

UNITED STATES
OFFICE OF THE COMPTROLLER OF THE CURRENCY
WASHINGTON, D.C. 20219

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, 2012

OCC Charter Number: 23616

VIRGINIA NATIONAL BANK

(Exact name of registrant as specified in its charter)

Virginia

(State or other jurisdiction of
incorporation or organization)

54-1902129

(I.R.S. Employer
Identification Number)

222 East Main Street, Charlottesville, Virginia

(Address of principal executive offices)

22902

(Zip Code)

Registrant's telephone number, including area code:

(434) 817-8621

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF CLASS

Common Stock, \$2.50 par value per share

NAME OF EXCHANGE ON WHICH REGISTERED

OTC Markets Group's OTCQB Tier

SECURITIES REGISTERED PURSUANT TO 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 Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 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 the 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.

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

On June 30, 2012, the aggregate market value of the common equity held by non-affiliates of the Registrant was \$33,158,731.

The Registrant has one class of common stock, of which 2,690,220 shares were outstanding as of close of business March 15, 2013.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are hereby incorporated into Part I and Part III of this Form 10-K by reference: the Proxy Statement for the Annual Meeting of Shareholders to be held on June 19, 2013.

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Part I

In addition to historical information, the following Report contains forward looking statements that are subject to risks and uncertainties that could cause the Bank's actual results to differ materially from those anticipated. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis only as of the date of the Report.

Item 1. BUSINESS.

General

Virginia National Bank (the "Bank") was organized under federal law as a national banking association to engage in general commercial and retail banking business. The Bank received its charter from the Comptroller of the Currency and commenced operations on July 29, 1998. The Bank's deposits are insured to the maximum amount provided by the Federal Deposit Insurance Act by the Federal Deposit Insurance Corporation ("FDIC"). The Bank is subject to the supervision, examination and regulation of the Office of the Comptroller of the Currency ("OCC").

The Bank emphasizes serving the needs of owner-operated businesses, professional concerns and individuals in the Charlottesville/Albemarle County area, the Orange County area, and the Winchester area. The Bank offers a full range of banking and related financial services, including checking accounts, NOW accounts, money market deposit accounts, certificates of deposit, individual retirement accounts and other depository services. The Bank actively solicits such accounts from individuals, businesses, associations and other organizations within its trade area. The Bank also offers short-to-long term commercial, real estate and consumer loans. The Bank is committed to providing its customers with banking services comparable to those that larger regional and nationwide banks generally reserve for their larger clients. Such services include being a reliable and consistent source of credit, with loans that are priced based upon an overall banking relationship, easy access to the Bank's local decision makers who possess strong local market knowledge, local delivery, fast response, and continuity in the banking relationship.

Other services offered by Virginia National Bank include automated teller machines ("ATMs"), Internet banking, safe deposit boxes, merchant card services, cash management services and direct deposit of payroll and federal recurring payments. In addition, the Bank is affiliated with Visa[®] which is accepted worldwide and offers debit cards to consumer and business customers.

In October 2012, the Bank started offering annuity, insurance and brokerage services to the public at its Banking Offices under the title of VNB Investment Strategies. The Bank entered into an agreement with LPL Financial LLC which provides broker/dealer and advisory services through registered representatives. The goal of the program is to offer customers additional opportunities to access additional financial products and services beyond the traditional banking products.

In January, 2000, the Bank received regulatory approval from the OCC to open a Trust Department which began operations in the first quarter of 2000. On May 18, 2007, the OCC granted approval to the Bank's application to establish a new national trust bank with the title VNBTrust, National Association ("VNBTrust"), which is now operating as a wholly-owned subsidiary of the Bank. Additionally, the OCC approved the Bank's application for VNBTrust to create a wholly-owned operating subsidiary, VNB Investment Management Company, LLC, a Delaware limited liability corporation, which has approval to organize and manage two private investment funds. One fund, known as Swift Run Capital, is in operation. In January, 2010, VNB Investment Management Company, LLC changed its name to Swift Run Capital Management, LLC.

Since July 29, 1998, the Bank has conducted business from its full-service main banking office located at 222 East Main Street in Charlottesville, Virginia. On March 15, 1999, a full-service banking office was opened at 1580 Seminole Trail in Charlottesville, Virginia. On December 21, 1999, a full-service banking office was opened at 1900 Arlington Boulevard in Charlottesville, Virginia. On November 8, 2000, a full-service banking office was opened at 102 East Main Street in Orange, Virginia. On January 28, 2002, a full-service banking office was opened at 186 North Loudoun Street, Winchester, Virginia. On December 29, 2003, a full-service banking office

was opened at 3119 Valley Avenue, #102, Winchester, Virginia. On April 28, 2008, a full-service banking office was opened at 404 People Place, Charlottesville, Virginia. Additionally, the multi-story office building houses the Bank's Operations Center and several administrative functions.

During 2006, the Trust Department relocated into leased space at 310 4th Street, NE, Suite 102, Charlottesville, Virginia where VNBTrust now conducts business.

Market Area

The market area served by Virginia National Bank continues to grow. According to the U.S. Census Bureau, the combined populations of the City of Charlottesville and Albemarle County stood at 142,733 persons as of April 1, 2010, an increase of approximately 14.8 percent between April 1, 2000 and April 1, 2010. The Virginia State Demographer projects the two municipalities to grow 13.0 percent to a population of 161,278 by 2020, according to the Virginia Employment Commission website. Charlottesville and Albemarle County support a diverse, well-rounded economy. Stability in the local economy stems from the significant number of persons employed by the University of Virginia, as well as several service companies.

The combined populations of the City of Winchester and Frederick County increased approximately 26.5 percent between April 1, 2000 and April 1, 2010, to a population of 104,767 persons in 2010. The combined population is expected to be 125,159 by 2020, an increase of 19.5 percent.

Orange County had a population of approximately 33,559 persons as of 2010. Between April 1, 2000 and April 1, 2010, its population grew 29.7 percent, compared to a 13.4 percent growth rate for the Commonwealth of Virginia as a whole.

The total market area served by Virginia National Bank grew 20.7 percent between 2000 and 2010, 7.3 percent ahead of the state as a whole. Over the next decade, the Commonwealth is expected to have only a 9.8 percent growth, where Virginia National Bank's current footprint is expected to be 15.3 percent higher by 2020 than reported by the 2010 Census.

Competition

The Bank engages in highly competitive activities. Each activity involves competition with other banks, as well as with non-banking enterprises that offer financial products and services that compete directly with the Bank's product and service offerings. The Bank actively competes with other banks in its efforts to obtain deposits and make loans, in the scope and types of services offered, in interest rates paid on time deposits and charged on loans, and in other aspects of banking.

In addition to competing with other commercial banks within and outside its primary service areas, the Bank competes with other financial institutions engaged in the business of making loans or accepting deposits, such as savings and loan associations, credit unions, insurance companies, small loan companies, finance companies, mortgage companies, certain governmental agencies and other enterprises. Competition for funds from securities brokers and mutual funds for money market accounts is strong. Additional competition for deposits comes from government and private issues of debt obligations and other investment alternatives for depositors such as money market funds.

The market areas served by Virginia National Bank are highly competitive with respect to banking. Competition for loans to small businesses and professionals is intense, and pricing is important. Many of the Bank's competitors have substantially greater resources and lending limits than the Bank and offer certain services such as extensive and established branch networks that the Bank does not expect to match. Deposit competition is also very strong. The Bank believes, however, that a market exists for the personal and customized financial services an independent, locally owned bank can offer.

Supervision and Regulation

The banking industry is highly regulated. Statutory and regulatory controls are designed primarily for the protection of depositors and the banking system, and not for the purpose of protecting the shareholders of financial institutions. The description of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, does not purport to be complete and is qualified in its entirety by reference to applicable laws and regulations.

Proposals to change the laws and regulations governing the banking industry are frequently raised in the 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 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 Bank.

General

The Bank is subject to supervision by the OCC, and is affected by the various applicable federal and Virginia laws, and regulations of the OCC, the Board of Governors of the Federal Reserve System and the FDIC. The various laws and regulations administered by these regulatory agencies affect corporate practices, expansion of business and provision of services. Also, monetary and fiscal policies of the United States directly affect bank loans and deposits and, thus, may affect the Bank's earnings. The OCC conducts regular examinations of the Bank, reviewing such matters as the quality of loans and investments, the adequacy of loan loss reserves, compliance with laws and regulations, management practices and other aspects of the Bank's operations. In addition to these regular examinations, the Bank must furnish periodic reports to regulatory agencies that contain a full and accurate statement of its affairs.

The Bank is also subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as administered by the OCC. The Bank's common stock is quoted on the OTC Markets Group's OTCQB tier under the symbol "VABK."

Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, as amended (the "Interstate Banking Act"), generally 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 Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), a bank must be well capitalized and well managed to engage in an interstate acquisition. 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.

Limitations on 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, 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 Securities Exchange Act of 1934 (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 be approved in advance by a majority of the institutions' disinterested 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.

Restrictions on Acquisitions; Changes in Control

Subject to certain exceptions, the Change in Bank Control Act, together with the applicable regulations, requires OCC 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 securities under Section 12 of the Exchange Act or no other person will own a greater percentage of that class of voting securities immediately after the acquisition. The Bank's common stock is registered under Section 12 of the Exchange Act.

Regulatory Reform

On July 21, 2010, President Obama signed into law 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. While some rulemaking under the Dodd-Frank Act has occurred, many of the provisions require study or rulemaking by federal agencies, a process which will take years to implement fully.

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 Bank. The Dodd-Frank Act permanently raises deposit insurance levels to \$250,000, and until December 31, 2012 provided unlimited deposit insurance coverage for transaction accounts. Pursuant to modifications under the Dodd-Frank Act, deposit insurance assessments will be calculated based on an insured depository institution's assets rather than its insured deposits and the minimum reserve ratio of the FDIC's Deposit Insurance Fund is to be raised to 1.35%. The payment of interest on business demand deposit accounts is permitted by the Dodd-Frank Act. Further, the Dodd-Frank Act bars banking organizations, such as the Bank, from engaging in proprietary trading and from sponsoring and investing in hedge funds and private equity funds, except as permitted under certain limited circumstances.

The Dodd-Frank Act established the Bureau of Consumer Financial Protection ("CFPB") as an independent bureau of the Federal Reserve. The CFPB has the exclusive authority to prescribe rules governing the provision of consumer financial products and services, which in the case of the Bank will be enforced by the OCC. The Dodd-Frank Act also provides that debit card interchange fees must be reasonable and proportional to the cost incurred by the card issuer with respect to the transaction. This provision is known as the "Durbin Amendment." In June 2011, the Federal Reserve adopted regulations setting the maximum permissible interchange fee as the sum of 21 cents per transaction and five basis points multiplied by the value of the transaction, with an additional adjustment of up to one cent per transaction if the card issuer implements certain fraud-prevention standards. The interchange fee restriction only applies to financial institutions with assets of \$10 billion or more and therefore currently has no effect on the Bank.

The Dodd-Frank Act enhances the requirements for certain transactions with affiliates under Sections 23A and 23B of the Federal Reserve Act, including an expansion of the definition of "covered transactions" and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained. These requirements became effective on July 21, 2011. The Dodd-Frank Act also provides that

the appropriate federal regulators must establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank or other “covered financial institution” that provides an insider or other employee with “excessive compensation” or compensation that gives rise to excessive risk or could lead to a material financial loss to such firm. In June 2010, prior to the Dodd-Frank Act, the 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.

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

Although a significant number of the rules and regulations mandated by the Dodd-Frank Act have been finalized, many of the new requirements have yet to be implemented and will likely be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies, the full extent of the impact such requirements will have on the operations of 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 capital requirements, liquidity and leverage ratio requirements, or otherwise adversely affect the business of the Bank. These changes may also require the Bank to invest significant management attention and resources to evaluate and make necessary changes to comply with new statutory and regulatory requirements.

Capital Requirements

The Federal Reserve, 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 risk-based capital requirements of these federal bank regulatory agencies, the Bank is required to maintain a minimum ratio of total capital to risk-weighted assets of at least 8.0%. 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 a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments) and a limited amount of the general loan loss allowance. Under regulations established by the federal banking agencies a “well capitalized” institution must have a Tier 1 capital ratio of at least 6%, and a total capital ratio of at least 10%, and not be subject to a capital directive order. An “adequately capitalized” institution must have a Tier 1 capital ratio of at least 4% and a total capital ratio of at least 8%. The Tier 1 and total capital to risk-weighted asset ratios of the Bank were 15.27% and 16.21% respectively, as of December 31, 2012, thus exceeding the minimum requirements and the requirements to be considered a “well capitalized institution”.

Each of the federal regulatory agencies 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 4% for banks and bank holding companies that meet certain specified criteria, including having the highest regulatory examination rating and are not contemplating significant growth or expansion. The Tier 1 leverage ratio of the Bank as of December 31, 2012 was 10.87%, which is above the minimum requirements. The guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets.

On June 7, 2012, the Federal Reserve and the other federal bank regulatory agencies issued a series of proposed rules that would revise their risk-based and leverage capital requirements and their method for calculating risk-weighted assets. The proposed rules implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The proposed rules would, among other things, establish a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets) and a higher minimum Tier 1 risk-based capital requirement (6% of risk-weighted assets), and assign higher risk weightings to loans that are more than 90 days past due, loans that are on nonaccrual status

and certain loans financing the acquisition, development or construction of commercial real estate. The proposed rules would also require unrealized gains and losses on certain securities holdings to be included for purposes of calculating regulatory capital requirements, and would limit a financial institution's capital distributions and certain discretionary bonus payments if the institution does not hold a "capital conservation buffer" consisting of a specified amount of common equity Tier 1 capital in addition to the amount necessary to meet its minimum risk-based capital requirements.

The federal bank regulatory agencies initially indicated that these proposed rules would be phased-in beginning January 1, 2013 with full compliance required by January 1, 2019. However, due to the volume of public comments received, the agencies elected not to begin implementing the rules on January 1, 2013 and have provided no further guidance on a new effective date. Management believes that, as of December 31, 2012, the Bank would meet all capital adequacy requirements under the proposed rules if such requirements were currently effective. The regulations ultimately implemented may be substantially different from the proposed rules issued in June 2012. Management will continue to monitor these and any future proposals submitted by our regulators.

Limits on Dividends and Other Payments

Statutory and regulatory limitations apply to the Bank's payment of dividends to its shareholders. 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.

FDIC Deposit Insurance

The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that, as described below, takes into account, among other things, a bank's capital level and supervisory rating (its "CAMELS rating"). Substantially all of the deposits of the Bank are insured up to applicable limits by the DIF of the FDIC and are subject to deposit insurance assessments to maintain the DIF. Deposit insurance assessments previously were based on deposit account balances; one of the major changes was to change the base of deposit insurance assessments to the average consolidated total assets during the assessment period less average tangible equity capital.

Deposit insurance assessments are based on average total assets minus average tangible equity. The initial base assessment rate ranges from 5 to 35 basis points on an annualized basis. After the effect of potential base-rate adjustments, the total base assessment rate could range from 2.5 to 45 basis points on an annualized basis. As the DIF reserve ratio grows, the rate schedule will be adjusted downward. Additionally, an institution must pay an additional premium equal to 50 basis points on every dollar (above 3% of an institution's Tier 1 capital) of long-term, unsecured debt held that was issued by another insured depository institution (excluding debt guaranteed under the Temporary Liquidity Guarantee Program). Any increase in insurance assessments could have a negative impact on the earnings of insured institutions, including the Bank. The Bank paid a deposit insurance premium in 2012 amounting to \$297 thousand.

Virginia National Bank is designated as an established small insured depository institution. Small banks (those with less than \$10 billion in assets) are divided into four risk categories based on their confidential composite CAMELS rating and level of capital. A Risk Category I bank represents lower risk to the insurance system, while a Risk Category IV bank represents higher risk. Because of its confidential composite CAMELS rating and capital levels, Virginia National Bank is designated as a Risk Category I bank. Small banks in Risk Category I are evaluated, and their premiums are set, based on a combination of financial ratios and supervisory ratings. The financial ratios are as follows:

- Tier I leverage ratio;
- Loans past due 30 – 89 days, as a percentage of gross assets;
- Nonperforming assets, as a percentage of gross assets;

- Net loan charge-offs, as a percentage of gross assets; and
- Net income before taxes, as a percentage of risk-weighted assets.

Supervisory ratings will also be taken into account using a weighted average of an institution's confidential CAMELS component ratings.

In addition, the Bank is required to make payments for the servicing of obligations of the Financing Corporation ("FICO") issued in connection with the resolution of savings and loan associations, so long as such obligations remain outstanding. The Bank paid a FICO assessment in 2012 amounting to \$28 thousand. The FICO annualized assessment rate for the first quarter of 2013 is \$0.64 cents per \$100 of deposits.

On November 17, 2009, the FDIC implemented a final rule requiring insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012. Such prepaid assessments were collected by the FDIC on December 30, 2009, along with each institution's quarterly risk-based deposit insurance assessment for the third quarter of 2009. As of December 31, 2012, \$629 thousand in pre-paid deposit insurance is included in "other assets" in the accompanying consolidated balance sheet.

In October 2010, the FDIC adopted a new DIF restoration plan to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. At least semi-annually, the FDIC will update its loss and income projections for the fund and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking if required.

In November 2010, the FDIC issued a final rule to implement provisions of the Dodd-Frank Act that provide for temporary unlimited coverage for noninterest-bearing transaction accounts. The separate coverage for noninterest-bearing transaction accounts became effective on December 31, 2010 and expired on December 31, 2012.

Under the FDIA, insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

In its resolution of the problems of an insured depository institution in default or in danger of default, the FDIC is generally required to satisfy its obligations to insured depositors at the least possible cost to the DIF. In addition, the FDIC may not take any action that would have the effect of increasing the losses to the DIF by protecting depositors for more than the insured portion of deposits or creditors other than depositors.

Community Reinvestment and Consumer Protection Laws

In connection with its lending activities, the Bank 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 CRA.

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 bank holding company applying for approval to acquire a bank or bank holding company, the record of each subsidiary bank of the applicant bank holding company 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 Bank was rated "satisfactory" in its most recent CRA evaluation.

Anti-Money Laundering Legislation

The Bank 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 Bank to take steps to prevent the use of its services for facilitating the flow of illegal or illicit money, to report large currency transactions, and to file suspicious activity reports. The Bank 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 financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions.

International Transactions

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These sanctions, which are administered by the U.S. Treasury Department Office of Foreign Assets Control ("OFAC"), take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (for example, property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal, financial and reputational consequences.

