stop paying common stock dividends. The Company's reduction, limitation or failure to pay such dividends on its common stock could have a material adverse effect on the market price of the common stock.

The Company's governing documents and Virginia law contain anti-takeover provisions that could negatively impact its shareholders.

The Company's Articles of Incorporation and Bylaws and the Virginia Stock Corporation Act contain certain provisions designed to enhance the ability of the Company's Board of Directors to deal with attempts to acquire control of the Company. These provisions and the ability to set the voting rights, preferences and other terms of any series of preferred stock that may be issued, may be deemed to have an anti-takeover effect and may discourage takeovers (which certain shareholders may deem to be in their best interest). To the extent that such takeover attempts are discouraged, temporary fluctuations in the market price of the Company's common stock resulting from actual or rumored takeover attempts may be inhibited. These provisions also could discourage or make more difficult a merger, tender offer, or proxy contest, even though such transactions may be favorable to the interests of shareholders, and could potentially adversely affect the market price of the Company's common stock.

ITEM 2 – PROPERTIES

As of December 31, 2013, the Company maintained twenty-five banking offices. The Company's Virginia banking offices are located in the cities of Danville, Martinsville and Lynchburg, and in the counties of Bedford, Campbell, Halifax, Henry, Nelson and Pittsylvania. In North Carolina, the Company's banking offices are located in the cities of Burlington, Greensboro, Mebane and Graham and in the counties of Alamance, Caswell, and Guilford. The Company also operates two loan production offices.

The principal executive offices of the Company are located at 628 Main Street in the business district of Danville, Virginia. This building, owned by the Company, was originally constructed in 1973 and has three floors totaling approximately 27,000 square feet.

The Company owns a building located at 103 Tower Drive in Danville, Virginia. This three-story facility serves as an operations center for data processing and deposit operations.

The Company has an office at 445 Mount Cross Road in Danville, Virginia where it consolidated two banking offices in January 2009 and gained additional administrative space.

The Company has an office at 3101 South Church Street in Burlington, North Carolina. This building serves as the head office for our North Carolina operations.

The Company owns thirteen other offices for a total of seventeen owned buildings. There are no mortgages or liens against any of the properties owned by the Company. The Company operates thirty-one Automated Teller Machines ("ATMs") on owned or leased facilities. The Company leases eight office locations and two storage warehouses. The Company occupies space rent-free for its two limited service offices in Burlington located in the Alamance Regional Medical Center and in the Village of Brookwood Retirement Center under agreements with the owners of those facilities.

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ITEM 3 – LEGAL PROCEEDINGS

In the ordinary course of operations, the Company and the Bank are parties to various legal proceedings.

ITEM 4 – MINE SAFETY DISCLOSURES

None.

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## PART II

## ITEM 5 – MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common stock is traded on the NASDAQ Global Select Market under the symbol "AMNB." At December 31, 2013, the Company had 2,201 shareholders of record. The following table presents the high and low sales prices for the Company's common stock and dividends declared for the past two years.

| <u>2013</u> | Sales Price |         | Dividends             |
|-------------|-------------|---------|-----------------------|
|             | High        | Low     | Declared<br>Per Share |
| 1st quarter | \$22.00     | \$19.57 | \$ 0.23               |
| 2nd quarter | 23.46       | 19.60   | 0.23                  |
| 3rd quarter | 25.90       | 20.77   | 0.23                  |
| 4th quarter | 27.74       | 21.16   | 0.23                  |
|             |             |         | \$ 0.92               |

| <u>2012</u> | Sales Price |         | Dividends             |
|-------------|-------------|---------|-----------------------|
|             | High        | Low     | Declared<br>Per Share |
| 1st quarter | \$22.19     | \$18.54 | \$ 0.23               |
| 2nd quarter | 24.00       | 20.91   | 0.23                  |
| 3rd quarter | 23.99       | 21.60   | 0.23                  |
| 4th quarter | 22.81       | 18.50   | 0.23                  |
|             |             |         | \$ 0.92               |

## Stock Compensation Plans

The Company maintains the 2008 Stock Incentive Plan ("2008 Plan"), which is designed to attract and retain qualified personnel in key positions, provide employees with an equity interest in the Company as an incentive to contribute to the success of the Company, and reward employees for outstanding performance and the attainment of targeted goals. The 2008 Plan and stock compensation in general is discussed in note 13 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K..

The December 31, 2013 position of the Company's equity investment compensation plan is summarized below:

| December 31, 2013   |  |  |
|---|--|--|
| Number<br>of<br>Shares<br>to be<br>Issued<br>Upon<br>Exercise | Weighted-Average<br>Per Share Exercise<br>Price of<br>Outstanding<br>Options | Number of<br>Shares<br>Remaining<br>Available<br>for Future<br>Issuance<br>Under |

|  | of<br>Outstanding<br>Options |          |         |
|--|------------------------------|----------|---------|
| Equity compensation plans approved by shareholders     | 207,247                      | \$ 24.65 | 324,541 |
| Equity compensation plans not approved by shareholders | -                            | -        | -       |
| Total  | 207,247                      | \$ 24.65 | 324,541 |

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## Comparative Stock Performance

The following graph compares the Company's cumulative total return to its shareholders with the returns of two indexes for the five-year period ended December 31, 2013. The cumulative total return was calculated taking into consideration changes in stock price, cash dividends, stock dividends, and stock splits since December 31, 2008. The indexes are the NASDAQ Composite Index; the SNL Bank \$ 1 Billion - \$5 Billion Index, which includes bank holding companies with assets of \$1 billion to \$5 billion and is published by SNL Financial, LC.

## American National Bankshares Inc.

| Index                             | Period Ending |           |           |           |           |           |
|-----------------------------------|---------------|-----------|-----------|-----------|-----------|-----------|
|                                   | 12/31/08      | 12/31/09  | 12/31/10  | 12/31/11  | 12/31/12  | 12/31/13  |
| American National Bankshares Inc. | \$ 100.00     | \$ 135.39 | \$ 152.12 | \$ 132.09 | \$ 142.85 | \$ 193.53 |
| NASDAQ Composite                  | 100.00        | 145.36    | 171.74    | 170.38    | 200.63    | 281.22    |
| SNL Bank \$1B-\$5B                | 100.00        | 71.68     | 81.25     | 74.10     | 91.37     | 132.87    |

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## ITEM 6 - SELECTED FINANCIAL DATA

The following table sets forth selected financial data for the Company for the last five years:

(Amounts in thousands, except per share information and ratios)

|  | December 31, |             |             |           |           |   |
|--|--------------|-------------|-------------|-----------|-----------|---|
|  | 2013         | 2012        | 2011        | 2010      | 2009      |   |
| <b>Results of Operations:</b>                |              |             |             |           |           |   |
| Interest income                              | \$52,956     | \$57,806    | \$49,187    | \$35,933  | \$38,061  |   |
| Interest expense                             | 6,583        | 8,141       | 8,780       | 8,719     | 10,789    |   |
| Net interest income                          | 46,373       | 49,665      | 40,407      | 27,214    | 27,272    |   |
| Provision for loan losses                    | 294          | 2,133       | 3,170       | 1,490     | 1,662     |   |
| Noninterest income                           | 10,827       | 11,410      | 9,244       | 9,114     | 8,518     |   |
| Noninterest expense                          | 35,105       | 36,643      | 30,000      | 23,379    | 24,793    |   |
| Income before income tax provision           | 21,801       | 22,299      | 16,481      | 11,459    | 9,335     |   |
| Income tax provision                         | 6,054        | 6,293       | 4,910       | 3,181     | 2,525     |   |
| Net income                                   | \$15,747     | \$16,006    | \$11,571    | \$8,278   | \$6,810   |   |
| <b>Financial Condition:</b>                  |              |             |             |           |           |   |
| Assets                                       | \$1,307,512  | \$1,283,687 | \$1,304,706 | \$833,664 | \$808,973 |   |
| Loans, net of unearned income                | 794,671      | 788,705     | 824,758     | 520,781   | 527,991   |   |
| Securities                                   | 351,013      | 340,533     | 339,385     | 235,691   | 199,686   |   |
| Deposits                                     | 1,057,675    | 1,027,667   | 1,058,754   | 640,098   | 604,273   |   |
| Shareholders' equity                         | 167,551      | 163,246     | 152,829     | 108,087   | 106,389   |   |
| Shareholders' equity, tangible               | 125,349      | 119,543     | 107,335     | 84,299    | 82,223    |   |
| <b>Per Share Information:</b>                |              |             |             |           |           |   |
| Earnings per share, basic                    | \$2.00       | \$2.04      | \$1.64      | \$1.35    | \$1.12    |   |
| Earnings per share, diluted                  | 2.00         | 2.04        | 1.64        | 1.35      | 1.12      |   |
| Cash dividends paid                          | 0.92         | 0.92        | 0.92        | 0.92      | 0.92      |   |
| Book value                                   | 21.23        | 20.80       | 19.58       | 17.64     | 17.41     |   |
| Book value, tangible                         | 15.89        | 15.23       | 13.75       | 13.76     | 13.46     |   |
| Weighted average shares outstanding, basic   | 7,872,870    | 7,834,351   | 6,982,524   | 6,123,870 | 6,097,810 |   |
| Weighted average shares outstanding, diluted | 7,884,561    | 7,845,652   | 6,989,877   | 6,131,650 | 6,102,895 |   |
| <b>Selected Ratios:</b>                      |              |             |             |           |           |   |
| Return on average assets                     | 1.20         | % 1.23      | % 1.07      | % 1.00    | % 0.84    | % |
| Return on average equity (1)                 | 9.52         | % 10.08     | % 8.88      | % 7.59    | % 6.57    | % |
| Return on average tangible equity (2)        | 13.75        | % 15.25     | % 12.97     | % 10.05   | % 8.94    | % |
| Dividend payout ratio                        | 46.03        | % 45.06     | % 55.50     | % 68.08   | % 82.40   | % |
| Efficiency ratio (3)                         | 57.57        | % 58.23     | % 58.48     | % 61.53   | % 63.46   | % |
| Net interest margin                          | 4.10         | % 4.44      | % 4.35      | % 3.78    | % 3.81    | % |
| <b>Asset Quality Ratios:</b>                 |              |             |             |           |           |   |
|  | 1.59         | % 1.54      | % 1.28      | % 1.62    | % 1.55    | % |

Allowance for loan losses to period end loans

Allowance for loan losses to period end

|                                       |        |    |        |   |       |   |        |   |        |   |
|---------------------------------------|--------|----|--------|---|-------|---|--------|---|--------|---|
| non-performing loans                  | 248.47 | %  | 227.95 | % | 76.76 | % | 324.22 | % | 224.22 | % |
| Non-performing assets to total assets | 0.65   | %  | 0.90   | % | 1.46  | % | 0.76   | % | 0.87   | % |
| Net charge-offs to average loans      | (0.02  | )% | 0.07   | % | 0.16  | % | 0.24   | % | 0.24   | % |

Capital Ratios:

|  |       |   |       |   |       |   |       |   |       |   |
|--|-------|---|-------|---|-------|---|-------|---|-------|---|
| Total risk-based capital ratio               | 18.14 | % | 17.00 | % | 15.55 | % | 19.64 | % | 18.82 | % |
| Tier 1 risk-based capital ratio              | 16.88 | % | 15.75 | % | 14.36 | % | 18.38 | % | 17.56 | % |
| Tier 1 leverage ratio                        | 11.81 | % | 11.27 | % | 10.32 | % | 12.74 | % | 12.81 | % |
| Tangible equity to tangible assets ratio (4) | 9.91  | % | 9.64  | % | 8.52  | % | 10.41 | % | 10.48 | % |

(1) Return on average common equity is calculated by dividing net income available to common shareholders by average common equity.

(2) Return on average tangible common equity is calculated by dividing net income available to common shareholders plus amortization of intangibles tax effected by average common equity less average intangibles.

(3) The efficiency ratio is calculated by dividing noninterest expense excluding gains or losses on the sale of OREO by net interest income including tax equivalent income on nontaxable loans and securities and excluding (a) gains or losses on securities and (b) gains or losses on sale of premises and equipment.

(4) Tangible equity to tangible assets ratio is calculated by dividing period-end common equity less period-end intangibles by period-end assets less period-end intangibles.

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ITEM 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on significant changes in the financial condition and results of operations of the Company during the past three years. The discussion and analysis are intended to supplement and highlight information contained in the accompanying Consolidated Financial Statements and the selected financial data presented elsewhere in this Annual Report on Form 10-K.

RECLASSIFICATION

In certain circumstances, reclassifications have been made to prior period information to conform to the 2013 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.

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 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, and 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.

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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);
- 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 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 analyses 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 the Financial Accounting Standards Board ("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.



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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, 2013, 2012 and 2011.

NON-GAAP PRESENTATIONS

The analysis of net interest income in this document is performed on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets.

ACQUISITION OF MIDCAROLINA FINANCIAL CORPORATION

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. 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. Details of the transaction are discussed in note 2 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K.

MANAGEMENT INFORMATION SYSTEM CHANGES

Coincidentally with the merger with MidCarolina, the Company converted its management information systems from an in-house data processing system to an outsourced processing strategy. Both banks' management information systems were fully integrated and converted to Jack Henry & Associates Silverlake processing system in mid-February 2012.

RESULTS OF OPERATIONS

Net Income

Net income available to common shareholders for 2013 was \$15,747,000 compared to \$16,006,000 for 2012, a decrease of \$259,000 or 1.6%. Basic and diluted earnings per share were \$2.00 for 2013 compared to \$2.04 for the 2012. This net income produced for 2013 a return on average assets of 1.20%, a return on average equity of 9.52%, and a return on average tangible equity of 13.75%.

Net income available to common shareholders for 2012 was \$16,006,000 compared to \$11,468,000 for 2011, an increase of \$4,538,000 or 39.6%. Basic and diluted earnings per share were \$2.04 for 2012 compared to \$1.64 for the 2011. This net income produced for 2012 a return on average assets of 1.23%, a return on average equity of 10.08%, and a return on average tangible equity of 15.25%.

Earnings for 2013, 2012, and the second half of 2011 were favorably impacted by the July 2011 merger between American National and MidCarolina Financial Corporation.

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. 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 July 2011 merger with MidCarolina has impacted net interest income positively for 2012 and 2013. This is discussed more fully in the Fair Value Impact to Net Income. The Company expects this favorable impact to decline rapidly over the next several years.

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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. All references in this section relate to average yields and rates and average asset and liability balances during the periods discussed.

Net interest income on a taxable equivalent basis decreased \$3,357,000 or 6.5% in 2013 from 2012, following a \$9,577,000 or 22.6% increase in 2012 from 2011. The decrease in net interest income in 2013 was primarily due to changes in interest rates and lower accretion income related to the MidCarolina acquired loan portfolio. Yields on loans were 5.65% in 2013 compared to 6.06% in 2012. Costs of funds were lower in 2013 compared to 2012, especially with respect to time deposits, which were 1.22% for 2013 compared to 1.36% for 2012. Deposit rates for demand account decreased to 0.07% in 2013 from 0.13% in 2012 and money market accounts decreased to 0.19% in 2013 from 0.30% in 2012. Management regularly reviews deposit pricing and attempts to keep costs as low as possible, while remaining competitive. The net interest margin was 4.10% for 2013, 4.44% for 2012, and 4.35% for 2011.

During 2008, the Federal Open Market Committee of the FRB reduced the federal funds rate seven times from 4.25% to 0.25%, where it has remained through 2013 and into early 2014. This historically low rate environment has had a significant effect on the Company's net interest margin. Based on recent FRB pronouncements, rates are expected to remain at or near historical lows for the foreseeable future. However, the recent beginning of reductions in the Federal Reserve's policy of quantitative easing may result in upper pressure on some market interest rates.

Net interest income on a taxable equivalent basis increased \$9,577,000 or 22.6% in 2012 from 2011, following a \$13,899,000 or 48.7% increase in 2011 from 2010. The increase in net interest income in 2012 was primarily due to the July 2011 merger with MidCarolina, driven mostly by accretion income related to the acquired loan portfolio. Yields on loans were 6.06% in 2012 compared to 6.05% in 2011. Costs of funds were lower in 2012 compared to 2011, especially with respect to time deposits, which were 1.36% for 2012 compared to 1.63% for 2011. Deposit rates for demand account decreased to 0.13% in 2012 from 0.21% in 2011 and money market accounts decreased to 0.30% in 2012 from 0.43% in 2011. Management actively and regularly reviews deposit pricing and attempts to keep costs as low as possible. The net interest margin was 4.44% for 2012, 4.35% for 2011, and 3.78% for 2010.

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The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the last three years. 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.

## Net Interest Income Analysis

(in thousands, except yields and rates)

|                                    | Average Balance |             |             | Interest Income/Expense |         |         | Average Yield/Rate |       |       |
|------------------------------------|-----------------|-------------|-------------|-------------------------|---------|---------|--------------------|-------|-------|
|                                    | 2013            | 2012        | 2011        | 2013                    | 2012    | 2011    | 2013               | 2012  | 2011  |
| <b>Loans:</b>                      |                 |             |             |                         |         |         |                    |       |       |
| Commercial                         | \$125,283       | \$128,031   | \$107,376   | \$6,082                 | \$6,642 | \$4,947 | 4.85%              | 5.19% | 4.61% |
| Real estate                        | 663,224         | 677,314     | 559,656     | 38,425                  | 42,088  | 35,298  | 5.79               | 6.21  | 6.31  |
| Consumer                           | 5,847           | 8,359       | 7,734       | 403                     | 605     | 575     | 6.89               | 7.24  | 7.43  |
| Total loans                        | 794,354         | 813,704     | 674,766     | 44,910                  | 49,335  | 40,820  | 5.65               | 6.06  | 6.05  |
| <b>Securities:</b>                 |                 |             |             |                         |         |         |                    |       |       |
| Federal agencies and GSEs          | 55,435          | 36,066      | 36,247      | 532                     | 545     | 946     | 0.96               | 1.51  | 2.61  |
| Mortgage-backed and CMOs           | 74,909          | 94,183      | 75,902      | 1,442                   | 1,906   | 2,148   | 1.93               | 2.02  | 2.83  |
| State and municipal                | 193,254         | 182,939     | 151,254     | 7,750                   | 7,829   | 6,872   | 4.01               | 4.28  | 4.54  |
| Other                              | 15,007          | 11,654      | 7,038       | 430                     | 435     | 279     | 2.87               | 3.73  | 3.96  |
| Total securities                   | 338,605         | 324,842     | 270,441     | 10,154                  | 10,715  | 10,245  | 3.00               | 3.30  | 3.79  |
| Deposits in other banks            | 53,857          | 32,080      | 29,394      | 151                     | 80      | 127     | 0.28               | 0.25  | 0.43  |
| Total interest earning assets      | 1,186,816       | 1,170,626   | 974,601     | 55,215                  | 60,130  | 51,192  | 4.65               | 5.14  | 5.25  |
| Nonearning assets                  | 120,338         | 132,455     | 102,493     |                         |         |         |                    |       |       |
| Total assets                       | \$1,307,154     | \$1,303,081 | \$1,077,094 |                         |         |         |                    |       |       |
| <b>Deposits:</b>                   |                 |             |             |                         |         |         |                    |       |       |
| Demand                             | \$161,602       | \$142,296   | \$137,211   | 111                     | 190     | 290     | 0.07               | 0.13  | 0.21  |
| Money market                       | 178,235         | 174,027     | 132,906     | 338                     | 521     | 572     | 0.19               | 0.30  | 0.43  |
| Savings                            | 84,162          | 78,358      | 68,038      | 71                      | 111     | 98      | 0.08               | 0.14  | 0.14  |
| Time                               | 405,213         | 443,549     | 382,008     | 4,940                   | 6,021   | 6,243   | 1.22               | 1.36  | 1.63  |
| Total deposits                     | 829,212         | 838,230     | 720,163     | 5,460                   | 6,843   | 7,203   | 0.66               | 0.82  | 1.00  |
| Customer repurchase agreements     | 47,816          | 46,939      | 46,411      | 40                      | 148     | 325     | 0.08               | 0.32  | 0.70  |
| Other short-term borrowings        | 1               | 496         | 66          | -                       | 2       | -       | 0.40               | 0.42  | 0.45  |
| Long-term borrowings               | 37,437          | 37,415      | 30,991      | 1,083                   | 1,148   | 1,252   | 2.89               | 3.07  | 4.04  |
| Total interest bearing liabilities | 914,466         | 923,080     | 797,631     | 6,583                   | 8,141   | 8,780   | 0.72               | 0.88  | 1.10  |

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|  |             |             |             |
|--|-------------|-------------|-------------|
| Noninterest bearing demand deposits        | 220,980     | 213,129     | 143,204     |
| Other liabilities                          | 6,370       | 8,025       | 5,939       |
| Shareholders' equity                       | 165,338     | 158,847     | 130,320     |
| Total liabilities and shareholders' equity | \$1,307,154 | \$1,303,081 | \$1,077,094 |

|                      |  |       |       |       |
|----------------------|--|-------|-------|-------|
| Interest rate spread |  | 3.93% | 4.26% | 4.15% |
| Net interest margin  |  | 4.10% | 4.44% | 4.35% |

|  |          |          |          |
|--|----------|----------|----------|
| Net interest income (taxable equivalent basis) | 48,632   | 51,989   | 42,412   |
| Less: Taxable equivalent adjustment            | 2,259    | 2,324    | 2,005    |
| Net interest income                            | \$46,373 | \$49,665 | \$40,407 |

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The following table presents the dollar amount of changes in interest income and interest expense, and distinguishes between changes resulting from fluctuations in average balances of interest earning assets and interest bearing liabilities (volume), and changes resulting from fluctuations in average interest rates on such assets and liabilities (rate). Changes attributable to both volume and rate have been allocated proportionately.

