

FIRST NATIONAL CORP /VA/  
Form 10-Q  
August 14, 2015  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2015**

**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)**

<b>Virginia</b> <b>(State or other jurisdiction of</b>	<b>54-1232965</b> <b>(I.R.S. Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>
<b>112 West King Street, Strasburg, Virginia</b> <b>(Address of principal executive offices)</b>	<b>22657</b> <b>(Zip Code)</b>
<b>(540) 465-9121</b>	
<b>(Registrant's telephone number, including area code)</b>	

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 14, 2015, 4,911,648 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

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**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, 2015	December 31, 2014
<b>Assets</b>		
Cash and due from banks	\$ 11,870	\$ 6,043
Interest-bearing deposits in banks	99,274	18,802
Securities available for sale, at fair value	112,468	83,292
Securities held to maturity, at carrying value (fair value, 2015, \$36,851; 2014, \$0)	37,343	
Restricted securities, at cost	1,391	1,366
Loans held for sale	1,978	328
Loans, net of allowance for loan losses, 2015, \$6,129; 2014, \$6,718	385,592	371,692
Other real estate owned, net of valuation allowance, 2015, \$137; 2014, \$375	2,407	1,888
Premises and equipment, net	21,277	16,126
Accrued interest receivable	1,423	1,261
Bank owned life insurance	11,521	11,357
Core deposit intangibles, net	2,765	55
Other assets	6,518	5,955
<b>Total assets</b>	<b>\$ 695,827</b>	<b>\$ 518,165</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 147,790	\$ 104,986
Savings and interest-bearing demand deposits	322,239	237,618
Time deposits	150,853	101,734
<b>Total deposits</b>	<b>\$ 620,882</b>	<b>\$ 444,338</b>
Federal funds purchased		52
Other borrowings	13	26

Trust preferred capital notes	9,279	9,279
Accrued interest payable and other liabilities	6,214	4,906
<b>Total liabilities</b>	<b>\$ 636,388</b>	<b>\$ 458,601</b>
<b>Shareholders Equity</b>		
Preferred stock, \$1,000 per share liquidation preference; authorized 1,000,000 shares; 14,595 shares issued and outstanding	\$ 14,595	\$ 14,595
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2015, 4,910,826 shares; 2014, 4,904,577 shares	6,139	6,131
Surplus	6,899	6,835
Retained earnings	33,642	33,557
Accumulated other comprehensive loss, net	(1,836)	(1,554)
<b>Total shareholders equity</b>	<b>\$ 59,439</b>	<b>\$ 59,564</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 695,827</b>	<b>\$ 518,165</b>

*See Notes to Consolidated Financial Statements*

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

Three months ended June 30, 2015 and 2014

*(in thousands, except per share data)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 4,688	\$ 4,403
Interest on deposits in banks	68	14
Interest and dividends on securities available for sale:		
Taxable interest	540	562
Tax-exempt interest	78	95
Dividends	18	21
Total interest and dividend income	\$ 5,392	\$ 5,095
<b>Interest Expense</b>		
Interest on deposits	\$ 266	\$ 372
Interest on federal funds purchased	1	
Interest on trust preferred capital notes	55	54
Interest on other borrowings	2	30
Total interest expense	\$ 324	\$ 456
Net interest income	\$ 5,068	\$ 4,639
Recovery of loan losses	(100)	(400)
Net interest income after recovery of loan losses	\$ 5,168	\$ 5,039
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 752	\$ 643
ATM and check card fees	497	365
Wealth management fees	499	472
Fees for other customer services	184	126
Income from bank owned life insurance	90	89

Net gains on sale of securities available for sale		22
Net gains on sale of loans	50	
Other operating income	237	8
<b>Total noninterest income</b>	<b>\$ 2,309</b>	<b>\$ 1,725</b>

**Noninterest Expense**

Salaries and employee benefits	\$ 3,597	\$ 2,554
Occupancy	339	278
Equipment	422	295
Marketing	163	126
Stationery and supplies	229	94
Legal and professional fees	431	247
ATM and check card fees	190	163
FDIC assessment	64	122
Bank franchise tax	130	105
Telecommunications expense	100	73
Data processing expense	226	134
Postage expense	80	49
Amortization expense	196	4
Other real estate owned expense (income), net	152	(70)
Other operating expense	536	374
<b>Total noninterest expense</b>	<b>\$ 6,855</b>	<b>\$ 4,548</b>



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

(Continued)

Three months ended June 30, 2015 and 2014

*(in thousands, except per share data)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
Income before income taxes	\$ 622	\$ 2,216
Income tax expense	178	674
<b>Net income</b>	<b>\$ 444</b>	<b>\$ 1,542</b>
Effective dividend and accretion on preferred stock	328	261
<b>Net income available to common shareholders</b>	<b>\$ 116</b>	<b>\$ 1,281</b>
<b>Earnings per common share</b>		
Basic	\$ 0.02	\$ 0.26
Diluted	\$ 0.02	\$ 0.26

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2015 and 2014

*(in thousands, except per share data)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 9,228	\$ 8,618
Interest on deposits in banks	73	30
Interest and dividends on securities available for sale:		
Taxable interest	898	1,124
Tax-exempt interest	142	190
Dividends	39	42
Total interest and dividend income	\$ 10,380	\$ 10,004
<b>Interest Expense</b>		
Interest on deposits	\$ 566	\$ 772
Interest on federal funds purchased	2	
Interest on trust preferred capital notes	109	108
Interest on other borrowings	3	59
Total interest expense	\$ 680	\$ 939
Net interest income	\$ 9,700	\$ 9,065
Recovery of loan losses	(100)	(600)
Net interest income after recovery of loan losses	\$ 9,800	\$ 9,665
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 1,299	\$ 1,273
ATM and check card fees	846	700
Wealth management fees	1,002	956
Fees for other customer services	291	213
Income from bank owned life insurance	164	163

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Net gains (losses) on sale of securities available for sale	(52)	22
Net gains on sale of loans	105	
Other operating income	245	14
<b>Total noninterest income</b>	<b>\$ 3,900</b>	<b>\$ 3,341</b>

**Noninterest Expense**

Salaries and employee benefits	\$ 6,722	\$ 5,063
Occupancy	656	593
Equipment	703	599
Marketing	260	235
Stationery and supplies	574	174
Legal and professional fees	643	449
ATM and check card fees	345	326
FDIC assessment	131	294
Bank franchise tax	252	199
Telecommunications expense	185	144
Data processing expense	413	249
Postage expense	197	89
Amortization expense	200	8
Other real estate owned expense (income), net	116	(39)
Net loss on disposal of premises and equipment		2
Other operating expense	945	776
<b>Total noninterest expense</b>	<b>\$ 12,342</b>	<b>\$ 9,161</b>

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

(Continued)

Six months ended June 30, 2015 and 2014

*(in thousands, except per share data)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
Income before income taxes	\$ 1,358	\$ 3,845
Income tax expense	370	1,157
<b>Net income</b>	<b>\$ 988</b>	<b>\$ 2,688</b>
Effective dividend and accretion on preferred stock	657	481
<b>Net income available to common shareholders</b>	<b>\$ 331</b>	<b>\$ 2,207</b>
<b>Earnings per common share</b>		
Basic	\$ 0.07	\$ 0.45
Diluted	\$ 0.07	\$ 0.45

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Consolidated Statements of Comprehensive Income (Loss)**