Other Safety and Soundness Regulations

There are a number of obligations and restrictions imposed on depository institutions 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 ("FDICIA"), the federal banking 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. At December 31, 2012 the Bank met the requirements for being classified as "well capitalized", as described above.

As required by FDICIA, the federal banking 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.

Privacy Legislation

Several recent regulations issued by federal banking 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.

Incentive Compensation

In June 2010, the federal banking 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 OCC will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of financial institutions, such as the Bank, 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.

Lending Activities

The Bank offers credit facilities, both secured and occasionally unsecured, to business customers. These facilities include term loans, single payment loans, revolving credit facilities and other lines of credit. These loans may be for temporary or seasonal working capital needs, or to provide funding for the acquisition of fixed assets or real estate. In addition, the Bank offers commercial real estate construction loans for both investment properties and owner-occupants of business facilities.

Installment loans, consumer purpose loans, revolving lines of credit and home equity lines of credit are also offered by the Bank.

The Bank's lending activities are subject to a variety of lending limits imposed by federal law and internal policy. While differing limits apply in certain circumstances based on the type of loan or the nature of the borrower, the Bank is generally subject to a loan-to-one-borrower limit in an amount equal to fifteen percent of the Bank's capital and surplus. Loans which are fully secured by readily marketable or other permissible types of collateral may exceed the fifteen percent limitation. Although the Bank's capitalization has enabled it to have a lending limit that satisfies the credit needs of a large portion of its target market, the Bank has also established relationships with correspondent banks to participate in loans when the amounts exceed the Bank's legal lending limit or the more stringent limits imposed by internal lending policies.

Credit Policies

The Bank employs a written credit policy to enhance its management of credit risk. The policy includes underwriting guidelines, principles of loan analysis, documentation requirements, maintenance guidelines for credit files, risk assessment rules and definitions, and procedures for ongoing identification and management of loans of less than acceptable risk. The policy also fixes the lending limits of all lending personnel for both secured and unsecured lending. Loans in excess of this amount require consideration by and approval of the Bank's Loan Committee, which meets at least once per week. The Bank places an extremely high value on the confidentiality of any customer information. The credit policy also addresses items such as aggregate loan diversification, conflicts of interest, loan pricing, concentrations of credit and the impact of business cycles on loan philosophy.

Employees

At December 31, 2012, the Bank had 118 full time equivalent employees. None of its employees is represented by any collective bargaining unit. The Bank considers relations with its employees to be good.

The Bank has purchased Bank Owned Life Insurance (“BOLI”) policies on executives and key personnel of the Bank. BOLI is a bank-eligible asset designed to recover costs of providing pre- and post-retirement benefits and/or to finance general employee benefit expenses. Under BOLI policies, the executives and other key personnel are the insured, and the Bank is the owner and beneficiary of the policies. The insured has no claim to the insurance policy or to the policy’s cash value. Under separate split dollar agreements, a portion of any death benefit may be paid to the beneficiaries of the insured employees, subject to the terms and restrictions of the split dollar endorsement agreement between the officer and the Bank.

Code of Ethics

VNB has adopted a Code of Ethics that applies to all of its employees, including its principal executive officer and its principal financial officer. The Code of Ethics is designed to deter wrongdoing and to promote the following:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships.
2. Full, fair, accurate, timely and understandable disclosure in reports and documents that are filed with regulatory agencies and in other public communications.
3. Compliance with applicable governmental laws, rules and regulations.
4. The prompt internal reporting of violations of the code to an appropriate person identified in the code.
5. Accountability for adherence to the code.

Availability of Information

The Bank files its periodic and annual reports with the Office of the Comptroller of the Currency. Our annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, plus any amendments to these reports, are available, free of charge, on the Bank’s Internet website at www.vnb.com. These reports are available as soon as reasonably practical after they are filed with the OCC. The information on the Bank’s Internet website is not incorporated into this Annual Report on Form 10-K or any other filing the Bank makes with the OCC.

Item 1A. RISK FACTORS.

Not required

Item 2. PROPERTIES.

The Bank currently occupies eight sites in Charlottesville, Winchester, and Albemarle and Orange Counties. The main office and a full-service banking facility are located at 222 East Main Street, Charlottesville, Virginia. Full-service banking facilities are also located at 1580 Seminole Trail, Charlottesville, Virginia; 1900 Arlington Boulevard, Charlottesville, Virginia; 102 East Main Street, Orange, Virginia; 186 North Loudoun Street, Winchester, Virginia; 3119 Valley Avenue, #102, Winchester, Virginia; and 404 People Place, Charlottesville, Virginia.

The property located at 1580 Seminole Trail, Charlottesville, VA (29 North Office) was leased in 1998 from Sunny Hill Land Trust (an entity in which Hunter Craig, a director of the Bank, holds a beneficial interest) for a term of five years with six five-year renewal options. In 2008, the Bank exercised the second five-year renewal option. Monthly rent for this space was a fair market rate as verified by an independent third-party appraisal. In

the first quarter of 2012, the Bank purchased the property from Sunny Hill Land Trust, thus terminating the lease.

As of December 31, 2012, all of the other full-service banking locations were leased as described further below. VNBTrust leases space at 310 4th Street, NE, Suite 102, Charlottesville, Virginia.

Lease terms for the above-mentioned properties are as follows:

222 East Main Street, Charlottesville, VA (Downtown Mall Office):

This property was originally leased from Williams Pentagram Corporation in 1998, and is currently in the fifth year of a five-year renewal term. The lease provides for three more five-year renewal options

1900 Arlington Boulevard, Charlottesville, VA (Barracks Road Office):

This property was leased in 1998 from Paul and Jean Holdren for a term of twenty years with seven five-year renewal options. The Arlington Boulevard site has additional space not occupied by the banking facility. This space has been leased to tenants.

102 East Main Street, Orange, VA (Orange Office):

This property was leased in 2000 from The Bryant Foundation for a term of three years with three five-year renewal options. The Bank has exercised the second five-year renewal option. The Bank entered a new five-year lease in January, 2011 for additional space on the second floor, where the Bank houses its Disaster Recovery site and some other operational office space. This lease has three two-year renewal options.

186 North Loudoun Street, Winchester, VA (Winchester Office):

This property was originally leased in 2001 from Shenandoah University for a term of ten years with two five-year renewal options. In 2011, the Bank and Shenandoah University entered a new lease for this property for a term of five years with one five-year renewal term.

3119 Valley Avenue, #102, Winchester, VA (Creekside Office):

This property is located in the Creekside Station Shopping Center. It was leased in 2003 from Joleen, L.C. for a term of ten years expiring January 31, 2014, with two five-year renewal options.

404 People Place, Charlottesville, VA (Pantops Park Office):

This property, consisting of approximately 8,167 square feet, is located just east of the Charlottesville city limits on Pantops Mountain, and fronts on Route 250 East. The building was constructed by the Bank on a pad site leased in 2005 from Pantops Park, LLC for a term of twenty years, with seven five-year renewal options. William D. Dittmar, Jr., a director of the Bank, is the sole managing member of Pantops Park, LLC. Monthly rent for this space is a fair market rate as verified by an independent third-party appraisal. A five-story building, consisting of approximately 43,000 square feet, was completed in early 2008, and the Bank opened this full-service office in April, 2008. Additionally, the building houses the Bank's Operations Center and several administrative functions. It also contains space for lease to third parties. A portion of the space has been rented, and the Bank is actively seeking other tenants.

310 4th Street, N.E., Suite 102, Charlottesville, VA (VNBTrust, N.A.):

This property is located approximately two blocks from the downtown Charlottesville banking office. It was leased in 2006 from Court Square, L.L.C. for a term of five years, with two five-year renewal options. The lease was amended effective December 20, 2010 to extend the lease until July 31, 2016 and to provide for an additional five-year renewal term with slightly reduced payment terms.

Item 3. LEGAL PROCEEDINGS.

There are no legal proceedings against the Bank that would have a material adverse effect on the Bank or its financial condition.

Item 4. MINE SAFETY DISCLOSURES.

Not applicable

Part II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Virginia National Bank's Common Stock is listed on the OTC Markets Group's (OTCQB) tier under the symbol VABK. As of December 31, 2012, the Bank had issued and outstanding 2,690,220 shares of Common Stock. These shares were held by approximately 572 shareholders of record and others who held shares at brokerage firms. The Bank's Common Stock was issued on June 26, 1998, at a price of \$10.00 per share.

On May 16, 2011, the Board of Directors declared a 15% stock dividend. The stock dividend was paid on June 30, 2011 to shareholders of record at the close of business on June 15, 2011. As a result of the stock dividend, each shareholder received 0.15 shares of Common Stock for every share of Common Stock held as of the record date. The Bank has not declared any cash dividends. Payments of dividends is at the discretion of the Bank's Board of Directors, is subject to various federal and state regulatory limitations, and is dependent upon the overall performance and capital requirements of the Bank.

For the years ended December 31, 2012 and December 31, 2011, the data in the table below represents the high bid and low bid quotations that occurred for the periods shown as reported by the OTCQB. These over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	2012		2011	
	High	Low	High	Low
First Quarter	\$15.95	\$13.87	\$22.50	\$16.51
Second Quarter	\$16.00	\$12.35	\$24.00	\$15.50
Third Quarter	\$15.00	\$12.38	\$18.50	\$13.00
Fourth Quarter	\$15.35	\$12.70	\$17.40	\$12.25

American Stock Transfer and Trust Company is the Bank's stock transfer agent and registrar.

Item 6. SELECTED FINANCIAL DATA.

Not required.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF CONSOLIDATED FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion provides information about the major components of the results of consolidated operations and financial condition, liquidity and capital resources of Virginia National Bank. This discussion and analysis should be read in conjunction with the "Consolidated Financial Statements" and "Notes to the Consolidated Financial Statements."

FORWARD-LOOKING STATEMENTS AND FACTORS THAT COULD AFFECT FUTURE RESULTS

Certain statements contained or incorporated by reference in this annual report on Form 10-K, including but not limited to, statements concerning future results of operations or financial position, borrowing capacity and future liquidity, future investment results, future credit exposure, future loan losses and plans and objectives for future operations, change in laws and regulations applicable to the Bank, adequacy of funding sources, actuarial expected benefit payment, valuation of foreclosed assets, our ability to hold to maturity securities designated as

held to maturity, regulatory requirements, economic environment and other statements contained herein regarding matters that are not historical facts, are “forward-looking statements” as defined in the Securities Exchange Act of 1934. These statements are not historical facts but instead are subject to numerous assumptions, risks and uncertainties, and represent only our belief regarding future events, many of which, by their nature, are inherently uncertain and outside our control. Any forward-looking statements the Bank may make speak only as of the date on which such statements are made. Our actual results and financial position may differ materially from the anticipated results and financial condition indicated in or implied by these forward-looking statements, and the Bank makes no commitment to update or revise forward-looking statements in order to reflect new information or subsequent events or changes in expectations.

Factors that could cause our actual results to differ materially from those in the forward-looking statements include, but are not limited to, the following: inflation, interest rates, market and monetary fluctuations; geopolitical developments including acts of war and terrorism and their impact on economic conditions; the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board; changes, particularly declines, in general economic conditions and in the local economies in which the Bank operates; the financial condition of the Bank’s borrowers; competitive pressures on loan and deposit pricing and demand; changes in technology and their impact on the marketing of new products and services and the acceptance of these products and services by new and existing customers; the willingness of customers to substitute competitors’ products and services for the Bank’s products and services; the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities and insurance); changes in accounting principles, policies and guidelines; other risks and uncertainties described from time to time in press releases and other public filings; and the Bank’s performance in managing the risks involved in any of the foregoing. The foregoing list of important factors is not exclusive, and the Bank will not update any forward-looking statement, whether written or oral, that may be made from time to time.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The accounting and reporting policies followed by the Bank conform, in all material respects, to U.S. generally accepted accounting principles (“U.S. GAAP”). In preparing the consolidated financial statements, management has made estimates, assumptions and judgments based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements may reflect different estimates, assumptions and judgments. Certain policies inherently have greater reliance on the use of estimates, assumptions and judgments and, as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation allowance to be established, or when an asset or liability must be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when readily available. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, which management believes to be reasonable under the circumstances. The Bank adjusts such estimates and assumptions when the Bank believes facts and circumstances dictate. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in those estimates resulting from continuing changes in the economic environment will be reflected in the financial statements in the future periods.

The Bank’s accounting policies are fundamental to understanding management’s discussion and analysis of financial condition and results of operations. The most significant accounting policies followed by the Bank are presented in Note 1 to the consolidated financial statements.

Management utilizes various inputs to determine the fair value of its securities portfolio. Fair value of securities is based upon market prices, where available (Level 1 inputs). If such quoted market prices are not available, fair value is based upon market prices determined by an outside, independent entity that primarily uses, as inputs, observable market-based parameters (Level 2 inputs). Valuation adjustments may be made to ensure

that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Bank's creditworthiness, among other things, as well as unobservable parameters (Level 3 inputs). Any such valuation adjustments are applied consistently over time. The Bank's valuation methodologies may produce a fair value calculation that may not be indicative of net realized value or reflective of future fair values. While management believes the Bank's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Additional discussion of valuation methodologies is presented in Note 14 of the Bank's consolidated financial statements.

A periodic review is conducted by management to determine if the decline in the fair value of any security appears to be other-than-temporary. Factors considered in determining whether the decline is other-than-temporary include, but are not limited to: the length of time and the extent to which fair value has been below cost; the financial condition and near-term prospects of the issuer; and the Bank's intent to sell. If the decline is deemed to be other-than-temporary, and the Bank does not have the intent to sell, and will not likely be required to sell, the security is written down to a new cost basis and the resulting credit component of the loss is reported in noninterest income and the remainder of the loss is recorded in shareholders' equity. If the Bank intends to sell or will be required to sell, the full amount of the other-than-temporary impairment is recorded in noninterest income.

The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The methodology used to determine the allowance for loan losses is outlined in Note 1 and Note 4 to the consolidated financial statements.

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in the Bank's consolidated financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could impact the Bank's consolidated financial condition or results of operations. Additional discussion on the accounting for income taxes is presented in Note 1 and in Note 8 of the Bank's consolidated financial statements.

Non-GAAP Presentations

The Bank, in referring to its net income, is referring to income under accounting principles generally accepted in the United States of America, or "GAAP". This management's discussion and analysis also refers to the efficiency ratio which is computed by dividing non-interest expense by the sum of net interest income and non-interest income. This is a non-GAAP financial measure which may provide important information concerning the Bank's operational efficiency. Comparison of our efficiency ratio with those of other companies may not be possible because other companies may calculate the efficiency ratio differently.

INCOME STATEMENT ANALYSIS

Net interest income, which represents the difference between interest earned on interest-earning assets and interest incurred on interest-bearing liabilities, is the Bank's primary source of earnings. Net interest income can be affected by changes in market interest rates as well as the level and composition of assets, liabilities and shareholders' equity. Net interest spread is the difference between the average rate earned, on a tax-equivalent basis, on interest-earning assets and the average rate paid on interest-bearing liabilities. The net yield on interest-earning assets ("net interest margin") is calculated by dividing tax equivalent net interest income by average interest-earning assets. Generally, the net interest margin will exceed the net interest spread because a portion of interest-earning assets are funded by various noninterest-bearing sources, principally noninterest-bearing deposits and shareholders' equity. The increases (decreases) in the components of interest income and interest expense, expressed in terms of fluctuation in average volume and rate, are provided in the Volume and Rate Analysis shown in Table 3, later in this report.

COMPARISON OF THE YEARS 2012 AND 2011

The Bank reported net income for the period ended December 31, 2012 was \$5.481 million, compared to \$2.341 million for the period ended December 31, 2011. The commercial bank earned net income of \$1.938 million in 2012, only \$70 thousand less than the \$2.008 million earned in 2011. The Bank's subsidiary, VNBTrust, N.A., earned net income of \$3.543 million in 2012, compared to net income of \$333 thousand in 2011.

The \$3.140 million increase in net income in 2012 from 2011 was attributed to a \$7.141 million increase in trust fee income and a \$614 thousand decrease in provision for loan loss. Net income was negatively impacted by a \$452 thousand decrease in net interest income, a \$207 thousand decrease in non-interest income (exclusive of trust fee income), a \$2.277 million increase in non-interest expense, and a \$1.679 million increase in income taxes.

TABLE 1

Consolidated Return on Equity and Assets

The annualized ratio of net income to average total assets and average shareholders' equity and certain other ratios for the periods indicated are as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Return on average assets	1.11%	0.51%	0.94%
Return on average equity	10.90%	4.95%	9.46%
Average equity to average assets	10.21%	10.21%	9.91%
Cash dividend payout ratio	0.00%	0.00%	0.00%

Net Interest Income

During 2012, net interest income was \$15.623 million compared to \$16.075 million in 2011. Despite higher average deposits funding additional earning assets of \$27.7 million during 2012 versus 2011, net interest income year to year was lower by \$452 thousand, mainly attributed to interest margin compression during this period of historically low interest rates and the mix of earning assets.

Total interest income aggregated \$16.9 million for 2012, down \$944 thousand from 2011 primarily as a result of a decline in loan interest income of \$1.061 million. Offsetting lower loan income was \$117 thousand in income from the investment portfolio and overnight Federal Funds sold and balances held in correspondent accounts. The tax-equivalent yield on interest-earning assets was 3.70% for 2012 compared to 4.14% for 2011.

Interest income earned on the loan portfolio decreased \$1.061 million for 2012 from \$15.781 million in 2011. Average loan balances amounted to \$294.830 million for 2012, an increase of \$4.364 million from an average of \$290.466 million in 2011. The increase in average loans accounted for a \$163 thousand increase in interest earned on loans; however rate adjustments and lower rates on new loans resulted in a decrease of \$1.224 million in loan income. The yield on the loan portfolio decreased to 4.99% for 2012 from 5.43% for 2011.

Interest earned on the securities portfolio, on a tax-equivalent basis, increased to \$2.124 million for 2012 from \$2.019 million in 2011. Average securities balances increased to \$104.800 million (22.8% of average earning assets) for 2012 from \$89.227 million (20.7% of average earning assets) in 2011. The average yield on investment securities decreased to 2.03% for 2012 from 2.26% in the corresponding 2011 period. The increase in the securities portfolio balances were the result of a continuing growth in deposit account balances in 2012 and slower loan growth. The continuing low rate environment continues to impact the overall portfolio yield.

Management's Asset/Liability strategy for the investment portfolio, starting in 2012, was to diversify the investment portfolio by adding mortgage-backed securities and bank-qualified municipal bonds. The average duration of the investment portfolio continues to be relatively short. Adding mortgage-backed securities has resulted in providing a consistent stream of cash flow that can be diverted to loan growth or re-invested in higher yielding securities when interest rates rise.