Changes in Net Interest Income (Rate / Volume Analysis)  
(in thousands)

|                                | 2013 vs. 2012 |                 |          | 2012 vs. 2011 |                 |         |
|--------------------------------|---------------|-----------------|----------|---------------|-----------------|---------|
|                                | Change        |                 |          | Change        |                 |         |
|                                | Increase      | Attributable to |          | Increase      | Attributable to |         |
|                                | (Decrease)    | Rate            | Volume   | (Decrease)    | Rate            | Volume  |
| Interest income                |               |                 |          |               |                 |         |
| Loans:                         |               |                 |          |               |                 |         |
| Commercial                     | \$(560 )      | \$(420 )        | \$(140 ) | \$1,695       | \$671           | \$1,024 |
| Real estate                    | (3,663)       | (2,801)         | (862 )   | 6,790         | (528 )          | 7,318   |
| Consumer                       | (202 )        | (28 )           | (174 )   | 30            | (16 )           | 46      |
| Total loans                    | (4,425)       | (3,249)         | (1,176)  | 8,515         | 127             | 8,388   |
| Securities:                    |               |                 |          |               |                 |         |
| Federal agencies and GSEs      | (13 )         | (242 )          | 229      | (401 )        | (396 )          | (5 )    |
| Mortgage-backed and CMOs       | (464 )        | (89 )           | (375 )   | (242 )        | (692 )          | 450     |
| State and municipal            | (79 )         | (507 )          | 428      | 957           | (417 )          | 1,374   |
| Other securities               | (5 )          | (114 )          | 109      | 156           | (17 )           | 173     |
| Total securities               | (561 )        | (952 )          | 391      | 470           | (1,522)         | 1,992   |
| Deposits in other banks        | 71            | 11              | 60       | (47 )         | (58 )           | 11      |
| Total interest income          | (4,915)       | (4,190)         | (725 )   | 8,938         | (1,453)         | 10,391  |
| Interest expense               |               |                 |          |               |                 |         |
| Deposits:                      |               |                 |          |               |                 |         |
| Demand                         | (79 )         | (102 )          | 23       | (100 )        | (110 )          | 10      |
| Money market                   | (183 )        | (195 )          | 12       | (51 )         | (201 )          | 150     |
| Savings                        | (40 )         | (48 )           | 8        | 13            | (2 )            | 15      |
| Time                           | (1,081)       | (585 )          | (496 )   | (222 )        | (1,145)         | 923     |
| Total deposits                 | (1,383)       | (930 )          | (453 )   | (360 )        | (1,458)         | 1,098   |
| Customer repurchase agreements | (108 )        | (111 )          | 3        | (177 )        | (181 )          | 4       |
| Other borrowings               | (67 )         | (53 )           | (14 )    | (102 )        | (346 )          | 244     |
| Total interest expense         | (1,558)       | (1,094)         | (464 )   | (639 )        | (1,985)         | 1,346   |
| Net interest income            | \$(3,357)     | \$(3,096)       | \$(261 ) | \$9,577       | \$532           | \$9,045 |

## Noninterest Income

Noninterest income is generated from a variety of sources, including fee-based deposit services, trust and investment services, mortgage banking, and retail brokerage. Noninterest income also includes net gains or losses on sales, calls, or impairment of investment securities.

## 2013 compared to 2012

Noninterest income was \$10,827,000 in 2013 compared to \$11,410,000 in 2012, a decrease of \$583,000 or 5.1%.

Fees from the management of trusts, estates, and asset management accounts were \$3,689,000 in 2013 compared to \$3,703,000 in 2012, a \$14,000 or 0.4% decrease. This decrease was primarily the result of a \$330,000 refund, paid in the first quarter of 2013, related to an error in a trust agreement going back two decades. This error was detected during a review and has been resolved and recorded as a reduction in trust income. The facts and circumstances of this trust relationship are unique. A substantial portion of trust fees are earned based on account market values, so changes in the equity markets may have a large impact on income.

Service charges on deposit accounts were \$1,750,000 in 2013 compared to \$1,757,000 in 2012, a \$7,000 or 0.4% decrease.

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Other fees and commissions were \$1,864,000 in 2013 compared to \$1,768,000 in 2012, a \$96,000 or 5.4% increase, due primarily to increases in VISA check card income.

Mortgage banking income was \$2,008,000 in 2013 compared to \$2,234,000 in 2012, a \$226,000 or 10.1% decrease. Recent increases in mortgage interest rates have slowed demand on mortgage loan refinancing and have, accordingly, reduced volume and income. Secondary market mortgage loan volume for the year was \$79,000,000 compared to over \$100,000,000 the prior year.

Securities gains were \$192,000 in 2013 compared to \$158,000 in 2012.

Other noninterest income was \$1,324,000 in 2013 compared to \$1,790,000 in 2012, a \$466,000 or 26.0% decrease. This decrease was primarily due a gain of \$495,000 realized in 2012 from the sale of the Riverside branch office property that had been closed since 2009.

2012 compared to 2011

Noninterest income was \$11,410,000 in 2012 compared to \$9,244,000 in 2011, an increase of \$2,166,000 or 23.4%.

Fees from the management of trusts, estates, and asset management accounts were \$3,703,000 in 2012 compared to \$3,561,000 in 2011, a \$142,000 or 4.0% increase. A substantial portion of trust fees are earned based on account market values, so changes in the equity markets may have a large and potentially volatile impact on revenue.

Service charges on deposit accounts were \$1,757,000 in 2012 compared to \$1,963,000 in 2011, a \$206,000 or 10.5% decrease. The almost contemporaneous nature of the MidCaolina merger, in July 2011, and the management information system conversion, in February 2012, resulted in some operational decisions that had a short term negative impact on service charge income.

Other fees and commissions were \$1,768,000 in 2012 compared to \$1,510,000 in 2011, a \$258,000 or 17.1% increase, due primarily to increases in VISA check card income.

Mortgage banking income was \$2,234,000 in 2012 compared to \$1,262,000 in 2011, a \$972,000 or 77.0% increase. Historically low mortgage interest rates in 2012 impacted the demand for refinanced mortgages from credit qualified borrowers. Volume during the year exceeded \$100,000,000.

Securities gains were \$158,000 in 2012 compared to a loss of \$1,000 in 2011.

Other noninterest income was \$1,790,000 in 2012 compared to \$949,000 in 2011, an \$841,000 or 88.6% increase. This increase was primarily due to the sale of the Riverside branch office property that closed in 2009. This transaction generated a net gain on sale of \$495,000 for 2012. In addition, brokerage income was up \$157,000 in 2012 over 2011.

Noninterest Expense

2013 compared to 2012

Noninterest expense was \$35,105,000 in 2013 compared to \$36,643,000 in 2012, a decrease of \$1,538,000 or 4.2%.

Salaries were \$14,059,000 in 2013 compared to \$15,785,000 in 2012, a decrease of \$1,726,000 or 10.9%. Employee benefits were \$3,848,000 in 2013 compared to \$3,604,000 in 2012, an increase of \$244,000 or 6.8%. Total full time



equivalent employees were 290 at the end of 2013 compared to 307 at the end of 2012.

Occupancy and equipment expense were \$3,614,000 for 2013 compared to \$3,951,000 for 2012, a decrease of \$337,000 or 8.5%.

FDIC insurance assessment was \$647,000 in 2013 compared to \$692,000 in 2012, a decrease of \$45,000 or 6.5%.

Bank franchise tax was \$745,000 in 2013 compared to \$690,000 in 2012, an increase of \$55,000 or 8.0%.

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Core deposit intangible amortization was \$1,501,000 in 2013 compared to \$1,935,000 in 2012, a decrease of \$434,000 or 22.4%.

Data processing expense was \$1,248,000 in 2013 compared to \$512,000 in 2012, an increase of \$736,000. The Company converted its management information systems from an in-house system to an outsourced processing system in the first quarter 2012. The first year monthly processing costs were heavily discounted.

Software expense was \$923,000 in 2013 compared to \$1,028,000 in 2012, a decrease of \$105,000 or 10.2%.

Foreclosed real estate, or what the Company refers to as Other Real Estate Owned, ("OREO") expense includes gains and losses on sale of foreclosed properties, adjustments related re-appraisals of foreclosed properties and operating expenses related to maintaining foreclosed properties. Total OREO related expense for 2013 and 2012 are shown in the following table:

|                            | 2013    | 2012    |
|----------------------------|---------|---------|
| (Gain) on sale of OREO     | \$(85 ) | \$(388) |
| OREO valuation adjustments | 1,070   | 502     |
| OREO related expense       | 538     | 414     |
|                            | \$1,523 | \$528   |

Merger related expenses associated with the acquisition of MidCarolina were zero in 2013 compared to \$19,000 in 2012.

Other noninterest expense was \$6,997,000 in 2013 compared to \$7,899,000 in 2012, a decrease of \$902,000 or 11.4%. Expenses in 2012 were negatively impacted by the combination of the MidCarolina merger in mid-2011 and the management information system conversion in early 2012.

2012 compared to 2011

Noninterest expense was \$36,643,000 in 2012 compared to \$30,000,000 in 2011, an increase of \$6,643,000 or 22.1%.

Salaries were \$15,785,000 in 2012 compared to \$12,409,000 in 2011, an increase of \$3,376,000 or 27.2%. Employee benefits were \$3,604,000 in 2012 compared to \$2,681,000 in 2011, an increase of \$923,000 or 34.4%. The biggest driver in these increases was the MidCarolina merger, which impacted 2012 for a full year and 2011 for the second half of the year. Total full time equivalent employees were 242 at the end of 2010, 315 at the end of 2011, and 307 at the end of 2012.

Occupancy and equipment expense were \$3,951,000 for 2012 compared to \$3,199,000 for 2011, an increase of \$752,000 or 23.5%. The MidCarolina merger resulted in an additional \$376,000 in depreciation expense and an additional \$106,000 in lease expense.

FDIC insurance assessment was \$692,000 in 2012 compared to \$651,000 in 2011, an increase of \$41,000 or 6.3%.

Bank franchise tax was \$690,000 in 2012 compared to \$763,000 in 2011, a decrease of \$73,000 or 9.6%. The decrease was related to a larger portion of the Bank's assets being in a lower franchise tax jurisdiction.

Core deposit intangible amortization was \$1,935,000 in 2012 compared to \$1,282,000 in 2011, an increase of \$653,000 or 50.9%.

Data processing expense was \$512,000 in 2012. The Company converted its management information systems from an in-house system to an outsourced processing system in the first quarter 2012.

Software expense was \$1,028,000 in 2012 compared to \$855,000 in 2011, an increase of \$173,000 or 20.2%. This increase was primarily due to upgrades to our data processing infrastructure.

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Total OREO related expense for the past 2012 and 2011 is shown in the following table:

|                            | 2012    | 2011    |
|----------------------------|---------|---------|
| (Gain) on sale of OREO     | \$(388) | \$(574) |
| OREO valuation adjustments | 502     | 453     |
| OREO related expense       | 414     | 417     |
|                            | \$528   | \$296   |

During 2012 and 2011, several major acquired impaired loans were transferred to OREO and subsequently sold. These relationships involved a significant amount of related legal and other expense during the complex and lengthy credit remediation and resolution process.

Merger related expenses associated with the acquisition of MidCarolina totaled \$19,000 in 2012 compared to \$1,607,000 in 2011, a decrease of \$1,588,000 as virtually all merger related expenses were incurred in 2011.

Other noninterest expense was \$7,899,000 in 2012 compared to \$6,257,000 in 2011, an increase of \$1,642,000 or 11.4%. The MidCarolina merger resulted in an overall increase in operating expenses. The largest drivers during 2012 included advertising, increased \$205,000; consultant fees, increased \$269,000; legal expenses, increased \$226,000; loan related expenses, increased \$405,000. The increase in consultant fees was mostly related to management of the investment portfolio. The increase in legal expense was almost entirely related to the resolution of a number of problem credits.

#### Income Taxes

Income taxes on 2013 earnings amounted to \$6,054,000, resulting in an effective tax rate of 27.8%, compared to 28.2% in 2012 and 29.8% in 2011. The major difference between the statutory rate and the effective rate results from income that is not taxable for federal income tax purposes. The primary non-taxable income is that of state and municipal securities and industrial revenue bonds or loans.

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## Fair Value Impact to Net Income

The July 2011 merger with MidCarolina has had a material and positive impact on earnings. The following tables present the actual effect of the accretable and amortizable fair value adjustments attributable to the merger on net interest income and pretax income for the years ended December 31, 2013 and 2012.

| (in thousands)                                | Income Statement Effect | Premium/<br>(Discount)<br>Balance on<br>December<br>31, 2012 | December 31, 2013        |  |
|---|-------------------------|--|--------------------------|--|
|   |                         |  | For the<br>year<br>ended | Remaining<br>Premium/<br>(Discount)<br>Balance |
| Interest income/(expense):                    |                         |  |                          |  |
| Loans   | Income                  | \$ (9,631 )  | \$ 4,601                 | \$ (5,010 ) (1)                                |
| Accretable portion of acquired impaired loans | Income                  | (2,165 )   | 2,635                    | (2,046 ) (2)                                   |
| Time deposits - brokered                      | Income                  | (278 )   | 278                      | -  |
| FHLB advances                                 | Expense                 | 109  | (22 )                    | 87   |
| Trust preferred securities                    | Expense                 | 2,066  | (102 )                   | 1,964  |
| Net Interest Income                           |                         |  | 7,390                    |  |
| Non-interest (expense)                        |                         |  |                          |  |
| Amortization of core deposit intangible       | Expense                 | \$ 4,094   | (1,125 )                 | \$ 2,969                                       |
| Net non-interest expense                      |                         |  | (1,125 )                 |  |
| Change in pretax income                       |                         |  | \$ 6,265                 |  |

(1) - Remaining discount balance includes \$9,000 of mark moved to OREO and \$11,000 of charge-offs against the mark.

(2) - Remaining discount balance includes \$2,516,000 in reclassifications from the non-accretable difference.

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| (in thousands)                                | Income<br>Statement<br>Effect | December 31, 2012  |                          |  |
|---|-------------------------------|--|--------------------------|--|
|   |                               | Premium/<br>(Discount)<br>Balance on<br>December<br>31, 2011 | For the<br>Year<br>ended | Remaining<br>Premium/<br>(Discount)<br>Balance |
| Interest income/(expense):                    |                               |  |                          |  |
| Loans   | Income                        | \$ (15,908 )   | \$ 6,098                 | \$ (9,631 ) (1)                                |
| Accretable portion of acquired impaired loans | Income                        | (1,056 )   | 2,616                    | (2,165 ) (2)                                   |
| Time deposits                                 | Income                        | (110 )   | 110                      | -  |
| Time deposits - brokered                      | Income                        | (694 )   | 416                      | (278 )   |
| FHLB advances                                 | Expense                       | 131  | (22 )                    | 109  |
| Trust preferred securities                    | Expense                       | 2,171  | (105 )                   | 2,066  |
| Net Interest Income                           |                               |  | 9,113                    |  |
| Non-interest (expense)                        |                               |  |                          |  |
| Amortization of core deposit intangible       | Expense                       | \$ 5,652   | (1,558 )                 | \$ 4,094                                       |
| Net non-interest expense                      |                               |  | (1,558 )                 |  |
| Change in pretax income                       |                               |  | \$ 7,555                 |  |

(1) - Remaining discount balance includes \$179,000 in charge-offs against the mark.

(2) - Remaining discount balance includes \$3,725,000 in reclassifications from the non-accretable difference.

### Impact of Inflation and Changing Prices

The majority of assets and liabilities of a financial institution are monetary in nature and therefore differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. The most significant effect of inflation is on noninterest expenses that tend to rise during periods of inflation. Changes in interest rates have a greater impact on a financial institution's profitability than do the effects of higher costs for goods and services. Through its balance sheet management practices, the Company has the ability to react to those changes and measure and monitor its interest rate and liquidity risk.

### Market Risk Management

Effectively managing market risk is essential to achieving the Company's financial objectives. Market risk reflects the risk of economic loss resulting from changes in interest rates and market prices. The Company is generally not subject to currency exchange risk or commodity price risk. The Company's primary market risk exposure is interest rate risk; however, market risk also includes liquidity risk. Both are discussed in the following sections.

### Interest Rate Risk Management

Interest rate risk and its impact on net interest income is a primary market risk exposure. The Company manages its exposure to fluctuations in interest rates through policies approved by its Asset Liability Committee ("ALCO") and Board of Directors, both of which receive and review periodic reports of the Company's interest rate risk position.

The Company uses computer simulation analysis to measure the sensitivity of projected earnings to changes in interest rates. Simulation takes into account current balance sheet volumes and the scheduled repricing dates, instrument level optionality, and maturities of assets and liabilities. It incorporates numerous assumptions including growth, changes in the mix of assets and liabilities, prepayments, and average rates earned and paid. Based on this information, management uses the model to project net interest income under multiple interest rate scenarios.

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A balance sheet is considered asset sensitive when its earning assets (loans and securities) reprice faster or to a greater extent than its liabilities (deposits and borrowings). An asset sensitive balance sheet will produce relatively more net interest income when interest rates rise and less net interest income when they decline. Based on the Company's simulation analysis, management believes the Company's interest sensitivity position at December 31, 2013 is asset sensitive. Management has no expectation that market interest rates will materially decline in the near term, given the prevailing economy and apparent FRB policy.

## Earnings Simulation

The table below shows the estimated impact of changes in interest rates on net interest income as of December 31, 2013, assuming gradual and parallel changes in interest rates, and consistent levels of assets and liabilities. Net interest income for the following twelve months is projected to increase when interest rates are higher than current rates. Due to the current low interest rate environment, no measurement was considered necessary for a further decline in interest rates.

Estimated Changes in Net Interest Income  
(dollars in thousands)

| Change in interest rates | December 31,<br>2013<br>Change in net<br>interest Income |         |
|--------------------------|--|---------|
|                          | Amount   | Percent |
| Up 4.0%                  | \$6,737  | 15.7 %  |
| Up 3.0%                  | 5,059  | 11.8    |
| Up 2.0%                  | 3,303  | 7.7     |
| Up 1.0%                  | 1,505  | 3.5     |

Management cannot predict future interest rates or their exact effect on net interest income. Computations of future effects of hypothetical interest rate changes are based on numerous assumptions and should not be relied upon as indicative of actual results. Certain limitations are inherent in such computations. Assets and liabilities may react differently than projected to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag changes in market interest rates. Interest rate shifts may not be parallel.

Changes in interest rates can cause substantial changes in the amount of prepayments of loans and mortgage-backed securities, which may in turn affect the Company's interest rate sensitivity position. Additionally, credit risk may rise if an interest rate increase adversely affects the ability of borrowers to service their debt.

## Economic Value Simulation

Economic value simulation is used to calculate the estimated fair value of assets and liabilities over different interest rate environments. Economic values are calculated based on discounted cash flow analysis. The net economic value of equity is the economic value of all assets minus the economic value of all liabilities. The change in net economic value over different rate environments is an indication of the longer-term earnings capability of the balance sheet. The same assumptions are used in the economic value simulation as in the earnings simulation. The economic value simulation uses instantaneous rate shocks to the balance sheet.



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The following chart reflects the estimated change in net economic value over different rate environments using economic value simulation for the balances at the period ended December 31, 2013 (dollars in thousands):

Estimated Changes in Economic Value of Equity  
(dollars in thousands)

| Change in interest rates | December 31, 2013 |           |          |
|--------------------------|-------------------|-----------|----------|
|                          | Amount            | \$ Change | % Change |
| Up 4%                    | \$223,454         | \$20,711  | 10.2 %   |
| Up 3%                    | 220,073           | 17,330    | 8.5 %    |
| Up 2%                    | 215,343           | 12,600    | 6.2 %    |
| Up 1%                    | 208,963           | 6,220     | 3.1 %    |
| Flat                     | 202,743           | -         | -        |

Due to the current low interest rate environment, no measurement was considered necessary for a further decline in interest rates.

### Liquidity Risk Management

Liquidity is the ability of the Company to convert assets into cash or cash equivalents without significant loss and to raise additional funds by increasing liabilities in a timely manner. Liquidity management involves maintaining the Company's ability to meet the daily cash flow requirements of its customers, whether they are borrowers requiring funds or depositors desiring to withdraw funds. Additionally, the Company requires cash for various operating needs including dividends to shareholders, the servicing of debt, and the payment of general corporate expenses. The Company manages its exposure to fluctuations in interest rates through policies approved by the ALCO and Board of Directors, both of which receive periodic reports of the Company's interest rate risk and liquidity position. The Company uses a computer simulation model to assist in the management of the future liquidity needs of the Company.

Liquidity sources include on balance sheet and off balance sheet sources.

Balance sheet liquidity sources include cash, amounts due from banks, loan repayments, and increases in deposits. The Company also maintains a large, high quality, very liquid bond portfolio, which is generally 50% to 60% unpledged and would, accordingly, be available for sale if necessary.

Off balance sheet sources include lines of credit from the Federal Home Loan Bank of Atlanta ("FHLB"), federal funds lines of credit, and access to the Federal Reserve Bank of Richmond's discount window

Management believes that these sources provide sufficient and timely liquidity, both on and off balance sheet.

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. Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, home equity lines of credit, commercial real estate loans and commercial construction loans. In addition, the Company pledges as collateral its capital stock in and deposits with the FHLB. At December 31, 2013, principal advance obligations to the FHLB consisted of \$9,951,000 in fixed-rate,

long-term advances compared to \$10,079,000 in long-term advances at December 31, 2012. The Company also had outstanding \$72,700,000 in letters of credit at December 31, 2013 and 2012, respectively. The letters of credit provide the Bank with additional collateral for securing public entity deposits above FDIC insurance levels, thereby providing less need for collateral pledging from the securities portfolio and thereby increasing on balance sheet liquidity.

Short term borrowing is discussed in note 10 and long-term borrowing is discussed in note 11 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K.

The Company has federal funds lines of credit established with two correspondent banks in the amounts of \$15,000,000 and \$10,000,000, and, additionally, has access to the Federal Reserve Bank's discount window. There were no amounts outstanding under these facilities at December 31, 2013.

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As a result of the merger with MidCarolina, the Company acquired a relationship with Promontory Network, the sponsoring entity for the Certificate of Deposit Account Registry Service® ("CDARS"). Through CDARS, the Company is able to provide deposit customers with access to aggregate FDIC insurance in amounts far exceeding \$250,000. This gives the Company the ability, as and when needed, to attract and retain large deposits from insurance and other safety conscious customers. CDARS are classified as brokered deposits, however they are generally derived from customers with whom our institution has or wishes to have a direct and ongoing relationship. As a result, management considers these deposits functionally, though not technically, in the same category as core deposits. With CDARS, the Company has the option to keep deposits on balance sheet or sell them to other members of the network. Additionally, subject to certain limits, the Bank can use CDARS purchase cost-effective funding without collateralization and in lieu of generating funds through traditional brokered CDs or the FHLB. In this manner, CDARS can provide the Company with another funding option. Thus, CDARS serves as a deposit-gathering tool and an additional liquidity management tool. Deposits through the CDARS program as of December 31, 2013 and 2012 was \$22,375,000 and \$22,150,000, respectively.

At the end of 2012, the FDIC's Transaction Account Guarantee program ("TAG") expired. TAG provided unlimited deposit insurance on noninterest bearing transaction accounts. In anticipation of this change, the Bank decided to participate in a new product which provides the Bank will the capability of providing additional deposit insurance to customers in the context of a money market account arrangement. The product is very analogous to the CDARS product discussed above. Based on experience during 2013, management has determined that the expiration of TAG has been a low profile event with very little impact on the Company's liquidity.