Three months ended June 30, 2015 and 2014

*(in thousands)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
Net income	\$ 444	\$ 1,542
Other comprehensive income (loss), net of tax		
Unrealized holding (losses) gains on available for sale securities, net of tax of (\$457) and \$239, respectively	(886)	465
Reclassification adjustment for gains included in net income, net of tax of \$0 and (\$7), respectively		(15)
Total other comprehensive income (loss)	(886)	450
Total comprehensive income (loss)	\$ (442)	\$ 1,992

*See Notes to Consolidated Financial Statements*

**Table of Contents****FIRST NATIONAL CORPORATION****Consolidated Statements of Comprehensive Income**

Six months ended June 30, 2015 and 2014

*(in thousands)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
Net income	\$ 988	\$ 2,688
Other comprehensive income (loss), net of tax		
Unrealized holding (losses) gains on available for sale securities, net of tax of (\$164) and \$471, respectively	(316)	915
Reclassification adjustment for losses (gains) included in net income, net of tax of \$18 and (\$7), respectively	34	(15)
Total other comprehensive income (loss)	(282)	900
Total comprehensive income	\$ 706	\$ 3,588

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2015 and 2014

*(in thousands)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 988	\$ 2,688
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	566	494
Amortization of core deposit intangibles	200	8
Origination of loans held for sale	(7,781)	
Proceeds from sale of loans held for sale	6,236	
Net gains on sales of loans held for sale	(105)	
Recovery of loan losses	(100)	(600)
Provision for other real estate owned	137	86
Net (gains) losses on sale of securities available for sale	52	(22)
Net gains on sale of other real estate owned	(72)	(160)
Losses on disposal of premises and equipment		2
Income from bank owned life insurance	(164)	(163)
Accretion of discounts and amortization of premiums on securities, net	311	322
Accretion of premium on time deposits	81	
Stock-based compensation	52	
Bargain purchase gain on branch acquisition	(201)	
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	(162)	44
(Increase) decrease in other assets	(302)	334
Increase (decrease) in other liabilities	1,290	(1,137)
Net cash provided by operating activities	\$ 1,026	\$ 1,896
<b>Cash Flows from Investing Activities</b>		
Proceeds from sales of securities available for sale	\$	\$ 3,453
Proceeds from maturities, calls, and principal payments of securities available for sale	7,690	6,247
Proceeds from maturities, calls, and principal payments of securities held to maturity	240	
Purchase of securities available for sale	(37,638)	(14,219)

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Purchase of securities held to maturity	(37,602)	
Proceeds from redemption of restricted securities	638	168
Purchase of restricted securities	(663)	
Purchase of premises and equipment	(1,222)	(160)
Proceeds from sale of other real estate owned	354	1,021
Net increase in loans	(14,738)	(10,574)
Acquisition of branches, net of cash paid	179,501	

Net cash provided by (used in) investing activities \$ 96,560 \$ (14,064)

**Cash Flows from Financing Activities**

Net increase in demand deposits and savings accounts	\$ 1,528	\$ 8,370
Net decrease in time deposits	(11,867)	(7,883)
Proceeds from other borrowings	15,000	
Principal payments on other borrowings	(15,013)	(13)
Cash dividends paid on preferred stock	(657)	(379)
Cash dividends paid on common stock, net of reinvestment	(226)	(113)
Decrease in federal funds purchased	(52)	

Net cash used in financing activities \$ (11,287) \$ (18)



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

(Continued)

Six months ended June 30, 2015 and 2014

*(in thousands)*

	(unaudited) June 30, 2015	(unaudited) June 30, 2014
Increase (decrease) in cash and cash equivalents	\$ 86,299	\$ (12,186)
<b>Cash and Cash Equivalents</b>		
Beginning	24,845	31,508
Ending	\$ 111,144	\$ 19,322
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 617	\$ 965
Income Taxes	\$ 752	\$ 321
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized gains on securities available for sale	\$ 428	\$ 1,364
Transfer from loans to other real estate owned	\$ 938	\$ 139
Issuance of common stock, dividend reinvestment plan	\$ 17	\$ 9
<b>Transactions Related to Acquisition</b>		
Assets acquired	\$ 193,638	\$
Liabilities assumed	186,819	
Net assets acquired	\$ 6,819	\$

*See Notes to Consolidated Financial Statements*

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## FIRST NATIONAL CORPORATION

## Consolidated Statements of Changes in Shareholders' Equity

Six months ended June 30, 2015 and 2014

*(in thousands)**(unaudited)*

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
<b>Balance, December 31, 2013</b>	\$ 14,564	\$ 6,127	\$ 6,813	\$ 27,360	\$ (1,304)	\$ 53,560
Net income				2,688		2,688
Other comprehensive income					900	900
Cash dividends on common stock (\$0.025 per share)				(122)		(122)
Issuance of 1,118 shares common stock, dividend reinvestment plan		1	8			9
Cash dividends on preferred stock				(379)		(379)
Accretion of preferred stock discount	31			(31)		
<b>Balance, June 30, 2014</b>	\$ 14,595	\$ 6,128	\$ 6,821	\$ 29,516	\$ (404)	\$ 56,656

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
<b>Balance, December 31, 2014</b>	\$ 14,595	\$ 6,131	\$ 6,835	\$ 33,557	\$ (1,554)	\$ 59,564
Net income				988		988
Other comprehensive loss					(282)	(282)
Cash dividends on common stock (\$0.05 per share)				(246)		(246)
Stock-based compensation			52			52
Issuance of 2,067 shares common stock, dividend reinvestment plan		3	17			20
Issuance of 4,182 shares common stock, stock incentive plan		5	(5)			

Cash dividends on preferred stock (657) (657)

<b>Balance, June 30, 2015</b>	\$ 14,595	\$ 6,139	\$ 6,899	\$ 33,642	\$ (1,836)	\$ 59,439
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*See Notes to Consolidated Financial Statements*

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**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, 2015 and December 31, 2014, the results of operations and comprehensive income (loss) for the three and six months ended June 30, 2015 and 2014 and the cash flows and changes in shareholders' equity for the six months ended June 30, 2015 and 2014. 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, 2014. Operating results for the three and six month periods ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015.

**Recent Accounting Pronouncements**

In June 2014, the FASB issued ASU No. 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The adoption of ASU 2014-11 did not have an impact on the Company's consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-12, *Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*. The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in *Compensation - Stock*

Compensation (Topic 718) , should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company does not expect the adoption of ASU 2014-12 to have an impact on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern . This update is intended to provide guidance about management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have an impact on its consolidated financial statements.