Total interest expense decreased by \$492 thousand for 2012 from \$1.773 million for 2011, due to a decrease in average interest-bearing liabilities of \$1.227 million for 2012. Rates paid for interest-bearing liabilities also declined from 0.59% for 2011 to 0.43% for 2012.

Interest expense on deposits decreased \$490 thousand for 2012 to \$1.277 million as compared to \$1.767 million for 2011. The decrease in interest expense was partially a result of lower time deposit rates and a change in the mix of deposit balances. Time deposit rates averaged 0.77% in 2012 or 30 basis points lower than the 1.07% paid in 2011. In total, the average balance of interest-bearing deposit accounts decreased \$1.528 million. Average time deposit balances decreased \$9.498 million in 2012, while interest checking and money market account balances increased \$5.260 million and \$2.710 million, respectively.

The Bank continues to experience double-digit growth in non-interest bearing deposit account balances. During 2012 the average balance was \$139.741 million, an increase of \$28.092 million or 25.2% from the 2011 average balance of \$111.649 million. This compares to the increase in 2011 of 12.0% or \$11.940 million from the average balance of \$99.709 million in 2010. These year-over-year increases assist in maintaining the Bank's low cost of funds.

(Continue to Tables 2 and 3 on the following pages for more details.)

TABLE 2

Consolidated Average Balance Sheet And Analysis of Net Interest Earnings

(dollars in thousands)	Year Ended December 31, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010		
	Average Balance	Interest Income Expense	Average Yield/ Cost	Average Balance	Interest Income Expense	Average Yield/ Cost	Average Balance	Interest Income Expense	Average Yield/ Cost
ASSETS									
Interest Earning Assets:									
Securities (1)	\$104,800	\$2,124	2.03%	\$89,227	\$2,019	2.26%	\$50,010	\$1,363	2.73%
Loans:									
Real estate	238,958	12,481	5.22%	240,429	13,573	5.65%	255,556	14,945	5.85%
Commercial	42,876	1,765	4.12%	38,128	1,717	4.50%	33,381	1,636	4.90%
Consumer	12,996	474	3.65%	11,909	491	4.12%	13,582	587	4.32%
Total Loans	294,830	14,720	4.99%	290,466	15,781	5.43%	302,519	17,168	5.68%
Fed Funds Sold	58,420	112	0.19%	51,444	48	0.09%	46,582	45	0.10%
Other Interest Bearing Deposits	751	8	0.00%	-	-	0.00%	-	-	0.00%
Total Earning Assets	458,801	16,964	3.70%	431,137	17,848	4.14%	399,111	18,576	4.65%
Less: Allowance for Loan Losses	(3,704)			(3,732)			(3,783)		
Total Non-Earning Assets	37,031			35,532			34,566		
Total Assets	<u>\$492,128</u>			<u>\$462,937</u>			<u>\$429,894</u>		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest Bearing Liabilities:									
Interest Bearing Deposits:									
Interest Checking	\$67,898	\$34	0.05%	\$62,638	\$31	0.05%	\$63,254	\$31	0.05%
Money Market Deposits	93,690	194	0.21%	90,980	168	0.18%	85,782	165	0.19%
Time Deposits	136,832	1,049	0.77%	146,330	1,568	1.07%	135,087	1,683	1.25%
Total Interest-Bearing Deposits	298,420	1,277	0.43%	299,948	1,767	0.59%	284,123	1,879	0.66%
Securities Sold Under Agreement to Repurchase	2,973	4	0.13%	2,672	6	0.22%	2,313	5	0.22%
Total Interest-Bearing Liabilities	301,393	1,281	0.43%	302,620	1,773	0.59%	286,436	1,884	0.66%
Non-Interest-Bearing Liabilities:									
Demand deposits	139,741			111,649			99,709		
Other liabilities	730			1,389			1,149		
Total Liabilities	441,864			415,658			387,294		
Shareholders' Equity	50,264			47,279			42,600		
Total Liabilities & Shareholders' Equity	<u>\$492,128</u>			<u>\$462,937</u>			<u>\$429,894</u>		
Net Interest Income		\$15,683			\$16,075			\$16,692	
Interest Rate Spread (2)			3.27%			3.55%			3.99%
Interest Expense as a Percentage of Average Earning Assets			0.28%			0.41%			0.47%
Net Interest Margin (3)			3.42%			3.73%			4.18%

(1) Tax-exempt income for investment securities has been adjusted to a tax-equivalent basis, resulting in a increase in interest income of \$59 thousand for 2012. A Federal income tax rate of 34% was used.

(2) Interest spread is the average yield earned on earning assets less the average rate paid on interest-bearing liabilities.

(3) Net interest margin is net interest income expressed as a percentage of average earning assets.

TABLE 3
Volume and Rate Analysis

The following table describes the impact on the net interest income of the Bank resulting from changes in average balances and average rates for the periods indicated. The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each. Interest income is reported on a tax-equivalent basis, assuming a Federal income tax rate of 34%.

2012 compared to 2011
(dollars in thousands)

	Change due to:		Increase / Decrease
	Volume	Rate	
Assets:			
Securities	\$ 330	\$ (225)	\$ 105
Loans:			
Real estate	(83)	(1,009)	(1,092)
Commercial	203	(155)	48
Consumer	43	(60)	(17)
Total loans	163	(1,224)	(1,061)
Federal funds sold	7	57	64
Other interest bearing deposits	8	-	8
Total earning assets	\$ 508	\$ (1,392)	\$ (884)
Liabilities and Shareholders' equity:			
Interest-bearing deposits:			
Interest checking	\$ 2	\$ 1	\$ 3
Money market	5	21	26
Time deposits	(96)	(423)	(519)
Total interest-bearing deposits	(89)	(401)	(490)
Short-term borrowings	1	(3)	(2)
Total interest-bearing liabilities	(88)	(404)	(492)
Change in net interest income	\$ 596	\$ (988)	\$ (392)

2011 compared to 2010
(dollars in thousands)

	Change due to:		Increase / Decrease
	Volume	Rate	
Assets:			
Securities	\$ 920	\$ (264)	\$ 656
Loans:			
Real estate	(865)	(507)	(1,372)
Commercial	221	(140)	81
Consumer	(70)	(26)	(96)
Total loans	(714)	(673)	(1,387)
Federal funds sold	4	(1)	3
Total earning assets	\$ 210	\$ (938)	\$ (728)
Liabilities and Shareholders' equity:			
Interest-bearing deposits:			
Interest checking	\$ -	\$ -	\$ -
Money market	10	(7)	3
Time deposits	131	(246)	(115)
Total interest-bearing deposits	141	(253)	(112)
Short-term borrowings	1	-	1
Total interest-bearing liabilities	142	(253)	(111)
Change in net interest income	\$ 68	\$ (685)	\$ (617)

Provision for Loan Losses

Based on management's continuing evaluation of the loan portfolio in 2012, the Bank recorded a net recovery of loan loss provision of \$79 thousand, compared to 2011 when the Bank recorded a provision for loan losses of \$535 thousand. Factors affecting the provision for the year 2012 included current economic conditions, an overall improvement in asset quality and a lower level of net charge-offs. As of December 31, 2012, the allowance for loan losses was \$3.267 million, a decrease of \$474 thousand from \$3.741 million at December 31, 2011.

The Bank decreased its allowance to total loans outstanding to 1.15% at December 31, 2012, compared to the 1.28% reported at December 31, 2011. There were \$608 thousand in loan balances charged off during 2012, with a total of \$213 thousand in recoveries of previously charged-off balances. This resulted in net charge-offs of \$395 thousand during 2012 and compares favorably to the net charge-offs of \$524 thousand reported for 2011. There were \$560 thousand in loan balances charged-off during 2011 and recoveries of \$36 thousand. The ratio of net charge-offs to average loans remained strong at 0.13% for 2012 and 0.18% for 2011. The decrease in the allowance was partially the result of some criticized loans being repaid in full, which ultimately impacts the estimates required in the allowance for potential loan losses.

The level of the allowance reflects changes in the size of the portfolio or in any of its components as well as management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality and economic, political and regulatory conditions. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Bank's control, including the performance of the Bank's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications. Additional information concerning management's methodology in determining the adequacy of the allowance for loan losses is contained in Note 1 and Note 4 of the "Notes to the Consolidated Financial Statements."

Non-Interest Income

Non-interest income increased to \$12.040 million for 2012 from \$5.106 million in 2011. The increase of \$6.934 million principally resulted from revenues from VNBTrust, which were up \$7.141 million in 2012 as compared to 2011. VNBTrust revenues are primarily derived from two forms of fee income: performance fees and fixed fees. VNBTrust recorded \$7.186 million in performance fee income in 2012 as compared to \$364 thousand in 2011, or an increase of \$6.822 million. VNBTrust recorded fixed fee income of \$2.543 million in 2012, which is an increase of \$319 thousand when compared to \$2.224 million reported in 2011. In accordance with a multi-year agreement, VNBTrust staff is compensated on the level of profits earned. There is a correlated increase in salaries and benefits expense for 2012 that is discussed below under Non-interest Expense.

Non-interest income, exclusive of trust income, totaled \$2.311 million in 2012 as compared to \$2.518 million in 2011. Year-to-year comparison is more meaningful when one-time income is excluded from each year's results. In 2012, non-interest income included \$133 thousand in gains from the sale of securities. In 2011, bank-owned life insurance income included \$358 thousand in death benefits. Non-interest income, excluding these two items, would be \$2.178 million in 2012 or an increase of \$18 thousand when compared to \$2.160 million in 2011. Management's strategy to diversify the investment portfolio in 2012 resulted in having to sell certain securities, which resulted in the gains mentioned above.

Non-Interest Expense

Total non-interest expense for the year ended December 31, 2012 was \$19.650 million, an increase of \$2.277 million from the \$17.373 million reported for the year ended December 31, 2011. The increase was primarily the result of higher personnel and other expense costs of \$1.436 million and \$1.133 million, respectively.

Personnel costs were higher in 2012, due to \$2.149 million booked as VNBTrust incentive compensation, in accordance with pre-established formulas, as compared to \$116 thousand recorded for 2011. Personnel

expense excluding the VNBTrust incentive compensation cost was \$8.813 million or \$597 thousand less than the full year personnel expense for 2011, also excluding the VNBTrust incentive compensation.

Other expense costs were \$5.668 million in 2012, an increase of \$1.133 million as compared to the \$4.535 million reported in 2011. The increase was primarily the result of one-time write-downs of \$845 thousand related to other real estate owned (OREO) properties that occurred during 2012. Other expense for 2012, excluding the OREO write-downs, totaled \$4.823 million, an increase of \$288 thousand, or 6.4%, when compared to the \$4.535 million reported in 2011.

Provision for Income Taxes

For 2012, the Bank provided \$2.611 million for Federal income taxes, resulting in an effective income tax rate of 32.3%. In 2011, the Bank provided \$932 thousand for Federal income taxes, resulting in an effective income tax rate of 28.5%. Please see Note 8 in the "Notes to Consolidated Financial Statements" for a discussion regarding net deferred tax and valuation allowance.

Updated Financial Strategic Plan Approved in 2012

In September 2012, the Board of Directors approved a new multi-year strategic plan called "Financial Strategic Plan 2012-2016". The management-recommended Plan was aimed at making some changes to the Bank's business model, while maintaining the Bank's "customer first" culture. The Plan's goals were aimed at addressing the changing banking landscape due to new regulatory requirements that are costly to implement and maintain; and also limited income from traditional revenue sources. These facts taken together with a slow economic recovery, which has kept market interest rates at historically low levels for over 5 years, required a prompt response by management and the Board.

The Plan's goals include reducing operating expenses by a minimum of \$1.35 million annually, starting in 2013. These reductions will be achieved in a number of ways including: eliminating vacant positions, services that were no longer relevant, and programs that were not likely to achieve a desired profitability level. Most of the changes indicated in the Plan are effective in 2013, however, there are a number of other cost reductions and new non-interest income sources that are slated to be deployed in future years.

BALANCE SHEET ANALYSIS

Securities

The Bank's investment portfolio as of December 31, 2012, totaled \$118.6 million, of which obligations of U.S. government corporations and government-sponsored enterprises amounted to \$88.7 million which is approximately 74.8% of the total.

The Bank has the intent and ability to hold to maturity securities classified as held to maturity, at which time it will receive full value for these securities. As of December 31, 2012, the HTM portfolio totaled \$6.0 million and consisted of corporate and municipal bonds. As of December 31, 2011, the HTM portfolio totaled \$6.0 million and consisted of U.S. government-sponsored agency and municipal bonds. These securities are carried at cost, adjusted for amortization of premiums and accretion of discounts. The gross unrealized gains and losses on held to maturity securities were \$69 thousand at December 31, 2012.

Securities classified as available for sale may be sold in the future, prior to maturity. These securities are carried at fair value. Net aggregate unrealized gains or losses on these securities are included, net of taxes, as a component of shareholders' equity. Given the generally high credit quality of the portfolio, management expects to realize all of its investment upon market recovery or the maturity of such instruments and thus believes that any impairment in value is interest-rate-related and therefore temporary. Available for sale securities included gross unrealized gains of \$1.972 million and gross unrealized losses of \$227 thousand. As of December 31, 2012, management does not have the intent to sell any of the securities classified as available for sale, and management believes that it is more likely than not that the Bank will not have to sell any such securities before a recovery of cost.

The Bank's holdings of restricted securities totaled \$1.7 million at December 31, 2012 and at December 31, 2011 and consisted of Federal Reserve Bank and Federal Home Loan Bank stock. The Bank is required to purchase these stocks as a condition of membership with each of these correspondent banks. The amount of stock required to be held by the Bank is periodically assessed by each bank. The stock is recorded at cost.

TABLE 4
Securities Held to Maturity and Available for Sale
(dollars in thousands)

<u>Carrying Value of Securities</u>	<u>As of December 31,</u>		
Securities Held to Maturity	2012	2011	2010
Amortized Cost:			
Municipal Bonds	\$1,967	\$1,975	\$1,984
U.S. Government-Sponsored Agencies	-	4,013	4,027
Corporate Bonds and Notes	4,024	-	1,510
	<u>\$5,991</u>	<u>\$5,988</u>	<u>\$7,521</u>
Securities Available for Sale			
Fair Value:			
U.S. Government-Sponsored Agencies	\$63,497	\$84,150	\$54,520
Mortgage-Backed Securities/CMOs	25,166	-	-
Municipal Bonds	17,023	-	-
Corporate Bonds	4,023	-	-
Asset-Backed Securities	1,144	-	-
	<u>\$110,853</u>	<u>\$84,150</u>	<u>\$54,520</u>
Restricted Securities			
Cost:			
Federal Reserve Bank Stock	\$1,033	\$1,030	\$836
Federal Home Loan Bank Stock	696	698	722
	<u>\$1,729</u>	<u>\$1,728</u>	<u>\$1,558</u>

The Bank does not hold any derivative instruments. The Bank held no issues that exceeded 10% of Shareholders' Equity at December 31, 2012.

TABLE 5
Maturity Distribution and Average Yields
(dollars in thousands)

Projected Maturities of Securities at December 31, 2012

	Amortized Cost	Fair Value	Tax Equivalent (T/E) Yield ⁽¹⁾
U.S. Government-Sponsored Agencies:			
One year or less	\$18,327	\$18,518	2.17%
After one year to five years	42,337	43,988	2.10%
After five years to ten years	1,000	991	1.40%
	<u>\$61,664</u>	<u>\$63,497</u>	<u>2.11%</u>
Mortgage-Backed Securities/CMOs ⁽²⁾			
After five years to ten years	2,316	2,295	0.35%
After ten years	22,944	22,871	1.17%
	<u>\$25,260</u>	<u>\$25,166</u>	<u>1.10%</u>
Asset-Backed Securities			
After ten years	1,151	1,144	1.56%
	<u>\$1,151</u>	<u>\$1,144</u>	<u>1.56%</u>
Corporate Bonds			
One year or less	\$2,009	\$2,021	1.20%
After one year to five years	6,052	6,076	1.49%
	<u>\$8,061</u>	<u>\$8,097</u>	<u>1.42%</u>
Municipal Securities			
One year or less	\$1,277	\$1,283	2.23%
After one year to five years	1,117	1,130	2.12%
After five years to ten years	2,042	2,049	3.23%
After ten years	14,527	14,547	3.52%
	<u>\$18,963</u>	<u>\$19,009</u>	<u>3.32%</u>
Total Securities ⁽³⁾	\$115,099	\$116,913	

⁽¹⁾ The tax equivalent (T/E) yield is based upon a federal income tax rate of 34%.

⁽²⁾ Projected maturities for Mortgage-Backed Securities are based on the expected weighted average maturities of the individual securities.

⁽³⁾ Excludes Federal Reserve Bank and Federal Home Loan Bank stocks which have no stated maturity dates.

Loan Portfolio

A management objective is to maintain the quality of the loan portfolio. The Bank seeks to achieve this objective by maintaining rigorous underwriting standards coupled with regular evaluation of the creditworthiness of and the designation of lending limits for each borrower. The portfolio strategies include seeking industry and loan size diversification in order to minimize credit exposure and originating loans in markets with which the Bank is familiar. The predominant market area for loans is Charlottesville, Albemarle County, Orange County, Winchester, Frederick County and adjacent counties.

The Bank's loan portfolio totaled \$284.9 million as of December 31, 2012 or 56.1% of total assets. Loan balances declined \$7.6 million from \$292.5 million as of December 31, 2011.

Based on underwriting standards, loans and leases may be secured in whole or in part by collateral such as liquid assets, accounts receivable, equipment, inventory and real property. The collateral securing any loan or lease may depend on the type of loan and may vary in value based on market conditions.

The Bank's commercial and industrial loan portfolio totaled \$45.4 million and represented approximately 15.9% of all loans as of December 31, 2012. Loans in this category are typically made to individuals and small and medium-sized businesses. Loans for construction and land development totaled \$14.2 million and represented 5.0% of all loans as of December 31, 2012, which is a decrease of \$3.3 million from December 31, 2011. Loans to consumers, included revolving credit and other fixed payment loans totaled \$12.0 million as of December 31, 2012 or 4.2% of all loans.

The Bank's real estate loan portfolio totaled \$213.3 million as of December 31, 2012, which represented approximately 74.9% of all loans, and are secured by mortgages on real property located principally in Virginia. Of this amount approximately \$88.2 million represented loans on residential properties. Commercial real estate loans totaled \$125.1 million as of December 31, 2012. Sources of repayment are from the borrower's operating profits, cash flows and liquidation of pledged collateral.