## BALANCE SHEET ANALYSIS

### Securities

The securities portfolio generates income, plays a strategic role in the management of interest rate sensitivity, provides a source of liquidity, and is used to meet collateral requirements. The securities portfolio consists primarily of high quality investments. Federal agency, mortgage-backed, and state and municipal securities comprise the majority of the portfolio.

The economic challenges on a local, regional and national level, from the recent financial crisis resulted in a significant slowdown in business activity throughout 2012, which has continued throughout much of 2013. By late 2013, economic indications were that a modest recovery was underway. The Company is cognizant of the continuing historically low interest rate environment and has elected to maintain a defensive asset liability strategy of purchasing high quality taxable securities of relatively short duration and somewhat longer term tax exempt securities, whose market values are not as volatile in rising rate environments as similar termed taxable investments.

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The following table presents information on the amortized cost, maturities, and taxable equivalent yields of securities at the end of the last three years.

(in thousands, except yields)

|                      | December 31,<br>2013 |                                | 2012              |                                | 2011              |                                |   |  |
|----------------------|----------------------|--------------------------------|-------------------|--------------------------------|-------------------|--------------------------------|---|--|
|                      | Amortized<br>Cost    | Taxable<br>Equivalent<br>Yield | Amortized<br>Cost | Taxable<br>Equivalent<br>Yield | Amortized<br>Cost | Taxable<br>Equivalent<br>Yield |   |  |
| Federal Agencies:    |                      |                                |                   |                                |                   |                                |   |  |
| Within 1 year        | \$ 1,000             | 3.17                           | % \$ 1,000        | 2.70                           | % \$ 2,597        | 3.30                           | % |  |
| 1 to 5 years         | 58,203               | 0.98                           | 38,929            | 1.03                           | 20,048            | 1.84                           |   |  |
| 5 to 10 years        | 7,038                | 0.88                           | 2,529             | 0.93                           | 9,426             | 2.64                           |   |  |
| Total                | 66,241               | 1.00                           | 42,458            | 1.07                           | 32,071            | 2.20                           |   |  |
| Mortgage-backed:     |                      |                                |                   |                                |                   |                                |   |  |
| Within 1 year        | 96                   | 2.72                           | 1                 | 4.89                           | -                 | -                              |   |  |
| 1 to 5 years         | 2,371                | 4.67                           | 3,049             | 4.51                           | 1,886             | 3.66                           |   |  |
| 5 to 10 years        | 22,285               | 2.43                           | 25,220            | 2.05                           | 34,930            | 2.50                           |   |  |
| Over 10 years        | 44,416               | 2.45                           | 53,315            | 2.24                           | 65,628            | 2.46                           |   |  |
| Total                | 69,168               | 2.52                           | 81,585            | 2.27                           | 102,444           | 2.49                           |   |  |
| State and Municipal: |                      |                                |                   |                                |                   |                                |   |  |
| Within 1 year        | 6,737                | 1.82                           | 5,889             | 2.81                           | 5,218             | 4.86                           |   |  |
| 1 to 5 years         | 73,986               | 2.72                           | 50,803            | 2.72                           | 42,345            | 3.30                           |   |  |
| 5 to 10 years        | 89,077               | 4.27                           | 94,254            | 4.10                           | 81,267            | 4.23                           |   |  |
| Over 10 years        | 23,451               | 4.92                           | 38,864            | 4.88                           | 54,122            | 4.73                           |   |  |
| Total                | 193,251              | 3.67                           | 189,810           | 3.85                           | 182,952           | 4.18                           |   |  |
| Other Securities:    |                      |                                |                   |                                |                   |                                |   |  |
| Within 1 year        | -                    | -                              | -                 | -                              | 1,988             | 6.28                           |   |  |
| 1 to 5 years         | 8,083                | 1.96                           | 1,183             | 1.74                           | 324               | 11.80                          |   |  |
| 5 to 10 years        | 2,876                | 1.91                           | 5,134             | 2.69                           | -                 | -                              |   |  |
| Total                | 10,959               | 1.95                           | 6,317             | 2.51                           | 2,312             | 7.06                           |   |  |
| Other Securities:    |                      |                                |                   |                                |                   |                                |   |  |
| No maturity          | 1,000                | 6.00                           | -                 | -                              | -                 | -                              |   |  |
| Total                | 1,000                | 6.00                           | -                 | -                              | -                 | -                              |   |  |
| Total portfolio      | \$ 340,619           | 2.87                           | % \$ 320,170      | 3.05                           | % \$ 319,779      | 3.46                           | % |  |

## Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans. Average loans decreased

\$19,350,000, or 2.4% from 2012 to 2013, and increased \$138,938,000, or 20.6% from 2011 to 2012, primarily driven by the July 2011 merger with MidCarolina.

At December 31, 2013, total loans were \$794,671,000, an increase of \$5,966,000 or 0.8% from the prior year.

Loans held for sale totaled \$2,760,000 at December 31, 2013, and \$13,852,000 at December 31, 2012. Loan production volume was \$79,000,000 and \$100,000,000 for 2013 and 2012, respectively. These loans were approximately 60% purchase, 40% refinancing. Management expects a continuing slowdown in this business line.

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Management of the loan portfolio is organized around portfolio segments. Each segment is comprised of a various loan types that are reflective of operational and regulatory reporting requirements. The following chart presents the Company's portfolio for the past five years by segment.

## Loans

| (in thousands)                    | December 31, |           |           |           |           |
|-----------------------------------|--------------|-----------|-----------|-----------|-----------|
|                                   | 2013         | 2012      | 2011      | 2010      | 2009      |
| Real estate:                      |              |           |           |           |           |
| Construction and land development | \$41,822     | \$48,812  | \$54,433  | \$37,168  | \$40,371  |
| Commercial real estate            | 364,616      | 355,433   | 351,961   | 210,393   | 208,066   |
| Residential real estate           | 171,917      | 161,033   | 179,812   | 119,398   | 121,639   |
| Home equity                       | 87,797       | 91,313    | 96,195    | 61,064    | 64,678    |
| Total real estate                 | 666,152      | 656,591   | 682,401   | 428,023   | 434,754   |
| Commercial and industrial         | 122,553      | 126,192   | 134,166   | 85,051    | 86,312    |
| Consumer                          | 5,966        | 5,922     | 8,191     | 7,707     | 6,925     |
| Total loans                       | \$794,671    | \$788,705 | \$824,758 | \$520,781 | \$527,991 |

The following table provides loan balance information by geographic regions. In some circumstances, loans may be originated in one region for borrowers located in other regions.

## Loans by Geographic Region

| (dollars in thousands) | December 31, 2013 |                               |   | Percentage<br>Change<br>in Balance<br>Since<br>December<br>31, 2012 |
|------------------------|-------------------|-------------------------------|---|---|
|                        | Balance           | Percentage<br>of<br>Portfolio |   |   |
| Danville region        | \$194,026         | 24.4                          | % | (0.9 )%   |
| Central region         | 144,180           | 18.1                          |   | (3.6 )  |
| Southside region       | 88,885            | 11.2                          |   | (13.7 )   |
| Eastern region         | 77,654            | 9.8                           |   | 11.3  |
| Alamance region        | 193,429           | 24.3                          |   | 1.1   |
| Guilford region        | 96,497            | 12.2                          |   | 21.8  |
| Total loans            | \$794,671         | 100.0                         | % | 0.8   |

The Danville region consists of offices in Danville and Yanceyville, North Carolina. The Central region consists of offices in Bedford, Lynchburg, and the counties of Bedford, Campbell, and Nelson. The Southside region consists of offices in Martinsville, and Henry County. The Eastern region consists of offices in South Boston and the counties of Halifax and Pittsylvania. The Alamance region consists of offices in Burlington, Graham, and Mebane, North Carolina. The Guilford region consists of offices in Greensboro, North Carolina.

The Company does not participate in or have any highly leveraged lending transactions, as defined by bank regulations. The Company has no foreign loans. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2013 or 2012, loans to lessors

of nonresidential buildings represented 16.7% of total loans at December 31, 2013 and 11.8% at December 31, 2012; the lessees and lessors are engaged in a variety of industries.

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The following table presents the maturity schedule of selected loan types.

Maturities of Selected Loan Types  
December 31, 2013

| (in thousands)    | Commercial<br>and<br>Industrial<br>(1) | Construction<br>and Land<br>Development | Total      |
|-------------------|--|---|------------|
| 1 year or less    | \$ 27,686                              | \$ 17,077                               | \$44,763   |
| 1 to 5 years (2)  | 62,475                                 | 21,953                                  | 84,428     |
| After 5 years (2) | 32,392                                 | 2,792                                   | 35,184     |
| Total             | \$ 122,553                             | \$ 41,822                               | \$ 164,375 |

(1) includes agricultural loans.

(2) Of the loans due after one year, \$114,828 have predetermined interest rates and \$4,784 have floating or adjustable interest rates.

#### Provision for Loan Losses

The provision for loan losses for the year ended December 31, 2013 was \$294,000, compared to \$2,133,000 for the year ended December 31, 2012 and \$3,170,000 for the year ended December 31, 2011.

The reduced provision expense in 2013 reflected the positive impact of continued improvements in overall asset quality metrics and robust loan loss recoveries.

The larger provision expenses in 2012 and 2011 related to the rapid maturities and renewals of the performing acquired loan portfolio of MidCarolina. As this relatively short duration loan portfolio turned over, most of these balances were included in the ongoing allowance evaluation. Since the July 2011 merger with MidCarolina, approximately \$95 million of the acquired loan portfolio has renewed under prevailing market terms and conditions and as such and are considered as part of the regular loan loss allowance analysis.

#### Allowance for Loan Losses

For the years ended December 31, 2013, 2012, and 2011, the allowance for loan losses was \$12,600,000, \$12,118,000, and \$10,529,000, respectively. The allowance for loan losses as a percentage of loans at each of those dates was 1.59%, 1.54%, and 1.28%, respectively.

In an effort to better evaluate the adequacy of its allowance for loan losses, the Company computes its ASC 450 loan balance by reducing total loans by acquired loans and loans that were evaluated for impairment individually. It also adjusts its loan loss reserve balance total by removing allowance associated with acquired loans and individually evaluated impaired loans. On a non-GAAP basis, the ASC 450 allowance as a percentage of the ASC 450 loans for the past three years was 1.75%, 1.98% and 1.97%. This segment of the allowance represents by far the largest portion of the risk in the loan portfolio. Management considers this methodical and gradual reduction of the level of this reserve directionally consistent with all major asset quality metrics related to the inherent risk in the portfolio.





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The following table presents the Company's loan loss and recovery experience for the past five years.

Summary of Loan Loss Experience  
(in thousands)

|                                   | Year Ended December 31, |          |          |         |         |
|-----------------------------------|-------------------------|----------|----------|---------|---------|
|                                   | 2013                    | 2012     | 2011     | 2010    | 2009    |
| Balance at beginning of period    | \$12,118                | \$10,529 | \$8,420  | \$8,166 | \$7,824 |
| Charge-offs:                      |                         |          |          |         |         |
| Construction and land development | -                       | 202      | 529      | -       | 130     |
| Commercial real estate            | 164                     | 370      | 173      | 666     | 303     |
| Residential real estate           | 213                     | 579      | 641      | 310     | 609     |
| Home equity                       | 156                     | 115      | 230      | 135     | 245     |
| Total real estate                 | 533                     | 1,266    | 1,573    | 1,111   | 1,287   |
| Commercial and industrial         | 129                     | 748      | 163      | 306     | 163     |
| Consumer                          | 175                     | 72       | 127      | 114     | 151     |
| Total charge-offs                 | 837                     | 2,086    | 1,863    | 1,531   | 1,601   |
| Recoveries:                       |                         |          |          |         |         |
| Construction and land development | 227                     | 87       | 36       | 147     | 2       |
| Commercial real estate            | 96                      | 388      | 270      | 9       | 15      |
| Residential real estate           | 179                     | 252      | 40       | 29      | 5       |
| Home equity                       | 65                      | 27       | 10       | 2       | 1       |
| Total real estate                 | 567                     | 754      | 356      | 187     | 23      |
| Commercial and industrial         | 335                     | 707      | 373      | 32      | 165     |
| Consumer                          | 123                     | 81       | 73       | 76      | 93      |
| Total recoveries                  | 1,025                   | 1,542    | 802      | 295     | 281     |
| Net charge-offs                   | (188 )                  | 544      | 1,061    | 1,236   | 1,320   |
| Provision for loan losses         | 294                     | 2,133    | 3,170    | 1,490   | 1,662   |
| Balance at end of period          | \$12,600                | \$12,118 | \$10,529 | \$8,420 | \$8,166 |

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The following table summarizes the allocation of the allowance for loan losses by major portfolio segments for the past five years.

Allocation of Allowance for Loan Losses  
(dollars in thousands)

|                            | December 31,<br>2013 |        | 2012     |        | 2011     |        | 2010    |        | 2009    |        |
|----------------------------|----------------------|--------|----------|--------|----------|--------|---------|--------|---------|--------|
|                            | Amount               | %      | Amount   | %      | Amount   | %      | Amount  | %      | Amount  | %      |
| Commercial                 | \$1,810              | 15.4 % | \$1,450  | 16.0 % | \$1,236  | 16.3 % | \$751   | 16.3 % | \$1,604 | 16.4 % |
| Commercial<br>real estate  | 6,819                | 51.1   | 6,822    | 51.2   | 5,719    | 49.3   | 4,623   | 47.5   | 3,565   | 47.0   |
| Residential<br>real estate | 3,690                | 32.7   | 3,638    | 32.0   | 3,412    | 33.5   | 2,929   | 34.7   | 2,849   | 35.3   |
| Consumer                   | 99                   | 0.8    | 208      | 0.8    | 162      | 1.0    | 117     | 1.5    | 148     | 1.3    |
| Unallocated                | 182                  | -      | -        | -      | -        | -      | -       | -      | -       | -      |
| Total                      | \$12,600             | 100.0% | \$12,118 | 100.0% | \$10,529 | 100.0% | \$8,420 | 100.0% | \$8,166 | 100.0% |

% - represents the percentage of loans in each category to total loans.

## Asset Quality Indicators

The following table provides certain qualitative indicators relevant to the Company's loan portfolio for the past five years.

## Asset Quality Ratios

|                                       | As of or for the Years Ended December 31, |        |        |        |        |
|---------------------------------------|---|--------|--------|--------|--------|
|                                       | 2013                                      | 2012   | 2011   | 2010   | 2009   |
| Allowance to loans*                   | 1.59                                      | % 1.54 | % 1.28 | % 1.62 | % 1.55 |
| Net charge-offs to year-end allowance | (1.49)                                    | 4.49   | 10.08  | 14.68  | 16.16  |
| Net charge-offs to average loans      | (0.02)                                    | 0.07   | 0.16   | 0.24   | 0.24   |
| Nonperforming assets to total assets* | 0.65                                      | 0.90   | 1.46   | 0.76   | 0.87   |
| Nonperforming loans to loans*         | 0.64                                      | 0.67   | 1.66   | 0.50   | 0.69   |
| Provision to net charge-offs          | (156.38)                                  | 392.10 | 298.77 | 120.52 | 125.91 |
| Provision to average loans            | 0.04                                      | 0.26   | 0.47   | 0.29   | 0.30   |
| Allowance to nonperforming loans*     | 248.47                                    | 227.95 | 76.74  | 324.22 | 224.22 |

\* - at year end.

Nonperforming Assets (Loans and Other Real Estate Owned)

Nonperforming loans include loans on which interest is no longer accrued and accruing loans that are contractually past due 90 days or more. Nonperforming loans include loans originated and loans acquired.

Nonperforming loans to total loans were 0.64% at December 31, 2013 compared to 0.67% at December 31, 2012.

Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming assets represented 0.65% of total assets at December 31, 2013, compared to 0.90% at December 31, 2012.

In most cases, it is the policy of the Company that any loan that becomes 90 days past due will automatically be placed on nonaccrual loan status, accrued interest reversed out of income, and further interest accrual ceased. Any payments received on such loans will be credited to principal. In some cases a loan in process of renewal may become 90 days past due. In these instances the loan may still be accruing because of a delayed renewal process in which the customer has not been billed.

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Loans will only be restored to full accrual status after six consecutive months of payments that were each less than 30 days delinquent. The Company strictly adheres with this policy before restoring a loan to normal accrual status.

At December 31, 2013, no non-accrual loans were excluded from impaired loan classifications.

The following table presents the Company's nonperforming asset history, including acquired impaired loans over the past five years.

Nonperforming Assets  
(in thousands)

|  | December 31, |          |          |         |         |
|--|--------------|----------|----------|---------|---------|
|  | 2013         | 2012     | 2011     | 2010    | 2009    |
| Nonaccrual loans:                                |              |          |          |         |         |
| Real estate                                      | \$5,060      | \$5,261  | \$11,651 | \$2,181 | \$3,138 |
| Commercial                                       | 11           | 52       | 1,820    | 401     | 463     |
| Agricultural                                     | -            | -        | -        | -       | -       |
| Consumer   | -            | 3        | 49       | 15      | 41      |
| Total nonaccrual loans                           | 5,071        | 5,316    | 13,520   | 2,597   | 3,642   |
| Loans past due 90 days<br>and accruing interest: |              |          |          |         |         |
| Real estate                                      | -            | -        | 197      | -       | -       |
| Commercial                                       | -            | -        | -        | -       | -       |
| Agricultural                                     | -            | -        | -        | -       | -       |
| Consumer   | -            | -        | -        | -       | -       |
| Total past due loans                             | -            | -        | 197      | -       | -       |
| Total nonperforming loans                        | 5,071        | 5,316    | 13,717   | 2,597   | 3,642   |
| Foreclosed real estate                           | 3,422        | 6,193    | 5,353    | 3,716   | 3,414   |
| Total nonperforming assets                       | \$8,493      | \$11,509 | \$19,070 | \$6,313 | \$7,056 |

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The following table shows loans that were considered impaired, exclusive of acquired impaired loans, as of year-end in the years indicated.

Impaired Loans  
(in thousands)

|                      | December 31, |         |         |       |         |
|----------------------|--------------|---------|---------|-------|---------|
|                      | 2013         | 2012    | 2011    | 2010  | 2009    |
| Accruing             | \$958        | \$499   | \$313   | \$560 | \$2,067 |
| On nonaccrual status | 5,071        | 2,548   | 2,925   | -     | 1,757   |
| Total impaired loans | \$6,029      | \$3,047 | \$3,238 | \$560 | \$3,824 |



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## Troubled Debt Restructuring ("TDRs")

TDRs exist whenever the Company makes a concession to customer based on the customer's financial distress that would not have otherwise been made in the normal course of business.

There was \$2,100,000 in TDRs at December 31, 2013 compared to \$1,755,000 at December 31, 2012.

## Foreclosed Assets

Foreclosed assets were carried on the consolidated balance sheets at \$3,422,000 and \$6,193,000 as of December 31, 2013 and 2012, respectively. Foreclosed assets are initially recorded at fair value, less estimated costs to sell, at the date of foreclosure. Loan losses resulting from foreclosure are charged against the ALLL at that time. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell with any additional write-downs charged against earnings. For significant assets, these valuations are typically outside annual appraisals. The following table shows OREO over the past five years.

Other Real Estate Owned  
(in thousands)

|                                     | Year Ended December 31, |          |          |          |          |
|-------------------------------------|-------------------------|----------|----------|----------|----------|
|                                     | 2013                    | 2012     | 2011     | 2010     | 2009     |
| Construction and land development   | \$ 1,683                | \$ 3,290 | \$ 3,001 | \$ 2,293 | \$ 2,521 |
| Farmland                            | -                       | 236      | -        | -        | -        |
| 1-4 family residential              | 1,400                   | 1,090    | 1,267    | 1,078    | 125      |
| Multifamily (5 or more) residential | -                       | 1,012    | -        | -        | -        |
| Commercial real estate              | 339                     | 565      | 1,085    | 345      | 768      |
|                                     | \$3,422                 | \$6,193  | \$5,353  | \$3,716  | \$3,414  |

Foreclosed asset expense, net, was \$1,523,000 for 2013 and \$528,000 for 2012.

## Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer time deposits. Average deposits decreased \$1,167,000 or 0.11% in 2013, after increasing \$187,992,000 or 21.8% in 2012. The large increase was due to the merger with MidCarolina.

Period-end total deposits increased \$30,008,000 or 2.9% during 2013. The increase was primarily related to growth in core deposits throughout the Bank, which is consistent with the Company's asset liability strategy. The Company has only a relatively small portion of its time deposits provided by wholesale sources. These include brokered time deposits, which totaled \$4,000,000 at year end 2013, compared to \$7,314,000 at year end 2012. They also included time deposits through the CDARs program, which totaled \$22,375,000 at year end 2013, compared to \$22,150,000 at year end 2012. Management considers the CDARs deposits the functional equivalent of core deposits, because they relate to balances derived from customers with long standing relationships with the Company.

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## Deposits

(dollars in thousands)

|                                 | December 31,<br>2013 |        | 2012               |        | 2011               |        |
|---------------------------------|----------------------|--------|--------------------|--------|--------------------|--------|
|                                 | Average<br>Balance   | Rate   | Average<br>Balance | Rate   | Average<br>Balance | Rate   |
| Noninterest bearing deposits    | \$ 220,980           | - %    | \$ 213,129         | - %    | \$ 143,204         | - %    |
| Interest bearing accounts:      |                      |        |                    |        |                    |        |
| NOW accounts                    | \$ 161,602           | 0.07 % | \$ 142,296         | 0.13 % | \$ 137,211         | 0.21 % |
| Money market                    | 178,235              | 0.19   | 174,027            | 0.30   | 132,906            | 0.43   |
| Savings                         | 84,162               | 0.08   | 78,358             | 0.14   | 68,038             | 0.14   |
| Time                            | 405,213              | 1.22   | 443,549            | 1.36   | 382,008            | 1.63   |
| Total interest bearing deposits | \$ 829,212           | 0.66 % | \$ 838,230         | 0.82 % | \$ 720,163         | 1.00 % |
| Average total deposits          | \$ 1,050,192         | 0.52 % | \$ 1,051,359       | 0.65 % | \$ 863,367         | 0.83 % |

Certificates of Deposit of \$100,000 or More  
(in thousands)

Certificates of deposit at December 31, 2013 in amounts of \$100,000 or more were classified by maturity as follows:

|                          |            |
|--------------------------|------------|
| 3 months or less         | \$ 35,288  |
| Over 3 through 6 months  | 16,844     |
| Over 6 through 12 months | 13,998     |
| Over 12 months           | 174,531    |
|                          | \$ 240,661 |

Certificates of Deposit of \$250,000 or More  
(in thousands)

Certificates of deposit at December 31, 2013 in amounts of \$250,000 or more were classified by maturity as follows:

|                          |            |
|--------------------------|------------|
| 3 months or less         | \$ 11,107  |
| Over 3 through 6 months  | 7,127      |
| Over 6 through 12 months | 7,405      |
| Over 12 months           | 108,453    |
|                          | \$ 134,092 |

## Borrowed Funds

In addition to internal deposit generation, the Company also relies on borrowed funds as a supplemental source of funding. Borrowed funds consist of customer repurchase agreements, overnight borrowings from the FHLB and longer-term FHLB advances, and trust preferred capital notes. Customer repurchase agreements are borrowings collateralized by securities of the U.S. Government or its agencies ("GSEs") and generally mature daily. The



Company considers these accounts to be a stable and relatively low cost source of funds. The securities underlying these agreements remain under the Company's control. Refer to Notes 11 and 12 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K for a discussion of long-term debt.