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

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

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

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

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



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

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

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

**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 at June 30, 2015 and December 31, 2014 were as follows (in thousands):

	June 30, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	\$ 97,013	\$ 289	\$ (1,082)	\$ 96,220
Obligations of states and political subdivisions	16,084	253	(96)	16,241
Corporate equity securities	1	6		7
<b>Total securities available for sale</b>	<b>\$ 113,098</b>	<b>\$ 548</b>	<b>\$ (1,178)</b>	<b>\$ 112,468</b>

Securities held to maturity:

U.S. agency and mortgage-backed securities	\$ 30,376	\$	\$ (404)	\$ 29,972
Obligations of states and political subdivisions	6,967		2 (90)	6,879
<b>Total securities held to maturity</b>	<b>\$ 37,343</b>	<b>\$</b>	<b>2 (494)</b>	<b>\$ 36,851</b>
<b>Total securities</b>	<b>\$ 150,441</b>	<b>\$</b>	<b>550 (1,672)</b>	<b>\$ 149,319</b>

		December 31, 2014		
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
<b>Securities available for sale:</b>				
U.S. agency and mortgage-backed securities	\$ 67,462	\$ 374	\$ (807)	\$ 67,029
Obligations of states and political subdivisions	16,031	325	(99)	16,257
Corporate equity securities	1	5		6
<b>Total securities available for sale</b>	<b>\$ 83,494</b>	<b>\$ 704</b>	<b>\$ (906)</b>	<b>\$ 83,292</b>

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At June 30, 2015 and December 31, 2014, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

	Less than 12 months		June 30, 2015 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
<b>Securities available for sale:</b>						
U.S. agency and mortgage-backed securities	\$ 46,557	\$ (537)	\$ 20,815	\$ (545)	\$ 67,372	\$ (1,082)
Obligations of states and political subdivisions	5,176	(48)	1,049	(48)	6,225	(96)
<b>Total securities available for sale</b>	<b>\$ 51,733</b>	<b>\$ (585)</b>	<b>\$ 21,864</b>	<b>\$ (593)</b>	<b>\$ 73,597</b>	<b>\$ (1,178)</b>
<b>Securities held to maturity:</b>						
U.S. agency and mortgage-backed securities	\$ 26,882	\$ (404)	\$	\$	\$ 26,882	\$ (404)
Obligations of states and political subdivisions	4,563	(90)			4,563	(90)
<b>Total securities held to maturity</b>	<b>\$ 31,445</b>	<b>\$ (494)</b>	<b>\$</b>	<b>\$</b>	<b>\$ 31,445</b>	<b>\$ (494)</b>
<b>Total securities</b>	<b>\$ 83,178</b>	<b>\$ (1,079)</b>	<b>\$ 21,864</b>	<b>\$ (593)</b>	<b>\$ 105,042</b>	<b>\$ (1,672)</b>

	Less than 12 months		December 31, 2014 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
<b>Securities available for sale:</b>						
U.S. agency and mortgage-backed securities	\$ 8,677	\$ (60)	\$ 32,527	\$ (747)	\$ 41,204	\$ (807)
Obligations of states and political subdivisions	715	(1)	2,841	(98)	3,556	(99)

Total securities available for sale	\$ 9,392	\$ (61)	\$ 35,368	\$ (845)	\$ 44,760	\$ (906)
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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, does not expect to be required to sell these securities, and expects to recover the entire amortized cost of all the securities.

At June 30, 2015, there were forty-seven U.S. agency and mortgage-backed securities and twenty-four obligations 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 4.7 years at June 30, 2015. At December 31, 2014, there were twenty-nine U.S. agency and mortgage-backed securities and seven obligations of states and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio was considered investment grade at December 31, 2014. The weighted-average re-pricing term of the portfolio was 3.9 years at December 31, 2014. The unrealized losses at June 30, 2015 in the U.S. agency and mortgage-backed securities portfolio and the obligation of states and political subdivisions portfolio were related to changes in market interest rates and not credit concerns of the issuers.

The amortized cost and fair value of securities at June 30, 2015 by contractual maturity are shown below (in thousands). Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties. Corporate equity securities are not included in the maturity categories in the following maturity summary because they do not have a stated maturity date.

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	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	\$	\$	\$	\$
Due after one year through five years	6,945	6,976		
Due after five years through ten years	21,699	21,557	10,062	9,890
Due after ten years	84,453	83,929	27,281	26,961
Corporate equity securities	1	6		
	\$ 113,098	\$ 112,468	\$ 37,343	\$ 36,851

Federal Home Loan Bank, Federal Reserve Bank and Community Bankers Bank stock are generally viewed as long-term investments and as restricted securities, which are carried at cost, because there is a minimal market for the stock. Therefore, when evaluating restricted securities for impairment, their value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider these investments to be other-than-temporarily impaired at June 30, 2015, and no impairment has been recognized. Restricted securities are not part of the securities portfolio.

The composition of restricted securities at June 30, 2015 and December 31, 2014 was as follows (in thousands):

	June 30, 2015	December 31, 2014
Federal Home Loan Bank stock	\$ 466	\$ 470
Federal Reserve Bank stock	875	846
Community Bankers Bank stock	50	50
	\$ 1,391	\$ 1,366

**Note 3. Loans**

Loans at June 30, 2015 and December 31, 2014 are summarized as follows (in thousands):

June 30, 2015	December 31, 2014
------------------	----------------------

Real estate loans:		
Construction and land development	\$ 32,009	\$ 29,475
Secured by 1-4 family residential	173,265	163,727
Other real estate loans	155,396	151,802
Commercial and industrial loans	19,319	21,166
Consumer and other loans	11,732	12,240
<b>Total loans</b>	<b>\$ 391,721</b>	<b>\$ 378,410</b>
Allowance for loan losses	(6,129)	(6,718)
<b>Loans, net</b>	<b>\$ 385,592</b>	<b>\$ 371,692</b>

Net deferred loan costs included in the above loan categories were \$138 thousand and \$130 thousand at June 30, 2015 and December 31, 2014, respectively. Consumer and other loans included \$419 thousand and \$285 thousand of demand deposit overdrafts at June 30, 2015 and December 31, 2014, respectively.

Risk characteristics of each loan portfolio class that are considered by the Company include:

1-4 family residential mortgage loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.

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Real estate construction and land development loans carry risks that the project may not be finished according to schedule, the project may 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 or other factors unrelated to the project.

Other real estate 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.

Commercial and industrial loans carry risks associated with the successful operation of a business because repayment of these loans may be dependent upon the profitability and cash flows of the business. 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 reliability.

Consumer and other loans carry risk associated with the continued creditworthiness of the borrower and the value of the collateral, i.e. rapidly depreciating assets such as automobiles, or lack thereof. Consumer loans are likely to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy, or other changes in circumstances.

The following table provides a summary of loan classes and an aging of past due loans as of June 30, 2015 and December 31, 2014 (in thousands):

June 30, 2015

								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	Current	Total Loans	Non-accrual Loans	

Real estate loans:

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Construction and land development	\$ 809	\$ 595	\$	\$ 1,404	\$ 30,605	\$ 32,009	\$ 1,979	\$
1-4 family residential	773	345	384	1,502	171,763	173,265	520	129
Other real estate loans	258	454	2,569	3,281	152,115	155,396	4,047	374
Commercial and industrial	50		108	158	19,161	19,319	120	92
Consumer and other loans	3		5	8	11,724	11,732		5
<b>Total</b>	<b>\$ 1,893</b>	<b>\$ 1,394</b>	<b>\$ 3,066</b>	<b>\$ 6,353</b>	<b>\$ 385,368</b>	<b>\$ 391,721</b>	<b>\$ 6,666</b>	<b>\$ 600</b>

December 31, 2014

	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
<b>Real estate loans:</b>								
Construction and land development	\$ 2,441	\$ 71	\$	\$ 2,512	\$ 26,963	\$ 29,475	\$ 1,787	\$
1-4 family residential	504	323	754	1,581	162,146	163,727	1,342	
Other real estate loans	554	800	2,519	3,873	147,929	151,802	4,756	
Commercial and industrial	10	106		116	21,050	21,166	115	
Consumer and other loans	14			14	12,226	12,240		
<b>Total</b>	<b>\$ 3,523</b>	<b>\$ 1,300</b>	<b>\$ 3,273</b>	<b>\$ 8,096</b>	<b>\$ 370,314</b>	<b>\$ 378,410</b>	<b>\$ 8,000</b>	<b>\$</b>



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**Notes to Consolidated Financial Statements**

*(unaudited)*

**Credit Quality Indicators**

As part of the ongoing 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 credit 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:

**Pass** Loans classified as pass exhibit acceptable operating trends, balance sheet trends, and liquidity. Sufficient cash flow exists to service the loan. All obligations have been paid by the borrower as agreed.

