

FIRST NATIONAL CORP /VA/  
Form 10-Q  
August 12, 2011  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2011

or

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

For the transition period from            to

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**54-1232965**  
(I.R.S. Employer  
Identification No.)

**112 West King Street, Strasburg, Virginia**  
(Address of principal executive offices)

**22657**  
(Zip Code)

**(540) 465-9121**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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 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  (Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of August 11, 2011, 2,955,649 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

**Table of Contents**

**TABLE OF CONTENTS**

	Page
<b><u>PART I FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets</u>	3
<u>Consolidated Statements of Operations</u>	4
<u>Consolidated Statements of Cash Flows</u>	6
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	33
Item 4. <u>Controls and Procedures</u>	34
<b><u>PART II OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	34
Item 1A. <u>Risk Factors</u>	34
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	34
Item 3. <u>Defaults upon Senior Securities</u>	34
Item 4. <u>Removed and Reserved</u>	34
Item 5. <u>Other Information</u>	34
Item 6. <u>Exhibits</u>	34

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****FIRST NATIONAL CORPORATION****Consolidated Balance Sheets***(in thousands, except share and per share data)*

	(unaudited) June 30, 2011	December 31, 2010
<b>Assets</b>		
Cash and due from banks	\$ 8,431	\$ 5,048
Interest-bearing deposits in banks	21,098	10,949
Federal funds sold		7,500
Securities available for sale, at fair value	82,780	60,420
Restricted securities, at cost	2,859	3,153
Loans held for sale		271
Loans, net of allowance for loan losses, 2011, \$13,778, 2010, \$16,036	401,724	418,994
Other real estate owned, net of valuation allowance, 2011, \$3,072, 2010, \$3,341	5,696	3,961
Premises and equipment, net	19,804	20,302
Interest receivable	1,706	1,667
Other assets	11,151	12,364
<b>Total assets</b>	<b>\$ 555,249</b>	<b>\$ 544,629</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 82,727	\$ 78,964
Savings and interest-bearing demand deposits	189,270	178,685
Time deposits	204,497	205,851
<b>Total deposits</b>	<b>\$ 476,494</b>	<b>\$ 463,500</b>
Other borrowings	18,111	20,122
Company obligated mandatorily redeemable capital securities	9,279	9,279
Accrued expenses and other liabilities	2,768	3,230
Commitments and contingencies		
<b>Total liabilities</b>	<b>\$ 506,652</b>	<b>\$ 496,131</b>
<b>Shareholders Equity</b>		
Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding	\$ 14,194	\$ 14,127
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2011, 2,955,649 shares, 2010, 2,948,901 shares	3,695	3,686

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Surplus	1,644	1,582
Retained earnings	27,991	28,969
Accumulated other comprehensive income, net	1,073	134
Total shareholders' equity	\$ 48,597	\$ 48,498
Total liabilities and shareholders' equity	\$ 555,249	\$ 544,629

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Consolidated Statements of Operations**

Three months ended June 30, 2011 and 2010

*(in thousands, except per share data)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 5,818	\$ 6,229
Interest on federal funds sold	4	
Interest on deposits in banks	5	2
Interest and dividends on securities available for sale:		
Taxable interest	572	432
Tax-exempt interest	121	142
Dividends	17	16
<b>Total interest and dividend income</b>	<b>\$ 6,537</b>	<b>\$ 6,821</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 1,303	\$ 1,501
Interest on federal funds purchased		6
Interest on company obligated mandatorily redeemable capital securities	109	109
Interest on other borrowings	42	103
<b>Total interest expense</b>	<b>\$ 1,454</b>	<b>\$ 1,719</b>
Net interest income	\$ 5,083	\$ 5,102
Provision for loan losses	3,550	1,000
Net interest income after provision for loan losses	\$ 1,533	\$ 4,102
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 535	\$ 682
ATM and check card fees	410	366
Trust and investment advisory fees	384	294
Fees for other customer services	74	91
Gains on sale of loans	22	25
Gains on sale of securities available for sale, net	41	
Other operating income	19	31
<b>Total noninterest income</b>	<b>\$ 1,485</b>	<b>\$ 1,489</b>

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**Noninterest Expense**

Salaries and employee benefits	\$ 2,280	\$ 2,290
Occupancy	331	351
Equipment	323	343
Marketing	100	128
Stationery and supplies	87	85
Legal and professional fees	269	194
ATM and check card fees	159	209
FDIC assessment	217	184
Bank franchise tax	104	109
Provision for other real estate owned	46	40
Other real estate owned expense	66	115
Net losses on sale of other real estate owned	8	
Telecommunications expense	86	70
Other operating expense	440	407
<b>Total noninterest expense</b>	<b>\$ 4,516</b>	<b>\$ 4,525</b>
Income (loss) before income taxes	\$ (1,498)	\$ 1,066
Income tax provision (benefit)	(553)	313
<b>Net income (loss)</b>	<b>\$ (945)</b>	<b>\$ 753</b>
Effective dividend on preferred stock	223	221
<b>Net income (loss) available to common shareholders</b>	<b>\$ (1,168)</b>	<b>\$ 532</b>
<b>Earnings (loss) per common share, basic and diluted</b>	<b>\$ (0.40)</b>	<b>\$ 0.18</b>

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Consolidated Statements of Operations**

Six months ended June 30, 2011 and 2010

*(in thousands, except per share data)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 11,651	\$ 12,489
Interest on federal funds sold	11	
Interest on deposits in banks	12	4
Interest and dividends on securities available for sale:		
Taxable interest	1,023	900
Tax-exempt interest	244	287
Dividends	34	28
<b>Total interest and dividend income</b>	<b>\$ 12,975</b>	<b>\$ 13,708</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 2,606	\$ 3,177
Interest on federal funds purchased		11
Interest on company obligated mandatorily redeemable capital securities	218	217
Interest on other borrowings	133	252
<b>Total interest expense</b>	<b>\$ 2,957</b>	<b>\$ 3,657</b>
Net interest income	\$ 10,018	\$ 10,051
Provision for loan losses	3,820	1,411
Net interest income after provision for loan losses	\$ 6,198	\$ 8,640
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 1,036	\$ 1,291
ATM and check card fees	781	680
Trust and investment advisory fees	726	604
Fees for other customer services	147	164
Gains on sale of loans	69	65
Gains on sale of securities available for sale, net	41	2
Other operating income	25	56
<b>Total noninterest income</b>	<b>\$ 2,825</b>	<b>\$ 2,862</b>



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**Noninterest Expense**

Salaries and employee benefits	\$ 4,568	\$ 4,517
Occupancy	672	695
Equipment	648	691
Marketing	205	252
Stationery and supplies	166	182
Legal and professional fees	470	420
ATM and check card fees	330	386
FDIC assessment	407	371
Bank franchise tax	209	209
Provision for other real estate owned	176	40
Other real estate owned expense	192	181
Net losses on sale of other real estate owned	8	52
Telecommunications expense	176	134
Other operating expense	844	844
<b>Total noninterest expense</b>	<b>\$ 9,071</b>	<b>\$ 8,974</b>
Income (loss) before income taxes	\$ (48)	\$ 2,528
Income tax provision (benefit)	(106)	760
<b>Net income</b>	<b>\$ 58</b>	<b>\$ 1,768</b>
Effective dividend on preferred stock	446	443
<b>Net income (loss) available to common shareholders</b>	<b>\$ (388)</b>	<b>\$ 1,325</b>
<b>Earnings (loss) per common share, basic and diluted</b>	<b>\$ (0.13)</b>	<b>\$ 0.45</b>

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Consolidated Statements of Cash Flows**

Six months ended June 30, 2011 and 2010

*(in thousands)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 58	\$ 1,768
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	592	623
Origination of loans held for sale	(4,001)	(4,626)
Proceeds from sale of loans held for sale	4,341	4,901
Gains on sale of loans held for sale	(69)	(65)
Provision for loan losses	3,820	1,411
Provision for other real estate owned	176	40
Gains on sale of securities available for sale, net	(41)	(2)
Net losses on sale of other real estate owned	8	52
Accretion of security discounts	(29)	(21)
Amortization of security premiums	234	185
Shares acquired by leveraged ESOP		42
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	(39)	13
(Increase) decrease in other assets	730	(310)
Decrease in accrued expenses and other liabilities	(562)	(1,527)
<b>Net cash provided by operating activities</b>	<b>\$ 5,218</b>	<b>\$ 2,484</b>
<b>Cash Flows from Investing Activities</b>		
Proceeds from maturities, calls, and principal payments of securities available for sale	\$ 9,921	\$ 5,615
Purchase of securities available for sale	(31,023)	
Proceeds from sales of restricted securities	294	
Decrease in federal funds sold	7,500	
Purchase of premises and equipment	(94)	(125)
Proceeds from sale of other real estate owned	384	1,779
Net (increase) decrease in loans	11,247	(3,007)
<b>Net cash provided by (used in) investing activities</b>	<b>\$ (1,771)</b>	<b>\$ 4,262</b>
<b>Cash Flows from Financing Activities</b>		
Net increase in demand deposits and savings accounts	\$ 14,348	\$ 12,422
Net decrease in time deposits	(1,354)	(34,193)
Proceeds from other borrowings	18,001	23,601
Principal payments on other borrowings	(20,012)	(23,654)

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Cash dividends paid on common stock	(519)	(715)
Cash dividends paid on preferred stock	(379)	(379)
Increase in federal funds purchased		13,304
Shares issued to leveraged ESOP		(26)
<b>Net cash provided by (used in) financing activities</b>	<b>\$ 10,085</b>	<b>\$ (9,640)</b>
Increase (decrease) in cash and cash equivalents	\$ 13,532	\$ (2,894)
<b>Cash and Cash Equivalents</b>		
Beginning	\$ 15,997	\$ 14,977
Ending	\$ 29,529	\$ 12,083

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Consolidated Statements of Cash Flows**

(Continued)