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The following table presents information pertaining to the Company's short-term borrowed funds.

Short-Term Borrowings  
(dollars in thousands)

|                                | December 31, |          |
|--------------------------------|--------------|----------|
|                                | 2013         | 2012     |
| Customer repurchase agreements | \$39,478     | \$49,942 |
| FHLB overnight borrowings      | -            | -        |
| Total                          | \$39,478     | \$49,942 |
| Weighted interest rate         | 0.02 %       | 0.68 %   |
| Average for the year ended:    |              |          |
| Outstanding                    | \$47,817     | \$47,435 |
| Interest rate                  | 0.08 %       | 0.32 %   |
| Maximum month-end outstanding  | \$53,888     | \$65,714 |

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At December 31, 2013, the Bank's public deposits totaled \$128,116,000. The Company is legally required to provide collateral to secure the deposits that exceed the insurance coverage provided by the FDIC. This collateral can be provided in the form of certain types of government agency bonds or letters of credit from the FHLB. At year-end 2013, the Company had \$72,000,000 in letters of credit with the FHLB outstanding to supplement collateral for such deposits.

#### Shareholders' Equity

The Company's goal with capital management is to be classified as "well capitalized" under regulatory capital ratios and to support growth, while generating acceptable returns on equity and paying a high rate of dividends.

Shareholders' equity was \$167,551,000 at December 31, 2013 and \$163,246,000 at December 31, 2012.

The Company declared and paid quarterly dividends totaling \$0.92 per share for each of the past three years. Cash dividends in 2013 totaled \$7,248,000 and represented a 46.0% payout of 2013 net income, compared to a 45.1% payout in 2012, and 55.5% payout in 2011.

One measure of a financial institution's capital level is the ratio of shareholders' equity to assets. Shareholders' equity was 12.81% of assets at December 31, 2013, 12.72% of assets at December 31, 2012 and 11.71% of assets at December 31, 2011. In addition, banking regulators have defined minimum regulatory capital ratios that the Company and its banking subsidiary are required to maintain. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and off-balance sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance sheet assets in relation to their perceived risk. Under the guidelines capital strength is measured in two tiers. Tier 1 capital consists primarily of shareholder's equity and trust preferred capital notes, while Tier 2 capital consists generally of qualifying allowance for loan losses. "Total" capital is the sum of Tier 1 and Tier 2 capital. Another regulatory indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier 1 capital by average quarterly assets less intangible assets.

The following table represents the major capital ratios for the Company for the past five years:

|  | December 31, |        |        |        |        |
|--|--------------|--------|--------|--------|--------|
|  | 2013         | 2012   | 2011   | 2010   | 2009   |
| Capital Ratios:                          |              |        |        |        |        |
| Total risk-based capital ratio           | 18.14%       | 17.00% | 15.55% | 19.64% | 18.82% |
| Tier 1 risk-based capital ratio          | 16.88%       | 15.75% | 14.36% | 18.38% | 17.56% |
| Tier 1 leverage ratio                    | 11.81%       | 11.27% | 10.32% | 12.74% | 12.81% |
| Tangible equity to tangible assets ratio | 9.91%        | 9.64%  | 8.52%  | 10.41% | 10.48% |

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As mandated by bank regulations, the following five capital categories are identified for insured depository institutions: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." These regulations require the federal banking regulators to take prompt corrective action with respect to insured depository institutions that do not meet minimum capital requirements. Under the regulations, well capitalized institutions must have Tier 1 risk-based capital ratios of at least 6%, total risk-based capital ratios of at least 10%, leverage ratios of at least 5%, and not be subject to capital directive orders. Management believes, as of December 31, 2013 and 2012, that the Company met the requirements to be considered "well capitalized."

## CONTRACTUAL OBLIGATIONS

The following items are contractual obligations of the Company as of December 31, 2013 (in thousands):

|                               | Payments Due By Period |                 |           |           |                         |
|-------------------------------|------------------------|-----------------|-----------|-----------|-------------------------|
|                               | Total                  | Under 1<br>Year | 1-3 Years | 3-5 Years | More<br>than<br>5 years |
| Time deposits                 | \$389,598              | \$133,481       | \$140,119 | \$115,998 | \$-                     |
| Repurchase agreements         | 39,478                 | 39,478          | -         | -         | -                       |
| FHLB borrowings               | 9,951                  | 38              | -         | 9,913     | -                       |
| Operating leases              | 1,567                  | 398             | 664       | 505       | -                       |
| Trust preferred capital notes | 27,419                 | -               | -         | -         | 27,419                  |

## OFF-BALANCE SHEET ACTIVITIES

The Company enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance sheet transactions. Other than AMNB Statutory Trust I, formed in 2006 to issue trust preferred securities, and the MidCarolina Trust I and MidCarolina Trust II, the Company does not have any off-balance sheet subsidiaries. Refer to Note 12 of the Consolidated Financial Statements contained in Item 8 of this Form 10-K for a discussion of trust preferred capital notes. Off-balance sheet transactions were as follows (in thousands):

| Off-Balance Sheet Transactions      | December 31, |           |
|-------------------------------------|--------------|-----------|
|                                     | 2013         | 2012      |
| Commitments to extend credit        | \$179,272    | \$170,202 |
| Standby letters of credit           | 3,405        | 4,591     |
| Mortgage loan rate-lock commitments | 5,913        | 9,486     |

Commitments to extend credit to customers represent legally binding agreements with fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future funding requirements. Standby letters of credit are conditional commitments issued by the Company guaranteeing the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements.

## ITEM 7A. – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

This information is incorporated herein by reference from Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Form 10-K.

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## ITEM 8 – FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## Quarterly Financial Results

(in thousands, except per share amounts)

| 2013  | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total    |
|---|------------------|-------------------|------------------|-------------------|----------|
| Interest income                                     | \$13,409         | \$13,347          | \$13,106         | \$13,094          | \$52,956 |
| Interest expense                                    | 1,727            | 1,654             | 1,613            | 1,589             | 6,583    |
| Net interest income                                 | 11,682           | 11,693            | 11,493           | 11,505            | 46,373   |
| Provision for loan losses                           | 294              | -                 | -                | -                 | 294      |
| Net interest income after provision for loan losses | 11,388           | 11,693            | 11,493           | 11,505            | 46,079   |
| Noninterest income                                  | 2,770            | 2,686             | 2,767            | 2,604             | 10,827   |
| Noninterest expense                                 | 8,318            | 8,428             | 8,455            | 9,904             | 35,105   |
| Income before income taxes                          | 5,840            | 5,951             | 5,805            | 4,205             | 21,801   |
| Income taxes  | 1,689            | 1,741             | 1,562            | 1,062             | 6,054    |
| Net income  | \$4,151          | 4,210             | 4,243            | 3,143             | 15,747   |
| Per common share:                                   |                  |                   |                  |                   |          |
| Net income - basic                                  | \$0.53           | \$0.54            | \$0.54           | \$0.40            | \$2.00   |
| Net income - diluted                                | 0.53             | 0.53              | 0.54             | 0.40              | 2.00     |
| Cash dividends                                      | 0.23             | 0.23              | 0.23             | 0.23              | 0.92     |
| 2012  | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total    |
| Interest income                                     | \$15,342         | \$14,866          | \$13,546         | \$14,032          | 57,806   |
| Interest expense                                    | 2,170            | 2,070             | 2,046            | 1,855             | 8,141    |
| Net interest income                                 | 13,172           | 12,816            | 11,500           | 12,177            | 49,665   |
| Provision for loan losses                           | 733              | 733               | 333              | 334               | 2,133    |
| Net interest income after provision for loan losses | 12,439           | 12,083            | 11,167           | 11,843            | 47,532   |
| Noninterest income                                  | 3,234            | 2,800             | 2,690            | 2,686             | 11,410   |
| Noninterest expense                                 | 9,927            | 8,833             | 8,880            | 9,003             | 36,643   |
| Income before income taxes                          | 5,746            | 6,050             | 4,977            | 5,526             | 22,299   |
| Income taxes  | 1,571            | 1,776             | 1,338            | 1,608             | 6,293    |
| Net income  | \$4,175          | \$4,274           | \$3,639          | \$3,918           | \$16,006 |

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|                      |        |        |        |        |        |
|----------------------|--------|--------|--------|--------|--------|
| Per common share:    |        |        |        |        |        |
| Net income - basic   | \$0.53 | \$0.55 | \$0.46 | \$0.50 | \$2.04 |
| Net income - diluted | 0.53   | 0.54   | 0.46   | 0.50   | 2.04   |
| Cash dividends       | 0.23   | 0.23   | 0.23   | 0.23   | 0.92   |

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
American National Bankshares Inc.  
Danville, Virginia

We have audited the accompanying consolidated balance sheets of American National Bankshares Inc. and subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American National Bankshares Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), American National Bankshares Inc. and subsidiaries' internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992, and our report dated March 12, 2014 expressed an unqualified opinion on the effectiveness of American National Bankshares Inc. and subsidiaries' internal control over financial reporting.

Winchester, Virginia  
March 12, 2014



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
American National Bankshares Inc.  
Danville, Virginia

We have audited American National Bankshares Inc. and subsidiaries' internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992. American National Bankshares Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, American National Bankshares Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2013 of American National Bankshares Inc. and subsidiaries and our report dated March 12, 2014 expressed an unqualified opinion.

Winchester, Virginia  
March 12, 2014

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American National Bankshares Inc. and Subsidiaries

Consolidated Balance Sheets

December 31, 2013 and December 31, 2012

(Dollars in thousands, except per share data)

| ASSETS  | 2013        | 2012        |
|---|-------------|-------------|
| Cash and due from banks   | \$19,808    | \$20,435    |
| Interest-bearing deposits in other banks  | 47,873      | 27,007      |
| Securities available for sale, at fair value  | 346,124     | 335,246     |
| Restricted stock, at cost   | 4,889       | 5,287       |
| Loans held for sale   | 2,760       | 13,852      |
| Loans, net of unearned income   | 794,671     | 788,705     |
| Less allowance for loan losses  | (12,600 )   | (12,118 )   |
| Net loans   | 782,071     | 776,587     |
| Premises and equipment, net   | 23,674      | 24,543      |
| Other real estate owned, net of valuation allowance of \$3,340 in 2013 and \$2,367 in 2012  | 3,422       | 6,193       |
| Goodwill  | 39,043      | 39,043      |
| Core deposit intangibles, net   | 3,159       | 4,660       |
| Bank owned life insurance   | 14,746      | 14,289      |
| Accrued interest receivable and other assets  | 19,943      | 16,545      |
| Total assets  | \$1,307,512 | \$1,283,687 |
| <b>LIABILITIES and SHAREHOLDERS' EQUITY</b>   |             |             |
| Liabilities:  |             |             |
| Demand deposits -- noninterest bearing  | \$229,347   | \$217,275   |
| Demand deposits -- interest bearing   | 167,736     | 153,578     |
| Money market deposits   | 185,270     | 166,111     |
| Savings deposits  | 85,724      | 81,135      |
| Time deposits   | 389,598     | 409,568     |
| Total deposits  | 1,057,675   | 1,027,667   |
| Customer repurchase agreements  | 39,478      | 49,942      |
| Long-term borrowings  | 9,951       | 10,079      |
| Trust preferred capital notes   | 27,419      | 27,317      |
| Accrued interest payable and other liabilities  | 5,438       | 5,436       |
| Total liabilities   | 1,139,961   | 1,120,441   |
| Shareholders' equity:   |             |             |
| Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding   | -           | -           |
| Common stock, \$1 par, 20,000,000 shares authorized 7,890,697 shares outstanding at December 31, 2013 and 7,846,912 shares outstanding at December 31, 2012 | 7,891       | 7,847       |
| Capital in excess of par value  | 58,050      | 57,211      |
| Retained earnings   | 99,090      | 90,591      |
| Accumulated other comprehensive income, net   | 2,520       | 7,597       |
| Total shareholders' equity  | 167,551     | 163,246     |

|  |             |             |
|--|-------------|-------------|
| Total liabilities and shareholders' equity | \$1,307,512 | \$1,283,687 |
|--|-------------|-------------|

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

American National Bankshares Inc. and Subsidiaries  
Consolidated Statements of Income  
For the Years Ended December 31, 2013, 2012, and 2011  
(Dollars in thousands, except per share data)

|   | 2013      | 2012      | 2011      |
|---|-----------|-----------|-----------|
| Interest and Dividend Income:                       |           |           |           |
| Interest and fees on loans                          | \$44,817  | \$49,189  | \$40,688  |
| Interest and dividends on securities:               |           |           |           |
| Taxable   | 3,530     | 4,044     | 4,595     |
| Tax-exempt  | 4,213     | 4,280     | 3,646     |
| Dividends   | 245       | 213       | 131       |
| Other interest income                               | 151       | 80        | 127       |
| Total interest and dividend income                  | 52,956    | 57,806    | 49,187    |
| Interest Expense:                                   |           |           |           |
| Interest on deposits                                | 5,460     | 6,843     | 7,203     |
| Interest on short-term borrowings                   | 40        | 150       | 325       |
| Interest on long-term borrowings                    | 329       | 335       | 229       |
| Interest on trust preferred capital notes           | 754       | 813       | 1,023     |
| Total interest expense                              | 6,583     | 8,141     | 8,780     |
| Net Interest Income                                 | 46,373    | 49,665    | 40,407    |
| Provision for Loan Losses                           | 294       | 2,133     | 3,170     |
| Net Interest Income after Provision for Loan Losses | 46,079    | 47,532    | 37,237    |
| Noninterest Income:                                 |           |           |           |
| Trust fees  | 3,689     | 3,703     | 3,561     |
| Service charges on deposit accounts                 | 1,750     | 1,757     | 1,963     |
| Other fees and commissions                          | 1,864     | 1,768     | 1,510     |
| Mortgage banking income                             | 2,008     | 2,234     | 1,262     |
| Securities gains (losses), net                      | 192       | 158       | (1)       |
| Other   | 1,324     | 1,790     | 949       |
| Total noninterest income                            | 10,827    | 11,410    | 9,244     |
| Noninterest Expense:                                |           |           |           |
| Salaries  | 14,059    | 15,785    | 12,409    |
| Employee benefits                                   | 3,848     | 3,604     | 2,681     |
| Occupancy and equipment                             | 3,614     | 3,951     | 3,199     |
| FDIC assessment                                     | 647       | 692       | 651       |
| Bank franchise tax                                  | 745       | 690       | 763       |
| Core deposit intangible amortization                | 1,501     | 1,935     | 1,282     |
| Data processing                                     | 1,248     | 512       | -         |
| Software  | 923       | 1,028     | 855       |
| Foreclosed real estate, net                         | 1,523     | 528       | 296       |
| Merger related expenses                             | -         | 19        | 1,607     |
| Other   | 6,997     | 7,899     | 6,257     |
| Total noninterest expense                           | 35,105    | 36,643    | 30,000    |
| Income Before Income Taxes                          | 21,801    | 22,299    | 16,481    |
| Income Taxes  | 6,054     | 6,293     | 4,910     |
| Net Income  | 15,747    | 16,006    | 11,571    |
| Dividends on preferred stock                        | -         | -         | 103       |
| Net income available to common shareholders         | \$ 15,747 | \$ 16,006 | \$ 11,468 |

|                                    |           |           |           |
|------------------------------------|-----------|-----------|-----------|
| Net Income Per Common Share:       |           |           |           |
| Basic                              | \$2.00    | \$2.04    | \$1.64    |
| Diluted                            | \$2.00    | \$2.04    | \$1.64    |
| Average Common Shares Outstanding: |           |           |           |
| Basic                              | 7,872,870 | 7,834,351 | 6,982,524 |
| Diluted                            | 7,884,561 | 7,845,652 | 6,989,877 |

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 Comprehensive Income  
 For the Years Ended December 31, 2013, 2012, and 2011  
 (Dollars in thousands)

|  | Year Ended December 31, |          |          |
|--|-------------------------|----------|----------|
|  | 2013                    | 2012     | 2011     |
| Net income   | \$15,747                | \$16,006 | \$11,571 |
| Other comprehensive income (loss):                           |                         |          |          |
| Unrealized gains (losses) on securities available for sale   | (9,379 )                | 1,647    | 11,622   |
| Income tax (expense) benefit                                 | 3,282                   | (576 )   | (4,068 ) |
| Reclassification adjustment for (gains) losses on securities | (192 )                  | (158 )   | 1        |
| Income tax expense   | 67                      | 55       | -        |
| Change in unfunded pension liability                         | 1,761                   | (309 )   | (871 )   |
| Income tax (expense) benefit                                 | (616 )                  | 108      | 305      |
| Other comprehensive income (loss)                            | (5,077 )                | 767      | 6,989    |
| Comprehensive income   | \$10,670                | \$16,773 | \$18,560 |

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

American National Bankshares Inc. and Subsidiaries  
Consolidated Statements of Changes in Shareholders' Equity  
For the Years Ended December 31, 2013, 2012, and 2011  
(Dollars in thousands except per share data)

|   | Preferred<br>Stock | Common<br>Stock | Capital<br>in<br>Excess<br>of<br>Par<br>Value | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|---|--------------------|-----------------|---|----------------------|--|----------------------------------|
| Balance, December 31, 2010                | -                  | 6,128           | 27,268  | 74,850               | (159 )   | 108,087                          |
| Net income                                | -                  | -               | -   | 11,571               | -  | 11,571                           |
| Other comprehensive income                | -                  | -               | -   | -                    | 6,989  | 6,989                            |
| Issuance of common stock                  | -                  | 1,626           | 28,279  | -                    | -  | 29,905                           |
| Issuance of preferred stock               | 5,000              | -               | -   | -                    | -  | 5,000                            |
| Issuance of replacement options           | -                  | -               | 132   | -                    | -  | 132                              |
| Retirement of preferred stock             | (5,000 )           | -               | -   | 1,900                | -  | (3,100 )                         |
| Stock options exercised                   | -                  | 11              | 162   | -                    | -  | 173                              |
| Stock based compensation expense          | -                  | -               | 63  | -                    | -  | 63                               |
| Equity based compensation                 | -                  | 42              | 491   | -                    | -  | 533                              |
| Dividends on preferred stock              | -                  | -               | -   | (103 )               | -  | (103 )                           |
| Cash dividends declared, \$0.92 per share | -                  | -               | -   | (6,421 )             | -  | (6,421 )                         |
| Balance, December 31, 2011                | -                  | 7,807           | 56,395  | 81,797               | 6,830  | 152,829                          |
| Net income                                | -                  | -               | -   | 16,006               | -  | 16,006                           |
| Other comprehensive income                | -                  | -               | -   | -                    | 767  | 767                              |
| Stock options exercised                   | -                  | 7               | 111   | -                    | -  | 118                              |
| Equity based compensation                 | -                  | 33              | 705   | -                    | -  | 738                              |
| Cash dividends declared, \$0.92 per share | -                  | -               | -   | (7,212 )             | -  | (7,212 )                         |
| Balance, December 31, 2012                | -                  | 7,847           | 57,211  | 90,591               | 7,597  | 163,246                          |
| Net income                                | -                  | -               | -   | 15,747               | -  | 15,747                           |
| Other comprehensive (loss)                | -                  | -               | -   | -                    | (5,077 )   | (5,077 )                         |
| Stock options exercised                   | -                  | 18              | 291   | -                    | -  | 309                              |
| Equity based compensation                 | -                  | 26              | 548   | -                    | -  | 574                              |
| Cash dividends declared, \$0.92 per share | -                  | -               | -   | (7,248 )             | -  | (7,248 )                         |
| Balance, December 31, 2013                | \$ -               | \$ 7,891        | \$ 58,050                                     | \$ 99,090            | \$ 2,520   | \$ 167,551                       |

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  
 For the Years Ended December 31, 2013, 2012, and 2011  
 (Dollars in thousands)

|   | 2013      | 2012      | 2011      |
|---|-----------|-----------|-----------|
| <b>Cash Flows from Operating Activities:</b>                                      |           |           |           |
| Net income  | \$ 15,747 | \$ 16,006 | \$ 11,571 |
| Adjustments to reconcile net income to net cash provided by operating activities: |           |           |           |
| Provision for loan losses   | 294       | 2,133     | 3,170     |
| Depreciation  | 1,734     | 1,761     | 1,385     |
| Net accretion of purchase accounting adjustments                                  | (7,390 )  | (9,113 )  | (5,400 )  |
| Core deposit intangible amortization  | 1,501     | 1,935     | 1,282     |
| Net amortization (accretion) of securities  | 3,158     | 3,261     | 1,836     |
| Net (gain) loss on sale or call of securities                                     | (192 )    | (158 )    | 1         |
| Gain on sale of loans held for sale   | (1,705 )  | (1,958 )  | (1,101 )  |
| Proceeds from sales of loans held for sale  | 92,189    | 94,555    | 52,169    |
| Originations of loans held for sale   | (79,392)  | (100,119) | (54,150 ) |
| Net (gain) loss on foreclosed real estate   | (85 )     | (388 )    | (574 )    |
| Valuation allowance on foreclosed real estate                                     | 1,070     | 502       | 453       |
| Net gain on sale of premises and equipment  | -         | (503 )    | (114 )    |
| Equity-based compensation expense   | 574       | 738       | 596       |
| Deferred income tax expense   | 2,024     | 5,557     | 3,053     |
| Net change in interest receivable   | (30 )     | 383       | 66        |
| Net change in other assets  | (1,355 )  | 1,708     | (1,306 )  |
| Net change in interest payable  | (145 )    | (77 )     | (36 )     |
| Net change in other liabilities   | 147       | (1,617 )  | (34 )     |
| Net cash provided by operating activities   | 28,144    | 14,606    | 12,867    |
| <b>Cash Flows from Investing Activities:</b>                                      |           |           |           |
| Proceeds from sales of securities available for sale                              | 2,623     | 4,208     | 2,099     |
| Proceeds from maturities, calls and paydowns of securities available for sale     | 53,792    | 65,833    | 69,011    |
| Proceeds from maturities, calls and paydowns of securities held to maturity       | -         | -         | 1,276     |
| Purchases of securities available for sale  | (79,830)  | (73,535 ) | (114,972) |
| Net change in restricted stock  | 398       | 732       | 120       |
| Net (increase) decrease in loans  | (368 )    | 37,240    | 27,444    |
| Proceeds from sale of premises and equipment                                      | -         | 572       | 189       |
| Purchases of premises and equipment   | (865 )    | (699 )    | (1,734 )  |
| Proceeds from sales of foreclosed real estate                                     | 3,612     | 6,051     | 2,965     |
| Capital improvements in other real estate owned                                   | -         | (22 )     | (140 )    |
| Cash paid in bank acquisition   | -         | -         | (12 )     |
| Cash acquired in bank acquisition   | -         | -         | 34,783    |
| Net cash provided by (used in) investing activities                               | (20,638)  | 40,380    | 21,029    |
| <b>Cash Flows from Financing Activities:</b>                                      |           |           |           |
| Net change in demand, money market, and savings deposits                          | 49,978    | (6,801 )  | 25,924    |
| Net change in time deposits   | (19,692)  | (23,760 ) | (27,220 ) |

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|   |          |           |           |
|---|----------|-----------|-----------|
| Net change in customer repurchase agreements        | (10,464) | 4,367     | (1,509 )  |
| Net change in other short-term borrowings           | -        | (3,000 )  | (3,110 )  |
| Net change in long-term borrowings                  | (150 )   | (149 )    | (8,151 )  |
| Common stock dividends paid                         | (7,248 ) | (7,212 )  | (6,421 )  |
| Preferred stock dividends paid                      | -        | -         | (103 )    |
| Repurchase of preferred stock                       | -        | -         | (3,100 )  |
| Proceeds from exercise of stock options             | 309      | 118       | 173       |
| Net cash provided by (used in) financing activities | 12,733   | (36,437 ) | (23,517 ) |
| <br>  |          |           |           |
| Net Increase in Cash and Cash Equivalents           | 20,239   | 18,549    | 10,379    |
| <br>  |          |           |           |
| Cash and Cash Equivalents at Beginning of Period    | 47,442   | 28,893    | 18,514    |
| <br>  |          |           |           |
| Cash and Cash Equivalents at End of Period          | \$67,681 | \$47,442  | \$28,893  |

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  
December 31, 2013, 2012, and 2011

Note 1 – Summary of Significant Accounting Policies

Nature of Operations and Consolidation

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, goodwill and intangible assets, other than temporary impairment, the valuation of deferred tax assets and liabilities, and the valuation of foreclosed real estate.