**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 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 weaknesses 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 non-accrual status.

**Loss** Loans classified as loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted.

The following tables provide an analysis of the credit risk profile of each loan class as of June 30, 2015 and December 31, 2014 (in thousands):

June 30, 2015

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	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$ 22,807	\$ 4,376	\$ 4,826	\$	\$ 32,009
Secured by 1-4 family residential	164,075	4,840	4,350		173,265
Other real estate loans	135,661	11,625	8,110		155,396
Commercial and industrial	18,575	437	307		19,319
Consumer and other loans	11,732				11,732
<b>Total</b>	<b>\$ 352,850</b>	<b>\$ 21,278</b>	<b>\$ 17,593</b>	<b>\$</b>	<b>\$ 391,721</b>

	December 31, 2014				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$ 20,476	\$ 2,962	\$ 6,037	\$	\$ 29,475
Secured by 1-4 family residential	152,004	5,058	6,665		163,727
Other real estate loans	126,211	14,776	10,815		151,802
Commercial and industrial	20,428	463	275		21,166
Consumer and other loans	12,240				12,240
<b>Total</b>	<b>\$ 331,359</b>	<b>\$ 23,259</b>	<b>\$ 23,792</b>	<b>\$</b>	<b>\$ 378,410</b>

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 4. Allowance for Loan Losses**

The following tables present, as of June 30, 2015, December 31, 2014 and June 30, 2014, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology (in thousands):

	June 30, 2015					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2014	\$ 1,403	\$ 1,204	\$ 3,658	\$ 310	\$ 143	\$ 6,718
Charge-offs		(47)	(471)	(59)	(206)	(783)
Recoveries	2	83	1	62	146	294
Provision for (recovery of) loan losses	204	(314)	(16)	(55)	81	(100)
Ending Balance, June 30, 2015	\$ 1,609	\$ 926	\$ 3,172	\$ 258	\$ 164	\$ 6,129
<b>Ending Balance:</b>						
Individually evaluated for impairment	437	79	1,025	22		1,563
Collectively evaluated for impairment	1,172	847	2,147	236	164	4,566
<b>Loans:</b>						
Ending Balance	32,009	173,265	155,396	19,319	11,732	391,721
Individually evaluated for impairment	3,319	2,387	4,944	120		10,770
Collectively evaluated for impairment	28,690	170,878	150,452	19,199	11,732	380,951

	December 31, 2014					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2013	\$ 2,710	\$ 2,975	\$ 4,418	\$ 442	\$ 99	\$ 10,644
Charge-offs	(91)	(272)	(203)	(43)	(318)	(927)
Recoveries	80	15	509	18	229	851
Provision for (recovery of) loan losses	(1,296)	(1,514)	(1,066)	(107)	133	(3,850)
Ending Balance, December 31, 2014	\$ 1,403	\$ 1,204	\$ 3,658	\$ 310	\$ 143	\$ 6,718
<b>Ending Balance:</b>						
Individually evaluated for impairment	245	173	1,456	33		1,907
Collectively evaluated for impairment	1,158	1,031	2,202	277	143	4,811
<b>Loans:</b>						
Ending Balance	29,475	163,727	151,802	21,166	12,240	378,410
Individually evaluated for impairment	3,205	3,414	7,183	120		13,922
Collectively evaluated for impairment	26,270	160,313	144,619	21,046	12,240	364,488

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	June 30, 2014					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2013	\$ 2,710	\$ 2,975	\$ 4,418	\$ 442	\$ 99	\$ 10,644
Charge-offs		(104)	(203)	(36)	(202)	(545)
Recoveries	40	7	339	3	118	507
Provision for (recovery of) loan losses	(636)	18	(167)	65	120	(600)
Ending Balance, June 30, 2014	\$ 2,114	\$ 2,896	\$ 4,387	\$ 474	\$ 135	\$ 10,006
<b>Ending Balance:</b>						
Individually evaluated for impairment	779	126	911	57		1,873
Collectively evaluated for impairment	1,335	2,770	3,476	417	135	8,133
<b>Loans:</b>						
Ending Balance	32,795	151,043	146,483	24,797	12,372	367,490
Individually evaluated for impairment	6,427	3,297	9,994	164		19,882
Collectively evaluated for impairment	26,368	147,746	136,489	24,633	12,372	347,608

Impaired loans and the related allowance at June 30, 2015, December 31, 2014 and June 30, 2014, were as follows (in thousands):

	June 30, 2015					
Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized

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Real estate loans:							
Construction and land development	\$ 3,464	\$ 2,684	\$ 635	\$ 3,319	\$ 437	\$ 3,165	\$ 31
Secured by 1-4 family	2,476	2,155	232	2,387	79	2,864	57
Other real estate loans	5,416	2,453	2,491	4,944	1,025	6,828	34
Commercial and industrial	130	16	104	120	22	137	2
Consumer and other loans							
<b>Total</b>	<b>\$ 11,486</b>	<b>\$ 7,308</b>	<b>\$ 3,462</b>	<b>\$ 10,770</b>	<b>\$ 1,563</b>	<b>\$ 12,994</b>	<b>\$ 124</b>

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	December 31, 2014						
	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 and land development	\$ 3,299	\$ 2,800	\$ 405	\$ 3,205	\$ 245	\$ 5,532	\$ 40
Secured by 1-4 family	4,327	2,526	888	3,414	173	3,433	138
Other real estate loans	7,623	3,708	3,475	7,183	1,456	10,115	206
Commercial and industrial	127	5	115	120	33	159	1
Consumer and other loans							
<b>Total</b>	<b>\$ 15,376</b>	<b>\$ 9,039</b>	<b>\$ 4,883</b>	<b>\$ 13,922</b>	<b>\$ 1,907</b>	<b>\$ 19,239</b>	<b>\$ 385</b>

	June 30, 2014						
	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 and land development	\$ 8,746	\$ 4,022	\$ 2,405	\$ 6,427	\$ 779	\$ 6,607	\$ 21
Secured by 1-4 family	4,230	2,766	531	3,297	126	3,248	62
Other real estate loans	10,501	7,347	2,647	9,994	911	10,998	125
Commercial and industrial	170	11	153	164	57	185	1
Consumer and other loans							
<b>Total</b>	<b>\$ 23,647</b>	<b>\$ 14,146</b>	<b>\$ 5,736</b>	<b>\$ 19,882</b>	<b>\$ 1,873</b>	<b>\$ 21,038</b>	<b>\$ 209</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 non-accrual loans.

As of June 30, 2015, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled \$1.6 million. At June 30, 2015, \$324 thousand of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were \$1.9 million in TDRs at December 31, 2014, \$790 thousand of which were performing under the restructured terms. Modified terms under TDRs may include rate reductions, extension of terms that are considered to be below market, conversion to interest only, and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. There were no loans modified under TDRs during the three and six month periods ended June 30, 2015 and the three month period ended June 30, 2014. There was one other real estate loan classified as a TDR during the six month period ended June 30, 2014 because the loan term was extended at a below market rate of interest. The recorded investment for this loan prior to the modification totaled \$283 thousand and the recorded investment after the modification totaled \$344 thousand.