TABLE 6
Loan Portfolio
(dollars in thousands)

	As of December 31,				
	2012	2011	2010	2009	2008
Commercial	\$ 45,370	\$ 42,157	\$ 40,737	\$ 38,955	\$ 41,915
Real estate construction	14,193	17,475	26,645	38,462	32,761
Real estate mortgage:					
Residential	56,820	59,995	58,107	70,281	61,823
Commercial	125,089	128,611	128,746	126,936	107,500
Home equity loans	31,433	32,802	31,330	26,921	21,294
Total real estate mortgage	213,342	221,408	218,183	224,138	190,617
Consumer	11,955	11,492	13,066	14,014	12,781
Total loans	284,860	292,532	298,631	315,569	278,074
Less: Allowance for loan losses	(3,267)	(3,741)	(3,730)	(3,732)	(3,084)
Net loans	<u>\$ 281,593</u>	<u>\$ 288,791</u>	<u>\$ 294,901</u>	<u>\$ 311,837</u>	<u>\$ 274,990</u>

TABLE 7
Maturities and Sensitivities of Selected Loans to Changes in Interest Rates
(dollars in thousands)

	As of December 31, 2012						Total
	1 Year or Less		1 - 5 Years		After 5 Years		
	Variable		Variable		Variable		
	Fixed Rate	Rate	Fixed Rate	Rate	Fixed Rate	Rate	
Commercial loans	\$ 4,646	\$ 10,406	\$ 5,146	\$ 15,237	\$ -	\$ 9,935	\$ 45,370
Real estate construction loans *	\$ 1,876	\$ 792	\$ 2,554	\$ 2,941	\$ 940	\$ 5,090	\$ 14,193

* includes land development and land loans

Asset Quality and the Allowance for Loan Losses

Intrinsic to the lending process is the possibility of loss. In times of economic slowdown, the risk of loss inherent in the Bank's loan portfolio may increase. While management endeavors to minimize this risk, it recognizes that loan losses will occur and that the amount of these losses will fluctuate depending on the risk characteristics of the loan portfolio, which in turn depend on current and future economic conditions, the financial condition of borrowers, the realization of collateral, and the credit management process.

At December 31, 2012, the allowance was \$3.267 million and represented 1.15% of outstanding loans. The allowance for loan losses at December 31, 2011, was \$3.741 million and represented 1.28% of outstanding loans. The purpose of the allowance is to provide for potential losses inherent in the loan portfolio. Since risks to the loan portfolio include general economic trends as well as conditions affecting individual borrowers, the allowance is an estimate.

The Bank places a loan on non-accrual status when management believes, after considering economic and business conditions and collections efforts, that it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement, or when the loan is past due for 90 days or more, unless the debt is both well-secured and in the process of collection.

TABLE 8
Non-Accrual Loans
(dollars in thousands)

	As of December 31,		
	2012	2011	2010
Total	\$ 1,403	\$ 403	\$ 4,548
Number of Loans	7	4	7

Loans Past Due 90 Days or More and Still Accruing
(dollars in thousands)

	As of December 31,		
	2012	2011	2010
Total	\$ 35	\$ 388	\$ 197
Number of Loans	1	2	1

At the end of 2012, the Bank had seven loans with balances of \$1.403 million classified as non-accrual. At the end of 2011, the Bank had four loans with balances of \$403 thousand classified as non-accrual. This increase was primarily due to the addition of one non-accrual loan in the fourth quarter of 2012, which was being carried for \$804 thousand as of December 31, 2012.

The Bank is committed to determining, on an ongoing basis, the adequacy of its allowance for loan losses. The Bank applies historical loss rates to various pools of loans. Thereafter, the adequacy of the allowance is evaluated through reference to the following qualitative factors: national and local economic trends; underlying collateral values; loan delinquency status and trends; loan risk classifications; industry concentrations; lending policies; experience, ability and depth of lending staff; and levels of policy exceptions.

TABLE 9
Summary of the Allowance for Loan Losses
(dollars in thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
Balance, beginning of period	\$ 3,741	\$ 3,730	\$ 3,732	\$ 3,084	\$ 2,646
Loans charged off					
Real estate	458	549	233	232	39
Commercial	132	0	160	146	233
Consumer	18	11	42	34	12
Total	<u>608</u>	<u>560</u>	<u>435</u>	<u>412</u>	<u>284</u>
Recoveries					
Real estate	176	3	13	-	62
Commercial	7	11	86	40	-
Consumer	30	22	20	1	5
Total	<u>213</u>	<u>36</u>	<u>119</u>	<u>41</u>	<u>67</u>
Provision for (recovery of) loan losses	<u>(79)</u>	<u>535</u>	<u>314</u>	<u>1,019</u>	<u>655</u>
Balance, December 31	<u>\$ 3,267</u>	<u>\$ 3,741</u>	<u>\$ 3,730</u>	<u>\$ 3,732</u>	<u>\$ 3,084</u>
Net charge-offs to average loans	0.13%	0.18%	0.10%	0.13%	0.09%
Allowance for loan losses as a percentage of period-end total loans	1.15%	1.28%	1.25%	1.18%	1.11%

Please refer to Note 4 in the "Notes to Consolidated Financial Statements" for additional insight into management's approach and methodology in estimating the allowance for loan losses.

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TABLE 10

**Allocation of the Allowance for Loan Loss
(dollars in thousands)**

December 31, 2012

	Allowance	Percentage of loans in each category to total loans
Commercial	\$303	15.93%
Real estate construction	168	4.98%
Real estate mortgage	2,750	74.89%
Consumer	46	4.20%
Unallocated	N/A	N/A
Totals	\$3,267	100.00%

December 31, 2011

	Allowance	Percentage of loans in each category to total loans
Commercial	\$397	14.41%
Real estate construction	319	5.97%
Real estate mortgage	2,954	75.69%
Consumer	68	3.93%
Unallocated	3	N/A
Totals	\$3,741	100.00%

December 31, 2010

	Allowance	Percentage of loans in each category to total loans
Commercial	\$476	13.64%
Real estate construction	488	8.92%
Real estate mortgage	2,644	73.06%
Consumer	122	4.38%
Totals	\$3,730	100.00%

December 31, 2009

	Allowance	Percentage of loans in each category to total loans
Commercial	\$545	12.34%
Real estate construction	604	12.19%
Real estate mortgage	2,488	71.03%
Consumer	95	4.44%
Totals	\$3,732	100.00%

December 31, 2008

	Allowance	Percentage of loans in each category to total loans
Commercial	\$465	15.08%
Real estate construction	363	11.77%
Real estate mortgage	2,114	68.55%
Consumer	142	4.60%
Totals	\$3,084	100.00%

Deposits

Depository accounts represent the Bank's primary source of funds and are comprised of demand deposits, interest-bearing checking accounts, money market deposit accounts and time deposits. Depository accounts held by the Bank as of December 31, 2012, totaled \$445.4 million, an increase of \$33.5 million or 8.1% as compared to the December 31, 2011 total of \$411.9 million. These deposits have been provided predominantly by individuals, professionals and small businesses in the Charlottesville/Albemarle area, the Orange County area, and the Winchester area.

At December 31, 2012, the balances of non-interest bearing demand deposits were 29.5% of total deposits, increasing to \$131.6 million from \$121.0 million at December 31, 2011. Interest-bearing transaction and money market accounts totaled \$183.7 million and \$159.4 million at December 31, 2012 and December 31, 2011 respectively. The Bank's low-cost deposit accounts, which include both non-interest and interest bearing checking accounts as well as money market accounts, represented 70.8% of total deposit account balances at December 31, 2012 and compares favorably to the 68.1% of total deposit account balances at December 31, 2011.

Certificates of deposit and other time deposit balances decreased slightly to \$130.1 million at December 31, 2012 from the balance of \$131.4 million at December 31, 2011. Included in this deposit total were brokered deposits totaling \$28.7 million and \$30.9 million at December 31, 2012 and 2011, respectively, which were reciprocal relationships under the Certificate of Deposit Account Registry Service (CDARS™), whereby depositors can obtain FDIC insurance on deposits up to \$50 million. As of year-end 2011, the Bank reported an additional \$11.5 million in brokered deposits representing bankruptcy trustee deposits placed through an agreement entered during the third quarter of 2011 with Financial Software Solutions, L.L.C., which provided its TrusteSolutions™ system to the bankruptcy trustees. During 2012, the Bank discontinued the bankruptcy trustee deposit program.

TABLE 11
Deposits
(dollars in thousands)

Average Deposits and Rates Paid

	Years Ended December 31					
	2012		2011		2010	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Non-interest-bearing demand deposits	\$ 139,741		\$ 111,649		\$ 99,709	
Interest checking	\$ 67,898	0.05 %	\$ 62,638	0.05 %	\$ 63,254	0.05 %
Money market deposits	\$ 93,690	0.21 %	\$ 90,980	0.18 %	\$ 85,782	0.19 %
Time deposits	\$ 136,832	0.77 %	\$ 146,330	1.07 %	\$ 135,087	1.25 %
Total interest-bearing deposits	\$ 298,420	0.43 %	\$ 299,948	0.59 %	\$ 284,123	0.66 %
Total deposits	\$ 438,161		\$ 411,597		\$ 383,832	

Maturities of CD's of \$100,000 and Over

	December 31, 2012	
	Amount	Percentage
Three months or less	\$ 64,916	69.64 %
Over three months to six months	\$ 14,008	15.03
Over six months to one year	\$ 8,057	8.64
Over one year	\$ 6,237	6.69
Totals	\$ 93,218	100.00 %

Securities Sold Under Agreements to Repurchase

The Bank offers commercial customers the opportunity to invest excess deposit balances into overnight repurchase agreements. Under the agreements to repurchase, invested funds are fully collateralized by Federal government or agency bonds that are pledged on behalf of customers utilizing this product.

TABLE 12

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(dollars in thousands)		
Period-end balance	\$ 4,000	\$ 2,623	\$ 1,801
Maximum amount at any month-end during the year	\$ 4,000	\$ 3,984	\$ 3,801
Annual average balance outstanding	\$ 2,973	\$ 2,672	\$ 2,313
Annual average interest rate paid	0.23%	0.22%	0.22%

ASSET/LIABILITY MANAGEMENT

The Bank's primary earnings source is its net interest income; therefore, the Bank devotes significant time and has invested in resources to assist in the management of interest rate risk and asset quality. The Bank's net interest income is affected by changes in market interest rates, and by the level and composition of interest-earning assets and interest-bearing liabilities. The Bank's objectives in its asset/liability management are to utilize its capital effectively, to provide adequate liquidity and to enhance net interest income, without taking undue risks or subjecting the Bank unduly to interest rate fluctuations. The Bank takes a coordinated approach to the management of its liquidity, capital and interest rate risk. This risk management process is governed by policies and limits established by senior management, which are reviewed and approved by the Asset/Liability Committee. This committee, which is comprised of Directors and members of senior management, meets to review, among other things, economic conditions, interest rates, yield curves, cash flow projections, expected customer actions, liquidity levels, capital ratios and repricing characteristics of assets, liabilities and financial instruments.

Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market indices such as interest rates. The Bank's principal market risk exposure is interest rate risk. Interest rate risk is the exposure to changes in market interest rates. Interest rate sensitivity is the relationship between market interest rates and net interest income due to the repricing characteristics of assets and liabilities. The Bank monitors the interest rate sensitivity of its balance sheet positions by examining its near-term sensitivity and its longer-term gap position. In its management of interest rate risk, the Bank utilizes several financial and statistical tools including traditional gap analysis and sophisticated income simulation models. A traditional gap analysis is prepared based on the maturity and repricing characteristics of interest-earning assets and interest-bearing liabilities for selected time bands. The mismatch between repricings or maturities within a time band is commonly referred to as the "gap" for that period. A positive gap (asset sensitive) where interest rate sensitive assets exceed interest rate sensitive liabilities generally will result in the net interest margin increasing in a rising rate environment and decreasing in a falling rate environment. A negative gap (liability sensitive) will generally have the opposite result on the net interest margin. However, the traditional gap analysis does not assess the relative sensitivity of assets and liabilities to changes in interest rates and other factors that could have an impact on interest rate sensitivity or net interest income. The Bank utilizes the gap analysis to complement its income simulations modeling, primarily focusing on the longer-term structure of the balance sheet. The Bank's balance sheet structure is primarily short-term in nature with a substantial portion of assets and liabilities repricing or maturing within one year.

The Bank utilizes income simulation models to complement its traditional gap analysis. While the Asset/Liability Committee routinely monitors simulated net interest income sensitivity over a rolling two-year horizon, it also utilizes additional tools to monitor potential longer-term interest rate risk. The income simulation models

measure the Bank's net interest income volatility or sensitivity to interest rate changes utilizing statistical techniques that allow the Bank to consider various factors, which impact net interest income. These factors include actual maturities, estimated cash flows, repricing characteristics, deposit growth/retention and, most importantly, the relative sensitivity of the Bank's assets and liabilities to changes in market interest rates. This relative sensitivity is important to consider as the Bank's core deposit base has not been subject to the same degree of interest rate sensitivity as its assets. The core deposit costs are internally managed and tend to exhibit less sensitivity to changes in interest rates than the Bank's adjustable rate assets whose yields are based on external indices and generally change in concert with market interest rates. The Bank's interest rate sensitivity is determined by identifying the probable impact of changes in market interest rates on the yields on the Bank's assets and the rates that would be paid on its liabilities. This modeling technique involves a degree of estimation based on certain assumptions that management believes to be reasonable. Utilizing this process, management projects the impact of changes in interest rates on net interest margin. The Bank has established certain policy limits for the potential volatility of its net interest margin assuming certain levels of changes in market interest rates with the objective of maintaining a stable net interest margin under various probable rate scenarios. Management generally has maintained a risk position well within the policy limits.

Also, as market conditions vary from those assumed in the sensitivity analysis, actual results will also differ due to: prepayment/refinancing levels likely deviating from those assumed, the varying impact of interest rate change caps or floors on adjustable rate assets, the potential effect of changing debt service levels on customers with adjustable rate loans, depositor early withdrawals and product preference changes, and other variables. Furthermore, the sensitivity analysis does not reflect actions that the Asset/Liability Committee might take in responding to or anticipating changes in interest rates.

TABLE 13
Interest Sensitivity Analysis
As of December 31, 2012

(dollars in thousands)

	Within 90 days	90 to 365 days	1 to 4 years	Over 4 years	Nonrate Sensitive	Total
<u>Assets</u>						
Loans	\$ 137,205	\$ 53,754	\$ 71,586	\$ 22,119	\$ 196	\$ 284,860
Investment securities	18,634	23,354	54,734	21,851	-	118,573
Interest bearing deposits	-	-	1,250	-	-	1,250
Federal funds sold	56,131	-	-	-	-	56,131
Non-interest-earning assets and allowance for loan losses	-	-	-	-	46,792	46,792
Total assets	<u>\$ 211,970</u>	<u>\$ 77,108</u>	<u>\$ 127,570</u>	<u>\$ 43,970</u>	<u>\$ 46,988</u>	<u>\$ 507,606</u>
<u>Liabilities and Shareholders' Equity</u>						
Interest checking	\$ 2,856	\$ 8,568	\$ 34,270	\$ 35,222	\$ -	\$ 80,916
Money market deposits	12,337	37,009	53,458	-	-	102,804
Time deposits	86,905	30,612	10,369	2,257	-	130,143
Repurchase agreements	4,000	-	-	-	-	4,000
Non-interest bearing liabilities and shareholders' equity	-	-	-	-	189,743	189,743
Total liabilities and shareholders' equity	<u>\$ 106,098</u>	<u>\$ 76,189</u>	<u>\$ 98,097</u>	<u>\$ 37,479</u>	<u>\$ 189,743</u>	<u>\$ 507,606</u>
Period gap	\$ 105,872	\$ 919	\$ 29,473	\$ 6,491	\$ (142,755)	\$ -
Cumulative gap	\$ 105,872	\$ 106,791	\$ 136,264	\$ 142,755	\$ -	\$ -
Ratio of cumulative gap to total earning assets	20.86%	21.04%	26.84%	28.12%		

The shape of the yield curve can cause downward pressure on net interest income. In general, if and to the extent that the yield curve is flatter (*i.e.*, the differences between interest rates for different maturities are relatively smaller) than previously anticipated, then the yield on the Bank's interest earning assets and its cash flows will tend to be lower. Management believes that a relatively flat yield curve could continue to affect adversely the Bank's results in 2013.

Liquidity

Liquidity represents the Bank's ability to provide funds to meet customer demand for loan and deposit withdrawals without impairing profitability. Effective management of balance sheet liquidity is necessary to fund growth in earning assets and to pay liability maturities and depository customers' withdrawal requirements. The Bank maintains a Liquidity Management Policy that is approved annually by the Board of Directors. The policy sets limits on a number of areas, including limits on the amount of non-core liabilities, and funding long-term assets with non-core liabilities.

The Bank's customer base has provided a stable and steadily increasing source of funds and liquidity. Limits contained within the Bank's Investment Policy also provides for appropriate levels of liquidity through maturities and cash flows within the securities portfolio. Other sources of balance sheet liquidity are obtained from the repayment of loan proceeds and overnight investments. The Bank has numerous secondary sources of liquidity including access to borrowing arrangements from a number of correspondent banks. Available borrowing arrangements maintained by the Bank include formal federal funds lines with three major regional correspondent banks, access to advances from the Federal Home Loan Bank of Atlanta and access to the discount window at the Federal Reserve Bank of Richmond.

TABLE 14

Borrowing Lines

As of December 31, 2012

(dollars in thousands)

Correspondent Banks	\$	27,000
Federal Home Loan Bank of Atlanta		46,500
Federal Reserve Bank of Richmond		11,858
Total Available	\$	<u>85,358</u>

As of December 31, 2012 there were no outstanding balances for any borrowing lines.

Any excess funds are sold on a daily basis in the federal funds market. The Bank maintained an average of \$58.2 million outstanding in federal funds sold during 2012. On December 31, 2012, the Bank sold \$56.1 million in the overnight federal funds market. The Bank intends to maintain sufficient liquidity at all times to meet its funding commitments.

Capital

The Bank is subject to risk-based capital regulations which quantitatively measure capital against risk-weighted assets, including certain off-balance-sheet items. These regulations define the elements of the Tier 1 and Tier 2 components of total capital and currently establish minimum ratios of 4% for Tier 1 capital and 8% for Total capital for capital adequacy purposes. Supplementing these regulations is a leverage requirement. This requirement establishes a minimum leverage ratio (at least 3% or 4%, depending upon an institution's regulatory status), which is calculated by dividing Tier 1 capital by adjusted quarterly average assets (after deducting

goodwill). Information regarding the Bank’s risk-based capital at December 31, 2012 and December 31, 2011 is presented in Note 12 of the “Notes to the Consolidated Financial Statements”.