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. This transaction expanded the Company's footprint in North Carolina, adding eight branches in Alamance and Guilford counties.

In July 2011, and in connection with its acquisition of MidCarolina Financial Corporation, the Company assumed the liabilities of the MidCarolina Trust I and MidCarolina Trust II, two separate Delaware statutory trust (the "MidCarolina Trusts"), which were also formed for the purpose of issuing preferred securities. Refer to Note 12 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 12.

Cash and Cash Equivalents

Cash includes cash on hand, cash with correspondent banks, and cash on deposit at the Federal Reserve Bank of Richmond. Cash equivalents are short-term, highly liquid investments that are readily convertible to cash with original maturities of three months or less and are subject to an insignificant risk of change in value. Cash and cash equivalents are carried at cost.

#### Interest-bearing Deposits in Other Banks

Interest-bearing deposits in other banks mature within one year and are carried at cost.

#### Securities

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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The Company does not currently have any securities in held to maturity or trading and has no plans to add any to either category.

The Company follows accounting guidance related to recognition and presentation of other-than-temporary impairment. The guidance specifies that (1) if a company does not have the intent to sell a debt security prior to recovery and (2) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired, unless there is a credit loss. When an entity does not intend to sell the security and it is more likely than not the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment should be amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

For equity securities, when the Company has decided to sell an impaired available-for-sale security and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other-than-temporary even if a decision to sell has not been made.

Due to the nature and restrictions placed on the Company's investment in common stock of the Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank of Richmond, these securities have been classified as restricted equity securities and carried at cost.

### Loans Held for Sale

Secondary market mortgage loans are designated as held for sale at the time of their origination. These loans are pre-sold with servicing released and the Company does not retain any interest after the loans are sold. These loans consist primarily of fixed-rate, single-family residential mortgage loans which meet the underwriting characteristics of certain government-sponsored enterprises (conforming loans). In addition, the Company requires a firm purchase commitment from a permanent investor before a loan can be committed, thus limiting interest rate risk. Loans held for sale are carried at the lower of cost or fair value. Gains on sales of loans are recognized at the loan closing date and are included in noninterest income.

### Derivative Loan Commitments

The Company enters into mortgage loan commitments whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheets with net changes in their fair values recorded in other expenses. Derivative loan commitments resulted in no income or loss for 2013, 2012 or 2011.

The period of time between issuance of a loan commitment and sale of the loan generally ranges from 30 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery contracts, by committing to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed the interest rate risk on the loan. As a result, the Company is not generally exposed to significant losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The

Company determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the estimated value of the underlying assets while taking into consideration the probability that the loan will be funded.

#### Loans

The Company makes mortgage, commercial, and consumer loans. A substantial portion of the loan portfolio is secured by real estate. The ability of the Company's debtors to honor their contracts is dependent upon the real estate market and general economic conditions in the Company's market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off, generally are reported at their outstanding unpaid principal balance adjusted for the allowance for loan losses, and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

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The accrual of interest on loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Loans are typically charged off when the loan is 120 days past due, unless secured and in process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Interest accrued but not collected for loans that are placed on nonaccrual status or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash basis or cost recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered past due when a payment of principal or interest or both is due but not paid. Management closely monitors past due loans in timeframes of 30-59 days, 60-89 days, and 90 or more days past due.

These policies apply to all loan portfolio classes and segments.

Substandard and doubtful risk graded commercial, commercial real estate, and construction loans equal to or greater than \$100,000 on an unsecured basis, and equal to or greater than \$250,000 on a secured basis are reviewed for impairment. All troubled debt restructurings, regardless of dollar amount, are also evaluated for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment and establishing a specific allowance include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, commercial real estate, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Generally, large groups of smaller balance homogeneous loans (residential real estate and consumer loans) are collectively evaluated for impairment. The Company's policy for recognizing interest income on impaired loans is consistent with its nonaccrual policy.

The Company's loan portfolio is organized by major segment. These include: commercial, commercial real estate, residential real estate and consumer loans. Each segment has particular risk characteristics that are specific to the borrower and the generic category of credit. Commercial loan repayments are highly dependent on cash flows associated with the underlying business and its profitability. They can also be impacted by changes in collateral values. Commercial real estate loans share the same general risk characteristics as commercial loans, but are often more dependent on the value of the underlying real estate collateral and, when construction is involved, the ultimate completion of and sale of the project. Residential real estate loans are generally dependent on the value of collateral and the credit worthiness of the underlying borrower. Consumer loans are very similar in risk characteristics to residential real estate.

In connection with the MidCarolina merger, certain loans were acquired which exhibited deteriorated credit quality since origination and for which the Bank does not expect to collect all contractual payments. Accounting for these loans is done in accordance with Accounting Standards Codification ("ASC") 310-30, "Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality." The loans were 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. On a quarterly basis, management, in collaboration with an outside valuation firm, reviews and evaluates the cash flows related to the pools in the loans acquired with deteriorated credit quality. Based on this ongoing review, adjustments are made to accretion and the nonaccretable yield.

#### Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDR"). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans. The Company has \$2,099,000 in loans classified as TDRs as of December 31, 2013 and \$1,755,000 as of December 31, 2012.

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Allowance for Loan Losses

The purpose of the allowance for loan losses ("ALLL") is to provide for probable losses 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 Committees 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 allowance for loan losses 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 allowance for loan losses 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, and portfolio concentrations. 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 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);
- 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.

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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.

## Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost, less accumulated depreciation and amortization. Premises and equipment are depreciated over their estimated useful lives ranging from three years to thirty-nine years; leasehold improvements are amortized over the lives of the respective leases or the estimated useful lives of the improvements, whichever is less. Software is generally amortized over three years. Depreciation and amortization are recorded on the straight-line method.

Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Gains and losses on routine dispositions are reflected in current operations.

## Goodwill and Intangible Assets

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. Additionally, acquired intangible assets (such as core deposit intangibles) are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful lives. Intangible assets related to branch transactions continued to amortize. The cost of purchased deposit relationships and other intangible assets, based on independent valuation, are being amortized over their estimated lives ranging from eight to ten years.

The Company records as goodwill the excess of 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 during the years ended December 31, 2013, 2012 and 2011.

## Trust Assets

Securities and other property held by the trust and investment services segment in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

## Other Real Estate Owned

Other real estate owned represents real estate that has been acquired through loan foreclosures or deeds received in lieu of loan payments. Generally, such properties are appraised at the time acquired, and are recorded at the fair value less estimated selling costs. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in noninterest expense.

## Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank – put presumptively beyond reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

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### Income Taxes

The Company uses the balance sheet method to account for deferred income tax assets and liabilities. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. The Company had no liability for unrecognized tax benefits as of December 31, 2013 and 2012.

### Stock-Based Compensation

Stock compensation accounting guidance FASB ASC 718, "Compensation – Stock Compensation" requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards.

### Earnings Per Common Share

Basic earnings per common share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflect the impact of additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company consist solely of outstanding stock options, and are determined using the treasury method.

### Comprehensive Income

Comprehensive income is shown in a two statement approach, the first statement presents total net income and its components followed by a second statement that presents all the components of other comprehensive income such as unrealized gains and losses on available for sale securities and changes in the funded status of a defined benefit postretirement plan.

### Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred, and were \$607,000, \$454,000, and \$356,000 in 2013, 2012, and 2011, respectively.

### Mergers and Acquisitions

Business combinations are accounted for under 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 relies on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analyses or other valuation techniques. Under the acquisition method of accounting, the Company identifies the acquirer and the closing date and apply applicable recognition principles and conditions.

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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 accounts 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 is 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.

### Reclassifications

Certain reclassifications have been made in prior years financial statements to conform to classifications used in the current year. There were no material reclassifications.

### Use of Estimates

In preparing consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and 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.

### Recent Accounting Pronouncements

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2012, the FASB issued ASU 2012-02, "Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment." The amendments in this ASU apply to all entities that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. The amendments in this ASU provide an entity with the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset's fair value when testing an indefinite-lived intangible asset for impairment. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued ASU 2013-01, "Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." The amendments in this ASU clarify the scope for derivatives accounted for in accordance with Topic 815, "Derivatives and Hedging," including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements and securities borrowing and securities lending transactions that are either offset or subject to netting arrangements. An entity is required to apply the amendments for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in the consolidated financial statements.

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In July 2013, the FASB issued ASU 2013-10, "Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes." The amendments in this ASU permit the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to interest rates on direct Treasury obligations of the U.S. government and the London Interbank Offered Rate. The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate under Topic 815. The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU 2013-11, "Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." The amendments in this ASU provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2014, the FASB issued ASU 2014-01, "Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company is currently assessing the impact that ASU 2014-01 will have on its consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, "Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded



investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements.

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 share of Company common stock outstanding immediately prior to the merger has continued to be outstanding after 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 additional common stock in connection with the MidCarolina merger. MidCarolina Bank was merged with and into the Bank.

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 recorded as goodwill in the amount of approximately \$16.6 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 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 |

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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 performing portion of the portfolio's estimated fair value was \$286.5 million. The excess of expected cash flows above the fair value of the performing portion of loans is being accreted to interest income over the remaining lives of the loans in accordance with FASB ASC 310-20 (formerly SFAS 91).

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 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 for assets other than land is being 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 is being 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 ("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 is being 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 is being 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 is being 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 2011, the Company incurred \$1.6 million in merger and acquisition integration expenses related to the transaction, including \$1.3 million in professional services, \$130,000 in technology and communications, \$22,000 in advertising and marketing, and \$26,000 in other non-interest expenses. During 2012, the Company incurred \$19,000 in merger related expense. There were no merger related expenses in 2013.

The following table presents unaudited pro forma information as if the merger with MidCarolina had occurred on January 1, 2010. This pro forma information gives effect to certain adjustments, including purchase accounting fair value adjustments, amortization of core deposit and other intangibles 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 MidCarolina occurred in 2010. In particular, expected operational cost savings are not reflected in the pro forma amounts.

| (in thousands)            | Pro forma<br>At December 31, |          |          |
|---------------------------|------------------------------|----------|----------|
|                           | 2013                         | 2012     | 2011     |
| Net interest income       | \$40,959                     | \$44,954 | \$50,781 |
| Provision for loan losses | 294                          | 2,133    | 5,570    |
| Non-interest income       | 10,827                       | 11,410   | 10,299   |
| Non-interest expense      | 34,780                       | 35,991   | 37,542   |
| Income Taxes              | 3,861                        | 3,649    | 5,321    |
| Net income                | \$12,851                     | \$14,591 | \$12,647 |

## Note 3 – Restrictions on Cash

The Company is a member of the Federal Reserve System and is required to maintain certain levels of its cash and cash equivalents as reserves based on regulatory requirements. This reserve requirement was approximately \$0 at December 31, 2013 and \$1,347,000 at December 31, 2012. The significant reduction in the amount of the required reserve was related to the implementation of a robust deposit reclassification program initiated in 2012.

The Company maintains cash accounts in other commercial banks. The amount on deposit with correspondent institutions at December 31, 2013 exceeded the insurance limits of the Federal Deposit Insurance Corporation by \$170,000.

## Note 4 - Securities

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

| (in thousands)                 | December 31, 2013 |                  |                   |                      |
|--------------------------------|-------------------|------------------|-------------------|----------------------|
|                                | Amortized Cost    | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Securities available for sale: |                   |                  |                   |                      |
| Federal agencies and GSEs      | \$66,241          | \$ 126           | \$ 486            | \$65,881             |
| Mortgage-backed and CMOs       | 69,168            | 1,085            | 645               | 69,608               |
| State and municipal            | 193,251           | 5,999            | 517               | 198,733              |
| Corporate                      | 10,959            | 4                | 164               | 10,799               |

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|                                     |           |          |          |           |
|-------------------------------------|-----------|----------|----------|-----------|
| Equity securities                   | 1,000     | 103      | -        | 1,103     |
| Total securities available for sale | \$340,619 | \$ 7,317 | \$ 1,812 | \$346,124 |

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|                                     | December 31, 2012 |                  |                   | Estimated  |
|-------------------------------------|-------------------|------------------|-------------------|------------|
|                                     | Amortized Cost    | Unrealized Gains | Unrealized Losses | Fair Value |
| Securities available for sale:      |                   |                  |                   |            |
| Federal agencies and GSEs           | \$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  |

The amortized cost and estimated fair value of investments in securities at December 31, 2013, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Because mortgage-backed securities have both known principal repayment terms as well as unknown principal repayments due to potential borrower pre-payments, it is difficult to accurately predict the final maturity of these investments. Mortgage-backed securities are shown separately.

| (in thousands)                         | Available for Sale |                      |
|--|--------------------|----------------------|
|  | Amortized Cost     | Estimated Fair Value |
| Due in one year or less                | \$7,737            | 7,782                |
| Due after one year through five years  | 140,272            | 142,014              |
| Due after five years through ten years | 98,991             | 101,691              |
| Due after ten years                    | 23,451             | 23,926               |
| Mortgage-backed and CMOs               | 69,168             | 69,608               |
| Equity securities                      | 1,000              | 1,103                |
|  | \$340,619          | \$346,124            |

Gross realized gains and losses from the call of certain securities or the sale of securities available for sale were as follows (in thousands):

|                                 | For the Years Ended<br>December 31, |       |      |
|---------------------------------|-------------------------------------|-------|------|
|                                 | 2013                                | 2012  | 2011 |
| Realized gains                  | \$229                               | \$193 | \$47 |
| Realized losses                 | (37)                                | (35)  | (48) |
| Other-than-temporary impairment | -                                   | -     | -    |

Securities with a carrying value of approximately \$154,946,000 and \$127,599,000, at December 31, 2013 and 2012, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required by law. FHLB letters of credit were used as additional collateral in the amounts of \$72,000,000 at December 31, 2013 and at December 31, 2012.

## 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 December 31, 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.

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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  |                 | Estimated           |                 | Estimated         |                 |
|                           | Fair Value | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss |
| Federal agencies and GSEs | \$41,586   | \$ 486          | \$41,586            | \$ 486          | \$-               | \$ -            |
| Mortgage-backed and CMOs  | 23,916     | 645             | 19,042              | 577             | 4,874             | 68              |
| State and municipal       | 33,192     | 517             | 29,732              | 462             | 3,460             | 55              |
| Corporate                 | 7,347      | 164             | 7,347               | 164             | -                 | -               |
| Total                     | \$106,041  | \$ 1,812        | \$97,707            | \$ 1,689        | \$8,334           | \$ 123          |

GSE debt securities: The unrealized losses on the Company's investment in 22 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 December 31, 2013.

GSE residential mortgage-backed securities: The unrealized losses on the Company's investment in 19 GSE mortgage-backed securities 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 bases 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 bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2013.

State and municipal securities: The unrealized losses on 34 state and municipal securities were caused by interest rate increases and not credit deterioration. 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 December 31, 2013.

Corporate securities: The unrealized losses on seven corporate securities were caused by interest rate increases and not credit deterioration. 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 .

The Company's investment in FHLB stock totaled \$2,000,000 at December 31, 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 December 31, 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.



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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 December 31, 2013 and 2012, there were no securities classified as other-than-temporary impaired.

## Note 5 – Loans

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

| (in thousands)                    | December 31, |            |
|-----------------------------------|--------------|------------|
|                                   | 2013         | 2012       |
| Commercial                        | \$ 122,553   | \$ 126,192 |
| Commercial real estate:           |              |            |
| Construction and land development | 41,822       | 48,812     |
| Commercial real estate            | 364,616      | 355,433    |
| Residential real estate:          |              |            |
| Residential                       | 171,917      | 161,033    |
| Home equity                       | 87,797       | 91,313     |
| Consumer                          | 5,966        | 5,922      |
| Total loans                       | \$794,671    | \$788,705  |

Net deferred loan (fees) costs included in the above loan categories are \$(299,000) for 2013 and \$(128,000) for 2012.

Overdraft deposits were reclassified to consumer loans in the amount of \$71,000 and \$110,000 for 2013 and 2012, respectively.

Acquired Loans

Interest income, including accretion, on loans acquired from MidCarolina for the year ended December 31, 2013 was approximately \$17.8 million. The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheets at December 31, 2013 and 2012, are as follows:

| (in thousands)                | 2013       | 2012       |
|-------------------------------|------------|------------|
| Outstanding principal balance | \$ 134,099 | \$ 219,569 |
| Carrying amount               | 124,828    | 203,981    |

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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, as of the indicated dates is as follows:

| (in thousands)                | December<br>31, 2013 | December<br>31, 2012 |
|-------------------------------|----------------------|----------------------|
| Outstanding principal balance | \$ 21,014            | \$ 26,349            |
| Carrying amount               | 16,644               | 20,182               |

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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 year ended December 31, 2013. The accretion reflected below includes \$1,764,000 related to loan payoffs.

|  |                     |
|--|---------------------|
| (in thousands)                                 | Accretable Discount |
| Balance at December 31, 2012                   | \$ 2,165            |
| Accretion                                      | (2,635 )            |
| Reclassification from nonaccretable difference | 2,516               |
| Balance at December 31, 2013                   | \$ 2,046            |

Past Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2013.

| (in thousands)                    | 30- 59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90 Days |                          | Total<br>Past<br>Due | Current   | Total<br>Loans |
|-----------------------------------|-------------------------------|------------------------------|---------|--------------------------|----------------------|-----------|----------------|
|                                   |                               |                              | +       | Non-<br>Accrual<br>Loans |                      |           |                |
| Commercial                        | \$27                          | \$-                          | \$ -    | \$ 11                    | \$38                 | \$122,515 | \$122,553      |
| Commercial real estate:           |                               |                              |         |                          |                      |           |                |
| Construction and land development | -                             | 51                           | -       | 877                      | 928                  | 40,894    | 41,822         |
| Commercial real estate            | 667                           | -                            | -       | 2,879                    | 3,546                | 361,070   | 364,616        |
| Residential:                      |                               |                              |         |                          |                      |           |                |
| Residential                       | 642                           | 202                          | -       | 880                      | 1,724                | 170,193   | 171,917        |
| Home equity                       | 109                           | 18                           | -       | 424                      | 551                  | 87,246    | 87,797         |
| Consumer                          | 21                            | 1                            | -       | -                        | 22                   | 5,944     | 5,966          |
| Total                             | \$1,466                       | \$272                        | \$ -    | \$ 5,071                 | \$6,809              | \$787,862 | \$794,671      |

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

| (in thousands)                    | 30- 59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90 Days |                          | Total<br>Past<br>Due | Current   | Total<br>Loans |
|-----------------------------------|-------------------------------|------------------------------|---------|--------------------------|----------------------|-----------|----------------|
|                                   |                               |                              | +       | Non-<br>Accrual<br>Loans |                      |           |                |
| 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 acquired impaired loans, at December 31, 2013.

| (in thousands)                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 19                  | \$ 19                          | \$ -                 | \$ 20                             | \$ 1                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 18                     | 18                             | -                    | 261                               | 4                                |
| Commercial real estate              | 936                    | 936                            | -                    | 950                               | 13                               |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 880                    | 888                            | -                    | 1,200                             | 11                               |
| Home equity                         | 424                    | 424                            | -                    | 433                               | -                                |
| Consumer                            | -                      | -                              | -                    | -                                 | -                                |
|                                     | \$ 2,277               | \$ 2,285                       | \$ -                 | \$ 2,864                          | \$ 29                            |
| With a related allowance recorded:  |                        |                                |                      |                                   |                                  |
| Commercial                          | -                      | -                              | -                    | -                                 | -                                |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 1,468                  | 1,507                          | 68                   | 1,551                             | 33                               |
| Commercial real estate              | 2,266                  | 2,264                          | 488                  | 1,198                             | 7                                |
| Residential                         |                        |                                |                      |                                   |                                  |
| Residential                         | -                      | -                              | -                    | -                                 | -                                |
| Home equity                         | -                      | -                              | -                    | -                                 | -                                |
| Consumer                            | 18                     | 18                             | 3                    | 19                                | 1                                |
|                                     | \$ 3,752               | \$ 3,789                       | \$ 559               | \$ 2,768                          | \$ 41                            |
| Total:                              |                        |                                |                      |                                   |                                  |
| Commercial                          | \$ 19                  | \$ 19                          | \$ -                 | \$ 20                             | \$ 1                             |
| Commercial real estate:             |                        |                                |                      |                                   |                                  |
| Construction and land development   | 1,486                  | 1,525                          | 68                   | 1,812                             | 37                               |
| Commercial real estate              | 3,202                  | 3,200                          | 488                  | 2,148                             | 20                               |
| Residential:                        |                        |                                |                      |                                   |                                  |
| Residential                         | 880                    | 888                            | -                    | 1,200                             | 11                               |
| Home equity                         | 424                    | 424                            | -                    | 433                               | -                                |
| Consumer                            | 18                     | 18                             | 3                    | 19                                | 1                                |
|                                     | \$ 6,029               | \$ 6,074                       | \$ 559               | \$ 5,632                          | \$ 70                            |