For the three and six months ended June 30, 2015 and 2014, there were no troubled debt restructurings that subsequently defaulted within twelve months of the loan modification. Management defines default as over ninety days past due or the foreclosure and repossession of the collateral and charge-off of the loan during the twelve month period subsequent to the modification.



**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 5. Other Real Estate Owned (OREO)**

At June 30, 2015 and December 31, 2014, OREO totaled \$2.4 million and \$1.9 million, respectively. OREO is primarily comprised of residential lots, raw land, non-residential properties and residential properties, and are located primarily in the Commonwealth of Virginia. Changes in the balance for OREO are as follows (in thousands):

	For the six months ended June 30, 2015	For the year ended December 31, 2014
Balance at the beginning of year, gross	\$ 2,263	\$ 4,695
Transfers in	938	139
Charge-offs	(375)	(1,302)
Sales proceeds	(354)	(1,502)
Gain on disposition	72	307
Deferred gain recognized		(73)
Depreciation		(1)
Balance at the end of period, gross	\$ 2,544	\$ 2,263
Less: valuation allowance	(137)	(375)
Balance at the end of period, net	\$ 2,407	\$ 1,888

At June 30, 2015, the carrying amount of residential real estate properties included in OREO was \$245 thousand. There were no residential real estate properties included in OREO at December 31, 2014. The recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings were in process was \$23 thousand as of June 30, 2015.

Changes in the valuation allowance are as follows (in thousands):

For the six months ended	For the year ended
-----------------------------	-----------------------

	June 30, 2015	June 30, 2014	December 31, 2014
Balance at beginning of year	\$ 375	\$ 1,665	\$ 1,665
Provision for losses	137	86	12
Charge-offs, net	(375)	(163)	(1,302)
Balance at end of period	\$ 137	\$ 1,588	\$ 375

Net expenses applicable to OREO, other than the provision for losses, were \$51 thousand and \$35 thousand for the six months ended June 30, 2015 and 2014, respectively and \$81 thousand for the year ended December 31, 2014.

#### **Note 6. Other Borrowings**

The Bank had unused lines of credit totaling \$154.3 million and \$121.1 million available with non-affiliated banks at June 30, 2015 and December 31, 2014, respectively. These amounts primarily consist of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta in which the Bank can borrow up to 19% of its total assets. The unused line of credit with FHLB totaled \$109.1 million at June 30, 2015.

The Bank had a letter of credit from the FHLB totaling \$23.0 million at June 30, 2015 and December 31, 2014. The Bank had collateral pledged on the borrowing line and the letter of credit at June 30, 2015 and December 31, 2014 including real estate loans totaling \$103.8 million and \$101.9 million, respectively, and Federal Home Loan Bank stock with a book value of \$466 thousand and \$470 thousand, respectively.

At June 30, 2015 and December 31, 2014, the Bank had a note payable totaling \$13 and \$26 thousand, respectively, secured by a deed of trust, for land purchased to construct a banking office, which requires monthly payments of \$2 thousand and matures January 3, 2016. The fixed interest rate on this loan was 4.00%.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 7. Capital Requirements**

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total (as defined in the regulations), Tier 1 (as defined), and common equity Tier 1 capital (as defined) to risk-weighted assets (as defined), and of Tier 1 capital to average assets. Management believes, as of June 30, 2015 and December 31, 2014, that the Bank met all capital adequacy requirements to which it is subject.

As of June 30, 2015, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum risk-based capital and leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

A comparison of the capital of the Bank at June 30, 2015 and December 31, 2014 with the minimum regulatory guidelines were as follows (dollars in thousands):

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>June 30, 2015:</b>						
Total Capital (to Risk-Weighted Assets)	\$ 72,362	18.28%	\$ 31,666	8.00%	\$ 39,582	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 67,400	17.03%	\$ 23,749	6.00%	\$ 31,666	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$ 67,400	17.03%	\$ 17,812	4.50%	\$ 25,729	6.50%

Tier 1 Capital (to Average Assets)	\$ 67,400	10.06%	\$ 26,794	4.00%	\$ 33,493	5.00%
<b>December 31, 2014:</b>						
Total Capital (to Risk-Weighted Assets)	\$ 71,941	19.14%	\$ 30,077	8.00%	\$ 37,596	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 67,217	17.88%	\$ 15,038	4.00%	\$ 22,557	6.00%
Tier 1 Capital (to Average Assets)	\$ 67,217	12.90%	\$ 20,841	4.00%	\$ 26,051	5.00%

**Note 8. Trust Preferred Capital Notes**

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, 2015 and December 31, 2014 was 2.88% and 2.84%, respectively. 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. The Company is current on its interest payments on the trust preferred securities.

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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 LIBOR-indexed floating rate of interest. The interest rate at June 30, 2015 and December 31, 2014 was 1.87% and 1.84%, respectively. The securities have a mandatory redemption date of October 1, 2036, and were subject to varying call provisions that began 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. The Company is current on its interest payments on the trust preferred securities.

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, 2015 and December 31, 2014, the total amount of trust preferred securities issued by the Trusts was included in the Company's Tier 1 capital.

**Note 9. 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. Effective May 1, 2011, the plan was frozen to new participants. Only individuals employed on or before April 30, 2011 were eligible to become participants in the plan upon satisfaction of the eligibility requirements. 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, 2015 and 2014 were as follows (in thousands):

	For the three months ended June 30,		For the six months ended June 30,	
	2015	2014	2015	2014
Service cost	\$ 112	\$ 87	\$ 223	\$ 174
Interest cost	75	67	151	134
Expected return on plan assets	(78)	(79)	(157)	(158)

Amortization of net loss		21		43
Net periodic benefit cost	\$	130	\$	75
	\$	260	\$	150

The Company expects to make no contribution to its pension plan during the year ended December 31, 2015. There was no minimum annual contribution required.

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. See Note 12 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 for additional information about the Company's benefit plans.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 10. 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.

The following table presents the computation of basic and diluted earnings per share for the three and six months ended June 30, 2015 and 2014 (dollars in thousands, except per share data):

	For the three months ended		For the six months ended	
	June 30, 2015	June 30, 2014	June 30, 2015	June 30, 2014
<b>(Numerator):</b>				
Net income	\$ 444	\$ 1,542	\$ 988	\$ 2,688
Effective dividend and accretion on preferred stock	328	261	657	481
Net income available to common shareholders	\$ 116	\$ 1,281	\$ 331	\$ 2,207
<b>(Denominator):</b>				
Weighted average shares outstanding basic	4,909,775	4,901,599	4,908,386	4,901,532
Potentially dilutive common shares restricted stock units	1,523		2,793	
Weighted average shares outstanding diluted	4,911,298	4,901,599	4,911,179	4,901,532
<b>Income per common share</b>				
Basic	\$ 0.02	\$ 0.26	\$ 0.07	\$ 0.45
Diluted	\$ 0.02	\$ 0.26	\$ 0.07	\$ 0.45

**Note 11. 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 an instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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



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**Fair Value Hierarchy**

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

- Level 1 Valuation is based on quoted prices in active markets for identical assets or 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 within 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 or 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.

An 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 assets recorded at fair value on a recurring basis in the financial statements:

**Securities available for sale**

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

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The following tables present the balances of assets measured at fair value on a recurring basis as of June 30, 2015 and December 31, 2014 (in thousands).