Six months ended June 30, 2011 and 2010

*(in thousands)*

	(unaudited) June 30, 2011	(unaudited) June 30, 2010
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 2,962	\$ 3,836
Income taxes	\$	\$ 2,541
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized gain on securities available for sale	\$ 1,422	\$ 405
Transfer from loans to other real estate owned	\$ 2,815	\$ 2,865
Loan originated from sale of other real estate owned	\$ 640	\$
Issuance of common stock, dividend reinvestment plan	\$ 71	\$ 107

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Consolidated Statements of Changes in Shareholders Equity**

Six months ended June 30, 2011 and 2010

*(in thousands, except share and per share data)**(unaudited)*

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
<b>Balance, December 31, 2009</b>	\$ 13,998	\$ 3,664	\$ 1,418	\$ 35,104	\$ (42)	\$ 665		\$ 54,807
Comprehensive income:								
Net income				1,768			\$ 1,768	1,768
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, \$139)							268	
Reclassification adjustment (net of tax, \$1)							(1)	
Other comprehensive income (net of tax, \$138)						267	\$ 267	267
Total comprehensive income							\$ 2,035	
Shares acquired by leveraged ESOP			(26)		42			16
Cash dividends on common stock (\$0.28 per share)				(822)				(822)
Issuance of 9,055 shares common stock, dividend reinvestment plan		12	95					107
Cash dividends on preferred stock				(379)				(379)
Accretion on preferred stock discount	64			(64)				
<b>Balance, June 30, 2010</b>	\$ 14,062	\$ 3,676	\$ 1,487	\$ 35,607	\$	\$ 932		\$ 55,764

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
<b>Balance, December 31, 2010</b>	\$ 14,127	\$ 3,686	\$ 1,582	\$ 28,969	\$	\$ 134		\$ 48,498

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Comprehensive income:

Net income		58		\$ 58	58
Other comprehensive income, net of tax:					
Unrealized holding gains arising during the period (net of tax, \$497)				966	
Reclassification adjustment (net of tax, \$14)				(27)	
Other comprehensive income (net of tax, \$483)			939	939	939
Total comprehensive income				\$ 997	
Cash dividends on common stock (\$0.20 per share)			(590)		(590)
Issuance of 6,748 shares common stock, dividend reinvestment plan	9	62			71
Cash dividends on preferred stock			(379)		(379)
Accretion on preferred stock discount	67		(67)		
<b>Balance, June 30, 2011</b>	\$ 14,194	\$ 3,695	\$ 1,644	\$ 27,991	\$ 1,073
					\$ 48,597

See Notes to Consolidated Financial Statements

**Table of Contents****FIRST NATIONAL CORPORATION****Notes to Consolidated Financial Statements***(unaudited)***Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2011 and December 31, 2010, the results of operations for the three and six months ended June 30, 2011 and 2010 and cash flows and changes in shareholders' equity for the six months ended June 30, 2011 and 2010. The statements should be read in conjunction with the consolidated financial statements and related notes included in the Annual Report on Form 10-K for the year ended December 31, 2010. Operating results for the three and six month periods ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

**Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. Amortized costs and fair values of securities available for sale at June 30, 2011 and December 31, 2010 were as follows:

	<i>(in thousands)</i>			
	June 30, 2011			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 66,976	\$ 2,303	\$ (3)	\$ 69,276
Obligations of states and political subdivisions	12,879	477	(29)	13,327
Corporate equity securities	23	154		177
	\$ 79,878	\$ 2,934	\$ (32)	\$ 82,780

	<i>(in thousands)</i>			
	December 31, 2010			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 45,627	\$ 1,508	\$ (211)	\$ 46,924
Obligations of states and political subdivisions	13,290	225	(214)	13,301
Corporate equity securities	23	172		195
	\$ 58,940	\$ 1,905	\$ (425)	\$ 60,420

At June 30, 2011 and December 31, 2010, investments in an unrealized loss position that were temporarily impaired were as follows:

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	<i>(in thousands)</i>					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 1,997	\$ (3)	\$	\$	\$ 1,997	\$ (3)
Obligations of states and political subdivisions			459	(29)	459	(29)
	\$ 1,997	\$ (3)	\$ 459	\$ (29)	\$ 2,456	\$ (32)



**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

	<i>(in thousands)</i>					
	Less than 12 months		December 31, 2010 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 11,286	\$ (211)	\$	\$	\$ 11,286	\$ (211)
Obligations of states and political subdivisions	2,923	(128)	893	(86)	3,816	(214)
	\$ 14,209	\$ (339)	\$ 893	\$ (86)	\$ 15,102	\$ (425)

The tables above provide information about securities that have been in an unrealized loss position for less than twelve consecutive months and securities that have been in an unrealized loss position for twelve consecutive months or more. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Impairment is considered to be other-than temporary if the Company (1) intends to sell the security, (2) more likely than not will be required to sell the security before recovering its cost, or (3) does not expect to recover the security's entire amortized cost basis. Presently, the Company does not intend to sell any of these securities, will not be required to sell these securities, and expects to recover the entire amortized cost of all the securities.

At June 30, 2011, there was one U.S. agency and mortgage-backed security and one obligation of state and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 4.0 years at June 30, 2011.

The Company's investment in Federal Home Loan Bank (FHLB) stock totaled \$2.0 million at June 30, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is a minimal market for the stock. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at June 30, 2011, and no impairment has been recognized. FHLB stock is shown in restricted securities on the balance sheet and is not part of the available for sale securities portfolio.

**Note 3. Loans**

Loans at June 30, 2011 and December 31, 2010 are summarized as follows:

	<i>(in thousands)</i>	
	June 30, 2011	December 31, 2010
Real estate loans:		
Construction	\$ 50,741	\$ 52,591
Secured by 1-4 family residential	120,575	121,506
Other real estate loans	195,766	207,371
Commercial and industrial loans	35,513	40,683
Consumer loans	12,907	12,879

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Total loans	\$ 415,502	\$ 435,030
Allowance for loan losses	13,778	16,036
Loans, net	\$ 401,724	\$ 418,994

Consumer loans included \$279 thousand and \$231 thousand of demand deposit overdrafts at June 30, 2011 and December 31, 2010, respectively.

The Company has a credit concentration of loans secured by real estate. These loans totaled \$367.1 million, or 88% of total loans, and \$381.5 million, or 88% of total loans, at June 30, 2011 and December 31, 2010, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be impacted by local economic conditions.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$42.3 million at June 30, 2011, representing 87% of total equity and 10% of total loans. At December 31, 2010, this concentration totaled \$41.6 million representing 86% of total equity and 10% of total loans. These loans are included in other real estate loans in the above table. The Company charged down \$1.5 million related to this concentration of credit risk during the six month period ended June 30, 2011 and \$147 thousand related to these loans during the year ended December 31, 2010.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

The following table provides a summary of loan classes and an aging of past due loans as of June 30, 2011 and December 31, 2010:

	June 30, 2011 <i>(in thousands)</i>				Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due				
<b>Real estate loans:</b>								
Construction	\$ 916	\$ 539	\$ 3,540	\$ 4,995	\$ 45,746	\$ 50,741	\$ 3,527	\$ 369
1-4 family residential	3,778	341	435	4,554	116,021	120,575	3,881	
Other real estate loans	2,150	258	2,211	4,619	191,147	195,766	6,122	
Commercial and industrial	456	839	536	1,831	33,682	35,513	112	424
Consumer	104	7		111	12,796	12,907		
<b>Total</b>	<b>\$ 7,404</b>	<b>\$ 1,984</b>	<b>\$ 6,722</b>	<b>\$ 16,110</b>	<b>\$ 399,392</b>	<b>\$ 415,502</b>	<b>\$ 13,642</b>	<b>\$ 793</b>

	December 31, 2010 <i>(in thousands)</i>				Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due				
<b>Real estate loans:</b>								
Construction	\$ 525	\$	\$ 3,665	\$ 4,190	\$ 48,401	\$ 52,591	\$ 5,780	\$
1-4 family residential	2,642	178	315	3,135	118,371	121,506	628	315
Other real estate loans	10,225	3,475	751	14,451	192,920	207,371	4,407	283
Commercial and industrial	1,033	3		1,036	39,647	40,683		
Consumer	168	10	1	179	12,700	12,879	2	
<b>Total</b>	<b>\$ 14,593</b>	<b>\$ 3,666</b>	<b>\$ 4,732</b>	<b>\$ 22,991</b>	<b>\$ 412,039</b>	<b>\$ 435,030</b>	<b>\$ 10,817</b>	<b>\$ 598</b>

**Credit Quality Indicators**

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including trends related to the risk grading of specified classes of loans.

The Company utilizes a risk grading matrix to assign a rating to each of its loans. The loan ratings are summarized into the following categories: pass, special mention, substandard, doubtful and loss. Pass rated loans include all risk rated credits other than those included in special mention, substandard or doubtful. Loans classified as loss are charged-off. Loan officers assign risk grades to loans at origination and as renewals arise. The Bank's Credit Administration department reviews risk grades for accuracy on a quarterly basis and as delinquency issues arise. In addition, a certain amount of loans are reviewed each year through the Company's internal and external loan review process. A description of the general

characteristics of the loan grading categories is as follows:

**Special Mention** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or the Bank's credit position at some future date.