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The following table presents the Company's impaired loan balances by portfolio segment, excluding acquired impaired loans, at December 31, 2012.

| (in thousands)                      | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|-------------------------------------|---------------------|--------------------------|-------------------|-----------------------------|----------------------------|
| With no related allowance recorded: |                     |                          |                   |                             |                            |
| 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                         |
| Home equity                         | -                   | -                        | -                 | -                           | -                          |
| Consumer                            | -                   | -                        | -                 | -                           | -                          |
|                                     | \$ 2,916            | \$ 3,221                 | \$ -              | \$ 3,256                    | \$ 34                      |
| With a related allowance recorded:  |                     |                          |                   |                             |                            |
| Commercial                          | \$ 110              | \$ 110                   | \$ 107            | \$ 35                       | \$ -                       |
| Commercial real estate:             |                     |                          |                   |                             |                            |
| Construction and land development   | -                   | -                        | -                 | -                           | -                          |
| Commercial real estate              | -                   | -                        | -                 | -                           | -                          |
| Residential:                        |                     |                          |                   |                             |                            |
| Residential                         | -                   | -                        | -                 | -                           | -                          |
| Home equity                         | -                   | -                        | -                 | -                           | -                          |
| Consumer                            | 21                  | 21                       | 21                | 10                          | -                          |
|                                     | \$ 131              | \$ 131                   | \$ 128            | \$ 45                       | \$ -                       |
| Total:                              |                     |                          |                   |                             |                            |
| 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                            | 21                  | 21                       | 21                | 10                          | -                          |
|                                     | \$ 3,047            | \$ 3,352                 | \$ 128            | \$ 3,301                    | \$ 34                      |

The following table shows the detail of loans modified as troubled debt restructurings ("TDRs") during the year ended December 31, 2013, 2012, and 2011, included in the impaired loan balances.

| (dollars in thousands) | Loans Modified as a TDR for the<br>Year Ended December 31, 2013        |  |
|------------------------|--|--|
|                        | Pre-Modification<br>Number of<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial             | - \$ -   | \$ -   |
| Commercial real estate | 1 1,190  | 1,190  |

|                          |   |          |          |
|--------------------------|---|----------|----------|
| Residential real estate: | - | -        | -        |
| Consumer                 | - | -        | -        |
| Total                    | 1 | \$ 1,190 | \$ 1,190 |

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| (dollars in thousands)  | Loans Modified as a TDR for the<br>Year Ended December 31, 2012 |                                       |                                       |
|-------------------------|---|---------------------------------------|---------------------------------------|
|                         | Number<br>of<br>Contracts                                       | Pre-Modification                      | Post-Modification                     |
|                         |   | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |
|                         | Commercial  | 1                                     | \$ 11                                 |
| Commercial real estate  | 9   | 2,421                                 | 1,403                                 |
| Residential real estate | 1   | 11                                    | 11                                    |
| Consumer                | 1   | 22                                    | 21                                    |
| Total                   | 12  | \$ 2,465                              | \$ 1,445                              |

| (dollars in thousands)  | Loans Modified as a TDR for the<br>Year Ended December 31, 2011 |                                       |                                       |
|-------------------------|---|---------------------------------------|---------------------------------------|
|                         | Number<br>of<br>Contracts                                       | Pre-Modification                      | Post-Modification                     |
|                         |   | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |
|                         | Commercial  | -                                     | \$ -                                  |
| Commercial real estate  | 4   | 417                                   | 369                                   |
| Residential real estate | 1   | 316                                   | 287                                   |
| Consumer                | -   | -                                     | -                                     |
| Total                   | 5   | \$ 733                                | \$ 656                                |

During the year ended December 31, 2013, 2012, and 2011, the Company had no loans that subsequently defaulted within twelve months of modification. The Company defines default as one or more payments that occur more than 90 days past the due date, charge-off or foreclosure subsequent to modification.

The following table summarizes the primary reason loan modification were classified as TDRs and includes newly designated TDRs as well as modifications made to existing TDRs. Balances represent the recorded investment at the end of the year in which the modification was made. Rate modifications include TDRs made with below market interest rates that also include modifications of loan structures.

| (dollars in thousands)  | Year Ended December 31, |                       |        |                         |                       |        |                         |                       |      |
|-------------------------|-------------------------|-----------------------|--------|-------------------------|-----------------------|--------|-------------------------|-----------------------|------|
|                         | 2013                    |                       |        | 2012                    |                       |        | 2011                    |                       |      |
|                         | Type of<br>Modification | ALLL<br>RateStructure | Impact | Type of<br>Modification | ALLL<br>RateStructure | Impact | Type of<br>Modification | ALLL<br>RateStructure |      |
| Commercial              | \$-                     | \$ -                  | \$ -   | \$-                     | \$ 10                 | \$ 8   | \$-                     | \$ -                  | \$ - |
| Commercial real estate  | -                       | 1,190                 | 137    | -                       | 1,403                 | -      | -                       | 369                   | -    |
| Residential Real Estate | -                       | -                     | -      | -                       | 11                    | -      | -                       | 287                   | -    |
| Consumer                | -                       | -                     | -      | -                       | 21                    | 22     | -                       | -                     | -    |
| Total                   | \$-                     | \$ 1,190              | \$ 137 | \$-                     | \$ 1,445              | \$ 30  | \$-                     | \$ 656                | \$ - |

Risk Ratings

The following table shows the Company's loan portfolio broken down by internal risk grading as of December 31, 2013.

(in thousands)

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

|                 | Commercial | Construction<br>and Land<br>Development | Commercial<br>Real Estate | Residential<br>Real<br>Estate | Home<br>Equity |
|-----------------|------------|---|---------------------------|-------------------------------|----------------|
| Pass            | \$ 121,033 | \$ 35,563                               | \$ 351,801                | \$ 158,478                    | \$ 85,163      |
| Special Mention | 1,500      | 1,005                                   | 6,795                     | 8,242                         | 1,650          |
| Substandard     | 20         | 5,254                                   | 6,020                     | 5,197                         | 984            |
| Doubtful        | -          | -                                       | -                         | -                             | -              |
| Total           | \$ 122,553 | \$ 41,822                               | \$ 364,616                | \$ 171,917                    | \$ 87,797      |

Consumer Credit Exposure  
Credit Risk Profile Based on Payment Activity

| Consumer      |          |
|---------------|----------|
| Performing    | \$ 5,966 |
| Nonperforming | -        |
| Total         | \$ 5,966 |

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 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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The following table shows the Company's 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 | Construction<br>and Land<br>Development | Commercial<br>Real Estate | Residential<br>Real<br>Estate | Home<br>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    | \$ 5,919 |
| Nonperforming | 3        |
| Total         | \$ 5,922 |

Note 6 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments for each of the years in the three-year period ended December 31, 2013, are presented below:

| (in thousands)                           | Years Ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2013                     | 2012     | 2011     |
| Allowance for Loan Losses                |                          |          |          |
| Balance, beginning of year               | \$12,118                 | \$10,529 | \$8,420  |
| Provision for loan losses                | 294                      | 2,133    | 3,170    |
| Charge-offs                              | (837 )                   | (2,086 ) | (1,863 ) |
| Recoveries                               | 1,025                    | 1,542    | 802      |
| Balance, end of year                     | \$12,600                 | \$12,118 | \$10,529 |
|  |                          |          |          |
|  | Years Ended December 31, |          |          |
|  | 2013                     | 2012     | 2011     |
| Reserve for Unfunded Lending Commitments |                          |          |          |
| Balance, beginning of year               | \$201                    | \$200    | \$218    |
| Provision for unfunded commitments       | 9                        | 1        | (18 )    |
| Charge-offs                              | -                        | -        | -        |
| Balance, end of year                     | \$210                    | \$201    | \$200    |

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

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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.

|                                       | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total     |
|---------------------------------------|------------|------------------------|-------------------------|----------|-------------|-----------|
| (in thousands)                        |            |                        |                         |          |             |           |
| Allowance for Loan Losses             |            |                        |                         |          |             |           |
| Balance as of December 31, 2012       | \$ 1,450   | \$ 6,822               | \$ 3,638                | \$ 208   | \$ -        | \$12,118  |
| Charge-offs                           | (129 )     | (164 )                 | (369 )                  | (175 )   | -           | (837 )    |
| Recoveries                            | 335        | 323                    | 244                     | 123      | -           | 1,025     |
| Provision                             | 154        | (162 )                 | 177                     | (57 )    | 182,000     | 294       |
| Balance at December 31, 2013          | \$ 1,810   | \$ 6,819               | \$ 3,690                | \$ 99    | \$ 182,000  | \$12,600  |
| Balance at December 31, 2013:         |            |                        |                         |          |             |           |
| Allowance for Loan Losses             |            |                        |                         |          |             |           |
| Individually evaluated for impairment | \$ -       | \$ 556                 | \$ -                    | \$ 3     | \$ -        | \$559     |
| Collectively evaluated for impairment | 1,810      | 6,039                  | 3,483                   | 96       | 182,000     | 11,610    |
| Acquired impaired loans               | -          | 224                    | 207                     | -        | -           | 431       |
| Total                                 | \$ 1,810   | \$ 6,819               | \$ 3,690                | \$ 99    | \$ 182,000  | \$12,600  |
| Loans                                 |            |                        |                         |          |             |           |
| Individually evaluated for impairment | \$ 19      | \$ 4,638               | \$ 1,304                | \$ 18    | \$ -        | \$5,979   |
| Collectively evaluated for impairment | 122,424    | 392,770                | 250,906                 | 5,948    | -           | 772,048   |
| Acquired impaired loans               | 110        | 9,030                  | 7,504                   | -        | -           | 16,644    |
| Total                                 | \$ 122,553 | \$ 406,438             | \$ 259,714              | \$ 5,966 | \$ -        | \$794,671 |
| Balance as of December 31, 2012:      |            |                        |                         |          |             |           |
| Allowance for Loan Losses             |            |                        |                         |          |             |           |
| 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  |
| Allowance for Loan Losses             |            |                        |                         |          |             |           |
| Individually evaluated for impairment | \$ 107     | \$ -                   | \$ -                    | \$ 21    | \$ -        | \$128     |
| Collectively evaluated for impairment | 1,343      | 6,376                  | 3,609                   | 187      | -           | 11,515    |
| Acquired impaired loans               | -          | 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   |
| Acquired impaired loans               | 336        | 13,143                 | 6,703                   | -        | -           | 20,182    |
| Total                                 | \$ 126,192 | \$ 404,245             | \$ 252,346              | \$ 5,922 | \$ -        | \$788,705 |

The allowance for loan losses is allocated to loan segments based upon historical loss factors, risk grades on individual loans, portfolio analyses 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, other lending staff and loan review; national, regional, and local economic trends and conditions; legal, regulatory and collateral factors; and concentrations of credit.



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## Note 7 – Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

| (in thousands)              | December 31, |          |
|-----------------------------|--------------|----------|
|                             | 2013         | 2012     |
| Land                        | \$5,794      | \$5,794  |
| Buildings                   | 22,968       | 22,754   |
| Leasehold improvements      | 1,238        | 1,238    |
| Furniture and equipment     | 17,965       | 17,366   |
|                             | 47,965       | 47,152   |
| Accumulated depreciation    | (24,291)     | (22,609) |
| Premises and equipment, net | \$23,674     | \$24,543 |

Depreciation expense for the years ended December 31, 2013, 2012, and 2011 was \$1,734,000, \$1,761,000, and \$1,385,000, respectively.

The Company has entered into operating leases for several of its branch and ATM facilities. The minimum annual rental payments under these leases at December 31, 2013 are as follows:

| (in thousands) | Minimum<br>Lease<br>Payments |
|----------------|------------------------------|
| Year           |                              |
| 2014           | \$ 589                       |
| 2015           | 553                          |
| 2016           | 455                          |
| 2017           | 399                          |
| 2018           | 275                          |
| 2019 and after | 3                            |
|                | \$ 2,274                     |

Rent expense, a component of occupancy and equipment expense, for the years ended December 31, 2013, 2012, and 2011 was \$629,000, \$649,000, and \$452,000, respectively.

## Note 8– Goodwill and Other Intangible Assets

The Company records as goodwill the excess of 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 during the years ended December 31, 2013, 2012, and 2011.

Core deposit intangibles resulting from the Community First acquisition in April 2006 were \$3,112,000 and are being amortized over 99 months. Core deposit intangibles resulting from the MidCarolina acquisition in July 2011 were \$6,556,000 and are being amortized on an accelerated basis over 108 months.

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The changes in the carrying amount of goodwill and intangibles for the twelve months ended December 31, 2013, are as follows (in thousands):

|                                 | Goodwill  | Intangibles |
|---------------------------------|-----------|-------------|
| Balance as of December 31, 2012 | \$ 39,043 | \$ 4,660    |
| Additions                       | -         | -           |
| Amortization                    | -         | (1,501 )    |
| Impairment                      | -         | -           |
| Balance at December 31, 2013    | \$ 39,043 | \$ 3,159    |

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Goodwill and intangible assets are as follow (in thousands):

|                          | Gross<br>Carrying<br>Value | Accumulated<br>Amortization | Net<br>Carrying<br>Value |
|--------------------------|----------------------------|-----------------------------|--------------------------|
| December 31, 2013        |                            |                             |                          |
| Core deposit intangibles | \$ 9,669                   | \$ (6,510 )                 | \$ 3,159                 |
| Goodwill                 | 39,043                     | -                           | 39,043                   |
| December 31, 2012        |                            |                             |                          |
| Core deposit intangibles | \$ 9,669                   | \$ (5,009 )                 | \$ 4,660                 |
| Goodwill                 | 39,043                     | -                           | 39,043                   |

Amortization expense of core deposit intangibles for the years ended December 31, 2013, 2012, and 2011 were \$1,501,000, \$1,935,000, and \$1,282,000, respectively. As of December 31, 2013, the estimated future amortization expense of core deposit intangibles is as follows (in thousands):

| Year           | Amount   |
|----------------|----------|
| 2014           | \$ 1,114 |
| 2015           | 906      |
| 2016           | 717      |
| 2017           | 320      |
| 2018           | 68       |
| 2019 and after | 34       |
| Total          | \$ 3,159 |

## Note 9 - Deposits

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2013 and 2012 was \$240,661,000 and \$249,246,000, respectively.

At December 31, 2013, the scheduled maturities of certificates of deposits (included in "time" deposits on the Consolidated Balance Sheet) were as follows (in thousands):

| Year  | Amount    |
|-------|-----------|
| 2014  | \$133,481 |
| 2015  | 24,711    |
| 2016  | 115,408   |
| 2017  | 72,396    |
| 2018  | 43,602    |
| Total | \$389,598 |

The Company has a relatively small portion of its time deposits provided by wholesale sources. Brokered time deposits totaled \$4,000,000 at December 31 2013, compared to \$7,314,000 at December 31 2012. Time deposits through the CDARs program totaled \$22,375,000 at December 31 2013, compared to \$22,150,000 at December 31 2012. Deposits through the CDARs program are generated from major customers with substantial relationships to the Bank.

## Note 10 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. The Company has federal funds lines of credit established with two correspondent banks in the amounts of \$15,000,000 and \$10,000,000, and, additionally, has access to the Federal Reserve Bank's discount window. Customer repurchase agreements are collateralized by securities of the U.S. Government, its agencies or GSEs. They mature daily. The interest rates are generally fixed but may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. FHLB overnight borrowings 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. Short-term borrowings consisted solely of customer repurchase agreements at December 31, 2013 and 2012.

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Short-term borrowings consisted solely of customer repurchase agreements at December 31, 2013 and 2012.

|                                | December 31, 2013   |      | December 31, 2012   |        |
|--------------------------------|---------------------|------|---------------------|--------|
|                                | Weighted<br>Average |      | Weighted<br>Average |        |
|                                | Amount              | Rate | Amount              | Rate   |
| Customer repurchase agreements | \$39,478            | 0.02 | % \$49,942          | 0.18 % |

## Note 11 – 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 December 31, 2013, \$377,420,000 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, advances as of December 31, 2013 and 2012 (dollars in thousands):

|               | December 31, 2013 |          |                 | December 31, 2012 |          |   |
|---------------|-------------------|----------|-----------------|-------------------|----------|---|
|               | Advance           | Weighted |                 | Advance           | Weighted |   |
| Due by        | Amount            | Average  | Due by          | Amount            | Average  |   |
|               |                   | Rate     |                 |                   | Rate     |   |
| March 2014    | \$38              | 3.78     | % March 2014    | \$188             | 3.78     | % |
| November 2017 | 9,913             | 2.98     | % November 2017 | 9,891             | 2.98     | % |
|               | \$9,951           | 2.98     | %               | \$10,079          | 2.99     | % |

The advance due in November 2017 is net of a valuation allowance of \$87,000. The original valuation allowance recorded on July 1, 2011 was a result of the merger with MidCarolina. The adjustment to the face value will be amortized into interest expense over the life of the borrowing.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At December 31, 2013, the Bank's public deposits totaled \$128,116,000. 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 December 31, 2013, the Company had \$72,000,000 in letters of credit with the FHLB outstanding as well as \$97,938,000 in agency, state, and municipal securities to provide collateral for such deposits.

## Note 12 – Trust Preferred Capital Notes

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust and a wholly owned subsidiary of the Company, issued \$20,000,000 of preferred securities in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on September 30, 2036, but may be redeemed at the Company's option beginning on June 30, 2011. Initially, the securities required quarterly distributions by the trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective June 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.

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The proceeds of the Trust Preferred Securities received by the trust, 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 "Trust Preferred Capital Notes"), issued pursuant to a junior subordinated debentures entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Trust Preferred Capital Notes were used to fund the cash portion of the merger consideration to the former shareholders of Community First 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 debentures to 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. The MidCarolina Trusts are not consolidated in the Company's financial statements.

In accordance with FASB ASC 810-10-15-14, "Consolidation – Overall - Scope and Scope Exceptions," the Company did not eliminate through consolidation the Company's \$619,000 equity investment in AMNB Statutory 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 securities outstanding payable to the trusts is shown below:

| Issuing Entity       | Date Issued | Interest Rate     | Maturity Date | (Amounts in thousands)             |                   |
|----------------------|-------------|-------------------|---------------|------------------------------------|-------------------|
|                      |             |                   |               | Principal Amount December 31, 2013 | December 31, 2012 |
| AMNB Trust I         | 04/07/06    | Libor plus 1.35 % | 06/30/36      | \$20,619                           | \$20,619          |
| MidCarolina Trust I  | 10/29/02    | Libor plus 3.45 % | 11/07/32      | 4,098                              | 4,042             |
| MidCarolina Trust II | 12/03/03    | Libor plus 2.95 % | 10/07/33      | 2,702                              | 2,656             |
|                      |             |                   |               | \$27,419                           | \$27,317          |

The principal amounts reflected for the MidCarolina Trusts are net of valuation allowances of \$1,057,000 and \$907,000 respectively. The original valuation allowances of \$1,197,000 and \$1,021,000 were recorded as a result of the merger with MidCarolina on July 1, 2011 and are being amortized into interest expense over the remaining lives of the respective borrowings.

Note 13 – 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, 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, which plan terminated in 2006.

#### 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.



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A summary of stock option transactions is as follows:

|                                  | Option<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual Term | Aggregate<br>Intrinsic<br>Value<br>(Term (\$000)) |
|----------------------------------|------------------|--|--|---|
| Outstanding at December 31, 2012 | 240,517          | \$ 24.28                                 |  |   |
| Granted                          | -                | -  |  |   |
| Exercised                        | 17,475           | 17.70                                    |  |   |
| Forfeited                        | 11,795           | 27.64                                    |  |   |
| Expired                          | 34,500           | 25.94                                    |  |   |
| Outstanding at December 31, 2013 | 176,747          | \$ 24.39                                 | 3.33 years   | \$ 556  |
| Exercisable at December 31, 2013 | 176,747          | \$ 24.39                                 | 3.33 years   | \$ 556  |

The aggregate intrinsic value of stock options in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2013. This amount changes based on changes in the market value of the Company's common stock.

The total proceeds of the in-the-money options exercised during the year ended December 31, 2013, 2012, and 2011 were \$309,000, \$118,000, and \$173,000, respectively. Total intrinsic value of options exercised during years ended December 31, 2013, 2012, and 2011 was \$75,000, \$33,000, and \$56,000, respectively.

As of December 31, 2013, 2012, and 2011, there was \$0, \$0, and \$16,000, respectively, in unrecognized compensation expense. Compensation expense related to stock options was \$0 in 2013, \$0 in 2012, and \$63,000 in 2011.

The following table summarizes information related to stock options outstanding on December 31, 2013:

| Options Outstanding         | Number of<br>Outstanding<br>Options | Weighted-<br>Average<br>Remaining<br>Contractual Life | Weighted-<br>Average<br>Exercise<br>Price | Options Exercisable                    |  |
|-----------------------------|-------------------------------------|---|---|--|--|
|                             |                                     |   |   | Number<br>of<br>Options<br>Exercisable | Weighted<br>Average<br>Exercise<br>Price |
| Range of<br>Exercise Prices |                                     |   |   |  |  |
| \$16.00 to \$20.00          | 37,000                              | 4.98 yrs  | \$ 16.95                                  | 37,000                                 | \$ 16.95                                 |
| 20.01 to 25.00              | 73,460                              | 2.82  | 23.52                                     | 73,460                                 | 23.52                                    |
| 25.01 to 30.00              | 23,925                              | 4.55  | 25.81                                     | 23,925                                 | 25.81                                    |
| 30.01 to 41.67              | 42,362                              | 2.10  | 31.59                                     | 42,362                                 | 31.59                                    |
|                             | 176,747                             | 3.33 yrs  | \$ 24.39                                  | 176,747                                | \$ 24.39                                 |

No stock options were granted in 2013 and 2012.

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 in 2013 cliff vests over 36 months based on the term of the award.