The bank regulatory agencies have encouraged banking organizations, including healthy, well-run banking organizations, to operate with capital ratios substantially in excess of the stated ratios required to maintain “well capitalized” status. This has resulted from, among other things, current economic conditions, the global financial crisis and the likelihood, as described below, of increased formal capital requirements for banking organizations. In light of the foregoing, the Bank expects to maintain capital ratios substantially in excess of these ratios.

The elements currently comprising Tier 1 capital and Tier 2 capital, the minimum Tier 1 capital and Total capital ratios and the minimum leverage ratio may in the future be subject to change, as discussed in greater detail under the caption “Supervision and Regulation”, found earlier in this report.

Impact of Inflation and Changing Prices

The Bank’s financial statements included herein have been prepared in accordance with U.S. GAAP, which require the Bank to measure financial position and operating results primarily in terms of historical dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on the operations of the Bank is reflected in increased operating costs. In management’s opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than do changes in the inflation rate.

While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond the control of the Bank, including changes in the expected rate of inflation, the influence of general and local economic conditions, and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities, among other things, as further discussed under the caption “Asset/Liability Management”, found earlier in this section.

Off-Balance Sheet Arrangements

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist primarily of commitments to extend credit and standby letters of credit. Additional information concerning the Bank’s off-balance sheet arrangements is contained in Note 10 of the “Notes to the Consolidated Financial Statements.”

Contractual Commitments

In the normal course of business, the Bank enters into contractual obligations, including obligations on lease arrangements, contractual commitments for capital expenditures, and service contracts. The significant contractual obligations include the leasing of certain of its banking and operations offices under operating lease agreements on terms ranging from 1 to 20 years with renewal options.

Following is a schedule of future minimum rental payments under non-cancelable operating leases that have initial or remaining terms in excess of one year as of December 31, 2012:

(dollars in thousands)	<u>1 year or less</u>	<u>1-3 years</u>	<u>3-5 years</u>	<u>After 5 years</u>	<u>Total</u>
Operating lease obligations	\$ 893	\$ 1,600	\$ 1,249	\$ 3,575	\$ 7,317

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not required for smaller reporting company.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

**VIRGINIA NATIONAL BANK AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS**

(dollars in thousands, except share data)

	<u>December 31, 2012</u>	<u>December 31, 2011</u>
ASSETS		
Cash and due from banks	\$ 15,647	\$ 12,477
Federal funds sold	56,131	44,567
Securities:		
Available for sale, at fair value	110,853	84,150
Held to maturity, at amortized cost (Fair value - \$6,060 in 2012, \$6,081 in 2011)	5,991	5,988
Restricted securities, at cost	<u>1,729</u>	<u>1,728</u>
Total securities	118,573	91,866
Total loans	284,860	292,532
Allowance for loan losses	<u>(3,267)</u>	<u>(3,741)</u>
Total loans, net	281,593	288,791
Premises and equipment, net	10,654	10,692
Other real estate owned, net of valuation allowance	1,746	4,242
Bank owned life insurance	12,150	6,869
Accrued interest receivable and other assets	<u>11,112</u>	<u>4,562</u>
Total assets	<u>\$ 507,606</u>	<u>\$ 464,066</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Demand deposits:		
Noninterest-bearing	\$ 131,559	\$ 120,989
Interest-bearing	80,916	68,622
Money market deposit accounts	102,804	90,815
Certificates of deposit and other time deposits	<u>130,143</u>	<u>131,442</u>
Total deposits	445,422	411,868
Securities sold under agreements to repurchase	4,000	2,623
Accrued interest payable and other liabilities	<u>4,245</u>	<u>654</u>
Total liabilities	<u>453,667</u>	<u>415,145</u>
Shareholders' equity:		
Preferred stock, \$2.50 par value, 2,000,000 shares authorized, no shares outstanding	-	-
Common stock, \$2.50 par value, 10,000,000 shares authorized; 2,690,220 shares issued and outstanding in 2012 and 2011 (including 575 and 863 non-vested shares at December 31, 2012 and December 31, 2011, respectively)	6,724	6,723
Capital surplus	27,809	27,705
Retained earnings	18,254	12,773
Accumulated other comprehensive income	<u>1,152</u>	<u>1,720</u>
Total shareholders' equity	53,939	48,921
Total liabilities and shareholders' equity	<u>\$ 507,606</u>	<u>\$ 464,066</u>

See Notes to Consolidated Financial Statements

**VIRGINIA NATIONAL BANK AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(dollars in thousands, except per share data)**

	For the years ended	
	December 31, 2012	December 31, 2011
Interest and dividend income:		
Loans, including fees	\$ 14,720	\$ 15,781
Federal funds sold	112	48
Investment securities:		
Taxable	1,817	1,927
Tax exempt	174	33
Dividends	73	59
Other	8	-
Total interest and dividend income	<u>16,904</u>	<u>17,848</u>
Interest expense:		
Demand and savings deposits	228	199
Certificates and other time deposits	1,049	1,568
Federal funds purchased and securities sold under agreements to repurchase	4	6
Total interest expense	<u>1,281</u>	<u>1,773</u>
Net interest income	15,623	16,075
Provision for (recovery of) loan losses	<u>(79)</u>	<u>535</u>
Net interest income after provision for (recovery of) loan losses	15,702	15,540
Noninterest income:		
Trust income	9,729	2,588
Customer service fees	982	1,081
Debit/credit card and ATM fees	726	669
Earnings/increase in value of bank owned life insurance	280	596
Gain on sale of securities	133	-
Other	190	172
Total noninterest income	<u>12,040</u>	<u>5,106</u>
Noninterest expenses:		
Salaries and employee benefits	10,962	9,526
Net occupancy expense	2,113	2,324
Equipment expense	907	988
Other	5,668	4,535
Total noninterest expenses	<u>19,650</u>	<u>17,373</u>
Income before income taxes	8,092	3,273
Provision for income taxes	<u>2,611</u>	<u>932</u>
Net income	<u>\$ 5,481</u>	<u>\$ 2,341</u>
Net income per share, basic	\$ 2.04	\$ 0.87
Net income per share, diluted	\$ 2.04	\$ 0.87

Per share information for all periods have been restated to reflect a 1.15 to 1.00 stock dividend paid on June 30, 2011.

See Notes to the Consolidated Financial Statements

**VIRGINIA NATIONAL BANK AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(dollars in thousands)

	For the years ended	
	December 31, 2012	December 31, 2011
Net income	\$ 5,481	\$ 2,341
Other comprehensive income (loss)		
Unrealized gains (losses) on securities, net of tax of (\$247) and \$413 for the years ended December 31, 2012 and December 31, 2011	(480)	803
Reclassification adjustment net of tax of (\$45) for the year ended December 31, 2012	(88)	-
Total other comprehensive income (loss)	-	-
Total comprehensive income	\$ 4,913	\$ 3,144

See Notes to Consolidated Financial Statements

VIRGINIA NATIONAL BANK AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(dollars in thousands)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2010	\$5,842	\$22,196	\$16,566	\$917	\$45,521
Equity adjustment for vested stock grants	5	(12)			(7)
Stock option/grant expense		263			263
Stock dividend:					
1.15 for 1 as of June 30, 2011	876	5,258	(6,134)		-
Net income			2,341		2,341
Other comprehensive income			-	803	803
Balance, December 31, 2011	<u>\$6,723</u>	<u>\$27,705</u>	<u>\$12,773</u>	<u>\$1,720</u>	<u>\$48,921</u>
Balance, December 31, 2011	\$6,723	\$27,705	\$12,773	\$1,720	\$48,921
Equity adjustment for vested stock grants	1	(1)			-
Stock option/grant expense		105			105
Net income			5,481		5,481
Other comprehensive (loss)				(568)	(568)
Balance, December 31, 2012	<u>\$6,724</u>	<u>\$27,809</u>	<u>\$18,254</u>	<u>\$1,152</u>	<u>\$53,939</u>

See Notes to Consolidated Financial Statements

**VIRGINIA NATIONAL BANK AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOW**

(dollars in thousands)

	For the years ended	
	December 31, 2012	December 31, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 5,481	\$ 2,341
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for (recovery of) loan losses	(79)	535
Net amortization and accretion of securities	828	595
Gain on sale of securities	(133)	-
Earnings/increase in value of bank owned life insurance	(280)	(596)
Depreciation and amortization	1,441	1,554
Deferred tax (benefit) expense	(216)	777
Stock option/stock grant expense	105	263
Writedown of other real estate owned	845	-
Gains on sale of other real estate owned	(2)	-
Net loss on disposal of Bank property	21	-
(Increase) decrease in accrued interest receivable and other assets	(6,042)	2,135
Increase (decrease) in accrued interest payable and other liabilities	3,591	(2,633)
Net cash provided by operating activities	5,560	4,971
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of held to maturity securities	(4,044)	-
Purchases of available for sale securities	(54,910)	(34,000)
Net increase in restricted investments	(1)	(170)
Proceeds from maturities, calls and principal payments of held to maturity securities	4,000	1,524
Proceeds from maturities, calls and principal payments of available for sale securities	16,386	5,000
Proceeds from sale of available for sale securities	10,307	-
Net decrease in loans	7,277	1,333
Purchase of bank owned life insurance	(5,001)	-
Proceeds from sale of other real estate owned	1,653	329
Proceeds from sale of bank property	100	-
Purchase of premises and equipment	(1,524)	(464)
Net cash used in investing activities	(25,757)	(26,448)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in demand deposits, NOW accounts and money market accounts	34,853	25,737
Net decrease in certificates of deposit and other time deposits	(1,299)	(21,557)
Net increase in securities sold under agreements to repurchase	1,377	822
Net equity adjustment for stock grants	-	(7)
Net cash provided by financing activities	34,931	4,995
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ 14,734	\$ (16,482)
CASH AND CASH EQUIVALENTS:		
Beginning of period	\$ 57,044	\$ 73,526
End of period	\$ 71,778	\$ 57,044
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash payments for:		
Interest	\$ 1,340	\$ 1,825
Taxes	\$ 870	\$ 1,610
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Unrealized gain (loss) on available for sale securities	\$ (860)	\$ 1,216
Transfer of loans to foreclosed assets	\$ -	\$ 4,242

See Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies:

Organization

Virginia National Bank ("Bank") was organized in 1998 under federal law as a national banking association to engage in a general banking business serving the community in and around the City of Charlottesville and Albemarle County, Virginia.

On May 1, 2007, the Office of the Comptroller of the Currency ("OCC") granted conditional approval to the Bank's application to establish a new national trust bank with the title VNBTrust, National Association ("VNBTrust"), which is now operating as a wholly-owned subsidiary of the Bank. Additionally, the OCC approved the Bank's application for VNBTrust to create a wholly-owned operating subsidiary, VNB Investment Management Company, LLC, a Delaware limited liability corporation, which has approval to organize and manage two private investment funds. One fund, known as Swift Run Capital, is in operation. In January 2010, VNB Investment Management Company, LLC changed its name to Swift Run Capital Management, LLC.

Summary of Significant Accounting Policies

The accounting and reporting policies of Virginia National Bank conform to accounting principles generally accepted in the United States of America and to the reporting guidelines prescribed by regulatory authorities. The following is a description of the more significant of those policies and practices.

Principles of Consolidation – The consolidated financial statements include the accounts of Virginia National Bank (Bank) and its wholly-owned subsidiary, VNBTrust, N.A. All significant intercompany balances and transactions have been eliminated in consolidation.

Securities – Unrestricted investments are to be classified in two categories as described below.

- **Securities Held to Maturity** – Securities classified as held to maturity are those debt and equity securities the Bank has both the positive intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions.
- **Securities Available for Sale** – Securities classified as available for sale are those debt and equity securities that the Bank intends to hold for an indefinite period of time but not necessarily to maturity. Any decision to sell a security classified as available for sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations, and other similar factors. Securities available for sale are carried at fair value. Unrealized gains or losses are reported as a separate component of other comprehensive income. Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings.
- **Restricted Securities** – As members of the Federal Reserve Bank and the Federal Home Loan Bank ("FHLB") of Atlanta, the Bank is required to maintain certain minimum investments in the common stock of the Federal Reserve Bank and the FHLB, which are carried at cost. Required levels of investments are based upon the Bank's capital and a percentage of qualifying assets.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities or to "call" dates, whichever occurs first. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (1) the Bank intends to sell the security or (2) it is more likely than not that the Bank will be required to sell the security before recovery of its amortized cost basis. If, however, the Bank does not intend to sell the security and it is not more-than-likely that the Bank will be required to sell the security before recovery, the Bank must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income.

Loans – Virginia National Bank makes commercial, residential and consumer loans to customers predominantly in its market areas of Central Virginia and Winchester. The loan portfolio is well diversified and generally is collateralized by assets of the customers. The loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers.

Loans are shown on the consolidated balance sheets net of the allowance for loan losses. Interest is computed by methods which result in level rates of return on principal. Loans of all classes are charged off when in the opinion of management they are deemed to be uncollectible, after taking into consideration such factors as the current financial condition of the customer and the underlying collateral and guarantees.

Accounting guidance requires that the impairment of loans that have been separately identified for evaluation is to be measured based on the present value of expected future cash flows or, alternatively, the observable market price of the loans or the fair value of the collateral. However, for those loans that are collateral dependent (that is, if repayment of those loans is expected to be provided solely by the underlying collateral) and for which management has determined foreclosure is probable, the measure of impairment of those loans is to be based on the fair value of the collateral. Additionally, accounting guidance requires certain disclosures about investments in impaired loans and the allowance for loan losses and interest income recognized on loans.

A loan is considered impaired when it is probable that the Bank will be unable to collect all principal and interest amounts according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, expected future cash flows, financial condition of the borrower, and current economic conditions. A performing loan may be considered impaired, if the factors above indicate a need for impairment. Charge-offs for impaired loans occur when the loan, or a portion of the loan, is determined to be uncollectible, as is the case for all loans.

Loans are placed on non-accrual when a loan is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more. Any unpaid interest previously accrued on those loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other non-accrual loans is recognized only to the extent of interest payments received.

The past due status of a loan is based on the contractual due date of the most delinquent payment due. Loans, including impaired loans, are generally classified as non-accrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. Loans greater than 90 days past due may remain on an accrual status if management determines it has adequate collateral to cover the principal and interest.

If a loan or a portion of a loan is adversely classified, or is partially charged off, the loan is generally classified as non-accrual. Additionally, whenever management becomes aware of facts or circumstances that may adversely impact the collectability of principal or interest on loans, it is management's practice to place such loans on a non-accrual status immediately, rather than delaying such action until the loans become 90 days past due.

Additionally, troubled debt restructurings are considered impaired loans. Troubled debt restructurings occur when the Bank agrees to modify the original terms of a loan by granting a concession that it would not otherwise consider due to the deterioration in the financial condition of the borrower. These concessions are done in an attempt to improve the paying capacity of the borrower and in some cases avoid foreclosure and are made with the intent to restore the loan to a performing status once sufficient payment history can be

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

demonstrated. These concessions could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions.

Allowance for Loan Losses – The allowance for loan losses is maintained at a level which, in management’s judgment, is adequate to absorb credit losses inherent in the loan portfolio. The allowance for loan losses is evaluated on a regular basis by management and is based upon management’s periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower’s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

To determine the total allowance for loan losses, the Bank estimates the reserves needed for each segment of the portfolio, including loans analyzed individually and loans analyzed on a pooled basis. Allowances for impaired loans are generally determined based on collateral values or the present value of estimated cash flows.

To determine the balance of the allowance account, loans are pooled by the following portfolio segments and an amount is assigned for each of these segments: (1) commercial loan portfolio, (2) real estate construction and land loan portfolio, (3) real estate mortgage loan portfolio, and (4) consumer loan portfolio. Each of these segments is further broken down by classes in order to estimate the required reserves, based on the associated risks within each class, as well as historical loss data gathered regarding each class. These historical loss percentages, calculated using an average eight quarter rolling basis, are applied to each pool. In addition, eight qualitative factors are applied to each segment and class. For each class of loans, management must exercise significant judgment to determine the estimation method that fits the credit risk characteristics of its various segments. Basis points are assigned to the various classifications in order to provide a method for quantifying the amount required for each pool of loans. Although the assignment of basis points is highly subjective, qualified management utilizes its significant knowledge and experience related to both the market and history of the Bank’s loan losses.

During these evaluations, particular characteristics associated with a segment of the loan portfolio are also considered. These characteristics are detailed below:

- Commercial loans not secured by real estate carry risks associated with the successful operation of a business, and the repayments of these loans depend on the profitability and cash flows of the business. Additional risk relates to the value of collateral where depreciation occurs and the valuation is less precise.
- Loans secured by commercial real estate also carry risks associated with the success of the business and the ability to generate a positive cash flow sufficient to service debts. Real estate security diminishes risks only to the extent that a market exists for the subject collateral.
- Consumer loans carry risks associated with the continued credit-worthiness of the borrower and the value of the collateral, such as automobiles which may depreciate more rapidly than other assets. In addition, these loans may be unsecured. Consumer loans are more likely than real estate loans to be immediately affected in an adverse manner by job loss, divorce, illness or personal bankruptcy. Consumer loans are further segmented into consumer revolving lines and all other consumer loans.
- Real estate secured construction loans carry risks that a project will not be completed as scheduled and budgeted and that the value of the collateral may, at any point, be less than the principal amount of the loan. Additional risks may occur if the general contractor, who may not be a loan customer, is unable to finish the project as planned due to financial pressures unrelated to the project.
- Residential real estate loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the non-collectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Because of uncertainties inherent in the estimation process, management’s estimate of credit

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

losses inherent in the loan portfolio and the related allowance may change in the near term. There are factors that can occur which result in the recorded allowance to be materially greater than the amount management estimates to be appropriate. Instances when such a situation occurs, management will record a recapture of previously recorded provision for loan losses.

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.

Other Real Estate Owned – Assets acquired through, or in lieu of, loan foreclosures are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. 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 net expenses for foreclosed assets.

Premises and Equipment – Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed by the straight-line method based on the estimated useful lives of assets, which range from 3 to 40 years. Expenditures for repairs and maintenance are charged to expense as incurred. The costs of major renewals and betterments are capitalized and depreciated over their estimated useful lives. Upon disposition, the asset and related accumulated depreciation are removed from the books and any resulting gain or loss is charged to income.

Use of Estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred tax assets, valuation of other real estate owned, and fair value measurements.

Income Taxes – Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating loss carry forwards, and tax credit carry forwards. Deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

When tax returns are filed, it is highly probable 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 sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the statements of income.

Earnings Per Common Share – Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect 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 Bank relate to outstanding stock options and are determined using the treasury stock method.