**Substandard** Loans classified as substandard are inadequately protected by the current net worth and payment capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation in full of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful** Loans classified as doubtful have all the weakness inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The Company considers all doubtful loans to be impaired and places the loan on nonaccrual status.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

The following tables provide an analysis of the credit risk profile of each loan class as of June 30, 2011 and December 31, 2010:

	June 30, 2011 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction	\$ 22,313	\$ 6,724	\$ 19,636	\$ 2,068	\$ 50,741
Secured by 1-4 family residential	101,448	7,628	11,428	71	120,575
Other real estate loans	145,750	17,076	30,673	2,267	195,766
Commercial and industrial	28,979	4,338	2,084	112	35,513
Consumer	12,907				12,907
<b>Total</b>	<b>\$ 311,397</b>	<b>\$ 35,766</b>	<b>\$ 63,821</b>	<b>\$ 4,518</b>	<b>\$ 415,502</b>

	December 31, 2010 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction	\$ 21,212	\$ 5,237	\$ 21,471	\$ 4,671	\$ 52,591
Secured by 1-4 family residential	106,722	4,435	10,349		121,506
Other real estate loans	143,874	17,915	43,443	2,139	207,371
Commercial and industrial	34,619	4,033	2,031		40,683
Consumer	12,864	13	1	1	12,879
<b>Total</b>	<b>\$ 319,291</b>	<b>\$ 31,633</b>	<b>\$ 77,295</b>	<b>\$ 6,811</b>	<b>\$ 435,030</b>

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the six months ended June 30, 2011 and 2010 and for the year ended December 31, 2010 were as follows:

	(in thousands)		
	June 30, 2011	December 31, 2010	June 30, 2010
Balance at beginning of year	\$ 16,036	\$ 7,106	\$ 7,106
Provision charged to operating expense	3,820	11,731	1,411
Loan recoveries	156	261	134

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Loan charge-offs	(6,234)	(3,062)	(1,017)
Balance at end of period	\$ 13,778	\$ 16,036	\$ 7,634

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

The following tables present, as of June 30, 2011 and December 31, 2010, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

	June 30, 2011 <i>(in thousands)</i>					
	Commercial and Industrial	Other Real Estate	Construction	Secured by 1-4 Family Residential	Consumer Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2010	\$ 858	\$ 9,187	\$ 4,050	\$ 1,681	\$ 260	\$ 16,036
Charge-offs	(22)	(2,939)	(2,556)	(569)	(148)	(6,234)
Recoveries					156	156
Provision for loan losses	245	1,978	783	755	59	3,820
Ending Balance, June 30, 2011	\$ 1,081	\$ 8,226	\$ 2,277	\$ 1,867	\$ 327	\$ 13,778
<b>Ending Balance:</b>						
Individually evaluated for impairment	210	3,655	923	1,236		6,025
Collectively evaluated for impairment	871	4,571	1,354	631	327	7,753
<b>Loans:</b>						
Ending Balance	\$ 35,513	\$ 195,766	\$ 50,741	\$ 120,575	\$ 12,907	\$ 415,502
Individually evaluated for impairment	225	21,206	5,844	6,629		33,905
Collectively evaluated for impairment	35,288	174,560	44,897	113,946	12,907	381,597
	December 31, 2010 <i>(in thousands)</i>					
	Commercial and Industrial	Other Real Estate	Construction	Secured by 1-4 Family Residential	Consumer Loans	Total
<b>Allowance for loan losses:</b>						
Ending Balance	\$ 858	\$ 9,187	\$ 4,050	\$ 1,681	\$ 260	\$ 16,036
<b>Ending Balance:</b>						
Individually evaluated for impairment	36	5,020	3,006	536		8,597
Collectively evaluated for impairment	822	4,167	1,044	1,145	260	7,439
<b>Loans:</b>						
Ending Balance	40,683	207,371	52,591	121,506	12,879	435,030
<b>Ending Balance:</b>						
Individually evaluated for impairment	48	28,426	9,709	5,682		43,865
Collectively evaluated for impairment	40,635	178,945	42,882	115,824	12,879	391,165





**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

Impaired loans and the related allowance at June 30, 2011 and December 31, 2010, were as follows:

	June 30, 2011 (in thousands)						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>Real estate loans:</b>							
Construction	\$ 7,860	\$ 3,022	\$ 2,822	\$ 5,844	\$ 923	\$ 7,311	\$ 65
Secured by 1-4 family	6,680	453	6,176	6,629	1,236	6,186	98
Other real estate loans	24,134	9,853	11,353	21,206	3,655	25,569	398
Commercial and industrial	225	14	210	225	210	72	6
Consumer							
<b>Total</b>	<b>\$ 38,898</b>	<b>\$ 13,343</b>	<b>\$ 20,562</b>	<b>\$ 33,905</b>	<b>\$ 6,025</b>	<b>\$ 39,138</b>	<b>\$ 567</b>

	December 31, 2010 (in thousands)						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>Real estate loans:</b>							
Construction	\$ 10,440	\$ 1,217	\$ 8,492	\$ 9,709	\$ 3,006	\$ 2,920	\$ 374
Secured by 1-4 family	5,701	595	5,087	5,682	536	795	222
Other real estate loans	29,480	7,904	20,522	28,426	5,020	18,432	1,345
Commercial and industrial	48		48	48	36	163	4
Consumer							
<b>Total</b>	<b>\$ 45,669</b>	<b>\$ 9,716</b>	<b>\$ 34,149</b>	<b>\$ 43,865</b>	<b>\$ 8,597</b>	<b>\$ 22,310</b>	<b>\$ 1,945</b>

The Recorded Investment amounts in the table above represent the outstanding principal balance on each loan represented in the table. The Unpaid Principal Balance represents the outstanding principal balance on each loan represented in the table plus any amounts that have been charged off on each loan and/or payments that have been applied towards principal on nonaccrual loans.

During the first quarter of 2011, the Bank adjusted its allowance for loan losses methodology by expanding the historical loss period that is applied to the general component of the allowance from one year to three years. The Company decreased the loss history to one year after significant deterioration in economic conditions in 2008. Since then, the Company has determined that a three-year loss history is more appropriate to reflect a reasonable loss inherent in the loan portfolio. For further information on the Company's allowance for loan losses methodology, see the Allowance for Loan Losses section included in Part I, Item 2 of this Form 10-Q.

**Note 5. Other Borrowings**

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The Bank had unused lines of credit totaling \$131.1 million available with non-affiliated banks at June 30, 2011. This amount primarily consists of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) under which the Bank can borrow up to 19% of its total assets.

At June 30, 2011, the Bank had borrowings from the FHLB system totaling \$18.0 million which mature through March 28, 2013. The interest rate on these notes payable ranged from 0.36% to 1.91% and the weighted average rate was 1.04%. The Bank had collateral pledged on these borrowings, including real estate loans totaling \$63.2 million and FHLB stock with a book value of \$2.0 million.

At June 30, 2011, the Bank had a \$111 thousand note payable, secured by a deed of trust, which requires monthly payments of \$2 thousand and matures January 3, 2016. The fixed interest rate on this loan is 4.00%.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 6. Capital Requirements**

A comparison of the capital of the Company and the Bank at June 30, 2011 and December 31, 2010 with the minimum regulatory guidelines were as follows:

	Actual		<i>(dollars in thousands)</i> Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>June 30, 2011:</b>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 61,295	14.33%	\$ 34,218	8.00%	N/A	N/A
First Bank	\$ 60,672	14.20%	\$ 34,180	8.00%	\$ 42,725	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 55,844	13.06%	\$ 17,109	4.00%	N/A	N/A
First Bank	\$ 55,227	12.93%	\$ 17,090	4.00%	\$ 25,635	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 55,844	10.18%	\$ 21,935	4.00%	N/A	N/A
First Bank	\$ 55,227	10.07%	\$ 21,936	4.00%	\$ 27,420	5.00%
<b>December 31, 2010:</b>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 63,163	14.18%	\$ 35,624	8.00%	N/A	N/A
First Bank	\$ 62,550	14.06%	\$ 35,584	8.00%	\$ 44,480	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 57,467	12.91%	\$ 17,812	4.00%	N/A	N/A
First Bank	\$ 56,861	12.78%	\$ 17,792	4.00%	\$ 26,688	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 57,467	10.54%	\$ 21,810	4.00%	N/A	N/A
First Bank	\$ 56,861	10.40%	\$ 21,859	4.00%	\$ 27,324	5.00%

**Note 7. Company Obligated Mandatorily Redeemable Capital Securities**

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On June 17, 2004, \$5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at June 30, 2011 was 2.85%. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions that began September 17, 2009. The principal asset of Trust II is \$5.2 million of the Company's junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

On July 24, 2006, First National (VA) Statutory Trust III (Trust III), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On July 31, 2006, \$4.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a fixed rate of interest of 7.26% until July 31, 2011. The securities then have a LIBOR-indexed floating rate of interest. The

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securities have a mandatory redemption date of October 1, 2036, and are subject to varying call provisions beginning October 1, 2011. The principal asset of Trust III is \$4.1 million of the Company's junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

While these securities are debt obligations of the Company, they are included in capital for regulatory capital ratio calculations. Under present regulations, the trust preferred securities may be included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At June 30, 2011, the total amount of trust preferred securities issued by the Trusts was included in the Company's Tier 1 capital.

**Note 8. Benefit Plans**

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service and hired prior to May 1, 2011. Benefits are generally based upon years of service and average compensation for the five highest-paid consecutive years of service. The Bank's funding practice has been to make at least the minimum required annual contribution permitted by the Employee Retirement Income Security Act of 1974, as amended, and the Internal Revenue Code of 1986, as amended.

Components of the net periodic benefit cost of the plan for the three and six months ended June 30, 2011 and 2010 were as follows:

	<i>(in thousands)</i>			
	For the three months ended June 30,		For the six months ended June 30,	
	2011	2010	2011	2010
Service cost	\$ 90	\$ 77	\$ 180	\$ 153
Interest cost	77	71	153	142
Expected return on plan assets	(85)	(78)	(170)	(156)
Amortization of prior service cost	1	1	2	2
Amortization of net obligation at transition		(1)		(2)
Amortization of net loss	9	5	18	10
<b>Net periodic benefit cost</b>	<b>\$ 92</b>	<b>\$ 75</b>	<b>\$ 183</b>	<b>\$ 149</b>

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2010, that it expected to contribute \$366 thousand to its pension plan for the 2011 plan year. The Company is planning to make the contribution for the 2011 plan year during the fourth quarter of 2011.

In addition to the defined benefit pension plan, the Company maintains a 401(k) plan and an employee stock ownership plan (ESOP) for eligible employees. The Bank also maintains a Split Dollar Life Insurance Plan that provides life insurance coverage to insurable directors. See Note 11 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 for additional information about the Company's benefit plans.