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Nonvested restricted stock activity for the year ended December 31, 2013 is summarized in the following table:

| Restricted Stock               | Shares | Weighted<br>Average<br>Grant<br>Date<br>Value |
|--------------------------------|--------|---|
| Nonvested at January 1, 2013   | 39,327 | \$ 20.17                                      |
| Granted                        | 13,599 | \$ 20.82                                      |
| Vested                         | 19,576 | \$ 21.31                                      |
| Forfeited                      | -      | -   |
| Nonvested at December 31, 2013 | 33,350 | \$ 19.77                                      |

As of December 31, 2013, 2012, and 2011, there were \$337,000, \$346,000, and \$404,000, respectively, in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. This cost is expected to be recognized over the next 12 to 30 months. The share based compensation expense for nonvested restricted stock was \$292,000, \$357,000, and \$291,000 during 2013, 2012, and 2011 respectively.

Starting in 2010, the Company began offering its outside directors alternatives with respect to director compensation. For 2013, the regular quarterly board retainer could be received in the form of either (i) \$3,000 in cash or (ii) shares of immediately vested, but restricted stock, with a market value of \$4,688. Monthly meeting fees can also be received as \$600 per meeting in cash or \$750 in immediately vested, but restricted stock. For 2013, all 13 outside directors elected to receive stock in lieu of cash for either all or part of their quarterly retainer or meeting fees. Only outside directors receive board fees. The Company issued 12,711, 17,908, and 12,818 shares and recognized share based compensation expense of \$282,000, \$381,000, and 242,000 during 2013, 2012 and 2011, respectively.

## Note 14 – Income Taxes

The Company files income tax returns in the U.S. federal jurisdiction and the states of Virginia and North Carolina. With few exceptions, the Company is no longer subject to U.S. federal, state, and local income tax examinations by tax authorities for years prior to 2010.

The components of the Company's net deferred tax assets (liabilities) were as follows:

| (in thousands)                              | December 31, |         |
|---|--------------|---------|
|   | 2013         | 2012    |
| Deferred tax assets:                        |              |         |
| Allowance for loan losses                   | \$4,410      | \$4,241 |
| Nonaccrual loan interest                    | 363          | 362     |
| Other real estate owned expense             | -            | 127     |
| Other real estate owned valuation allowance | 1,420        | 869     |
| Deferred compensation                       | 665          | 579     |
| Loans                                       | 5,390        | 8,165   |
| Other                                       | 543          | 889     |
| Total deferred tax assets                   | 12,791       | 15,232  |
| Deferred tax liabilities:                   |              |         |
| Depreciation                                | 1,021        | 1,055   |
| Accretion of discounts on securities        | 210          | 147     |

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|                                       |         |         |
|---------------------------------------|---------|---------|
| Core deposit intangibles              | 1,105   | 1,631   |
| Net unrealized gains on securities    | 1,927   | 5,277   |
| Prepaid pension expense               | 656     | 265     |
| Pension liability                     | 570     | 1,186   |
| Trust preferred fair value adjustment | 687     | 723     |
| Other                                 | 253     | 528     |
| Total deferred tax liabilities        | 6,429   | 10,812  |
| Net deferred tax assets               | \$6,362 | \$4,420 |

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The provision for income taxes consists of the following:

| (in thousands)           | Years Ended December 31, |         |         |
|--------------------------|--------------------------|---------|---------|
|                          | 2013                     | 2012    | 2011    |
| Taxes currently payable  | \$4,030                  | \$736   | \$1,857 |
| Deferred tax expense     | 2,024                    | 5,557   | 3,053   |
| Total income tax expense | \$6,054                  | \$6,293 | \$4,910 |

A reconciliation of the "expected" Federal income tax expense to reported income tax expense is as follows:

| (in thousands)                 | Years Ended December 31, |         |         |
|--------------------------------|--------------------------|---------|---------|
|                                | 2013                     | 2012    | 2011    |
| Expected federal tax expense   | \$7,630                  | \$7,805 | \$5,768 |
| Nondeductible interest expense | 77                       | 97      | 83      |
| Tax-exempt interest            | (1,491)                  | (1,545) | (1,331) |
| State income taxes             | 254                      | 214     | 68      |
| Other, net                     | (416 )                   | (278 )  | 322     |
| Total income tax expense       | \$6,054                  | \$6,293 | \$4,910 |

## Note 15 – Earnings Per Common 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.

|   | Years Ended December 31, |                  |           |                  |           |                  |
|---|--------------------------|------------------|-----------|------------------|-----------|------------------|
|   | 2013                     |                  | 2012      |                  | 2011      |                  |
|   | Shares                   | Per Share Amount | Shares    | Per Share Amount | Shares    | Per Share Amount |
| Basic earnings per share                      | 7,872,870                | \$ 2.00          | 7,834,351 | \$ 2.04          | 6,982,524 | \$ 1.64          |
| Effect of dilutive securities - stock options | 11,691                   | -                | 11,301    | -                | 7,353     | -                |
| Diluted earnings per share                    | 7,884,561                | \$ 2.00          | 7,845,652 | \$ 2.04          | 6,989,877 | \$ 1.64          |

Outstanding stock options on common stock which were not included in computing diluted earnings per share in 2013, 2012, and 2011 because their effects were antidilutive, averaged 161,831 shares, 196,394 shares, and 145,986 shares, respectively.

## Note 16 – Off-Balance Sheet Activities

The Company is party to credit-related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if applicable, is based on management's credit evaluation of the customer.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

The following off-balance sheet financial instruments were outstanding whose contract amounts represent credit risk:

| (in thousands)                      | December 31, |            |
|-------------------------------------|--------------|------------|
|                                     | 2013         | 2012       |
| Commitments to extend credit        | \$ 179,272   | \$ 170,202 |
| Standby letters of credit           | 3,405        | 4,591      |
| Mortgage loan rate lock commitments | 5,913        | 9,486      |

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally consist of unused portions of lines of credit issued to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

At December 31, 2013, the Company had locked-rate commitments to originate mortgage loans amounting to approximately \$5,913,000 and loans held for sale of \$2,760,000. Risks arise from the possible inability of counterparties to meet the terms of their contracts, though the Company has never experienced a failure of one of its counterparties to perform. If a loan becomes past due 90 days within 180 days of sale, the Company would be required to repurchase the loan.

Note 17 – Related Party Transactions

In the ordinary course of business, loans are granted to executive officers, directors, and their related entities. Management believes that all such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans to similar, unrelated borrowers, and do not involve more than a normal risk of collectability or present other unfavorable features. As of December 31, 2013 and 2012, none of these loans were restructured, past due, or on nonaccrual status.

An analysis of these loans for 2013 is as follows (in thousands):

|                              |           |
|------------------------------|-----------|
| Balance at December 31, 2012 | \$ 16,240 |
| Additions                    | 7,953     |
| Repayments                   | (4,966 )  |
| Balance at December 31, 2013 | \$ 19,227 |

Related party deposits totaled \$28,462,000 at December 31, 2013 and \$15,423,000 at December 31, 2012.

Note 18 – Employee Benefit Plans

Defined Benefit Plan

The Company previously maintained a non-contributory defined benefit pension plan which covered substantially all employees who were 21 years of age or older and who had at least one year of service. The Company froze its pension plan to new participants and converted its pension plan to a cash balance plan effective December 31, 2009. Each year existing participants will receive, with some adjustments, income based on the yield of the 10 year U.S. Treasury Note in December of the preceding year.

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Information pertaining to the activity in the plan is as follows:

| (in thousands)  | As of and for the Years<br>Ended December 31, |          |          |
|---|---|----------|----------|
|   | 2013  | 2012     | 2011     |
| <b>Change in Benefit Obligation:</b>                              |   |          |          |
| Projected benefit obligation at beginning of year                 | \$10,931                                      | \$9,769  | \$9,279  |
| Service cost  | -   | -        | 111      |
| Interest cost   | 288   | 389      | 403      |
| Actuarial (gain) loss   | (201 )  | 1,289    | 725      |
| Benefits paid   | (2,022 )                                      | (516 )   | (749 )   |
| Projected benefit obligation at end of year                       | 8,996   | 10,931   | 9,769    |
| <b>Change in Plan Assets:</b>                                     |   |          |          |
| Fair value of plan assets at beginning of year                    | 11,689  | 11,144   | 11,674   |
| Actual return on plan assets                                      | 1,203   | 1,061    | 219      |
| Benefits paid   | (2,022 )                                      | (516 )   | (749 )   |
| Fair value of plan assets at end of year                          | 10,870  | 11,689   | 11,144   |
| Funded Status at End of Year                                      | \$1,874                                       | \$758    | \$1,375  |
| <b>Amounts Recognized in the Consolidated Balance Sheets</b>      |   |          |          |
| Other assets  | \$1,874                                       | \$758    | \$1,375  |
| <b>Amounts Recognized in Accumulated Other Comprehensive Loss</b> |   |          |          |
| Net actuarial loss  | \$1,628                                       | \$3,389  | \$3,080  |
| Deferred income tax asset   | (570 )  | (1,186 ) | (1,078 ) |
| Amount recognized   | \$1,058                                       | \$2,203  | \$2,002  |
| <b>As of and for the Years<br/>Ended December 31,</b>             |   |          |          |
|   | 2013  | 2012     | 2011     |
| <b>Components of Net Periodic Benefit Cost</b>                    |   |          |          |
| Service cost  | \$-   | \$-      | \$111    |
| Interest cost   | 288   | 389      | 403      |
| Expected return on plan assets                                    | (513 )  | (541 )   | (525 )   |
| Recognized net loss due to settlement                             | 594   | 128      | -        |
| Recognized net actuarial loss                                     | 275   | 332      | 160      |
| Net periodic benefit cost   | \$644   | \$308    | \$149    |

**Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive (Income) Loss**

|  |  |                  |              |                |
|--|--|------------------|--------------|----------------|
| Net actuarial (gain) loss  |  | \$(1,761)        | \$309        | \$871          |
| Amortization of prior service cost   |  | -                | -            | -              |
| Total recognized in other comprehensive (income) loss                                      |  | \$(1,761)        | \$309        | \$871          |
| <b>Total Recognized in Net Periodic Benefit Cost and Other Comprehensive (Income) Loss</b> |  | <b>\$(1,117)</b> | <b>\$617</b> | <b>\$1,020</b> |



|  | As of and for the Years<br>Ended December 31, |       |       |
|--|---|-------|-------|
|  | 2013  | 2012  | 2011  |
| Weighted-Average Assumptions at End of Year      |   |       |       |
| Discount rate used for net periodic pension cost | 3.00%   | 3.75% | 4.75% |
| Discount rate used for disclosure                | 4.00%   | 3.00% | 3.75% |
| Expected return on plan assets                   | 5.00%   | 5.00% | 5.00% |
| Rate of compensation increase                    | N/A   | N/A   | N/A   |

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The accumulated benefit obligation as of December 31, 2013, 2012, and 2011 was \$8,996,000, \$10,931,000, and \$9,769,000, respectively. The rate of compensation increase is no longer applicable since the defined benefit plan was converted to a cash balance plan.

The plan sponsor selected the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate was intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience that may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period in which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

Below is a description of the plan's assets. The plan's weighted-average asset allocations by asset category are as follows:

| Asset Category          | December 31, |        |
|-------------------------|--------------|--------|
|                         | 2013         | 2012   |
| Fixed Income            | 33.3%        | 33.5%  |
| Equity                  | 13.5%        | 15.1%  |
| Mutual Funds            | 49.8%        | 49.8%  |
| Cash and Accrued Income | 3.4%         | 1.6%   |
| Total                   | 100.0%       | 100.0% |

The investment policy and strategy for plan assets can best be described as a growth and income strategy. Diversification is accomplished by limiting the holding of any one equity issuer to no more than 5% of total equities. Exchange traded funds are used to provide diversified exposure to the small capitalization and international equity markets. All fixed income investments are rated as investment grade, with the majority of these assets invested in corporate issues. The assets are managed by the Company's Trust and Investment Services Division. No derivatives are used to manage the assets. Equity securities do not include holdings in the Company.

The fair value of the Company's pension plan assets at December 31, 2013 and 2012, by asset category are as follows (in thousands):

| Asset Category | Balance as of December 31, 2013 | Fair Value Measurements at December 31, 2013 Using Quoted Prices in Active Markets Significant for Other Significant Unobservable Inputs |                           |   |
|----------------|---------------------------------|--|---------------------------|---|
|                |                                 | Identical Assets   | Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
|                |                                 |  |                           |   |

|                               |           | Level<br>1 |          |    |   |
|-------------------------------|-----------|------------|----------|----|---|
| Cash                          | \$ 369    | \$369      | \$ -     | \$ | - |
| Fixed income securities       |           |            |          |    |   |
| Government sponsored entities | 1,159     | -          | 1,159    |    | - |
| Municipal bonds and notes     | 119       | -          | 119      |    | - |
| Corporate bonds and notes     | 2,339     | -          | 2,339    |    | - |
| Mutual funds                  | 5,415     | -          | 5,415    |    | - |
| Equity securities             |           |            |          |    |   |
| U.S. companies                | 1,454     | 1,454      | -        |    | - |
| Foreign companies             | 15        | 15         | -        |    | - |
|                               | \$ 10,870 | \$1,838    | \$ 9,032 | \$ | - |

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| Asset Category                | Balance<br>as of<br>December<br>31,<br>2012 | Fair Value Measurements at<br>December 31, 2012 Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>Significant<br>Other<br>Significant |                                 |                                   |
|-------------------------------|---|---|---------------------------------|-----------------------------------|
|                               |   | Identical<br>Assets<br>Level<br>1   | Observable<br>Inputs<br>Level 2 | Unobservable<br>Inputs<br>Level 3 |
| Cash                          | \$ 188                                      | \$188   | \$ -                            | \$ -                              |
| Fixed income securities       |   |   |                                 |                                   |
| Government sponsored entities | 904   | -   | 904                             | -                                 |
| Municipal bonds and notes     | 61  | -   | 61                              | -                                 |
| Corporate bonds and notes     | 2,944                                       | -   | 2,944                           | -                                 |
| Mutual funds                  | 5,826                                       | -   | 5,826                           | -                                 |
| Equity securities             |   |   |                                 |                                   |
| U.S. companies                | 1,721                                       | 1,721   | -                               | -                                 |
| Foreign companies             | 45  | 45  | -                               | -                                 |
|                               | \$ 11,689                                   | \$1,954   | \$ 9,735                        | \$ -                              |

Projected benefit payments for the years 2014 to 2023 are as follows (in thousands):

| Year      | Amount |
|-----------|--------|
| 2014      | 3,005  |
| 2015      | 202    |
| 2016      | 280    |
| 2017      | 326    |
| 2018      | 480    |
| 2019-2023 | 3,473  |

**401(k) Plan**

The Company maintains a 401(k) plan that covers substantially all full-time employees of the Company. The Company matches a portion of the contribution made by employee participants after at least one year of service. The Company contributed \$542,000, \$568,000, and \$469,000 to the 401(k) plan in 2013, 2012, and 2011, respectively. These amounts are included in employee benefits expense for the respective years.

**Deferred Compensation Arrangements**

The Company maintains deferred compensation agreements with certain current and former employees providing for annual payments to each ranging from \$25,000 to \$50,000 per year for ten years upon their retirement. The liabilities under these agreements are being accrued over the officers' remaining periods of employment so that, on the date of their retirement, the then-present value of the annual payments would have been accrued. The expense for these agreements was \$13,000, \$15,000, and \$17,000 for the years 2013, 2012, and 2011, respectively.

Profit Sharing and Incentive Arrangements

The Company maintains a cash profit sharing plan for full-time employees based on the Company's performance and a cash incentive compensation plan for officers based on the Company's performance and individual officer goals. The total amount charged to salary expense for these plans was \$890,000, \$1,086,000, and \$367,000 for the years 2013, 2012, and 2011, respectively.

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Note 19 – Fair Value Measurements

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, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.

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

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

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

In connection with the merger, the Company acquired a corporate bond, a trust preferred security, with a par value of \$500,000. There was no readily determinable market value for this security. The Company acquired an outside appraisal of the security and recorded it in connection with the merger at approximately 62% of par value. The security has consistently performed and was the only security recorded with a Level 3 valuation at December 31, 2012. This security was sold in the first quarter of 2013.

In mid-2013, the Company purchased \$1,000,000 in convertible preferred stock from a Virginia based, publicly traded community bank. There is no secondary market for this bank's preferred stock; however its common stock is traded on a limited basis in the over the counter market. The Company uses an independent third party to assist in the valuation of these securities. Given the convertible nature of the securities, the common stock of the issuing community bank is used as a proxy for the preferred stock value. This is the only security recorded with a Level 3 valuation at December 31, 2013.

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The following table presents the balances of financial assets measured at fair value on a recurring basis during the period (in thousands):

| Description                    | Balance as of December 31, 2013 | Fair Value Measurements at December 31, 2013 Using Quoted Prices in Active Markets for Identical Assets Level |           |          |
|--------------------------------|---------------------------------|---|-----------|----------|
|                                |                                 | Level 1   | Level 2   | Level 3  |
| Assets:                        |                                 |   |           |          |
| Securities available for sale: |                                 |   |           |          |
| Federal agencies and GSEs      | \$65,881                        | \$-   | \$65,881  | \$ -     |
| Mortgage-backed and CMOs       | 69,608                          | -   | 69,608    | -        |
| State and municipal            | 198,733                         | -   | 198,733   | -        |
| Corporate                      | 10,799                          | -   | 10,799    | -        |
| Equity securities              | 1,103                           | -   | -         | 1,103    |
| Total                          | \$346,124                       | \$-   | \$345,021 | \$ 1,103 |

  

| Description                    | Balance as of December 31, 2012 | Fair Value Measurements at December 31, 2012 Using Quoted Prices in Active Markets for Identical Assets Level |           |         |
|--------------------------------|---------------------------------|---|-----------|---------|
|                                |                                 | Level 1   | Level 2   | Level 3 |
| Assets:                        |                                 |   |           |         |
| Securities available for sale: |                                 |   |           |         |
| Federal agencies and GSEs      | \$42,759                        | \$-   | \$42,759  | \$ -    |
| Mortgage-backed and CMOs       | 83,308                          | -   | 83,308    | -       |
| State and municipal            | 202,731                         | 2,110   | 200,621   | -       |
| Corporate                      | 6,448                           | -   | 6,097     | 351     |
| Total                          | \$335,246                       | \$2,110   | \$332,785 | \$ 351  |

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)

| Balance as of January 1, | Total Realized / Unrealized Gains (Losses) Included in | Purchases, Sales, Issuances and | Transfer Balances In (Out) of Level 3 | Balances as of December 31, 2013 |
|--------------------------|--|---------------------------------|---------------------------------------|----------------------------------|
|--------------------------|--|---------------------------------|---------------------------------------|----------------------------------|



|                                | 2013  | Net    | Other         | Settlements, |      |          |
|--------------------------------|-------|--------|---------------|--------------|------|----------|
|                                |       | Income | Comprehensive | Net          |      |          |
|                                |       |        | Income        |              |      |          |
| Securities available for sale: |       |        |               |              |      |          |
| Corporate                      | \$351 | \$136  | \$ -          | \$ (487 )    | \$ - | \$ -     |
| Equity                         | -     | -      | 103           | 1,000        | -    | 1,103    |
| Total assets                   | \$351 | \$136  | \$ 103        | \$ 513       | \$ - | \$ 1,103 |

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the 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 years ended December 31, 2013 and 2012. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

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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. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the 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 comparable 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 receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Other real estate owned: Measurement for fair values for other real estate owned are the same as impaired loans. Any fair value adjustments are recorded in the period incurred as a valuation allowance against other real estate owned with the associated expense included in foreclosed real estate expense on the Consolidated Statements of Income.

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

| Description                                | Balance as of December 31, 2013 | Fair Value Measurements at December 31, 2013 Using              |   |   |
|--|---------------------------------|---|---|---|
|  |                                 | Quoted Prices in Active Markets for Identifiable Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| Assets:                                    |                                 |   |   |   |
| Loans held for sale                        | \$ 2,760                        | \$-   | \$ 2,760                                    | \$ -                                    |
| Impaired loans, net of valuation allowance | 3,193                           | -   | -   | 3,193                                   |
| Other real estate owned                    | 3,422                           | -   | -   | 3,422                                   |

| Balance as of December 31, 2012 | Fair Value Measurements at December 31, 2012 Using |                                     |                                 |
|---------------------------------|--|-------------------------------------|---------------------------------|
|                                 | Quoted Prices in Active Markets for Identical      | Significant Other Observable Inputs | Significant Unobservable Inputs |
|                                 |  |                                     |                                 |

| Description                                | 2012      | Assets  |           |         |
|--|-----------|---------|-----------|---------|
|  |           | Level 1 | Level 2   | Level 3 |
| Assets:                                    |           |         |           |         |
| Loans held for sale                        | \$ 13,852 | \$-     | \$ 13,852 | \$ -    |
| Impaired loans, net of valuation allowance | 3         | -       | -         | 3       |
| Other real estate owned                    | 6,193     | -       | -         | 6,193   |

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Quantitative Information About Level 3 Fair Value Measurements as of December 31, 2013:

| Assets                        | Valuation Technique           | Unobservable Input                                      | Weighted Rate |
|-------------------------------|-------------------------------|---|---------------|
| Securities available for sale | Discounted cash flow analysis | Discount rate   | 11%           |
| Impaired loans                | Discounted appraised value    | Selling cost  | 6%            |
| Other real estate owned       | Discounted appraised value    | Selling cost  | 6%            |
| Other real estate owned       | Discounted appraised value    | Discount for lack of marketability and age of appraisal | 9%            |

ASC 825, "Financial Instruments," requires disclosure about fair value of financial instruments for interim periods and excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company. The carrying values and estimated fair value of the Company's financial instruments as of December 31, 2013 are as follows (in thousands):

|                               | Fair Value Measurements at December 31, 2013 Using |  |   |   |  | Fair Value Balance |
|-------------------------------|--|--|---|---|--|--------------------|
|                               | Carrying Value                                     | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |  |                    |
| <b>Financial Assets:</b>      |  |  |   |   |  |                    |
| Cash and cash equivalents     | \$67,681   | \$ -   | \$ 67,681                                   | \$ -                                    |  | \$67,681           |
| Securities available for sale | 346,124  | -  | 345,021                                     | 1,103                                   |  | 346,124            |
| Restricted stock              | 4,889  | -  | 4,889                                       | -                                       |  | 4,889              |
| Loans held for sale           | 2,760  | -  | 2,760                                       | -                                       |  | 2,760              |
| Loans, net of allowance       | 782,071  | -  | -   | 783,825                                 |  | 783,825            |
| Bank owned life insurance     | 14,746   | -  | 14,746                                      | -                                       |  | 14,746             |
| Accrued interest receivable   | 4,741  | -  | 4,741                                       | -                                       |  | 4,741              |
| <b>Financial Liabilities:</b> |  |  |   |   |  |                    |
| Deposits                      | \$1,057,675  | \$ -   | \$ 668,077                                  | \$ 392,991                              |  | \$1,061,068        |
| Repurchase agreements         | 39,478   | -  | 39,478                                      | -                                       |  | 39,478             |
| Other borrowings              | 9,951  | -  | -   | 10,560                                  |  | 10,560             |
| Trust preferred capital notes | 27,419   | -  | -   | 18,162                                  |  | 18,162             |
| Accrued interest payable      | 610  | -  | 610   | -                                       |  | 610                |

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The carrying values and estimated fair values of the Company's financial instruments at December 31, 2012 are as follows (in thousands):

|                               | Fair Value Measurements at December 31, 2012 Using |  |   |   |                    |
|-------------------------------|--|--|---|---|--------------------|
|                               | Carrying Value                                     | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Fair Value Balance |
| <b>Financial Assets:</b>      |  |  |   |   |                    |
| Cash and cash equivalents     | \$47,442   | \$ -   | \$ 47,442                                   | \$ -                                    | \$47,442           |
| Securities available for sale | 335,246  | 2,110  | 332,785                                     | 351                                     | 335,246            |
| Restricted stock              | 5,287  | -  | 5,287                                       | -                                       | 5,287              |
| Loans held for sale           | 13,852   | -  | 13,852                                      | -                                       | 13,852             |
| Loans, net of allowance       | 776,587  | -  | -   | 777,761                                 | 777,761            |
| Bank owned life insurance     | 14,289   | -  | 14,289                                      | -                                       | 14,289             |
| Accrued interest receivable   | 4,711  | -  | 4,711                                       | -                                       | 4,711              |
| <b>Financial Liabilities:</b> |  |  |   |   |                    |
| Deposits                      | \$1,027,667  | \$ -   | \$ 618,099                                  | \$ 424,378                              | \$1,042,477        |
| Repurchase agreements         | 49,942   | -  | 49,942                                      | -                                       | 49,942             |
| Other borrowings              | 10,079   | -  | -   | 11,062                                  | 11,062             |
| Trust preferred capital notes | 27,317   | -  | -   | 22,524                                  | 22,524             |
| Accrued interest payable      | 755  | -  | 755   | -                                       | 755                |

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.