Description	Balance as of June 30, 2015	Fair Value Measurements at June 30, 2015		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Securities available for sale</b>				
U.S. agency and mortgage-backed securities	\$ 96,220	\$	\$ 96,220	\$
Obligations of states and political subdivisions	16,241		16,241	
Corporate equity securities	7	7		
	\$ 112,468	\$ 7	\$ 112,461	\$

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Description	Fair Value Measurements at December 31, 2014			
	Balance as of December 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 67,029	\$	\$ 67,029	\$
Obligations of states and political subdivisions	16,257		16,257	
Corporate equity securities	6	6		
	\$ 83,292	\$ 6	\$ 83,286	\$

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 six months ended June 30, 2015 and the year ended December 31, 2014.

**Impaired Loans**

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected. The

measurement of loss associated with impaired loans can be based on the present value of expected future cash flows discounted at the loan's effective interest rate, the observable market price of the loan, or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data (Level 2) within the last twelve months. However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

#### Other real estate owned

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 appraisal documents and assessed the same way as impaired loans described above.

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The following tables summarize the Company's assets that were measured at fair value on a nonrecurring basis during the periods (dollars in thousands):

Description	Fair Value Measurements at June 30, 2015			
	Balance as of June 30, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	\$ 1,899	\$	\$	\$ 1,899
Other real estate owned, net	2,407			2,407

Description	Fair Value Measurements at December 31, 2014			
	Balance as of December 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans, net	\$ 2,976	\$	\$	\$ 2,976
Other real estate owned, net	1,888			1,888

Quantitative information about Level 3 Fair Value Measurements for June 30, 2015				
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Impaired loans, net	\$ 1,899	Property appraisals	Selling cost	0-10% (7%)
			Property condition	0-13% (1%)

Other real estate owned, net	\$ 2,407	Property appraisals	Selling cost	7%
			Property condition	0-7% (2%)

Quantitative information about Level 3 Fair Value Measurements for December 31, 2014

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Impaired loans, net	\$ 2,976	Property appraisals	Selling cost	10%
Other real estate owned, net	\$ 1,888	Property appraisals	Selling cost	7%

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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 and Federal Funds Sold**

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

**Securities Held to Maturity**

Certain debt securities that management has the positive intent and ability to hold until maturity are recorded at amortized cost. Fair values are determined in a manner that is consistent with securities available for sale.

**Restricted Securities**

The carrying value of restricted securities approximates fair value based on redemption.

**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 non-performing 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**

Accrued interest receivable and payable were estimated to equal the carrying value due to the short-term nature of these financial instruments.

### **Borrowings and Federal Funds Purchased**

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.

### **Bank Owned Life Insurance**

Bank owned life insurance represents insurance policies on officers, directors, and past directors of the Company. The cash values of these policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

### **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, 2015 and December 31, 2014, fair value of loan commitments and standby letters of credit was immaterial.



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The carrying values and estimated fair values of the Company's financial instruments at June 30, 2015 and December 31, 2014 are as follows (in thousands):

	Carrying Amount	Fair Value Measurements at June 30, 2015 Using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>Financial Assets</b>					
Cash and short-term investments	\$ 111,144	\$ 111,144	\$	\$	\$ 111,144
Securities available for sale	112,468	7	112,461		112,468
Securities held to maturity	37,343		36,851		36,851
Restricted securities	1,391		1,391		1,391
Loans held for sale	1,978		1,978		1,978
Loans, net	385,592			392,974	392,974
Bank owned life insurance	11,521		11,521		11,521
Accrued interest receivable	1,423		1,423		1,423
<b>Financial Liabilities</b>					
Deposits	\$ 620,882	\$	\$ 470,029	\$ 149,446	\$ 619,475
Other borrowings	13			13	13
Trust preferred capital notes	9,279			9,147	9,147
Accrued interest payable	117		117		117

## Fair Value Measurements at December 31, 2014 Using

	Carrying Amount	Fair Value Measurements at December 31, 2014 Using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	

**Financial Assets**

Cash and short-term investments	\$ 24,845	\$ 24,845	\$	\$	\$ 24,845
Securities	83,292	6	83,286		83,292
Restricted securities	1,366		1,366		1,366
Loans held for sale	328		328		328
Loans, net	371,692			378,930	378,930
Bank owned life insurance	11,357		11,357		11,357
Accrued interest receivable	1,261		1,261		1,261

**Financial Liabilities**

Deposits	\$ 444,338	\$	\$ 342,604	\$ 101,606	\$ 444,210
Federal funds purchased	52		52		52
Other borrowings	26			26	26
Trust preferred capital notes	9,279			9,756	9,756
Accrued interest payable	135		135		135

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**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 with terms that mitigate the Company's overall interest rate risk.

**Note 12. Preferred Stock**

The Company has (i) 13,900 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a par value of \$1.25 per share and liquidation preference of \$1,000 per share (the Preferred Stock) and (ii) 695 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series B, with a par value of \$1.25 per share and liquidation preference of \$1,000 per share (the Warrant Preferred Stock). The Preferred Stock paid cumulative dividends at a rate of 5% per annum until May 14, 2014, 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 was fully amortized over a five year period through March 12, 2014, using the constant effective yield method.

**Note 13. Stock Compensation Plans**

On May 13, 2014, the Company's shareholders approved the First National Corporation 2014 Stock Incentive Plan, which makes available up to 240,000 shares of common stock for the granting of stock options, restricted stock awards, stock appreciation rights and other stock-based awards. Awards are made at the discretion of management and compensation cost equal to the fair value of the award is recognized over the vesting period.

**Restricted Stock Units**

Restricted stock units are an award of units that correspond in number and value to a specified number of shares of employer stock which the recipient receives according to a vesting plan and distribution schedule after achieving required performance milestones or upon remaining with the employer for a particular length of time. Each restricted stock unit that vests entitles the recipient to receive one share of common stock on a specified issuance date.

In the first quarter of 2015, 12,546 restricted stock units were granted to employees, with 4,182 units vesting immediately and 8,364 units subject to a two year vesting schedule with one half of the units vesting each year on the grant date anniversary. The recipient does not have any stockholder rights, including voting, dividend or liquidation rights, with respect to the shares underlying awarded restricted stock units until vesting has occurred and the recipient

becomes the record holder of those shares. The unvested restricted stock units will vest on the established schedule if the employees remain employed by the Company on future vesting dates.

A summary of the activity for the Company's restricted stock units for the period indicated is presented in the following table:

	June 30, 2015	Weighted Average Grant Date Fair Value
	Shares	Value
Balance at January 1, 2015		\$
Granted	12,546	9.00
Vested	(4,182)	9.00
Forfeited		
Balance at June 30, 2015	8,364	\$ 9.00

At June 30, 2015, based on restricted stock unit awards outstanding at that time, the total unrecognized pre-tax compensation expense related to unvested restricted stock unit awards was \$61 thousand. This expense is expected to be recognized through 2017. Compensation expense recognized for the six months ended June 30, 2015 totaled \$52 thousand. As of June 30, 2015, the Company does not expect the forfeiture of any unvested restricted stock units.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 14. Accumulated Other Comprehensive Loss**

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

	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Loss
<b>Balance at December 31, 2013</b>	\$ (1,129)	\$ (175)	\$ (1,304)
Unrealized holding gains (net of tax, \$471)	915		915
Reclassification adjustment (net of tax, \$7)	(15)		(15)
Change during period	900		900
<b>Balance at June 30, 2014</b>	\$ (229)	\$ (175)	\$ (404)
<b>Balance at December 31, 2014</b>	\$ (133)	\$ (1,421)	\$ (1,554)
Unrealized holding losses (net of tax, (\$164))	(316)		(316)
Reclassification adjustment (net of tax, \$18)	34		34
Change during period	(282)		(282)
<b>Balance at June 30, 2015</b>	\$ (415)	\$ (1,421)	\$ (1,836)