Comprehensive Income – Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Advertising Costs – The Bank follows the policy of charging the costs of advertising to expense as they are incurred.

Cash and Cash Equivalents – For purposes of the statements of cash flows, the Bank considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. Cash and cash equivalents consist of cash on hand, funds due from banks, and federal funds sold.

VNBTrust, N.A. – Securities and other property held by VNBTrust in a fiduciary or agency capacity are not assets of the Bank and are not included in the accompanying consolidated financial statements.

Stock-Based Compensation – The Bank accounts for all plans under recognition and measurement accounting principles which require that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Share-based compensation arrangements include share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. Stock-based compensation is estimated at the date of grant, using the Black-Scholes option valuation model for determining fair value. The model employs the following assumptions:

- Dividend yield - calculated as the ratio of historical cash dividends paid per share of common stock to the stock price on the date of grant;
- Expected life (term of the option) - based on the average of the contractual life and vesting schedule for the respective option;
- Expected volatility - based on the monthly historical volatility of the Bank's stock price over the expected life of the options;
- Risk-free interest rate - based upon the U.S. Treasury bill yield curve, for periods within the contractual life of the option, in effect at the time of grant.

The Bank is required to estimate forfeitures when recognizing compensation expense and that this estimate of forfeitures be adjusted over the requisite service period or vesting schedule based on the extent to which actual forfeitures differ from such estimates. Changes in estimated forfeitures are recognized through a cumulative catch-up adjustment, which is recognized in the period of change, and also will impact the amount of estimated unamortized compensation expense to be recognized in future periods.

Fair Value Measurements – ASC Topic 820, "Fair Value Measurements and Disclosures," defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires certain disclosures about fair value measurements. In general, fair values of financial instruments are based upon internally developed models that primarily use, as inputs, observable market-based parameters. Any such valuation adjustments are applied consistently over time.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Reclassifications – Certain reclassifications have been made to prior periods to conform to current year presentation.

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

Adoption of New Accounting Standards

In April 2011, the FASB issued ASU 2011-03, “Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements.” The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU were effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. The adoption of the new guidance did not have a material impact on the Bank’s consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, “Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.” This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments were effective for interim and annual periods beginning after December 15, 2011 with prospective application. The adoption of the new guidance did not have a material impact on the Bank’s consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, “Comprehensive Income (Topic 220) – Presentation of Comprehensive Income.” The new guidance amends disclosure requirements for the presentation of comprehensive income. The amended guidance eliminates the option to present components of other comprehensive income (“OCI”) as part of the statement of changes in shareholders’ equity. All changes in OCI must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive financial statements. The guidance does not change the items that must be reported in OCI. The Bank adopted this guidance effective 2012 and has elected to present two separate but consecutive financial statements.

Newly Issued Not Yet Effective Standards

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 Bank does not expect the adoption of ASU 2011-11 to have a material impact on its 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 Bank does not expect the adoption of ASU 2013-01 to have a material impact on its consolidated financial statements.

NOTES TO 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. Public companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Bank is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

2. Securities

The amortized cost and fair values of securities held to maturity as of December 31, 2012 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(dollars in thousands)			
Corporate bonds	\$ 4,024	\$ 50	\$ -	\$ 4,074
Municipal bonds	1,967	19	-	1,986
	<u>\$ 5,991</u>	<u>\$ 69</u>	<u>\$ -</u>	<u>\$ 6,060</u>

The amortized cost and fair values of securities held to maturity as of December 31, 2011 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(dollars in thousands)			
U.S. Government agencies	\$ 4,013	\$ 49	\$ -	\$ 4,062
Municipal bonds	1,975	44	-	2,019
	<u>\$ 5,988</u>	<u>\$ 93</u>	<u>\$ -</u>	<u>\$ 6,081</u>

The amortized cost and fair values of securities available for sale as of December 31, 2012 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(dollars in thousands)			
U.S. Government agencies	\$ 61,664	\$ 1,842	\$ 9	\$ 63,497
Corporate bonds	4,037	-	14	4,023
Asset-backed securities	1,151	-	7	1,144
Mortgage-backed securities/CMOs	25,260	43	137	25,166
Municipal bonds	16,996	87	60	17,023
	<u>\$ 109,108</u>	<u>\$ 1,972</u>	<u>\$ 227</u>	<u>\$ 110,853</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The amortized cost and fair values of securities available for sale as of December 31, 2011 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(dollars in thousands)		
U.S. Government agencies	\$ 81,545	\$ 2,605	\$ -	\$ 84,150

For the year ended December 31, 2012, proceeds from the sales of securities amounted to \$10,307,000 and realized gains on these available for sale securities were \$133,000. There were no sales of held to maturity or available for sale securities in 2011.

In addition, the Bank held restricted securities of \$1,729,000 as of December 31, 2012 and \$1,728,000 as of December 31, 2011. These restricted securities are carried at cost and are comprised of Federal Reserve Bank stock and Federal Home Loan Bank of Atlanta stock.

The Bank's securities portfolio is primarily made up of fixed rate bonds, whose prices move inversely with interest rates. At the end of any accounting period, the portfolio may have both unrealized gains and losses. Unrealized losses within the Bank's portfolio typically occur as market interest rates rise. Such unrealized losses are considered temporary in nature. In the event that a security would suffer an impairment for a reason that was "other-than-temporary," the Bank would be expected to write down the security's value to its new fair value, and the amount of the writedown would be included in earnings as a realized loss.

At December 31, 2012, 29 of the 74 securities in the portfolio had an unrealized loss. The following table recaps all unrealized losses in the Bank's securities portfolio at December 31, 2012:

(dollars in thousands)	Continuous Unrealized Loss Position of Less Than 12 Months		Continuous Unrealized Loss Position of 12 Months or More		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
	U.S. Government agencies	\$ 991	\$ 9	\$ -	\$ -	\$ 991
Municipal bonds	5,806	60	-	-	5,806	60
Corporate bonds	4,023	14	-	-	4,023	14
Asset-backed securities	1,144	7	-	-	1,144	7
Mortgage-backed/CMOs	19,740	137	-	-	19,740	137
	\$ 31,704	\$ 227	\$ -	\$ -	\$ 31,704	\$ 227

At December 31, 2011, none of the securities in the portfolio had an unrealized loss.

Securities having carrying values of \$7,307,000 at December 31, 2012 were pledged to secure deposits and for other purposes required by law. At December 31, 2011, securities having carrying values of \$7,735,000 were similarly pledged.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The amortized cost and fair value of investment securities as of December 31, 2012, by contractual maturities, are shown below:

	Amortized Cost	Fair Value
	(dollars in thousands)	(dollars in thousands)
U.S. Government-Sponsored Agencies		
One year or less	\$ 18,327	\$ 18,518
After one year to five years	42,337	43,988
After five years to ten years	1,000	991
	\$ 61,664	\$ 63,497
Mortgage-Backed Securities/CMOs		
After five years to ten years	\$ 2,316	\$ 2,295
Ten years or more	22,944	22,871
	\$ 25,260	\$ 25,166
Municipal Securities		
One year or less	\$ 1,277	\$ 1,283
After one year to five years	1,117	1,130
After five years to ten years	2,042	2,049
Ten years or more	14,527	14,547
	\$ 18,963	\$ 19,009
Corporate Bonds		
One year or less	\$ 2,009	\$ 2,021
After one year to five years	6,052	6,076
	\$ 8,061	\$ 8,097
Asset-Backed Securities		
Ten years or more	\$ 1,151	\$ 1,144
Total Securities ⁽¹⁾	\$ 115,099	\$ 116,913

⁽¹⁾ Excludes Federal Reserve Bank and Federal Home Loan Bank stocks which have no stated maturity dates.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Loans

The composition of the loan portfolio by loan classification at December 31, 2012 and 2011 appears below.

	December 31	
	2012	2011
	(dollars in thousands)	
Commercial	\$ 45,370	\$ 42,157
Real estate construction and land		
Residential construction	-	91
Other construction and land	14,193	17,384
Total construction and land	<u>14,193</u>	<u>17,475</u>
Real estate mortgage:		
1-4 family	56,820	59,995
Home equity loans	31,433	32,802
Multifamily mortgages	23,033	18,309
Commercial owner occupied	57,487	60,248
Commercial nonowner occupied	44,569	50,054
Total real estate mortgage	<u>213,342</u>	<u>221,408</u>
Consumer		
Consumer revolving credit	1,938	1,430
Consumer all other credit	10,017	10,062
Total consumer loans	<u>11,955</u>	<u>11,492</u>
 Total loans	 284,860	 292,532
Less: Allowance for loan losses	<u>(3,267)</u>	<u>(3,741)</u>
Net loans	<u>\$ 281,593</u>	<u>\$ 288,791</u>

Included in loan balances are overdrafts, which are deposit accounts with a negative balance. As of December 31, 2012, the Bank had \$213,000 in overdrafts and \$54,000 as of December 31, 2011.

Accounting guidance requires certain disclosures about investments in impaired loans and the allowance for loan losses and interest income recognized on loans. A loan is considered impaired when it is probable that the Bank will be unable to collect all principal and interest amounts according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, expected future cash flows, financial condition of the borrower, and current economic conditions. Generally, loans for all classes are placed on non-accrual when a loan is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more.

At December 31, 2012, the Bank had nine loans in the amount of \$2,816,000 classified as impaired loans. Seven of these loans were non-accrual loans for a total of \$1,403,000, and of this non-accrual total, two loans of \$248,000 were also classified as Troubled Debt Restructurings (TDR). The remaining \$1,413,000 in impaired loans were two additional loans classified as TDRs but which were still accruing interest.

At December 31, 2011, the Bank had four loans in the amount of \$403,000 classified as non-accrual, in addition to one loan of \$2,721,000 classified as a Troubled Debt Restructuring (TDR) which was still accruing interest, for a total of \$3,124,000 in impaired loans. This TDR loan was paid off in the first quarter of 2012.

At both December 31, 2012 and December 31, 2011, there was no valuation allowance on any of these loans after consideration was given for each borrowing as to the fair value of the collateral on the loan or the present value of expected future cash flows from the customer.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Following is a breakdown by class of the loans classified as impaired loans as of December 31, 2012 and December 31, 2011. These loans are reported at their recorded investment, which is the carrying amount of the loan as reflected on the Bank's balance sheet, net of charge-offs and other amounts applied to reduce the net book balance. Average recorded investment in impaired loans is computed using an average of month-end balances for these loans for the twelve months ended December 31, 2012 and December 31, 2011. Interest income recognized is for the years ended December 31, 2012 and December 31, 2011.

December 31, 2012

	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
	(dollars in thousands)				
Impaired loans without a valuation allowance:					
Other real estate construction and land	\$ 194	\$ 229	\$ -	\$ 337	\$ 25
1-4 family residential mortgages	294	341	-	195	4
Commercial owner occupied real estate	2,328	2,671	-	915	22
Impaired loans with a valuation allowance	-	-	-	-	-
Total impaired loans	\$ 2,816	\$ 3,241	\$ -	\$ 1,447	\$ 51

December 31, 2011

	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
	(dollars in thousands)				
Impaired loans without a valuation allowance:					
Other real estate construction and land	\$ 338	\$ 447	\$ -	\$ 475	\$ 23
Commercial owner occupied real estate	2,721	2,721	-	2,757	147
1-4 family residential mortgages	65	71	-	1,755	26
Impaired loans with a valuation allowance	-	-	-	-	-
Total impaired loans	\$ 3,124	\$ 3,239	\$ -	\$ 4,987	\$ 196

The impaired loans classified as non-accruals are shown below by class:

Non-accrual balance	December 31, 2012	December 31, 2011
	(dollars in thousands)	
Other real estate construction and land	\$ 194	\$ 338
1-4 family residential mortgages	65	65
Commercial owner occupied real estate	1,144	-
Total nonaccrual loans	\$ 1,403	\$ 403

Two of these non-accrual loans carrying total balances of \$248,000 had their terms modified at a below market rate in 2012 and therefore are also classified as Troubled Debt Restructuring (TDR) loans. Additionally during 2012, two other loans which are still accruing interest for a total of \$1.4 million have been identified as Troubled Debt Restructuring (TDR) loans as their terms have also been modified at a below market rate.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of loans that were modified under the terms of a TDR during the twelve months ended December 31, 2012 is shown below by class:

	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
(dollars in thousands)			
1-4 family residential mortgages	2	\$ 257	\$ 295
Commercial owner occupied real estate	2	1,466	1,484
	<u>4</u>	<u>\$ 1,723</u>	<u>\$ 1,779</u>

There were no loans modified under the terms of a TDR during the twelve months ended December 31, 2011. Additionally, there were no loans modified as TDRs that subsequently defaulted during the twelve months ended December 31, 2012 or December 31, 2011 and were modified as TDRs within the 12 months prior to default.

4. Allowance for Loan Losses

A summary of the transactions in the allowance for loan losses for the years ended December 31, 2012 and 2011 appears below:

	<u>2012</u>	<u>2011</u>
(dollars in thousands)		
Balance, beginning of period	\$ 3,741	\$ 3,730
Loans charged off	(608)	(560)
Recoveries	213	36
Provision for (recovery of) loan losses	<u>(79)</u>	<u>535</u>
Balance, December 31	<u>\$ 3,267</u>	<u>\$ 3,741</u>

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Bank has segmented certain loans in the portfolio by product type. Within these segments, the Bank has sub-segmented its portfolio by classes, based on the associated risks within these classes.

LOAN SEGMENTS

Commercial

Real estate construction and land

Real estate mortgages

Consumer

LOAN CLASSES

Commercial and industrial loans

Residential construction loans

Other construction and land loans

1-4 family mortgages

Home equity lines of credit

Multifamily mortgages

Commercial owner occupied real estate

Commercial non-owner occupied real estate

Consumer revolving credit

Consumer all other credit

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Based on the internal risk ratings assigned to each credit, an historical factor is assigned to the balances for each class of loans, using an average eight quarter rolling basis. The Bank's internal creditworthiness grading system is based on experiences with similarly graded loans. Category ratings are reviewed quarterly by experienced senior lenders based on each borrower's situation. Additionally, internal and external monitoring and review of credits are conducted on an annual basis.

Loans that trend upward toward more positive risk ratings generally have a lower risk factor associated. Conversely, loans that migrate toward more negative ratings generally will result in a higher risk factor being applied to those related loan balances.

RISK RATINGS	DESCRIPTION/HISTORICAL LOSS FACTOR APPLIED
Excellent	0% applied, as these loans are secured by cash and represent a minimal risk. The Bank has never experienced a loss for this category.
Good	0% applied, as these loans are secured by marketable securities within margin and represent a low risk. The Bank has never experienced a loss for this category.
Pass	<p>Loans with the following risk ratings are pooled by class and considered together as "pass."</p> <ul style="list-style-type: none"> • Satisfactory - modest risk loans where the borrower has strong and liquid financial statement and more than adequate cash flow • Average – average risk loans where the borrower has reasonable debt service capacity • Marginal – acceptable risk loans where the borrower has an acceptable financial statement but is leveraged • Watch – acceptable risk loans which require more attention than normal servicing. <p>Historical loss factor for loans rated "pass" is applied to current balances of like-rated loans, pooled by class.</p>
Special Mention	These potential problem loans are currently protected but are potentially weak. Historical loss factor for loans rated "special mention" is applied to current balances of like-rated loans pooled by class.
Substandard	These problem loans are inadequately protected by the sound worth and paying capacity of the borrower and/or the value of any collateral pledged. These loans may be considered impaired and evaluated on an individual basis. Otherwise, an historical loss factor for loans rated "substandard" is applied to current balances of all other "substandard" loans pooled by class.
Doubtful	Loans with this rating have significant deterioration in the sound worth and paying capacity of the borrower and/or the value of any collateral pledged, making collection or liquidation of the loan in full highly questionable. These loans would be considered impaired and evaluated on an individual basis.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following represents the loan portfolio designated by the internal risk ratings assigned to each credit as of December 31, 2012:

Internal Risk Rating Grades (dollars in thousands)	Excellent	Good	Pass	Special Mention	Sub- standard	Doubtful	TOTAL
Commercial loans	\$ 3,868	\$ 17,422	\$ 23,424	\$ 260	\$ 396	\$ -	\$ 45,370
Real estate construction							
Residential construction	-	-	-	-	-	-	-
Other construction and land	-	-	13,016	549	628	-	14,193
Real estate mortgages							
1-4 family mortgages	-	1,958	52,502	1,063	1,297	-	56,820
Home equity lines of credit	-	-	31,168	-	265	-	31,433
Multifamily mortgages	-	-	23,033	-	-	-	23,033
Commercial owner occupied	-	-	54,132	-	3,355	-	57,487
Commercial nonowner occupied	-	-	41,350	710	2,509	-	44,569
Consumer loans							
Consumer revolving credit	-	1,146	783	-	9	-	1,938
Consumer all other credit	234	6,685	3,043	-	55	-	10,017
Total Loans	\$ 4,102	\$ 27,211	\$ 242,451	\$ 2,582	\$ 8,514	\$ -	\$ 284,860

The following represents the loan portfolio designated by the internal risk ratings assigned to each credit as of December 31, 2011:

Internal Risk Rating Grades (dollars in thousands)	Excellent	Good	Pass	Special Mention	Sub- standard	Doubtful	TOTAL
Commercial loans	\$ 707	\$ 15,432	\$ 24,505	\$ 5	\$ 1,508	\$ -	\$ 42,157
Real estate construction							
Residential construction	-	-	91	-	-	-	91
Other construction and land	-	-	12,436	3,587	1,361	-	17,384
Real estate mortgages							
1-4 family mortgages	-	1,978	55,510	1,213	1,294	-	59,995
Home equity lines of credit	-	-	32,658	35	109	-	32,802
Multifamily mortgages	-	-	17,927	-	382	-	18,309
Commercial owner occupied	-	-	53,694	230	6,324	-	60,248
Commercial nonowner occupied	-	-	42,899	2,132	5,023	-	50,054
Consumer loans							
Consumer revolving credit	-	847	583	-	-	-	1,430
Consumer all other credit	208	5,540	4,264	-	50	-	10,062
Total Loans	\$ 915	\$ 23,797	\$ 244,567	\$ 7,202	\$ 16,051	\$ -	\$ 292,532

In addition to the historical factors, the adequacy of the Bank's allowance for credit losses is evaluated through reference to eight qualitative factors, listed below and ranked in order of importance:

- 1) Changes in national and local economic conditions, including the condition of various market segments
- 2) Changes in the value of underlying collateral
- 3) Changes in volume of classified assets, measured as a percentage of capital
- 4) Changes in volume of delinquent loans
- 5) The existence and effect of any concentrations of credit and changes in the level of such concentrations
- 6) Changes in lending policies and procedures, including underwriting standards
- 7) Changes in the experience, ability and depth of lending management and staff
- 8) Changes in the level of policy exceptions

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

It has been the Bank's experience that the first four factors drive losses to a much greater extent than the last four factors; therefore, the first four factors are weighted more heavily. Although the markets served by the Bank remain stronger than the national economy as a whole, management continues to pay close attention on a case-by-case basis for any yet unforeseen potential ripple effects of the housing downturn and the related financial market fallout.