**Note 9. Earnings per Common Share**

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects 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. There are no potential common shares that would have a dilutive effect. Shares not committed to be released under the Company's leveraged ESOP are not

considered to be outstanding. See Note 11 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 for additional information about the Company's leveraged ESOP. The average number of common shares outstanding used to calculate basic and diluted earnings per common share were 2,952,818 and 2,937,480 for the three months ended June 30, 2011 and 2010, respectively, and 2,951,002 and 2,935,192 for the six months ended June 30, 2011 and 2010, respectively.

**Note 10. Fair Value Measurements**

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

## **Table of Contents**

### **Notes to Consolidated Financial Statements**

*(unaudited)*

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.

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

- Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2 Valuation is based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
- Level 3 Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires a significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

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

#### **Securities available for sale**

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2).

The following tables present the balances of financial assets measured at fair value on a recurring basis as of June 30, 2011 and December 31, 2010.

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Description	Fair Value Measurements at June 30, 2011 (in thousands)			
	Balance as of June 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 69,276	\$	\$ 69,276	\$
Obligations of states and political subdivisions	13,327		13,327	
Corporate equity securities	177	177		
	\$ 82,780	\$ 177	\$ 82,603	\$



**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

Description	Fair Value Measurements at December 31, 2010 <i>(in thousands)</i>			
	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 46,924	\$	\$ 46,924	\$
Obligations of states and political subdivisions	13,301		13,301	
Corporate equity securities	195	195		
	\$ 60,420	\$ 195	\$ 60,225	\$

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

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

**Loans held for sale**

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the six months ended June 30, 2011.

**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. Fair value is measured based on the value of the collateral securing the loans or the present value of expected future cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, 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 using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement

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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 Operations.

### Other real estate owned

Loans are transferred to other real estate owned when the collateral securing them is foreclosed on or acquired through a deed in lieu of foreclosure. The measurement of loss associated with other real estate owned is based on the fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. Any fair value adjustments to other real estate owned are recorded in the period incurred and expensed against current earnings.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

The following tables summarize the Company's financial assets that were measured at fair value on a nonrecurring basis during the periods:

Description	Balance as of June 30, 2011	Carrying Value at June 30, 2011 <i>(in thousands)</i>		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Impaired loans	\$ 14,537	\$	\$ 13,460	\$ 1,077

Description	Balance as of December 31, 2010	Carrying Value at December 31, 2010 <i>(in thousands)</i>		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Impaired loans	\$ 25,552	\$	\$ 17,584	\$ 7,968

The following tables summarize the Company's nonfinancial assets that were measured at fair value on a nonrecurring basis during the periods.

Description	Balance as of June 30, 2011	Carrying Value at June 30, 2011 <i>(in thousands)</i>		
		Quoted Prices in Active Markets for Identical	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

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		Assets (Level 1)		
<b>Assets</b>				
Other real estate owned	\$	5,696	\$	\$ 5,696
				\$

  

		Carrying Value at December 31, 2010 <i>(in thousands)</i>		
Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		<b>Assets</b>		
Other real estate owned	\$	3,961	\$	\$ 3,961
				\$

## **Table of Contents**

### **Notes to Consolidated Financial Statements**

*(unaudited)*

Accounting guidance requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The methodologies for estimating the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The methodologies for other financial assets and financial liabilities are discussed below:

#### **Cash and Cash Equivalents**

The carrying amounts of cash and short-term instruments approximate fair values.

#### **Loans**

For variable-rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for all other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

#### **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 using the rates currently offered for deposits of similar remaining maturities.

#### **Accrued Interest**

The carrying amounts of accrued interest approximate fair value.

#### **Borrowings**

The carrying amounts of federal funds purchased and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of all other borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

#### **Commitments and Unfunded Credits**

The fair value of commitments to extend credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates.

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At June 30, 2011 and December 31, 2010, fair value of loan commitments and standby letters of credit was immaterial.

The estimated fair values of the Company's financial instruments at June 30, 2011 and December 31, 2010 were as follows:

*(in thousands)*

	<b>June 30, 2011</b>		<b>December 31, 2010</b>	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets</b>				
Cash and short-term investments	\$ 29,529	\$ 29,529	\$ 23,497	\$ 23,497
Securities	82,780	82,780	60,420	60,420
Loans, net	401,724	401,073	418,994	420,011
Loans held for sale			271	271
Accrued interest receivable	1,706	1,706	1,667	1,667
<b>Financial Liabilities</b>				
Deposits	\$ 476,494	\$ 448,940	\$ 463,500	\$ 433,300
Other borrowings	18,111	18,233	20,122	20,400
Company obligated mandatorily redeemable capital securities	9,279	9,279	9,279	9,279
Accrued interest payable	546	546	551	551

**Table of Contents**

**Notes to Consolidated Financial Statements**

*(unaudited)*

The Company 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 Company's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Company. 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 and borrowing wholesale funding with terms that mitigate the Company's overall interest rate risk.

**Note 11. Capital Purchase Program**

On March 13, 2009, the Company entered into a Letter Agreement and Securities Purchase Agreement Standard Terms (collectively, the Purchase Agreement) with the Treasury Department, pursuant to which the Company sold (i) 13,900 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$1.25 per share and liquidation preference \$1,000 per share (the Preferred Stock) and (ii) a warrant (the Warrant) to purchase 695 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the Warrant Preferred Stock), at an exercise price of \$1.25 per share, for an aggregate purchase price of \$13.9 million in cash. The Treasury immediately exercised the Warrant and, after net settlement, received 695 shares of the Company's Warrant Preferred Stock, which has a liquidation preference amount of \$1,000 per share. Closing of the sale occurred on March 13, 2009 and increased Tier 1 and total capital by \$13.9 million. The Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years, and thereafter at a rate of 9% per annum. The Warrant Preferred Stock pays cumulative dividends at a rate of 9% per annum from the date of issuance. The discount on the Preferred Stock is amortized over a five year period using the constant effective yield method.

## **Table of Contents**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **Cautionary Statement Regarding Forward-Looking Statements**

The Company makes forward-looking statements in this Form 10-Q that are subject to risks and uncertainties. These forward-looking statements include statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals. The words believes, expects, may, will, should, projects, contemplates, anticipates, forecasts, intends, or other similar terms are intended to identify forward-looking statements. These forward-looking statements are subject to significant uncertainties because they are based upon or are affected by factors including:

the Company may be adversely affected by economic conditions in the market area;

risks inherent in the loan portfolio such as repayment risks, fluctuating collateral values and concentrations;

the adequacy of the allowance for loan losses related to changes in general economic and business conditions in the market area;

successful management of credit risk including certain concentrations in loans secured by real estate or to certain industry;

the adequacy of the valuation allowance for other real estate owned related to changes in economic conditions and local real estate activity;

the reliance on secondary sources, such as Federal Home Loan Bank advances, sales of securities and loans, federal funds lines of credit from correspondent banks and out-of-market time deposits, to meet liquidity needs;

the ability to raise capital as needed;

the successful management of interest rate risk;

potential impact on the Company of legislation;

difficult market conditions in the Company's industry; and

other factors identified in Item 1A. Risk Factors of the Company's Form 10-K for the year ending December 31, 2010.

Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition and results of operations of the Company for the three and six month periods ended June 30, 2011 should be read in conjunction with the consolidated financial statements and related notes included in Part I, Item 1, of this Form 10-Q and in Part II, Item 8, of the Form 10-K for the period ending December 31, 2010. The results of operations for the three and six month periods ended June 30, 2011 may not be indicative of the results to be achieved for the year.

#### **Executive Overview**



The Company

First National Corporation (the Company) is the bank holding company of:

First Bank (the Bank). The Bank owns:

First Bank Financial Services, Inc.

Shen-Valley Land Holdings, LLC

First National (VA) Statutory Trust II (Trust II)

First National (VA) Statutory Trust III (Trust III)

First Bank Financial Services, Inc. invests in partnerships that provide title insurance and investment services. Shen-Valley Land Holdings, LLC was formed to hold other real estate owned and future office sites. The Trusts were formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities.

Products, Services, Customers and Locations

The Bank's primary market area is located within the northern Shenandoah Valley region of Virginia, including Shenandoah County, Warren County, Frederick County and the City of Winchester. Within the market area there are various types of industry including medical and professional services, manufacturing, retail and higher education. Customers include individuals, small and medium-sized businesses, local governmental entities and non-profit organizations.

The Bank provides loan, deposit, investment, trust and asset management and other products and services in the northern Shenandoah Valley region of Virginia. Loan products and services include personal loans, residential mortgages, home equity loans and commercial loans. Deposit products and services include checking, savings, NOW accounts, money market accounts, IRA accounts, certificates of deposit and cash management accounts. The Bank offers other services, including internet banking, mobile banking, remote deposit capture and other traditional banking services.

The Bank's Trust and Asset Management Department offers a variety of trust and asset management services including estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, estate settlement and benefit plans. The Bank offers financial planning and brokerage services for its customers through its investment division, First Financial Advisors.

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## Table of Contents

The Bank's products and services are provided through 10 branch offices, 30 ATMs and its website, [www.therespowerinone.com](http://www.therespowerinone.com). The Bank operates six of its offices under the Financial Center concept. A Financial Center offers all of the Bank's financial services at one location. This concept allows loan, deposit, trust and investment advisory personnel to be readily available to serve customers throughout the Bank's market area. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2010.

### Revenue Sources and Expense Factors

The primary source of revenue is from net interest income earned by the Bank. Net interest income is the difference between interest income and interest expense and typically represents between 75% to 80% of the Company's total revenue. Interest income is determined by the amount of interest-earning assets outstanding during the period and the interest rates earned on those assets. The Bank's interest expense is a function of the amount of interest-bearing liabilities outstanding during the period and the interest rates paid. In addition to net interest income, noninterest income is the other source of revenue for the Company. Noninterest income is derived primarily from service charges on loans and deposits and fees earned from other services. The Bank generates fee income from other services that include trust and investment advisory services and through the origination and sale of residential mortgages.