Restricted stock. The carrying value of restricted stock approximates fair value based on the redemption provisions of the respective entity.

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 analyses, 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 analyses 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 value 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.

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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 December 31, 2013 and 2012, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the table above. The various off-balance sheet instruments were discussed in Note 16.

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 20 – Dividend Restrictions and Regulatory Capital

The approval of the Comptroller of the Currency is required if the total of all dividends declared by a national bank in any calendar year exceeds the bank's retained net income, as defined, for that year combined with its retained net income for the preceding two calendar years. Under this formula, the Bank can distribute as dividends to the Company, without the approval of the Comptroller of the Currency, \$25,211,000 as of December 31, 2013.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are subject to qualitative judgments by the regulators concerning components, risk weighting, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under the guidelines, total capital is defined as core ("Tier 1") capital and supplementary ("Tier 2") capital less certain specified deductions from total capital such as reciprocal holdings of depository institution capital instruments and equity investments. At least half of the total capital is required to be Tier 1 capital, which consists principally of common and certain qualifying preferred shareholders' equity (including trust preferred securities), less certain intangibles and other adjustments. The remainder, Tier 2 capital, consists of cumulative preferred stock, long-term perpetual preferred stock, a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments) and a limited amount of the general loan loss allowance. The definition of assets has been modified to include items on and off the balance sheet, with each item being assigned a "risk-weight" for the determination of the ratio of capital to risk-adjusted assets. Management believes, as of December 31, 2013 and 2012, that the Company met the requirements to be considered "well capitalized."

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The following table provides summary information regarding regulatory capital:

| (in thousands)    | Actual<br>Amount | Ratio   | Minimum<br>Capital<br>Requirement<br>Amount | Ratio | To Be Well<br>Capitalized<br>Under<br>Prompt<br>Corrective<br>Action<br>Provisions<br>Amount | Ratio   |   |
|-------------------|------------------|---------|---|-------|--|---------|---|
| December 31, 2013 |                  |         |   |       |  |         |   |
| Total Capital     |                  |         |   |       |  |         |   |
| Company           | \$ 161,442       | 18.14 % | \$ 71,212                                   | >8.0% |  |         |   |
| Bank              | 156,356          | 17.59 % | 71,129                                      | >8.0% | \$ 88,911  | >10.0   | % |
| Tier 1 Capital    |                  |         |   |       |  |         |   |
| Company           | 150,248          | 16.88 % | 35,606                                      | >4.0% |  |         |   |
| Bank              | 145,221          | 16.33 % | 35,564                                      | >4.0% | 53,347   | >6.0    | % |
| Leverage Capital  |                  |         |   |       |  |         |   |
| Company           | 150,248          | 11.81 % | 50,900                                      | >4.0% |  |         |   |
| Bank              | 145,221          | 11.43 % | 50,825                                      | >4.0% | 63,532   | >5.0    | % |
| December 31, 2012 |                  |         |   |       |  |         |   |
| Total Capital     |                  |         |   |       |  |         |   |
| Company           | \$ 150,328       | 17.00 % | \$ 70,725                                   | >8.0% |  |         |   |
| Bank              | 145,808          | 16.49 % | 70,724                                      | >8.0% | \$ 88,406  | >10.00% |   |
| Tier 1 Capital    |                  |         |   |       |  |         |   |
| Company           | 139,262          | 15.75 % | 35,363                                      | >4.0% |  |         |   |
| Bank              | 135,774          | 15.36 % | 35,362                                      | >4.0% | 53,043   | >6.0    | % |
| Leverage Capital  |                  |         |   |       |  |         |   |
| Company           | 139,262          | 11.27 % | 49,441                                      | >4.0% |  |         |   |
| Bank              | 135,774          | 10.98 % | 49,467                                      | >4.0% | 61,834   | >5.0    | % |

## Note 21 – Segment and Related Information

The Company has two reportable segments, community banking and 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 community banking.

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 division receives fees for investment and administrative services.

Amounts shown in the "Other" column include activities of the Company which are primarily debt service on trust preferred securities and corporate items. Intersegment eliminations primarily consist of the Company's interest income on deposits held by the Bank.

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Segment information as of and for the years ended December 31, 2013, 2012, and 2011, is shown in the following table:

| (in thousands)                    | 2013                 |                                     |         |                              |           |
|-----------------------------------|----------------------|-------------------------------------|---------|------------------------------|-----------|
|                                   | Community<br>Banking | Trust and<br>Investment<br>Services | Other   | Intersegment<br>Eliminations | Total     |
| Interest income                   | \$52,928             | \$ -                                | \$28    | \$ -                         | \$52,956  |
| Interest expense                  | 5,829                | -                                   | 754     | -                            | 6,583     |
| Noninterest income                | 6,649                | 4,158                               | 20      | -                            | 10,827    |
| Income (loss) before income taxes | 20,142               | 2,605                               | (946 )  | -                            | 21,801    |
| Net income (loss)                 | 14,489               | 1,882                               | (624 )  | -                            | 15,747    |
| Depreciation and amortization     | 3,220                | 15                                  | -       | -                            | 3,235     |
| Total assets                      | 1,305,540            | -                                   | 1,972   | -                            | 1,307,512 |
| Capital expenditures              | 861                  | 4                                   | -       | -                            | 865       |
|                                   | 2012                 |                                     |         |                              |           |
|                                   | Community<br>Banking | Trust and<br>Investment<br>Services | Other   | Intersegment<br>Eliminations | Total     |
| Interest income                   | \$57,806             | \$ -                                | \$6     | \$ (6 )                      | \$57,806  |
| Interest expense                  | 7,334                | -                                   | 813     | (6 )                         | 8,141     |
| Noninterest income                | 7,255                | 4,136                               | 19      | -                            | 11,410    |
| Income (loss) before income taxes | 21,051               | 2,380                               | (1,132) | -                            | 22,299    |
| Net income (loss)                 | 15,049               | 1,709                               | (752 )  | -                            | 16,006    |
| Depreciation and amortization     | 3,677                | 19                                  | -       | -                            | 3,696     |
| Total assets                      | 1,282,796            | -                                   | 891     | -                            | 1,283,687 |
| Capital expenditures              | 699                  | -                                   | -       | -                            | 699       |
|                                   | 2011                 |                                     |         |                              |           |
|                                   | Community<br>Banking | Trust and<br>Investment<br>Services | Other   | Intersegment<br>Eliminations | Total     |
| Interest income                   | \$49,187             | \$ -                                | \$55    | \$ (55 )                     | \$49,187  |
| Interest expense                  | 7,811                | -                                   | 1,024   | (55 )                        | 8,780     |
| Noninterest income                | 5,379                | 3,836                               | 29      | -                            | 9,244     |
| Income (loss) before income taxes | 16,610               | 2,330                               | (2,459) | -                            | 16,481    |
| Net income (loss)                 | 11,886               | 1,697                               | (2,012) | -                            | 11,571    |
| Depreciation and amortization     | 2,647                | 20                                  | -       | -                            | 2,667     |
| Total assets                      | 1,303,816            | -                                   | 890     | -                            | 1,304,706 |
| Capital expenditures              | 1,731                | 3                                   | -       | -                            | 1,734     |

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## Note 22 – Parent Company Financial Information

Condensed Parent Company financial information is as follows (in thousands):

| Condensed Balance Sheets                   | December 31, |           |  |
|--|--------------|-----------|--|
|  | 2013         | 2012      |  |
| Cash                                       | \$2,872      | \$2,288   |  |
| Investment in subsidiaries                 | 190,759      | 187,958   |  |
| Due from subsidiaries                      | 322          | 380       |  |
| Other assets                               | 1,123        | 8         |  |
| Total Assets                               | \$195,076    | \$190,634 |  |
| Trust preferred capital notes              | \$27,419     | \$27,317  |  |
| Other liabilities                          | 106          | 71        |  |
| Shareholders' equity                       | 167,551      | 163,246   |  |
| Total Liabilities and Shareholders' Equity | \$195,076    | \$190,634 |  |

  

| Condensed Statements of Income                               | Years Ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2013                     | 2012     | 2011     |
| Dividends from subsidiary                                    | \$9,000                  | \$8,000  | \$4,500  |
| Other income   | 48                       | 27       | 84       |
| Expenses   | 994                      | 1,159    | 2,542    |
| Income taxes (benefit)                                       | (322 )                   | (380 )   | (447 )   |
| Income before equity in undistributed earnings of subsidiary | 8,376                    | 7,248    | 2,489    |
| Equity in undistributed earnings of subsidiary               | 7,371                    | 8,758    | 9,082    |
| Net Income   | \$15,747                 | \$16,006 | \$11,571 |

  

| Condensed Statements of Cash Flows                       | Years Ended December 31, |         |           |
|--|--------------------------|---------|-----------|
|  | 2013                     | 2012    | 2011      |
| Cash provided by dividends received from subsidiary      | \$9,000                  | \$8,000 | \$4,500   |
| Cash used for payment of dividends                       | (7,248)                  | (7,212) | (6,524)   |
| Cash used for repurchase of stock                        | -                        | -       | (3,100)   |
| Proceeds from exercise of options and stock compensation | 883                      | 856     | 769       |
| Other  | (2,051)                  | (1,326) | (2,260)   |
| Net increase (decrease) in cash                          | \$584                    | \$318   | \$(6,615) |

## Note 23 – Concentrations of Credit Risk

Substantially all the Company's loans are made within its market area, which includes Southern and Central Virginia and the northern portion of Central North Carolina. The ultimate collectability of the Company's loan portfolio and the ability to realize the value of any underlying collateral, if necessary, are impacted by the economic conditions and real estate values of the market area.

Loans secured by real estate were \$666,152,000, or 83.8% of the loan portfolio at December 31, 2013, and \$656,591,000, or 83.2% of the loan portfolio at December 31, 2012. Loans secured by commercial real estate represented the largest portion of loans at \$364,616,000 at December 31, 2013, and \$355,433,000 at December 31, 2012, 45.9% and 45.1%, respectively of total loans. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2013 or 2012, loans to lessors of nonresidential buildings represented 16.7% of total loans at December 31, 2013 and 11.8% at December 31, 2012; the lessees and lessors are engaged in a variety of industries.

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## Note 24 – Supplemental Cash Flow Information

| (in thousands)  | For the Years ended  |          |          |
|---|----------------------|----------|----------|
|   | December 31,<br>2013 | 2012     | 2011     |
| Supplemental Schedule of Cash and Cash Equivalents:     |                      |          |          |
| Cash and due from banks                                 | \$19,808             | \$20,435 | \$22,561 |
| Interest-bearing deposits in other banks                | 47,873               | 27,007   | 6,332    |
|   | \$67,681             | \$47,442 | \$28,893 |
| Supplemental Disclosure of Cash Flow Information:       |                      |          |          |
| Cash paid for:  |                      |          |          |
| Interest on deposits and borrowed funds                 | \$6,728              | \$8,243  | \$8,782  |
| Income taxes  | 4,530                | 584      | 3,619    |
| Noncash investing and financing activities:             |                      |          |          |
| Transfer of loans to other real estate owned            | 1,826                | 6,983    | 803      |
| Unrealized gain (loss) on securities available for sale | (9,571 )             | 1,489    | 11,623   |
| Change in unfunded pension liability                    | (1,761 )             | 309      | 871      |
| Non-cash transactions related to acquisitions:          |                      |          |          |
| Assets acquired:  |                      |          |          |
| 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   |
| Liabilities assumed:                                    |                      |          |          |
| Demand, MMDA, and savings deposits                      | -                    | -        | 281,311  |
| Time deposits   | -                    | -        | 138,937  |
| FHLB advances   | -                    | -        | 9,858    |
| Other borrowings  | -                    | -        | 6,546    |
| Other liabilities                                       | -                    | -        | 3,838    |
| Consideration:  |                      |          |          |
| Issuance of preferred stock                             | -                    | -        | 5,000    |
| Issuance of common stock                                | -                    | -        | 29,905   |
| Fair value of replacement stock options                 | -                    | -        | 132      |

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## Note 25 – Accumulated Other Comprehensive Income ("AOCI")

Changes in each component of accumulated other comprehensive income (loss) were as follows (in thousands):

|   | Net<br>Unrealized<br>Gains<br>(Losses)<br>on<br>Securities | Adjustments<br>Related to<br>Pension<br>Benefits | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|---|--|--|--|
| Balance at December 31, 2010  | \$ 1,277   | \$ (1,436 )                                      | \$ (159 )  |
| Net unrealized gains on securities available for sale, net of tax, \$4,068    | 7,554  | -  | 7,554  |
| Reclassification adjustment for losses on securities, net of tax, \$0         | 1  | -  | 1  |
| Change in unfunded pension liability, net of tax, \$(305)                     | -  | (566 )   | (566 )   |
| Balance at December 31, 2011  | 8,832  | (2,002 )   | 6,830  |
| Net unrealized gains on securities available for sale, net of tax, \$576      | 1,071  | -  | 1,071  |
| Reclassification adjustment for gains on securities, net of tax, \$(55)       | (103 )   | -  | (103 )   |
| Change in unfunded pension liability, net of tax, \$(108)                     | -  | (201 )   | (201 )   |
| Balance at December 31, 2012  | 9,800  | (2,203 )   | 7,597  |
| Net unrealized losses on securities available for sale, net of tax, \$(3,282) | (6,097 )   | -  | (6,097 )   |
| Reclassification adjustment for gains on securities, net of tax, \$67         | (125 )   | -  | (125 )   |
| Change in unfunded pension liability, net of tax, \$616                       | -  | 1,145  | 1,145  |
| Balance at December 31, 2013  | \$ 3,578   | \$ (1,058 )                                      | \$ 2,520   |

The following table provides information regarding reclassifications out of accumulated other comprehensive income (loss):

Reclassifications Out of Accumulated Other  
Comprehensive Income  
For the Three Years Ending December 31, 2013

Details about AOCI Components

Affected Line Item in  
the Statement of Where  
Net Income is Presented

| (in thousands)                      | Amount<br>Reclassified from<br>AOCI<br>Year Ended<br>December 31, |        |      |                                |
|-------------------------------------|---|--------|------|--------------------------------|
|                                     | 2013  | 2012   | 2011 |                                |
| Available for sale securities:      |   |        |      |                                |
| Realized gain on sale of securities | \$ 192  | \$ 158 | \$ 1 | Securities gains (losses), net |
|                                     | (67 )   | (55 )  | -    | Income taxes                   |
| Total reclassifications             | \$ 125  | \$ 103 | \$ 1 | Net of tax                     |

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ITEM 9A – CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management, including the Chief Executive Officer and Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act), as of December 31, 2013. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. There were no significant changes in the Company's internal controls over financial reporting that occurred during the quarter ended December 31, 2013 that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Management regularly monitors its internal control over financial reporting, and actions are taken to correct deficiencies as they are identified.

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of internal control over financial reporting. This assessment was based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992. Based on this evaluation under the framework in Internal Control – Integrated Framework, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2013, as such term is defined in Exchange Act Rule 13a-15(f).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, because of changes in conditions, internal control effectiveness may vary over time.

The Company's independent registered public accounting firm, Yount, Hyde and Barbour, P.C., has audited the Company's internal control over financial reporting as of December 31, 2012, as stated in their report included herein. Yount, Hyde and Barbour, P.C. also audited the Company's consolidated financial statements as of and for the year ended December 31, 2013.

/s/ Jeffrey V. Haley  
Jeffrey V. Haley  
President and Chief Executive Officer

/s/ William W. raynham  
William W. Traynham  
Senior Vice President and  
Chief Financial Officer

March 12, 2014





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## PART IV

## ITEM 15 – EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements. See Item 8 for reference.

(a)(2) Financial Statement Schedules. All applicable financial statement schedules required under Regulation S-X have been included in the Notes to the Consolidated Financial Statements.

(a)(3) Exhibits. The exhibits required by Item 601 of Regulation S-K are listed below.

## EXHIBIT INDEX

| Exhibit No. | Description  | Location  |
|-------------|--|---|
| 2.1         | Agreement and Plan of Reorganization, as of December 15, 2010, between American National Bankshares Inc. and MidCarolina Financial Corporation                           | Exhibit 2.1 on Form 8-K filed December 17, 2010                   |
| 3.1         | Articles of Incorporation, as amended  | Exhibit 3.1 on Form 10-Q filed July 5, 2011                       |
| 3.2         | Bylaws, as amended   | Exhibit 3.2 on Form 8-K filed December 18, 2012                   |
| 10.1        | Deferred Compensation Agreement between American National Bank and Trust Company, and Charles H. Majors dated December 31, 2008  | Exhibit 10.1 on Form 10-K filed March 16, 2009                    |
| 10.2        | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Jeffrey V. Haley dated June 30, 2013              | Exhibit 10.1 on Form 8-K filed June 14, 2013                      |
| 10.3        | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and R. Helm Dobbins dated December 31, 2008           | Exhibit 10.4 on Form 10-K filed March 16, 2009                    |
| 10.4        | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Dabney T. P. Gilliam, Jr. dated December 31, 2008 | Exhibit 10.5 on Form 10-K filed March 16, 2009                    |
| 10.5        | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and William W. Traynham dated April 21, 2009          | Exhibit 10.1 on Form 10-Q filed August 7, 2009                    |
| 10.6        | Employment Agreement between American National Bank and Trust Company, and Charles T. Canaday, Jr., dated December 15, 2010.   | Exhibit 10.9 on Amendment No. 1 to Form S-4 filed March 29, 2011  |
| 10.7        | Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Charles T. Canaday, Jr. dated December 15, 2010   | Exhibit 10.10 on Amendment No. 1 to Form S-4 filed March 29, 2011 |

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- |      |   |  |
|------|---|--|
| 10.8 | American National Bankshares Inc. 2008 Stock Incentive Plan | Exhibit 99.0 to Form S-8 filed May 30, 2008      |
| 10.9 | American National Bankshares Inc. 1997 Stock Option Plan    | Exhibit 4.3 on Form S-8 filed September 17, 1997 |

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## EXHIBIT INDEX

| Exhibit No. | Description   | Location       |
|-------------|---|----------------|
| 11.1        | Refer to Earnings Per Share calculation in the Notes to Financial Statements                        | Filed herewith |
| 21.1        | Subsidiaries of the registrant  | Filed herewith |
| 31.1        | Section 302 Certification of Jeffrey V. Haley, President and Chief Executive Officer                | Filed herewith |
| 31.2        | Section 302 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer | Filed herewith |
| 32.1        | Section 906 Certification of Jeffrey V. Haley, President and Chief Executive Officer                | Filed herewith |
| 32.2        | Section 906 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer | Filed herewith |
| 101.INS     | XBRL Instance Document  |                |
| 101.SCH     | XBRL Taxonomy Extension Schema Document   |                |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase Document   |                |
| 101.DEF     | XBRL Taxonomy Extension Definition Linkbase Document  |                |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase Document   |                |
| 101.PRE     | SBRL Taxonomy Presentation Linkbase Document  |                |

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

March 12, 2014

AMERICAN NATIONAL BANKSHARES INC

By: /s/ Jeffrey V. Haley  
 President and Chief  
 Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 10, 2014.

|  |   |  |  |
|--|---|--|--|
| /s/ Jeffrey V. Haley<br>Jeffrey V. Haley           | Director, President and<br>Chief Executive Officer<br>(principal executive officer) |  |  |
| /s/ Charles H. Majors<br>Charles H. Majors         | Director and Executive<br>Chairman  | /s/ John H. Love<br>John H. Love               | Director   |
| /s/ Fred A. Blair<br>Fred A. Blair                 | Director  | /s/ Franklin W. Maddux<br>Franklin W. Maddux   | Director   |
| /s/ Frank C. Crist, Jr.<br>Frank C. Crist, Jr.     | Director  | /s/ Martha W. Medley<br>Martha W. Medley       | Director   |
| /s/ Ben J. Davenport, Jr.<br>Ben J. Davenport, Jr. | Director  | /s/ Claude B. Owen, Jr.<br>Claude B. Owen, Jr. | Director   |
| /s/ Michael P. Haley<br>Michael P. Haley           | Director  | /s/ Dan M. Pleasant<br>Dan M. Pleasant         | Director   |
| /s/ Charles S. Harris<br>Charles S. Harris         | Director  | /s/ Robert A. Ward<br>Robert A. Ward           | Director   |
| /s/ F. D. Hornaday, III<br>F. D. Hornaday, III     | Director  | /s/ William W. Traynham<br>William W. Traynham | Senior Vice President and<br>Chief Financial Officer<br>(and principal accounting officer) |
| /s/ Lester A. Hudson, Jr.<br>Lester A. Hudson, Jr. | Director  |  |  |