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

Impaired loans are individually evaluated and, if deemed appropriate, a specific allocation is made for these loans. In reviewing the nine loans in the amount of \$2,816,000 classified as impaired loans at December 31, 2012, there was no valuation allowance on any of these loans after consideration was given for each borrowing as to the fair value of the collateral on the loan or the present value of expected future cash flows from the customer.

Allowance for Credit Losses Rollforward by Portfolio Segment

For the year ended December 31, 2012

(dollars in thousands)

	Commercial	Real Estate Construction	Real Estate Mortgage	Consumer	Unallocated	Total
Allowance for credit losses:						
Balance as of January 1, 2012	\$ 397	\$ 319	\$ 2,954	\$ 68	\$ 3	\$ 3,741
Charge-offs	(132)	(27)	(431)	(18)	-	(608)
Recoveries	7	107	69	30	-	213
Provision for (recovery of) loan losses	31	(231)	158	(34)	(3)	(79)
Ending Balance	\$ 303	\$ 168	\$ 2,750	\$ 46	\$ -	\$ 3,267

Ending Balance:

Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Collectively evaluated for impairment	303	168	2,750	46	-	3,267

Financing Receivables:

Ending Balance	\$ 45,370	\$ 14,193	\$ 213,342	\$ 11,955	\$ -	\$ 284,860
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Ending Balance:

Individually evaluated for impairment	-	194	2,622	-	-	2,816
Collectively evaluated for impairment	45,370	13,999	210,720	11,955	-	282,044

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Allowance for Credit Losses Rollforward by Portfolio Segment

For the year ended December 31, 2011

(dollars in thousands)

	Commercial	Real Estate Construction	Real Estate Mortgage	Consumer	Unallocated	Total
Allowance for credit losses:						
Balance as of January 1, 2011	\$ 476	\$ 488	\$ 2,644	\$ 122	\$ -	\$ 3,730
Charge-offs	-	(31)	(518)	(11)	-	(560)
Recoveries	11	-	3	22	-	36
Provision for (recovery of) loan losses	(90)	(138)	825	(65)	3	535
Ending Balance	\$ 397	\$ 319	\$ 2,954	\$ 68	\$ 3	\$ 3,741

Ending Balance:

Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Collectively evaluated for impairment	397	319	2,954	68	3	3,741

Financing Receivables:

Ending Balance	\$ 42,157	\$ 17,475	\$ 221,408	\$ 11,492	\$ -	\$ 292,532
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Ending Balance:

Individually evaluated for impairment	-	338	2,786	-	-	3,124
Collectively evaluated for impairment	42,157	17,137	218,622	11,492	-	289,408

As previously mentioned, one of the major factors that the Bank uses in evaluating the adequacy of its allowance for loan losses is changes in the volume of delinquent loans. Management monitors payment activity on a regular basis. For all classes of loans, the Bank considers the entire balance of the loan to be contractually delinquent if the minimum payment is not received by the due date. Interest and fees continue to accrue on past due loans until they are changed to non-accrual status.

As of December 31, 2012 and December 31, 2011, the Bank showed the following aging of past due loans. Also included are loans that are 90 or more days past due but still accruing, because they are well secured and in the process of collection. As of December 31, 2012, the Bank had only one such credit for a balance of \$35,000. As of December 31, 2011, the Bank had two loans for a balance of \$388,000 that were 90 days or more past due but still accruing.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Past Due Aging as of December 31, 2012 (dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due and Still Accruing
Commercial loans	\$ -	\$ 74	\$ -	\$ 74	\$ 45,296	\$ 45,370	\$ -
Real estate construction							
Residential construction	-	-	-	-	-	-	-
Other construction and land	38	-	-	38	14,155	14,193	-
Real estate mortgages							
1-4 family mortgages	181	-	-	181	56,639	56,820	-
Home equity lines of credit	-	-	35	35	31,398	31,433	35
Multifamily mortgages	-	-	-	-	23,033	23,033	-
Commercial owner occupied	-	-	961	961	56,526	57,487	-
Commercial nonowner occupied	-	-	-	-	44,569	44,569	-
Consumer loans							
Consumer revolving credit	-	-	-	-	1,938	1,938	-
Consumer all other credit	9	-	-	9	10,008	10,017	-
Total Loans	\$ 228	\$ 74	\$ 996	\$ 1,298	\$ 283,562	\$ 284,860	\$ 35

Past Due Aging as of December 31, 2011 (dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due and Still Accruing
Commercial loans	\$ -	\$ -	\$ -	\$ -	\$ 42,157	\$ 42,157	\$ -
Real estate construction							
Residential construction	-	-	-	-	91	91	-
Other construction and land	-	-	388	388	16,996	17,384	388
Real estate mortgages							
1-4 family mortgages	286	-	-	286	59,709	59,995	-
Home equity lines of credit	-	35	-	35	32,767	32,802	-
Multifamily mortgages	-	-	-	-	18,309	18,309	-
Commercial owner occupied	-	-	-	-	60,248	60,248	-
Commercial nonowner occupied	-	-	-	-	50,054	50,054	-
Consumer loans							
Consumer revolving credit	-	-	-	-	1,430	1,430	-
Consumer all other credit	92	-	-	92	9,970	10,062	-
Total Loans	\$ 378	\$ 35	\$ 388	\$ 801	\$ 291,731	\$ 292,532	\$ 388

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Other Real Estate Owned (OREO)

At December 31, 2012, OREO was \$1,746,000 and was comprised of a residential property and a residential lot located in Virginia. At December 31, 2011, OREO was carried at \$4,242,000.

Changes in the balance for OREO are as follows:

(dollars in thousands)	<u>December 31, 2012</u>	<u>December 31, 2011</u>
Balance at beginning of year, gross	\$ 4,242	\$ 605
Transfer from loans	-	4,242
Previously recognized impairment losses on disposition	(262)	(276)
Gain on sale of property	2	-
Sales proceeds	<u>(1,653)</u>	<u>(329)</u>
Balance at end of year, gross	\$ 2,329	\$ 4,242
Less valuation allowance	<u>(583)</u>	<u>-</u>
Balance at end of year, net	<u><u>\$ 1,746</u></u>	<u><u>\$ 4,242</u></u>

Changes in the valuation allowance for OREO are as follows:

(dollars in thousands)	<u>December 31, 2012</u>	<u>December 31, 2011</u>
Balance at beginning of year	\$ -	\$ 276
Valuation allowance	845	-
Charge-offs	(262)	(276)
Recoveries	-	-
Balance at end of year	<u><u>\$ 583</u></u>	<u><u>\$ -</u></u>

Expenses applicable to OREO, other than the valuation allowance, were \$65,000 for both the year ended December 31, 2012 and the year ended December 31, 2011.

6. Premises and Equipment

Bank premises and equipment are summarized as follows:

(dollars in thousands)	<u>December 31, 2012</u>	<u>December 31, 2011</u>
Leasehold improvements	\$ 15,284	\$ 15,267
Buildings	-	176
Land	1,207	9
Construction and fixed assets in progress	-	25
Furniture and equipment	5,123	5,080
Computer software	<u>1,824</u>	<u>1,640</u>
	\$ 23,438	\$ 22,197
Less accumulated depreciation and amortization	<u>12,784</u>	<u>11,505</u>
	<u><u>\$ 10,654</u></u>	<u><u>\$ 10,692</u></u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Depreciation and amortization expense included in the operating expenses amounted to \$1,441,000 in 2012 and \$1,554,000 in 2011.

7. Deposits

The aggregate amount of time deposits with a minimum balance of \$100,000 was \$93,218,000 at December 31, 2012 and \$92,756,000 at December 31, 2011.

Brokered deposits totaled \$28,705,000 and \$42,387,000 at December 31, 2012 and 2011, respectively. As of year-end 2011, \$30,883,000 of these brokered deposits were reciprocal relationships established under the Certificate of Deposit Account Registry Service (CDARS™), whereby depositors can obtain FDIC insurance on deposits up to \$50 million. The remaining brokered deposits of \$11,504,000 represented bankruptcy trustee deposits placed through an agreement entered during the third quarter of 2011 with Financial Software Solutions, L.L.C., which provided its TrusteSolutions™ system to the bankruptcy trustees. During 2012, the Bank discontinued the bankruptcy trustee deposit program. Therefore, all of the \$28,705,000 in brokered deposits at year-end 2012 were reciprocal relationships under the CDARS program.

At December 31, 2012, the scheduled maturities of time deposits are as follows:

(dollars in thousands)

Scheduled Maturities at December 31, 2012

2013	\$	117,517
2014		3,366
2015		2,430
2016		4,573
2017		2,257
	\$	<u>130,143</u>

8. Income Taxes

The Bank files tax returns in the U.S. federal jurisdiction. With few exceptions, the Bank is no longer subject to U.S. federal tax examinations by tax authorities for years prior to 2009.

The Commonwealth of Virginia assesses a Bank Franchise Tax instead of a state income tax. The Bank Franchise Tax expense is reported in non-interest expense and the tax's calculation is unrelated to taxable income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Net deferred tax assets consist of the following components as of December 31, 2012 and December 31, 2011:

(dollars in thousands)	2012	2011
Deferred tax assets:		
Alternative minimum tax	\$ -	\$ 58
Allowance for loan losses	978	1,154
Non-accrual loan interest	10	3
Stock option/grant expense	317	293
Start-up expenses	1	1
Home equity closing costs	58	68
Deferred OREO expense	218	22
Deferred compensation expense	9	9
Deferred loan fees	7	-
Depreciation	451	256
	\$ 2,049	\$ 1,864
Deferred tax liabilities:		
Securities available for sale	\$ 594	\$ 886
Deferred loan costs	-	35
Investment from subsidiary income	13	9
	\$ 607	\$ 930
	\$ 1,442	\$ 934

The provision for income taxes charged to operations for years ended December 31, 2012 and 2011 consists of the following:

(dollars in thousands)	2012	2011
Current tax expense	\$ 2,827	\$ 155
Deferred tax	(216)	777
	\$ 2,611	\$ 932

The income tax provision differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2012 and 2011 due to the following:

(dollars in thousands)	2012	2011
Federal statutory rate	34%	34%
Computed statutory tax expense	\$ 2,751	\$ 1,113
Increase (decrease) in tax resulting from:		
Tax-exempt interest income	(78)	(37)
Tax-exempt income from Bank Owned Life Insurance (BOLI)	(95)	(203)
Stock option expense	10	42
Social dues	12	9
Other	11	8
Provision for income taxes	\$ 2,611	\$ 932

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. Commitments and Contingent Liabilities

In the normal course of business, there are various outstanding commitments and contingent liabilities, which are not reflected in the accompanying financial statements. The Bank does not anticipate any material loss as a result of these transactions.

As a member of the Federal Reserve System, the Bank is required to maintain certain average clearing balances. Those balances include amounts on deposit with the Federal Reserve. For the final weekly reporting period in the years ended December 31, 2012 and December 31, 2011, the amounts of daily average required balances were \$495,000 and \$573,000, respectively.

At December 31, 2012, the Bank had leased certain of its banking and operations offices under operating lease agreements on terms ranging from 1 to 20 years with renewal options. Rent expense charged to operations under operating lease agreements totaled \$1,035,000 in 2012 and \$1,153,000 in 2011.

The following is a schedule of future minimum rental payments required under non-cancelable operating leases that have initial or remaining terms in excess of one year as of December 31, 2012:

	(dollars in thousands)
2013	\$ 893
2014	810
2015	790
2016	689
2017	560
Thereafter	3,575
	<u>\$ 7,317</u>

10. Financial Instruments With Off-Balance Sheet Risk and Credit Risk

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist primarily of commitments to extend credit and standby letters of credit. In addition to the amounts shown below, the Bank has extended commitment letters at December 31, 2012 in the amount of \$8,344,000 to various borrowers. At December 31, 2011, commitment letters totaled \$12,219,000. Commitment letters are done in the normal course of business and typically expire after 120 days. All of these off-balance-sheet instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The totals for financial instruments whose contract amount represents credit risk are shown below as of December 31, 2012 and December 31, 2011.

(dollars in thousands)	Notional Amount	
	December 31, 2012	December 31, 2011
Unfunded lines-of-credit	\$107,310	\$106,740
Letters of credit	3,550	3,984
Total	<u>\$110,860</u>	<u>\$110,724</u>

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral normally consists of real property.

Standby letters of credit are conditional commitments by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions.

The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds real estate and bank deposits as collateral supporting those commitments for which collateral is deemed necessary.

The Bank has approximately \$195,000 in deposits in other financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) at December 31, 2012.

11. Related Party Transactions

During 2012, the Bank had, and may be expected to have in the future, banking transactions in the ordinary course of business with directors, principal officers, their immediate families and affiliated companies in which they are principal shareholders (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. Related parties were indebted to the Bank for loans totaling \$6,401,000 and \$4,873,000 at December 31, 2012 and 2011, respectively. During 2012, total principal additions were \$3,996,000 and total principal payments were \$2,468,000.

In 2012, the Bank had business dealings with companies owned by directors of the Bank. Expenditures made to these companies in 2012 include rental expenditures of \$438,000 (including reimbursements for taxes, insurance, and other expenses), paid to an entity for which a director of the Bank is an owner. For another property owned by an entity in which a different director has a beneficial interest, the Bank had a ground lease and paid rent of \$10,000 in early 2012. In February of 2012, VNB purchased this real estate for \$1,200,000, and the approximate dollar value of the interest of the director individually and his immediate family members, without regard to the amount of profit or loss, was \$200,000 and \$400,000, respectively. Monthly rent for both properties was a fair market rate as verified by an independent third-party appraisal.

12. Capital Requirements

The Bank is 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 Bank's

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2012 and 2011, that the Bank met all capital adequacy requirements to which it is subject.

The Bank's capital ratios remain above the levels designated by bank regulators as "well capitalized" at December 31, 2012. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Bank's actual capital amounts and ratios as of December 31, 2012, are presented in the following table:

(dollars in thousands)	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Total Capital						
(To Risk Weighted Assets)	\$56,054	16.21%	\$27,658	8.00%	\$34,573	10.00%
Tier 1 Capital						
(To Risk Weighted Assets)	\$52,787	15.27%	\$13,829	4.00%	\$20,744	6.00%
Tier 1 Capital						
(To Average Assets)	\$52,787	10.87%	\$19,432	4.00%	\$24,290	5.00%

The Bank's actual capital amounts and ratios as of December 31, 2011, are presented in the following table:

(dollars in thousands)	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Total Capital						
(To Risk Weighted Assets)	\$50,942	14.35%	\$28,404	8.00%	\$35,505	10.00%
Tier 1 Capital						
(To Risk Weighted Assets)	\$47,201	13.29%	\$14,202	4.00%	\$21,303	6.00%
Tier 1 Capital						
(To Average Assets)	\$47,201	10.28%	\$18,361	4.00%	\$22,951	5.00%

13. Dividend Restrictions

Federal regulations limit the amount of dividends which the Bank can pay without obtaining prior approval. The amount of cash dividends that the Bank may pay is limited to current year earnings plus retained net profits for the two preceding years. In addition, dividends paid by the Bank would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements. Notwithstanding the regulatory limitations on cash dividends, the Bank's Board of Directors approved a cash dividend payment policy that, once combined with any previous cash dividends paid within the last 12 months, the total of which will not exceed 50% of the Bank's after-tax earnings, excluding any extraordinary items, for the preceding 12-months. If the previous 3 quarterly dividends are not within the preceding 12 months, then only the amounts of

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

dividends paid in the previous 12 months, plus the proposed dividend, in total will not exceed 60% of the Bank's after-tax earnings.

At December 31, 2012, the maximum amount available to the Bank for cash dividends was \$11,852,000. The Bank paid no cash dividends during 2012 or 2011. However, on May 16, 2011, the Board of Directors declared a 15% stock dividend. The stock dividend was paid on June 30, 2011 to shareholders of record at the close of business on June 15, 2011. As a result of the stock dividend, each shareholder received 0.15 shares of Common Stock for every share of Common Stock held as of the record date.

14. Fair Value Measurements

Determination of Fair Value

The Bank 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 Bank'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 Bank groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

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

Level 2 – Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

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

The following describes the valuation techniques used by the Bank 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,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2).

The following table presents the balances measured at fair value on a recurring basis as of December 31, 2012:

(dollars in thousands)	Fair Value Measurements at December 31, 2012 Using:			
	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Assets:				
U.S. Government agencies	\$ 63,497	\$ -	\$ 63,497	\$ -
Mortgage-backed securities/CMOs	25,166	-	25,166	-
Municipal bonds	17,023	-	17,023	-
Corporate bonds	4,023	-	4,023	-
Asset-backed securities	1,144	-	1,144	-
Total securities available for sale	<u>\$ 110,853</u>	<u>\$ -</u>	<u>\$ 110,853</u>	<u>\$ -</u>

The following table presents the balances measured at fair value on a recurring basis as of December 31, 2011:

(dollars in thousands)	Fair Value Measurements at December 31, 2011 Using:			
	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Assets:				
U.S. Government agencies	<u>\$ 84,150</u>	<u>\$ -</u>	<u>\$ 84,150</u>	<u>\$ -</u>

Certain financial 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 Bank to measure certain financial assets recorded at fair value on a nonrecurring basis in the financial statements:

Other Real Estate Owned

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

The Bank had two OREO properties carried at a balance of \$1,746,000 as of December 31, 2012. At December 31, 2011, OREO balances were \$4,242,000.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Bank because of marketability, then the fair value is considered Level 3.

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

Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. The Bank had \$2,816,000 and \$3,124,000 in impaired loans as of December 31, 2012 and December 31, 2011, respectively. None of these impaired loans required a valuation allowance after consideration was given for each borrowing as to the fair value of the collateral on the loan or the present value of expected future cash flows from the customer.