The provision for loan losses and noninterest expense are the two major expense categories. The provision is determined by factors that include loan growth, asset quality, net charge-offs and economic conditions. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company's control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for loan losses. The largest component of noninterest expense for the six month period ended June 30, 2011 was salaries and employee benefits, comprising 50% of noninterest expenses, followed by occupancy and equipment expense, comprising 15% of noninterest expenses.

### Quarterly Performance

During the second quarter 2011, the Company recorded \$3.6 million in provision for loan losses which resulted in a loss of \$945 thousand. After the effective dividend on preferred stock, net loss available to common shareholders was \$1.2 million, or \$0.40 per basic and diluted share, compared to net income available to common shareholders of \$532 thousand, or \$0.18 per basic and diluted share, for the same period in 2010. Net interest income, noninterest income and noninterest expense were all relatively consistent when comparing the two periods. Return on assets and return on equity were -0.69% and -7.68%, respectively, for the second quarter of 2011 compared to 0.55% and 5.41% for the same quarter in 2010.

Comparing the quarter ended June 30, 2011 to the same period in 2010, net interest income remained stable at \$5.1 million. Average interest-earning assets were \$11.0 million higher when comparing the two periods. The net interest margin was 4.00% for the second quarter of 2011, compared to 4.11% for the same period in 2010. The slight decline in the margin resulted from a change in the earning asset mix.

The provision for loan losses totaled \$3.6 million in the second quarter of 2011 compared to \$1.0 million for the same period in 2010. Net charge-offs were \$2.9 million for the second quarter of 2011 compared to \$531 thousand for the same period in 2010. The allowance for loan losses totaled \$13.8 million or 3.32% of total loans at June 30, 2011, compared to \$7.6 million or 1.73% of total loans at June 30, 2010. The higher provision was related to lower loan collateral values and an increase in charge-offs. Management regularly evaluates the loan portfolio, economic conditions and other factors to determine an appropriate allowance for loan losses. As a result of those evaluations, management believes the allowance for loan losses was appropriate at June 30, 2011.

Noninterest income totaled \$1.5 million for the second quarter of 2011, which was consistent with the same quarter of 2010. Increases in ATM, check card and trust and investment advisory fees offset a decrease in overdraft fee income. Noninterest expense was relatively unchanged at \$4.5 million for the second quarter of 2011 when compared to the same quarter of 2010, resulting in an efficiency ratio of 67.58% compared to 67.22% for the prior year period.

### Year-to-Date Performance

For the six months ended June 30, 2011, net income was \$58 thousand compared to \$1.8 million for the same period in 2010. After the effective dividend on preferred stock, net loss available to common shareholders was \$388 thousand, or \$0.13 per basic and diluted share, compared to net income available to common shareholders of \$1.3 million, or \$0.45 per basic and diluted share, for the same period in 2010. The decrease in earnings for the six months ended June 30, 2011 was primarily the result of a \$2.4 million increase in the provision for loan losses when comparing the periods. Return on assets was 0.02% for the six months ended June 30, 2011 compared to 0.65% for the same period in 2010, and return on equity was 0.24% for the six months ended June 30, 2011 compared to 6.42% for the same period in 2010.

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Net interest income was relatively unchanged at \$10.0 million for the six months ended June 30, 2011 compared to \$10.1 million for the same period in 2010. The net interest margin was 12 basis points lower while average interest-earning assets were \$12.2 million higher when comparing the two periods. The net interest margin was 3.94% for the six months ended June 30, 2011, compared to 4.06% for the same period in 2010.

For the six months ended June 30, 2011, the loan loss provision totaled \$3.8 million compared to \$1.4 million for the same period in 2010. During 2011, the provision for loan losses was a result of lower loan collateral values and higher net charge-offs. Net charge-offs were \$6.1 million for the first half of 2011 compared to \$883 thousand for the same period in 2010. During 2010, the provision for loan losses resulted from unfavorable economic conditions, declines in collateral values and specific reserves on impaired loans.

**Table of Contents**

Noninterest income decreased slightly to \$2.8 million for the six months ended June 30, 2011 from \$2.9 million for the same period in 2010. Increases in ATM, check card and trust and investment advisory fees were offset by a decrease in overdraft fee income. Noninterest expense was relatively unchanged for the six months ended June 30, 2011, compared to the same period in 2010, when excluding the provision for other real estate owned. The provision for other real estate owned totaled \$176 thousand for the six months ended June 30, 2011 compared to \$40 thousand for the same period in 2010.

**Management Outlook**

The Company does not expect a significant change in net interest income, noninterest income or noninterest expense (excluding the provision for OREO) for the remainder of the year when compared to second quarter results. Net interest income is expected to be relatively unchanged as the net interest margin and average earning asset balances are projected to remain stable. The Company is not planning for economic conditions to improve significantly in the local market, which should result in low loan demand and deposit growth. As a result, the earning asset mix is expected to continue to change as loan balances continue decreasing while balances of securities increase. Even though net interest margin pressure is expected from this change in the earning asset mix, the Company plans to continue reallocating investments from interest-bearing deposits in banks and federal funds sold to investment securities, which will lessen the impact of the mix change. In addition, interest-bearing liabilities are expected to re-price slightly lower throughout the remainder of the year which should also mitigate margin pressure.

Noninterest income and noninterest expense levels are not expected to change significantly for the remainder of the year, when compared to second quarter results. Higher levels of ATM and check card fee income, and trust and advisory fee income are expected to continue offsetting lower levels of income from service charges on deposit accounts.

Management believes that the allowance for loan losses provides prudent coverage of the risks in the loan portfolio, and that the carrying value of other real estate owned reflects current market conditions. However, the amount of provision for loan losses and provision for other real estate owned will be influenced by collateral values and economic conditions, among other factors. In addition, gains or losses that may occur from the sale of other real estate owned will be impacted by changes in market values.

**Non-GAAP Financial Measures**

The Company measures the net interest margin as an indicator of profitability. The net interest margin is calculated by dividing tax-equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax-equivalent net interest income is considered in the calculation of this ratio. Tax-equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for 2011 and 2010 is 34%. The reconciliation of tax-equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below.

**Reconciliation of Net Interest Income to****Tax-Equivalent Net Interest Income***(in thousands)*

	For the three months ended		For the six months ended	
	June 30,	June 30,	June 30,	June 30,
	2011	2010	2011	2010

**GAAP measures:**

Interest income - loans	\$ 5,818	\$ 6,229	\$ 11,651	\$ 12,489
Interest income - investments and other	719	592	1,324	1,219
Interest expense - deposits	1,303	1,501	2,606	3,177
Interest expense - other borrowings	42	103	133	252
Interest expense - other	109	115	218	228

<b>Total net interest income</b>	<b>\$ 5,083</b>	<b>\$ 5,102</b>	<b>\$ 10,018</b>	<b>\$ 10,051</b>
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**Non-GAAP measures:**

Tax benefit realized on non-taxable interest income - loans	\$ 15	\$ 10	\$ 26	\$ 20
Tax benefit realized on non-taxable interest income - municipal securities	62	73	126	147

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Total tax benefit realized on non-taxable interest income	\$ 77	\$ 83	\$ 152	\$ 167
Total tax-equivalent net interest income	\$ 5,160	\$ 5,185	\$ 10,170	\$ 10,218

**Critical Accounting Policies**

General

The Company's consolidated financial statements and related notes are prepared in accordance with GAAP. The financial information contained within the statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate

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## Table of Contents

value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. The Bank uses historical loss factors as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from the historical factors used. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact transactions could change. For further information about the Bank's loans and the allowance for loan losses, see Notes 3 and 4 to consolidated financial statements, included in Item 1 of this Form 10-Q.

Presented below is a discussion of those accounting policies that management believes are the most important ( Critical Accounting Policies ) to the portrayal and understanding of the Company's financial condition and results of operations. The Critical Accounting Policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial condition or results of operations is a reasonable likelihood.

### Allowance for Loan Losses

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 uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. For further information about the Company's loans and the allowance for loan losses, see Notes 3 and 4.

The allowance for loan losses is evaluated on a quarterly 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.

The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Management's judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of the collateral, overall portfolio quality and review of specific potential losses. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revisions as more information becomes available. The evaluation also considers the following risk characteristics of each loan portfolio:

Residential mortgage loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

Real estate construction loans carry risks that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may, at any point in time, be less than the principal amount of the loan; Construction loans also bear the risk that the general contractor, who may or may not be a loan customer, may be unable to finish the construction project as planned because of financial pressure unrelated to the project.

Commercial real estate and commercial and industrial loans carry risks associated with the successful operation of a business or a real estate project, in addition to other risks associated with the ownership of real estate, because repayment of these loans may be dependent upon the profitability and cash flows of the business or project. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time and cannot be appraised with as much precision.

Consumer loans carry risk associated with the continued credit-worthiness of the borrower and the value of the collateral (i.e., rapidly depreciating assets such as automobiles), or lack thereof. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy.

The allowance for loan losses consists of specific and general components. The specific component relates to loans that are classified as impaired, and is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. For collateral dependent loans, an updated appraisal will be ordered if a current one is not on file. Appraisals are

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performed by independent third-party appraisers with relevant industry experience. Adjustments to the appraised value may be made based on recent sales of like properties or general market conditions when appropriate.

The general component relates to loans that are not considered impaired. These unimpaired loans are segregated by loan type and allowance factors are assigned by management based on a three-year loss history, delinquencies, national and local economic trends, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, concentrations of credit, quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The factors assigned differ by loan segment. The general component recognizes potential losses whose impact on the portfolio has yet to be recognized by a specific allowance. Allowance factors and the overall size of the allowance may change from period to period based on management's assessment of the above described factors and the relative weights given to each factor.