The following tables present information related to reclassifications from accumulated other comprehensive loss for the three and six month periods ended June 30, 2015 and 2014 (in thousands):

Details About Accumulated Other Comprehensive Loss Amount Reclassified from Affected Line Item in the	Accumulated	Consolidated
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	Other Comprehensive Loss <b>For the three months ended June 30, 2015      2014</b>		Statements of Income
<b>Securities available for sale:</b>			
Net securities gains reclassified into earnings			Net gains on sale of securities available for sale
	\$	\$ (22)	
Related income tax expense		7	Income tax expense
Total reclassifications	\$	\$ (15)	Net of tax

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss <b>For the six months ended June 30, 2015      2014</b>		Affected Line Item in the Consolidated Statements of Income
<b>Securities available for sale:</b>			
Net securities (gains) losses reclassified into earnings			Net gains (losses) on sale of securities available for sale
	\$ 52	\$ (22)	
Related income tax expense (benefit)	(18)	7	Income tax expense
Total reclassifications	\$ 34	\$ (15)	Net of tax

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 15. Acquisition**

On April 17, 2015, the Bank completed its acquisition of six branch banking operations located in Virginia from Bank of America, National Association (the Acquisition). The Bank paid cash of \$6.6 million for the deposits and premises and equipment. The Bank acquired all related premises and equipment valued at \$4.5 million and assumed \$186.8 million of deposit liabilities. No loans were acquired in the transaction.

The transaction was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed, and consideration exchanged were recorded at estimated fair values on the acquisition date. Fair values are preliminary and subject to refinement for up to one year after the closing date of the Acquisition as additional information regarding the closing date fair values becomes available. The Bank engaged third party specialists to assist in valuing certain assets, including the real estate, core deposit intangible, and goodwill (bargain purchase gain) that resulted from the Acquisition.

The following table provides a preliminary assessment of the consideration transferred, assets purchased, and the liabilities assumed (in thousands):

	As Recorded by Bank of America	Fair Value and Other Merger Related Adjustments	As Recorded by the Company
<b>Consideration paid:</b>			
Cash paid			\$ 6,618
<b>Total consideration</b>			<b>\$ 6,618</b>
<b>Assets acquired:</b>			
Cash and cash equivalents	\$ 186,119	\$	\$ 186,119
Premises and equipment, net	2,165	2,330	4,495
Other assets	114		114
Core deposit intangibles		2,910	2,910
<b>Total assets acquired</b>	<b>\$ 188,398</b>	<b>\$ 5,240</b>	<b>\$ 193,638</b>

**Liabilities assumed:**

Deposits	\$ 186,119	\$ 683	\$ 186,802
Other liabilities	17		17

<b>Total liabilities assumed</b>	<b>\$ 186,136</b>	<b>\$ 683</b>	<b>\$ 186,819</b>
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**Net identifiable assets acquired over liabilities assumed**

	\$ 2,262	\$ 4,557	\$ 6,819
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<b>Goodwill (bargain purchase gain)</b>			<b>\$ (201)</b>
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The bargain purchase gain from the transaction may have resulted from Bank of America's decision to no longer operate bank branches in certain markets and their willingness to sell the related premises and equipment lower than fair value.

**Note 16. Subsequent Event**

On August 12, 2015, the Board of Directors of the Company declared a quarterly cash dividend of \$0.025 per common share, which is payable on September 18, 2015 to shareholders of record as of September 4, 2015.



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**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, adequacy of capital, 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 words 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:

conditions in the financial markets and economic conditions may adversely affect the Company's business;

the inability of the Company to successfully manage its growth or implement its growth strategy;

difficulties in combining the operations of acquired bank branches or entities with the Company's own operations;

the Company's inability to successfully obtain the expected benefits of the acquisition of bank branches;

intense competition from other financial institutions both in making loans and attracting deposits;

consumers may increasingly decide not to use the Bank to complete their financial transactions;

limited availability of financing or inability to raise capital;

exposure to operational, technological, and organizational risk;

reliance on other companies to provide key components of their business infrastructure;

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

operational functions of business counterparties over which the Company may have limited or no control may experience disruptions;

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

allowance for loan losses may prove to be insufficient to absorb losses in the loan portfolio;

the concentration in loans secured by real estate may adversely affect earnings due to changes in the real estate markets;

legislative or regulatory changes or actions, or significant litigation;

the limited trading market for the Company's common stock; it may be difficult to sell shares;

unexpected loss of management personnel;

losses that could arise from breaches in cyber-security;

increases in FDIC insurance premiums could adversely affect the Company's profitability;

the ability to retain customers and secondary funding sources if the Bank's reputation would become damaged;

changes in interest rates could have a negative impact on the Company's net interest income and an unfavorable impact on the Bank's customers' ability to repay loans; and

other factors identified in Item 1A. Risk Factors of the Company's Form 10-K for the year ending December 31, 2014.

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 at June 30, 2015 and results of operations of the Company for the three and six month periods ended June 30, 2015 and 2014 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, 2014. The results of operations for the three and six month periods ended June 30, 2015 may not be indicative of the results to be achieved for the year.

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### **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 entities 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.

#### Acquisition of Branches

On April 17, 2015, the Bank expanded its branch network in the Shenandoah Valley and central Virginia regions through the acquisition of six bank branches from Bank of America, National Association located in Woodstock, Staunton, Elkton, Waynesboro, Farmville and Dillwyn, Virginia (the Acquisition). The Acquisition included the purchase of \$2.2 million of premises and equipment and the assumption of \$186 million of deposit liabilities. No loans were purchased in the transaction. Upon completion of the Acquisition, the Bank hired all 36 of the employees working at the six acquired branches. During second quarter of 2015, the Bank also hired a regional president and two market executives in the new markets. As a result of the transaction, the Bank increased the number of bank branch locations from 10 to 16, in addition to its two existing loan production offices in the cities of Harrisonburg and Staunton, Virginia, and its customer service center located in a retirement community in Winchester, Virginia.

#### Products, Services, Customers and Locations

The Bank provides loan, deposit, wealth management and other products and services in the Shenandoah Valley and central regions 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's wealth management division offers estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, estate settlement, 401(k) and benefit plans. In addition, the division offers financial planning and brokerage services to individuals throughout the Bank's market area.

The Bank launched a new mortgage division named First Mortgage during the second quarter of 2014. The mortgage division began originating residential mortgage loans to customers in the third quarter of 2014. The majority of loans originated in future periods through this division are expected to be sold to investors in the secondary market. First Mortgage offers mortgage services to customers throughout the Bank's market area.

The Bank's office locations are well-positioned in strong markets along the Interstate 81, Interstate 66 and Interstate 64 corridors in the Shenandoah Valley and central regions of Virginia. Within this market area, there are various types of industry including medical and professional services, manufacturing, retail, government contracting and higher education. Customers include individuals, small and medium-sized businesses, local governmental entities and non-profit organizations.

The Bank's products and services are delivered through 16 branch offices, 1 customer service center, 2 loan production offices, 31 ATMs, internet banking, mobile banking and remote deposit capture. The branch offices are comprised of 14 full service retail banking offices and two drive-thru retail banking offices. Full service retail banking offices offer all of the Bank's financial services at one location, which allows loan, deposit, and wealth management personnel to be readily available to serve customers throughout the Bank's market area. The location and general character of the properties owned prior to the Acquisition is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2014.