The following table presents the Bank's assets that were measured at fair value on a nonrecurring basis as of December 31, 2012:

(dollars in thousands)	Balance as of December 31, 2012	<u>Fair Value Measurements at December 31, 2012 Using:</u>		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Assets:				
Other Real Estate Owned (OREO)	\$ 1,746	\$ -	\$ -	\$ 1,746

The following table presents the Bank's assets that were measured at fair value on a nonrecurring basis as of December 31, 2011:

(dollars in thousands)	Balance as of December 31, 2011	<u>Fair Value Measurements at December 31, 2011 Using:</u>		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Assets:				
Other Real Estate Owned (OREO)	\$ 4,242	\$ -	\$ -	\$ 4,242

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the assets measured at fair value on a nonrecurring basis as of December 31, 2012, the following table displays quantitative information about Level 3 Fair Value Measurements:

(dollars in thousands)

Description	Fair Value	Valuation Technique	Unobservable Inputs	Weighted Average
Assets:				
Other Real Estate Owned (OREO)	\$ 1,746	Market comparables	Discount applied to market comparables *	6%

* A discount percentage is applied based on age of independent appraisals, current market conditions, and experience within the local market.

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

Cash and Short-Term Investments

For those short-term instruments, including cash, due from banks and federal funds sold, the carrying amount is a reasonable estimate of fair value.

Interest bearing deposits

The carrying amounts of interest bearing deposits maturing within ninety days approximate their fair value.

Securities

Fair values for securities, excluding restricted securities, are based on third party vendor pricing models. The carrying value of restricted Federal Reserve Bank and FHLB stock approximates fair value based on the redemption provisions of each entity and is therefore excluded from the following table.

Loan Receivables

The fair value of performing loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar remaining maturities. This calculation ignores loan fees and certain factors affecting the interest rates charged on various loans such as the borrower's creditworthiness and compensating balances and dissimilar types of real estate held as collateral. The fair value of impaired loans is measured as described within the Impaired Loans section of this note.

Bank Owned Life Insurance

The carrying amounts of Bank Owned Life Insurance approximate fair value.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Deposit Liabilities

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Short-Term Borrowings

The carrying amounts of securities sold under agreements to repurchase approximate fair value.

Off-Balance Sheet Financial Instruments

At December 31, 2012 and 2011, the fair values of loan commitments and standby letters of credit are immaterial. Therefore, they have not been included in the following table.

The carrying values and estimated fair values of the Bank's financial instruments as of December 31, 2012 are as follows:

		Fair Value Measurement at December 31, 2012 using:			
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
(dollars in thousands)	Carrying value				
Assets					
Cash and cash equivalent	\$ 71,778	\$ 71,778	\$ -	\$ -	\$ 71,778
Securities	116,844	-	116,913	-	116,913
Loans, net	281,593	-	-	289,246	289,246
Bank owned life insurance	12,150	-	12,150	-	12,150
Accrued interest receivable	1,367	-	1,367	-	1,367
Liabilities					
Demand deposits and interest-bearing transaction and money market accounts	\$ 315,279	\$ -	\$ 315,279	\$ -	\$ 315,279
Certificates of deposit	130,143	-	130,602	-	130,602
Securities sold under agreements to repurchase	4,000	-	4,000	-	4,000
Accrued interest payable	154	-	154	-	154

The carrying values and estimated fair values of the Bank's financial instruments as of December 31, 2011 are as follows:

		Fair Value Measurement at December 31, 2011 using:			
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
(dollars in thousands)	Carrying value				
Assets					
Cash and cash equivalent	\$ 57,044	\$ 57,044	\$ -	\$ -	\$ 57,044
Securities	90,138	-	90,231	-	90,231
Loans, net	288,791	-	-	285,793	285,793
Bank owned life insurance	6,869	-	6,869	-	6,869
Accrued interest receivable	1,369	-	1,369	-	1,369
Liabilities					
Demand deposits and interest-bearing transaction and money market accounts	\$ 280,426	\$ -	\$ 280,426	\$ -	\$ 280,426
Certificates of deposit	131,442	-	131,435	-	131,435
Securities sold under agreements to repurchase	2,623	-	2,623	-	2,623
Accrued interest payable	213	-	213	-	213

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Bank's financial instruments will change when interest rate levels change, and that change may be either favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk; however, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

15. Other Expenses

The Bank had the following other expenses as of the dates indicated:

(dollars in thousands)	<u>December 31, 2012</u>	<u>December 31, 2011</u>
FDIC deposit insurance assessment	\$ 325	\$ 353
Marketing, advertising and promotion	700	620
Professional fees	562	479
Third party processing	879	742
Telecommunications	285	291
ATM, debit and credit card expense	327	303
Net OREO write downs and expenses	908	65
Virginia franchise tax	242	278
Other	1,440	1,404
	<u>\$ 5,668</u>	<u>\$ 4,535</u>

16. Employee Benefit Plans

The Bank has a 401(k) plan available to all employees who are at least 18 years of age. Employees are able to elect the amount to contribute, not to exceed a maximum amount as determined by IRS regulation. In 2012, the Bank matched 50% of every dollar contributed by employees up to a maximum of 6% of annual compensation. Effective January 1, 2013, the company match will be 100% of the first 3% of employee contributions and 50% for the next 2% of employee contributions.

"Vesting" refers to the rights of ownership to the assets in the 401(k) accounts. Through December 31, 2012, Bank contributions to the plan were vested by the employees according to the following schedule: 50% after two years of service, 75% after three years of service and 100% after four years of service. Effective January 1, 2013, matching contributions will be fully vested immediately. Employee contributions to the plan have always been 100% vested.

The Bank contributed \$216,000 to the plan in 2012 and \$178,000 in 2011.

17. Stock Incentive Plans

At the Annual Meeting of Shareholders of Virginia National Bank, held on May 17, 1999, shareholders approved the Virginia National Bank 1998 Stock Incentive Plan ("1998 Stock Plan"). An aggregate of 430,100 shares were issuable under the 1998 Stock Plan. Options for 381,089 shares have been issued, net of forfeited and expired options. No new grants will be issued under this Plan. At December 31, 2012, stock options covering 7,216 shares of VNB Common Stock were issued and outstanding. Of the total issuance, all were fully vested. These options are exercisable for a 10-year period from the date of grant at an exercise price per share ranging from \$18.61 to \$23.30.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At the Annual Meeting of Shareholders of Virginia National Bank, held on May 21, 2003, shareholders approved the Virginia National Bank 2003 Stock Incentive Plan ("2003 Stock Plan"). An aggregate of 128,369 shares are presently issuable under the 2003 Stock Plan. Options for 127,240 shares have been issued, net of forfeited and expired options. At December 31, 2012, stock options for 52,850 shares were outstanding. Of this total, 39,295 stock options were fully vested. All unvested stock options vest by the fourth or fifth anniversary of the date of the grant. These options are exercisable for a 10-year period from the date of grant at an exercise price per share ranging from \$15.65 to \$24.78. There are 1,129 shares still available under this plan.

At the Annual Meeting of Shareholders of Virginia National Bank, held on May 16, 2005, shareholders approved the Virginia National Bank 2005 Stock Incentive Plan, and the Amended and Restated 2005 Stock Incentive Plan was approved by shareholders at the annual meeting held on May 15, 2006 (as amended, "2005 Stock Plan"). An aggregate of 230,000 shares are presently issuable under the 2005 Stock Plan. Options for 173,648 shares have been issued, net of forfeited and expired options. At December 31, 2012, stock options for 172,355 shares were outstanding. Of this total, 161,349 stock options were fully vested. All of the unvested stock options vest by the fourth or fifth anniversary of the date of the grant. These options are generally exercisable for a 10-year period from the date of grant at an exercise price per share ranging from \$11.74 to \$36.74. There are 56,352 shares still available under this plan.

All three stock plans provide for granting of both incentive and nonqualified stock options. The option price of incentive options will not be less than the fair market value of the stock at the time an option is granted. Nonqualified options may be granted at a price established by the Board of Directors, including prices less than the fair market value on the date of grant. All options expire ten years from the grant date.

Changes in the stock options outstanding related to the 1998 Plan, the 2003 Plan and the 2005 Plan are summarized as follows:

	<u>Number of</u>	<u>2012</u>
	<u>Shares</u>	<u>Weighted Average</u>
		<u>Exercise Price</u>
Outstanding at beginning of year	278,310	\$25.83
Granted	--	--
Exercised	--	--
Forfeited	(10,929)	\$21.41
Expired	(34,960)	\$21.87
Outstanding at end of year	232,421	\$26.63
Options exercisable at year-end	207,859	\$27.57

The fair value of any grant is estimated at the grant date using the Black-Scholes option-pricing model.

For the year ended December 31, 2012, the Bank recognized \$101,136 in compensation expense for stock options. As of December 31, 2012, there was \$104,171 in unamortized compensation expense remaining to be recognized in future reporting periods through 2015. For the year ended December 31, 2011, the Bank recognized \$222,232 in compensation expense for stock options.

There was \$1,041 in aggregate intrinsic value for options outstanding and \$515 in aggregate intrinsic value for options exercisable at December 31, 2012. The aggregate intrinsic value of options outstanding at December 31, 2011 was \$1,230.

The total intrinsic value of options exercised during the year ended December 31, 2012 was \$0, as no options were exercised in the period.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Summary information pertaining to options outstanding at December 31, 2012 is as follows:

Exercise Price	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
\$11.74 to 20.00	45,404	6.0 Years	\$17.56	26,815	\$17.85
20.01 to 30.00	96,339	4.3 Years	24.62	91,047	24.74
30.01 to 36.74	<u>90,678</u>	3.5 Years	33.32	<u>89,997</u>	33.33
Total	<u>232,421</u>	4.3 Years	\$26.63	<u>207,859</u>	\$27.57

The Bank recorded \$3,503 and \$39,753 in compensation expense related to restricted stock awards in 2012 and 2011, respectively. The requisite service period for these awards is four years. The weighted average remaining contractual term for non-vested awards at December 31, 2012 was 1.4 years. As of December 31, 2012, there was \$6,421 of total unrecognized compensation expense related to the non-vested awards. No restricted stock awards were granted in 2012 or in 2011.

The following table summarizes restricted stock activity at December 31, 2012:

	<u>Number of Shares</u>	<u>Average Grant-Date Fair Value</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at beginning of year	863	\$12.18	\$11,970
Issued	-	-	
Vested	<u>288</u>	\$12.18	
Non-vested at end of year	<u>575</u>	\$12.18	\$7,791

18. Earnings Per Share

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of diluted potential common stock. Potential dilutive common stock has no effect on income available to common shareholders. All per share information has been restated to reflect a 1.15 to 1.00 stock dividend paid on June 30, 2011.

	<u>2012</u>		<u>2011</u>	
	<u>Shares</u>	<u>Per Share Amount</u>	<u>Shares</u>	<u>Per Share Amount</u>
Basic EPS	2,690,220	\$2.04	2,690,220	\$0.87
Effect of dilutive securities and stock options	<u>0</u>		<u>2,712</u>	
Diluted EPS	<u>2,690,220</u>	<u>\$2.04</u>	<u>2,692,932</u>	<u>\$0.87</u>

In 2012, stock options representing 232,421 average shares were not included in the calculation of earnings per share, as their effect would have been antidilutive. Stock options representing 274,856 average shares were similarly not included in 2011.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

19. Segment Reporting

The Bank has two reportable segments, the commercial bank and VNBTrust, N.A.

Commercial banking involves making loans and generating deposits from individuals and businesses. Loan fee income, service charges from deposit accounts, and other non-interest-related fees such as automatic teller machine fees and safe deposit box fees generate additional income for the commercial bank.

VNBTrust services include investment management, trust account administration, and estate planning. VNBTrust receives fees on both a fixed basis and a performance basis for the provision of these services.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Each reportable segment is a strategic business unit that offers different products and services. They are managed separately because each segment appeals to different markets and, accordingly, requires different technology and marketing strategies.

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

<u>2012</u>	<u>Commercial</u> <u>Bank</u>	<u>VNBTrust</u>	<u>Consolidated</u> <u>Totals</u>
(dollars in thousands)			
Net interest income	\$ 15,606	\$ 17	\$ 15,623
Provision for (recovery of) loan losses	(79)	-	(79)
Non-interest income	2,311	9,729	12,040
Non-interest expense	15,261	4,389	19,650
Income before income taxes	2,735	5,357	8,092
Provision for income taxes	797	1,814	2,611
Net income	<u>\$ 1,938</u>	<u>\$ 3,543</u>	<u>\$ 5,481</u>
 Total assets	 <u>\$ 493,679</u>	 <u>\$ 13,927</u>	 <u>\$ 507,606</u>

<u>2011</u>	<u>Commercial</u> <u>Bank</u>	<u>VNBTrust</u>	<u>Consolidated</u> <u>Totals</u>
(dollars in thousands)			
Net interest income	\$ 16,064	\$ 11	\$ 16,075
Provision for loan losses	535	-	535
Non-interest income	2,529	2,577	5,106
Non-interest expense	15,296	2,077	17,373
Income before income taxes	2,762	511	3,273
Provision for income taxes	754	178	932
Net income	<u>\$ 2,008</u>	<u>\$ 333</u>	<u>\$ 2,341</u>
 Total assets	 <u>\$ 457,367</u>	 <u>\$ 6,699</u>	 <u>\$ 464,066</u>



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Virginia National Bank and Subsidiary
Charlottesville, Virginia

We have audited the accompanying consolidated balance sheets of Virginia National Bank and subsidiary as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank'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. The Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Virginia National Bank and subsidiary as of December 31, 2012 and 2011 and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
March 20, 2013

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None

Item 9A. CONTROLS AND PROCEDURES.

Management is responsible for establishing and maintaining adequate control over financial reporting, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"), that are designed to ensure that information required to be disclosed in reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to management, including the Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

In designing and evaluating its disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, Management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Management conducted an evaluation of the effectiveness of the Bank's internal control over financial reporting as of December 31, 2012. This assessment was based on criteria established in "Internal Control-Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, the Bank's Principal Executive Officer and Principal Financial Officer have concluded that the disclosure controls and procedures were effective at the reasonable assurance level as of December 31, 2012. There was no change in the internal control over financial reporting that occurred during the fourth quarter ended December 31, 2012 that has materially affected, or is reasonably likely to materially affect, the internal control over financial reporting.

This annual report does not include an attestation report of the Bank's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Bank's registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Bank to provide only Management's report in this annual report.

Item 9B. OTHER INFORMATION.

None

Part III

Item 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE.

Information is incorporated by reference to the information that appears under the headings "Proposal 2 – Election of Directors", "Executive Compensation – Executive Officers", "Related Party Transactions and Other Information Related to Directors", "Section 16(a) Beneficial Ownership Reporting Compliance", "Code of Ethics", "Information about the Board of Directors and Board Committees" and "Audit and Compliance Committee Report" contained in the Bank's 2013 Definitive Proxy Statement ("Proxy Statement") to be filed by April 30, 2013.

Item 11. EXECUTIVE COMPENSATION.

This information is incorporated by reference from the "Executive Compensation" section of the Bank's Definitive Proxy Statement to be filed by April 30, 2013.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

Other than as set forth below, this information is incorporated by reference from Note 17, "Stock Incentive Plans," contained in the "Notes to Consolidated Financial Statements" of this Form 10-K and from the "Ownership of Virginia National Bank Common Stock" section of the Bank's Definitive Proxy Statement to be filed by April 30, 2013.

The following table summarizes information, as of December 31, 2012, relating to the Bank's 1998 Stock Incentive Plan, 2003 Stock Incentive Plan and 2005 Stock Incentive Plan:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	232,421	\$26.63	57,481
Equity compensation plans not approved by security holders	--	--	--
Total	232,421	\$26.63	57,481

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

This information is incorporated by reference from the "Information about the Board of Directors and Board Committees" and "Related Party Transactions and Other Information Related to Directors" sections of the Bank's Definitive Proxy Statement to be filed by April 30, 2013. For further information, see Note 11 of the "Notes to Consolidated Financial Statements".

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

This information is incorporated by reference from the "Independent Auditors" section of the Bank's Definitive Proxy Statement to be filed by April 30, 2013.

Part IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a) Exhibit Index:

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
3.1	Articles of Association of Virginia National Bank, as amended ^a
3.2	Bylaws of Virginia National Bank, as amended ^b
4.0	Form of Common Stock Certificate of Virginia National Bank ^c
10.1	Form of Virginia National Bank 1998 Stock Incentive Plan ^d
10.2	Form of Virginia National Bank 2003 Stock Incentive Plan ^e
10.3	Form of Virginia National Bank Amended and Restated 2005 Stock Incentive Plan ^f
21.0	Subsidiaries of the Registrant ^g
31.1	302 Certification of Principal Executive Officer
31.2	302 Certification of Principal Financial Officer
32.1	906 Certification

^a Incorporated herein by reference from Virginia National Bank's Definitive Proxy Statement, filed with the Office of the Comptroller of the Currency on April 16, 2012.

^b Incorporated herein by reference from Virginia National Bank's 2011 Annual Report on Form 10-K, filed with the Office of the Comptroller of the Currency on March 28, 2012.

^c Incorporated herein by reference from Virginia National Bank's Registration Statement on Form SB-2, filed with the Office of the Comptroller of the Currency's Southeastern District Office on May 21, 1998, as amended.

^d Incorporated herein by reference from Virginia National Bank's Definitive Proxy Statement, filed with the Office of the Comptroller of the Currency on or around April 16, 1999.

^e Incorporated herein by reference from Virginia National Bank's Definitive Proxy Statement, filed with the Office of the Comptroller of the Currency on April 24, 2003.

^f Incorporated herein by reference from Virginia National Bank's Definitive Proxy Statement, filed with the Office of the Comptroller of the Currency on March 30, 2006.

^g Refer to page 3 for a discussion of Virginia National Bank's direct and indirect subsidiaries.

EXHIBIT 31.1

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER

I, Glenn W. Rust, certify that:

1. I have reviewed this annual report on Form 10-K of Virginia National Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such disclosure over financial reporting to be designed under our supervision, 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;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: March 19, 2013

/s/ Glenn W. Rust
Glenn W. Rust
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER

I, Ronald E. Baron, certify that:

1. I have reviewed this annual report on Form 10-K of Virginia National Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such disclosure over financial reporting to be designed under our supervision, 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;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: March 19, 2013

/s/Ronald E. Baron
Ronald E. Baron
Chief Financial Officer

EXHIBIT 32.1

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350 AS ADOPTED PURSUANT
TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Virginia National Bank (the "Bank") on Form 10-K for the period ending December 31, 2012 as filed with the Office of the Comptroller of the Currency on the date hereof (the "Report"), the undersigned Chief Executive Officer and Chief Financial Officer of the Bank hereby certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 that, based on their knowledge and belief: (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Bank as of and for the periods covered in the Report.

/s/ Glenn W. Rust

Glenn W. Rust, Principal Executive Officer

/s/ Ronald E. Baron

Ronald E. Baron, Principal Financial Officer

March 19, 2013