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## **Table of Contents**

### **Lending Policies**

#### **General**

The principal risk associated with each of the categories of loans in the Bank's portfolio is the creditworthiness of its borrowers. Within each category, such risk is increased or decreased, depending on prevailing economic conditions. The risk associated with real estate mortgage loans, commercial and consumer loans varies, based on economic conditions, fluctuations in the value of real estate and other conditions that affect the ability of borrowers to repay indebtedness. The risk associated with real estate construction loans varies, based on the supply and demand for the type of real estate under construction.

In an effort to manage risk, the Bank's loan policy gives loan amount approval limits to individual loan officers based on their position within the Bank and level of experience. The Management Loan Committee can approve secured loans up to \$1.5 million and unsecured loans up to \$1.2 million. The Management Loan Committee consists of the Chief Executive Officer (CEO), Executive Vice President (EVP) Loan Administration and the Senior Vice President (SVP) Credit Administration. The Board Loan Committee approves all loans which exceed the authority of the Management Loan Committee. The Board Loan Committee consists of five non-management directors. The Board Loan Committee approves the Bank's Loan Policy and reviews loans that have been charged-off. It also reviews the loan watch list, concentrations of credit and other management reports. The Board Loan Committee meets on a monthly basis and the Chairman of the Committee then reports to the Board of Directors.

Residential loan originations are primarily generated by Bank loan officer solicitations, referrals by real estate professionals and customers. Commercial loans and commercial real estate loan originations are obtained through broker referrals, direct solicitation of developers and continued business from customers. All completed loan applications are reviewed by the Bank's loan officers. As part of the application process, information is obtained concerning the income, financial condition, employment and credit history of the applicant. Information is also obtained to evaluate cash flow available for debt service. Loan quality is analyzed based on the Bank's experience and credit underwriting guidelines as well as the guidelines issued by the purchasers of loans, depending on the type of loan involved. Real estate collateral is appraised by independent appraisers who have been pre-approved by the Board Loan Committee.

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, certain appraisals are analyzed by management or by an outsourced appraisal review specialist throughout the year. This is performed to ensure reasonableness of collateral valuations. The Company also obtains an independent review of the loan portfolio on an annual basis to analyze loan risk ratings and validate specific reserves on impaired loans.

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities that are disclosed but not reflected in its financial statements, including commitments to extend credit. At June 30, 2011, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$58.8 million.

#### **Commercial Business Lending**

Commercial business loans generally have a higher degree of risk than loans secured by real estate, but typically have higher yields. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as real estate. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers. At June 30, 2011 and December 31, 2010, commercial loans not secured by real estate totaled \$35.5 million or 9% of total loans and \$40.7 million, or 9% of total loans, respectively.

#### **Commercial Real Estate Lending**

Commercial real estate loans are secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches. At June 30, 2011, commercial real estate loans totaled \$195.8 million or 47% of the Bank's total loans, as compared to \$207.4 million, or 48%, at December 31, 2010. In its underwriting of commercial real estate, the Bank may lend, under federal regulation, up to 85% of the secured property's appraised value, although the Bank's loan to original appraised value ratio on such properties is typically 80% or less. Commercial real estate lending entails significant additional risk, compared with residential mortgage lending. Commercial real estate loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Additionally, the payment experience on loans secured by income producing



properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or in the economy, in general. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrowers' principal owners and carefully evaluates the location and environmental condition of the real estate collateral. To further mitigate risk, the Company monitors loan concentrations within the commercial real estate portfolio, including hotel loans, which totaled \$42.3 million, or 10%, of the Bank's total loans at June 30, 2011 compared to \$41.6 million, or 10%, of total loans at December 31, 2010.

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## **Table of Contents**

### **Construction Lending**

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. Construction and land development loans outstanding at June 30, 2011 and December 31, 2010, were \$50.7 million, or 12% of total loans, and \$52.6 million, or 12% of total loans, respectively. The majority of these loans have an average life of approximately one year and re-price monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans often involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is attributable to the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated prior to the completion of construction. Thus, it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank typically obtains a first lien on the property as security for its construction loans, requires personal guarantees from the borrower's principal owners, and monitors the progress of the construction project during the draw period.

### **Residential Real Estate Lending**

Residential lending activity may be generated by Bank loan officer solicitations, referrals by real estate professionals, and existing or new bank customers. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant. Residential mortgage loans generally are made on the basis of the borrower's ability to make repayment from employment and other income and are secured by real estate whose value tends to be readily ascertainable. In addition to the Bank's underwriting standards, loan quality may be analyzed based on guidelines issued by a secondary market investor. Typically, the Bank originates all fixed rate mortgage loans with the intent to sell to correspondent lenders. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans. At June 30, 2011, \$120.6 million, or 29%, of total loans consisted of residential real estate loans as compared to \$121.5 million, or 28%, at December 31, 2010.

In connection with residential real estate loans, the Bank requires title insurance, hazard insurance and, where applicable, flood insurance. Flood determination letters with life of loan tracking are obtained on all federally related transactions with improvements serving as security for the transaction. The Bank does require escrows for real estate taxes and insurance for secondary market loans.

The Company does not participate in sub-prime lending practices so issues in the residential mortgage market from sub-prime lending have not had, and are not expected to have, a direct impact on earnings. Nevertheless, the Company is subject to risks associated with general economic and business conditions in its market area, as well as the condition of the regional residential mortgage market, each of which has been impacted by sub-prime lending and related issues.

### **Consumer Lending**

The Bank offers various secured and unsecured consumer loans, including unsecured personal loans and lines of credit, automobile loans, deposit account loans and installment and demand loans. Consumer loans, including deposit overdraft balances, totaled \$12.9 million, or 3% of total loans for each period ending June 30, 2011 and December 31, 2010. Consumer loans may entail greater risk than residential mortgage loans, particularly in the case of consumer loans which are unsecured, such as lines of credit, or secured by rapidly depreciable assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. Consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

The underwriting standards employed by the Bank for consumer loans include a determination of the applicant's payment history on other debts and an assessment of ability to meet existing obligations and payments on a proposed loan. The stability of the applicant's monthly income may be determined by verification of gross monthly income from primary employment, and additionally from any verifiable secondary income. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes an analysis of the value of the collateral in relation to the proposed loan amount.

## **Results of Operations**

### **General**

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Net interest income represents the primary source of earnings for the Company. Net interest income equals the amount by which interest income on interest-earning assets, predominantly loans and securities, exceeds interest expense on interest-bearing liabilities, including deposits, other borrowings and trust preferred securities. Changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as their respective yields and rates, are the components that impact the level of net interest income. The net interest margin is calculated by dividing tax-equivalent net interest income by average earning assets. The provision for loan losses, noninterest income and noninterest expense are the other components that determine net income. Noninterest income and expense primarily consists of income from service charges on deposit accounts; fees charged for other customer services, including trust and investment advisory services; gains and losses from the sale of assets, including loans held for sale, securities, premises and equipment and other real estate owned; general and administrative expenses; and income tax expense.

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## Table of Contents

During the second quarter 2011, the Company recorded \$3.6 million in provision for loan losses which resulted in a loss of \$945 thousand. After the effective dividend on preferred stock, net loss available to common shareholders was \$1.2 million, or \$0.40 per basic and diluted share, compared to net income available to common shareholders of \$532 thousand, or \$0.18 per basic and diluted share, for the same period in 2010. Net interest income, noninterest income and noninterest expense were all relatively consistent when comparing the two periods. Return on assets and return on equity were -0.69% and -7.68%, respectively, for the second quarter of 2011 compared to 0.55% and 5.41% for the same quarter in 2010.

For the six months ended June 30, 2011, net income was \$58 thousand compared to \$1.8 million for the same period in 2010. After the effective dividend on preferred stock, net loss available to common shareholders was \$388 thousand, or \$0.13 per basic and diluted share, compared to net income available to common shareholders of \$1.3 million, or \$0.45 per basic and diluted share, for the same period in 2010. The decrease in earnings for the six months ended June 30, 2011 was primarily the result of a \$2.4 million increase in the provision for loan losses when comparing the periods. Return on assets was 0.02% for the six months ended June 30, 2011 compared to 0.65% for the same period in 2010, and return on equity was 0.24% for the six months ended June 30, 2011 compared to 6.42% for the same period in 2010.

### Net Interest Income

Comparing the quarter ended June 30, 2011 to the same period in 2010, net interest income remained stable at \$5.1 million. Average interest-earning assets were \$11.0 million higher when comparing the two periods. The net interest margin was 4.00% for the second quarter of 2011, compared to 4.11% for the same period in 2010. The slight decline in the margin resulted from a change in the earning asset mix. Loan balances were lower and cash, due from banks, federal funds sold and securities balances were higher in the second quarter of 2011 when compared to the same quarter in 2010.

Net interest income was relatively unchanged at \$10.0 million for the six months ended June 30, 2011 compared to \$10.1 million for the same period in 2010. The net interest margin was 12 basis points lower while average interest-earning assets were \$12.2 million higher when comparing the two periods. The net interest margin was 3.94% for the six months ended June 30, 2011, compared to 4.06% for the same period in 2010.

The Company does not expect a significant change in net interest income for the remainder of the year when compared to second quarter results. Net interest income is expected to be relatively unchanged as the net interest margin and average earning asset balances are projected to remain stable. The Company is not planning for economic conditions to improve significantly in the local market, which should result in low loan demand and deposit growth. As a result, the earning asset mix is expected to continue to change as loan balances continue decreasing while balances of securities increase. Even though the Company expects net interest margin pressure from this change in the earning asset mix, the Company plans to continue reallocating investments from interest-bearing deposits in banks and federal funds sold to investment securities, which will lessen the impact of the mix change. In addition, interest-bearing liabilities are expected to re-price slightly lower throughout the remainder of the year which should also mitigate margin pressure.

### Provision for Loan Losses

The provision for loan losses totaled \$3.6 million in the second quarter of 2011 compared to \$1.0 million for the same period in 2010. Net charge-offs were \$2.9 million for the second quarter of 2011 compared to \$531 thousand for the same period in 2010. The allowance for loan losses totaled \$13.8 million or 3.32% of total loans at June 30, 2011, compared to \$7.6 million or 1.73% of total loans at June 30, 2010. The higher provision was related to lower collateral values and an increase in charge-offs.

For the six months ended June 30, 2011, the loan loss provision totaled \$3.8 million compared to \$1.4 million for the same period in 2010. During 2011, the provision for loan losses was a result of lower loan collateral values and higher net charge-offs. Net charge-offs were \$6.1 million for the first half of 2011 compared to \$883 thousand for the same period in 2010. During 2010, the provision for loan losses resulted from unfavorable economic conditions, declines in collateral values and specific reserves on impaired loans.

Management believes that the allowance for loan losses provides prudent coverage of the risks in the loan portfolio. However, the amount of provision for loan losses will be influenced by collateral values and economic conditions, among other factors.

### Noninterest Income

Noninterest income totaled \$1.5 million for the second quarter of 2011, which was consistent with the same quarter of 2010. Trust and investment advisory fees increased \$90 thousand, or 31%, to \$384 thousand for the second quarter of 2011 compared to \$294 thousand for the same quarter of 2010. In addition, ATM and check card fees increased \$44 thousand, or 12%, to \$410 thousand for the second quarter of 2011,

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compared to \$366 thousand for the same period in 2010. This was related to an increase in ATM and check card transactions during the quarter. Service charges on deposit accounts decreased \$147 thousand, or 22%, to \$535 thousand for the second quarter of 2011 compared to \$682 thousand for the same quarter of 2010, as a result of a decrease in overdraft fee income.

Noninterest income decreased slightly to \$2.8 million for the six months ended June 30, 2011 from \$2.9 million for the same period in 2010. Increases in ATM, check card and trust and investment advisory fees were offset by a decrease in overdraft fee income.

## Table of Contents

Noninterest income levels are not expected to change significantly for the remainder of the year, when compared to second quarter results. Higher levels of ATM and check card fee income, and trust and advisory fee income are expected to continue offsetting lower levels of income from service charges on deposit accounts.

### Noninterest Expense

Noninterest expense was relatively unchanged at \$4.5 million for the second quarter of 2011 compared to the same period in 2010, resulting in an efficiency ratio of 67.58% compared to 67.22% for the prior year period.

The Company does not expect a significant change in noninterest expense, excluding provision for other real estate owned, for the remainder of 2011. Management believes that the carrying value of other real estate owned reflects current market conditions. However, the amount of provision for other real estate owned will be influenced by collateral values and economic conditions, among other factors. In addition, gains or losses that may occur from the sale of other real estate owned may be impacted by changes in market values.

### Income Taxes

The Company's income tax provision differed from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the three and six month periods ended June 30, 2011 and 2010. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income. A more detailed discussion of the Company's tax calculation is contained in Note 9 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

## **Financial Condition**

### General

Total assets were \$555.2 million at June 30, 2011 compared to \$544.6 million at December 31, 2010. The Company's trust and investment advisory group had assets under management of \$221.7 million at June 30, 2011 compared to \$205.5 million at December 31, 2010. Assets managed by the trust and investment advisory group are not held on the Company's balance sheet.

The Company is not planning for economic conditions to improve significantly in the local market, which should result in low loan demand and deposit growth. As a result, the earning asset mix is expected to change as loan balances continue decreasing while balances of securities increase.

### Loans

The Company, through its banking subsidiary, grants mortgage, commercial and consumer loans to customers. The bank segments its loan portfolio into real estate loans, commercial loans, and consumer loans. Real estate loans are further divided into the following classes: Construction; 1-4 family residential; and Other Real Estate Loans. Descriptions of the Company's loan classes are as follows:

**Commercial Loans:** Commercial loans are typically secured with non-real estate commercial property. The Company makes commercial loans primarily to businesses located within our market area.

**Real Estate Loans - Construction:** The Company originates construction loans for the acquisition and development of land and construction of condominiums, townhomes, and one-to-four family residences.

**Real Estate Loans - 1-4 Family:** This class of loans includes loans secured by one to four family homes. Typically, the Bank originates fixed rate mortgage loans with the intent to sell to correspondent lenders. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans.

**Real Estate Loans - Other:** This loan class consists primarily of loans secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches.

**Consumer Loans:** Consumer loans include all loans made to individuals for consumer or personal purposes. They include new and used automobile loans, unsecured loans and lines of credit.

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A substantial portion of the loan portfolio is represented by residential and commercial loans secured by real estate throughout the northern Shenandoah Valley region of Virginia. The ability of the Bank's debtors to honor their contracts is subject to the real estate and general economic conditions in this area.

The Company has a credit concentration in mortgage loans on real estate. These loans totaled \$367.1 million, or 88% of total loans at June 30, 2011 and \$381.5 million, or 88% of total loans at December 31, 2010. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations is influenced by local economic conditions.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$42.3 million at June 30, 2011, representing 87% of total equity and 10% of total loans. At December 31, 2010, this concentration totaled \$41.6 million representing 86% of total shareholders' equity and 10% of total loans. These loans are included in other real estate loans in the table found in Note 3 of the notes to consolidated

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## Table of Contents

financial statements of this Form 10-Q. The Company charged down \$1.5 million related to this concentration of credit risk during the six month period ended June 30, 2011 and \$147 thousand during the year ended December 31, 2010. The Company analyzes this concentration by performing interest rate and vacancy rate stress tests on a quarterly basis. In addition, occupancy reports are evaluated monthly to identify performance trend lines.

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

A loan's past due status is based on the contractual due date of the most delinquent payment due. Loans are generally placed on nonaccrual status when the collection of principal or interest is 90 days or more past due, or earlier, if collection is uncertain based on an evaluation of the net realizable value of the collateral and the financial strength of the borrower. Loans greater than 90 days past due may remain on accrual status if management determines it has adequate collateral to cover the principal and interest. For those loans that are carried on nonaccrual status, payments are first applied to principal outstanding. A loan may be returned to accrual status if the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms of the loan and there is reasonable assurance the borrower will continue to make payments as agreed. These policies are applied consistently across the loan portfolio.

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

Any unsecured loan that is over 120 days past due is charged-off in full. Any secured loan that is 120 days delinquent and is considered by management to be uncollectible is partially charged-off and carried at the fair value of the collateral less estimated selling costs. This charge-off policy applies to all loan segments.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value (net of selling costs), and the probability of collecting scheduled principal and interest payments when due. Additionally, management's policy is to evaluate substandard and doubtful loans greater than \$500 thousand for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair market value of the collateral, net of selling costs, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, residential and certain small commercial loans that are less than \$500 thousand for impairment disclosures, except for troubled debt restructurings (TDRs) as noted below.

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a TDR. TDRs are considered impaired loans. Upon designation as a TDR, the Company evaluates the borrower's payment history, past due status and ability to make payments based on the revised terms of the loan. If a loan was accruing prior to being modified as a TDR and if the Company concludes that the borrower is able to make such payments, and there are no other factors or circumstances that would cause it to conclude otherwise, the loan will remain on an accruing status. If a loan was on nonaccrual status at the time of the TDR, the loan will remain on nonaccrual status following the modification and may be returned to accrual status based on the policy for returning loans to accrual status as noted above.

## Asset Quality

Management classifies as nonperforming assets non-accrual loans and other real estate owned (OREO). OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. OREO is recorded at the lower of cost or market, less estimated selling costs, and is actively marketed by the Bank through brokerage channels. The Bank had \$5.7 million in OREO, net of the valuation allowance, at June 30, 2011 and \$4.0 million at December 31, 2010. The valuation allowance for other real estate owned totaled \$3.1 million at June 30, 2011 and \$3.3 million at December 31, 2010.



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Nonperforming assets were \$19.3 million at June 30, 2011, \$14.8 million at December 31, 2010 and \$14.3 million at June 30, 2010, representing 3.48%, 2.71% and 2.62% of total assets, respectively. Nonperforming assets included \$13.6 million in nonaccrual loans and \$5.7 million in OREO, net of the valuation allowance at June 30, 2011.

The levels of nonperforming assets in 2011 and 2010 were primarily attributable to weaker local economic conditions that negatively impacted the ability of certain borrowers to service debt. Borrowers that have not been able to meet their debt requirements are primarily business customers involved in retail operations and residential real estate development. At June 30, 2011, 40% of nonperforming assets related to commercial real estate loans, 38% related to residential

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## Table of Contents

development loans and 22% related to residential real estate loans. Nonperforming assets could increase due to other potential problem loans identified by management. Other potential problem loans are defined as performing loans that possess certain risks, including the borrower's ability to pay and the collateral value securing the loan, that management has identified that may result in the loans not being repaid in accordance with their terms. Other potential problem loans totaled \$54.7 million and \$73.3 million at June 30, 2011 and December 31, 2010, respectively. The amount of other potential problem loans in future periods will be dependent on economic conditions.

The allowance for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio. The allowance for loan losses totaled \$13.8 million at June 30, 2011 and \$16.0 million at December 31, 2010, representing 3.32% and 3.69% of total loans, respectively.

Impaired loans totaled \$33.9 million and \$43.9 million at June 30, 2011 and December 31, 2010, respectively. The related allowance for loan losses provided for these loans totaled \$6.0 million and \$8.6 million at June 30, 2011 and December 31, 2010, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2011 and the year ended December 31, 2010 was \$39.1 million and \$22.3 million, respectively. Included in the impaired loans total at June 30, 2011 are loans classified as TDRs totaling \$8.0 million. These loans represent situations in which a modification to the contractual interest rate or repayment structure has been granted to address a financial hardship. As of June 30, 2011, these TDRs were performing under the restructured terms and were not considered nonperforming assets.

Management believes, based upon its review and analysis, that the Bank has sufficient reserves to cover losses inherent within the loan portfolio. For each period presented, the provision for loan losses charged to expense was based on management's judgment after taking into consideration all factors connected with the collectability of the existing portfolio. Management considers economic conditions, historical loss factors, past due percentages, internally generated loan quality reports and other relevant factors when evaluating the loan portfolio. There can be no assurance, however, that an additional provision for loan losses will not be required in the future, including as a result of changes in the economic assumptions underlying management's estimates and judgments, adverse developments in the economy, on a national basis or in the Company's market area, or changes in the circumstances of particular borrowers. For further discussion regarding the allowance for loan losses, see Critical Accounting Policies above.

## Securities

Securities at June 30, 2011 were \$82.8 million, an increase of \$22.4 million, or 37%, from \$60.4 million at December 31, 2010. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. As of June 30, 2011, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios.

## Deposits

Deposits were \$476.5 million at June 30, 2011, an increase of 3% from \$463.5 million at December 31, 2010. Savings and interest-bearing demand deposits increased \$10.6 million or 6% to \$189.3 million at June 30, 2011 compared to \$178.7 million at December 31, 2010. Non-interest bearing demand deposits increased \$3.8 million or 5% to \$82.7 million during the first six months of 2011 from \$79.0 million at December 31, 2010. Time deposits, which include brokered deposits, decreased \$1.4 million or 1% during the first six months of 2011 to \$204.5 million compared to \$205.9 million at December 31, 2010.

## Liquidity

Liquidity represents the ability to meet present and future financial obligations through either the sale or maturity of existing assets or with borrowings from correspondent banks or other deposit markets. The Company classifies cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, investment securities and loans maturing within one year as liquid assets. As a result of the Bank's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Bank maintains overall liquidity sufficient to satisfy its depositors' requirements and to meet its customers' borrowing needs. As part of the Bank's liquidity risk management, stress tests and cash flow modeling are performed quarterly.

At June 30, 2011, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, loans maturing within one year, and expected maturities, calls and principal repayments from the securities portfolio within one year totaled \$135.5 million. At June 30, 2011, 25% or \$105.7 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled \$131.3 million at June 30, 2011, which included \$87.4 million available from FHLB, \$40.0 million of unsecured federal funds lines of credit with other correspondent banks and \$3.9 million available through the Federal Reserve Discount Window. During the first six months of 2011, other borrowing activity

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included repayment of a fixed rate advance from FHLB totaling \$10.0 million and borrowing Daily Rate Credit advances as an alternative to purchasing federal funds.

### Capital Resources

The adequacy of the Company's capital is reviewed by management on an ongoing basis with reference to the size, composition, and quality of the Company's asset and liability levels and consistent with regulatory requirements and industry standards. Management seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and absorb potential losses.

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## Table of Contents

In order to maintain solid capital levels in light of the current economic environment, the Company's Board of Directors determined in July 2011 to suspend cash dividends on the Company's common stock.

The Board of Governors of the Federal Reserve System has adopted capital guidelines to supplement the existing definitions of capital for regulatory purposes and to establish minimum capital standards. Specifically, the guidelines categorize assets and off-balance sheet items into four risk-weighted categories. The minimum ratio of qualifying total capital to risk-weighted assets is 8.00%, of which at least 4.00% must be Tier 1 capital, composed of common equity, retained earnings and a limited amount of perpetual preferred stock, less certain goodwill items. The Company had a ratio of total capital to risk-weighted assets of 14.31% at June 30, 2011 and a ratio of Tier 1 capital to risk-weighted assets of 13.04%. Both of these exceed the capital requirements adopted by the federal regulatory agencies.

On March 13, 2009, the Company entered into a Letter Agreement and Securities Purchase Agreement Standard Terms (collectively, the Purchase Agreement) with the Treasury Department, pursuant to which the Company sold (i) 13,900 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$1.25 per share and liquidation preference \$1,000 per share (the Preferred Stock) and (ii) a warrant (the Warrant) to purchase 695 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the Warrant Preferred Stock), at an exercise price of \$1.25 per share, for an aggregate purchase price of \$13.9 million in cash. The Treasury immediately exercised the Warrant and, after net settlement, received 695 shares of the Company's Warrant Preferred Stock, which has a liquidation preference amount of \$1,000 per share. Closing of the sale occurred on March 13, 2009 and increased Tier 1 and total capital by \$13.9 million. The Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years, and thereafter at a rate of 9% per annum. The Warrant Preferred Stock pays cumulative dividends at a rate of 9% per annum from the date of issuance.

### Contractual Obligations

There have been no material changes outside the ordinary course of business to the contractual obligations disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

### Off-Balance Sheet Arrangements

The Company, through the Bank, is a party to credit related financial instruments with risk not reflected in the consolidated financial statements in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policies in making commitments as it does for on-balance sheet instruments.

Commitments to extend credit, which amounted to \$52.1 million at June 30, 2011, and \$53.4 million at December 31, 2010, 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. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized as deemed necessary and might not be drawn upon to the total extent to which the Bank is committed.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. At June 30, 2011 and December 31, 2010, the Bank had \$6.5 million and \$6.9 million in outstanding standby letters of credit, respectively.

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The Company had \$150 thousand in locked-rate commitments to originate mortgage loans at June 30, 2011 and none at December 31, 2010. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Bank does not expect any counterparty to fail to meet its obligations.

### **Recent Accounting Pronouncements**

In January 2010, the Financial Accounting Standards Board (FASB) issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

**Table of Contents**

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The new disclosure guidance will significantly expand the existing requirements and will lead to greater transparency into a company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period became effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance rollforward and modification disclosures were required for periods beginning on or after December 15, 2010. The Company has included the required disclosures in its consolidated financial statements.

In March 2011, the SEC issued Staff Accounting Bulletin (SAB) 114. This SAB revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as a part of the FASB's Codification. The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing through the SAB Series. The effective date for SAB 114 is March 28, 2011. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*. The amendments in this ASU clarify the guidance on a creditor's evaluation of whether it has granted a concession to a debtor. They also clarify the guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulty. The amendments in this Update are effective for the first interim or annual period beginning on or after June 15, 2011. Early adoption is permitted. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, an entity may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company does not expect the adoption of the new guidance to have a material impact on its 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 IFRS*. This ASU is the result of joint efforts by the FASB and 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 IFRS. The amendments are effective for interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The Company is currently assessing the impact that ASU 2011-04 will have on its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220) Presentation of Comprehensive Income*. The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years beginning after December 15, 2011. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. The Company is currently assessing the impact that ASU 2011-05 will have on its consolidated financial statements.

The SEC has issued Final Rule No. 33-9002, *Interactive Data to Improve Financial Reporting*, which requires companies to submit financial statements in XBRL (extensible business reporting language) format with their SEC filings on a phased-in schedule. Large accelerated filers and foreign large accelerated filers using U.S. GAAP were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2010. All remaining filers are required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2011. The Company complied with this Rule with the filing of this June 30, 2011 Form 10-Q.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not required.



## **Table of Contents**

### **Item 4. Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to provide assurance that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods required by the SEC. An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2011 was carried out under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer. Based on and as of the date of such evaluation, the aforementioned officers concluded that the Company's disclosure controls and procedures were effective.

The Company's management is also responsible for establishing and maintaining adequate internal control over financial reporting. There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation of it that occurred during the Company's last fiscal quarter that materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

There are no material pending legal proceedings, other than ordinary routine litigation incidental to the Company's business, to which the Company is a party or to which the property of the Company is subject.

### **Item 1A. Risk Factors**

Other than as set forth below, there were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2010.

*Concerns regarding downgrade of the U.S. credit rating could have a material adverse effect on our business, financial condition and liquidity.*

On August 5, 2011, Standard & Poor's lowered its long term sovereign credit rating on the United States of America from AAA to AA+. On August 8, 2011, Standard & Poor's downgraded the credit ratings of certain long-term debt instruments issued by Fannie Mae and Freddie Mac and other U.S. government agencies linked to long-term U.S. debt. These downgrades could have a material adverse impact on financial markets and economic conditions in the United States generally, the market value of such instruments and the credit risk associated with State governments such as Virginia that have significant economic relationships with the U.S. government. Debt instruments of this nature are key assets on the balance sheets of financial institutions, including ours. In turn, the market's anticipation of these impacts could have a material adverse effect on our business, financial condition and liquidity and could exacerbate the other risks to which we are subject, including those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

### **Item 3. Defaults upon Senior Securities**

None

### **Item 4. Removed and Reserved**

None

### **Item 5. Other Information**

None

### **Item 6. Exhibits**



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The following documents are attached hereto as Exhibits:

- 3.1 Bylaws, as restated in electronic format only as of August 3, 2011 (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on August 8, 2011).
- 10.1 Employment Agreement, dated May 9, 2011, by and between First National Corporation and Scott C. Harvard, incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on May 9, 2011.
- 31.1 Certification of Chief Executive Officer, Section 302 Certification
- 31.2 Certification of Chief Financial Officer, Section 302 Certification
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
- 101 The following materials from First National Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Cash Flows, (iv) Consolidated Statements of Changes in Shareholders' Equity, and (v) Notes to Consolidated Financial Statements.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**FIRST NATIONAL CORPORATION**

(Registrant)

/s/ Scott C. Harvard  
Scott C. Harvard  
President and Chief Executive Officer

August 12, 2011  
Date

/s/ M. Shane Bell  
M. Shane Bell  
Executive Vice President and Chief Financial Officer

August 12, 2011  
Date

**Table of Contents**

**EXHIBIT INDEX**

Number	Document
3.1	Bylaws, as restated in electronic format only as of August 3, 2011 (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on August 8, 2011).
10.1	Employment Agreement, dated May 9, 2011, by and between First National Corporation and Scott C. Harvard, incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on May 9, 2011.
31.1	Certification of Chief Executive Officer, Section 302 Certification
31.2	Certification of Chief Financial Officer, Section 302 Certification
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101	The following materials from First National Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Cash Flows, (iv) Consolidated Statements of Shareholders' Equity, and (v) Notes to Consolidated Financial Statements.