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**Table of Contents****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 70% and 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 deposits, fee income from wealth management services and ATM and check card fees.

The provision for loan losses and noninterest expense are generally the two major expense categories. The provision is determined by factors that include net charge-offs, asset quality, economic conditions and loan growth. 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 or recovery of loan losses. The largest component of noninterest expense for the six month period ended June 30, 2015 was salaries and employee benefits, comprising 54% of noninterest expenses, followed by occupancy and equipment expense, comprising 11% of noninterest expenses.

**Quarterly Performance**

For the three months ended June 30, 2015, net income totaled \$444 thousand compared to \$1.5 million for the same period in 2014. After the effective dividend on preferred stock, net income available to common shareholders was \$116 thousand, or \$0.02 per basic and diluted share, compared to \$1.3 million, or \$0.26 per basic and diluted share, for the same period in 2014. Return on average assets and return on average equity were 0.27% and 2.97%, respectively, for the second quarter of 2015 compared to 1.16% and 11.05% for the same quarter in 2014. Net income for the second quarter of 2015 was negatively impacted by integration expenses of \$458 thousand and other operating costs related to the Acquisition, which was completed on April 17, 2015. The integration expenses primarily included legal and professional fees, stationery and supplies expense, data processing expense, and postage expense.

Net interest income increased 9%, or \$429 thousand to \$5.1 million for the quarter ended June 30, 2015, compared to \$4.6 million for the second quarter of 2014. The net interest margin was 3.29% for the second quarter of 2015 compared to 3.81% for the same period in 2014. The increase in net interest income was the result of higher balances of earning assets as loan balances, interest-bearing deposits, and securities increased, combined with a lower cost of funds, when comparing the periods. The Bank recorded a recovery of loan losses \$100 thousand during the second quarter, compared to a recovery of loan losses of \$400 thousand for the same quarter in 2014. Noninterest income increased \$584 thousand, or 34%, to \$2.3 million for the second quarter, compared to \$1.7 million for the same period one year ago. The increase in noninterest income was primarily attributable to increased revenue from service charges on deposit accounts and ATM and check card fees resulting from an increase in the number of deposit accounts following the branch expansion. Noninterest income also included a \$201 thousand gain recorded in other operating income from the Acquisition. Noninterest expense increased \$2.3 million, or 51%, to \$6.9 million for the quarter compared to \$4.5 million for the same period in 2014. The increase in expenses was primarily attributable to higher salaries and employee benefit costs, integration expenses related to the Acquisition, and increased operating costs from execution of the Company's growth strategy, which included the expansion of its banking franchise into new markets and the creation of new business lines to increase and diversify revenue.

**Year-to-Date Performance**

Net income totaled \$988 thousand for the six months ended June 30, 2015 compared to \$2.7 million for the same period in 2014. After the effective dividend on preferred stock, net income available to common shareholders was \$331 thousand, or \$0.07 per basic and diluted share, compared to \$2.2 million, or \$0.45 per basic and diluted share, for the same period in 2014. Return on average assets and return on average equity were 0.34% and 3.32%, respectively, for the six months ended June 30, 2015 compared to 1.03% and 9.81% for the same period in 2014.

For the six months ended June 30, 2015, net interest income increased 7%, or \$635 thousand, compared to the same period of 2014. The net interest margin was 3.58% for the six months ended June 30, 2015 compared to 3.77% for the same period in 2014. The Bank recorded a recovery of loan losses of \$100 thousand, compared to a recovery of loan losses of \$600 thousand for the same period one year ago. Noninterest income increased \$559 thousand, or 17%, to \$3.9 million compared to \$3.3 million when comparing the two periods. Noninterest expense increased \$3.2 million, or 35%, to \$12.3 million compared to \$9.2 million for the same period in 2014.

**Table of Contents****Non-GAAP Financial Measures**

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO income/(expense) and losses on disposal of premises and equipment, by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding securities (gains) losses and bargain purchase gain. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes, however, such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under GAAP. The components of the efficiency ratio calculation are summarized in the following table (dollars in thousands).

	<b>Efficiency Ratio</b>			
	For the three months ended		For the six months ended	
	June 30, 2015	June 30, 2014	June 30, 2015	June 30, 2014
Noninterest expense	\$ 6,855	\$ 4,548	\$ 12,342	\$ 9,161
Add/(Subtract): other real estate owned income/(expense), net	(152)	70	(116)	39
Subtract: losses on disposal of premises and equipment, net				(2)
	\$ 6,703	\$ 4,618	\$ 12,226	\$ 9,198
Tax-equivalent net interest income	\$ 5,135	\$ 4,716	\$ 9,826	\$ 9,219
Noninterest income	2,309	1,725	3,900	3,341
Add/(Subtract): securities (gains) losses, net		(22)	52	(22)
Subtract: bargain purchase gain	(201)		(201)	
	\$ 7,243	\$ 6,419	\$ 13,577	\$ 12,538
Efficiency ratio	92.54%	71.94%	90.05%	73.36%

This report also refers to net interest margin, which 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 each of 2015 and 2014 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 (in thousands).

**Reconciliation of Net Interest Income to  
Tax-Equivalent Net Interest Income**

For the three months ended For the six months ended

	June 30, 2015	June 30, 2014	June 30, 2015	June 30, 2014
<b>GAAP measures:</b>				
Interest income - loans	\$ 4,688	\$ 4,403	\$ 9,228	\$ 8,618
Interest income - investments and other	704	692	1,152	1,386
Interest expense - deposits	(266)	(372)	(566)	(772)
Interest expense - other borrowings	(2)	(30)	(3)	(59)
Interest expense - trust preferred capital notes	(55)	(54)	(109)	(108)
Interest expense - other	(1)		(2)	
<b>Total net interest income</b>	<b>\$ 5,068</b>	<b>\$ 4,639</b>	<b>\$ 9,700</b>	<b>\$ 9,065</b>
<b>Non-GAAP measures:</b>				
Tax benefit realized on non-taxable interest income - loans	\$ 27	\$ 28	\$ 53	\$ 56
Tax benefit realized on non-taxable interest income - municipal securities	40	49	73	98
<b>Total tax benefit realized on non-taxable interest income</b>	<b>\$ 67</b>	<b>\$ 77</b>	<b>\$ 126</b>	<b>\$ 154</b>
<b>Total tax-equivalent net interest income</b>	<b>\$ 5,135</b>	<b>\$ 4,716</b>	<b>\$ 9,826</b>	<b>\$ 9,219</b>



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### **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 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.

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 determines that the loan balance is uncollectible. 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 in this Form 10-Q.

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 Company performs regular credit reviews of the loan portfolio to review credit quality and adherence to underwriting standards. The credit reviews consist of reviews by its internal credit administration department and reviews performed by an independent third party. Upon origination, each loan is assigned a risk rating ranging from one to nine, with loans closer to one having less risk. This risk rating scale is our primary credit quality indicator. The Company has various committees that review and ensure that the allowance for loans losses methodology is in accordance with GAAP and loss factors used appropriately reflect the risk characteristics of the loan portfolio.

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. The evaluation also considers the following risk characteristics of each loan portfolio class:

1-4 family residential mortgage loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.

Real estate construction and land development loans carry risks that the project may not be finished according to schedule, the project may 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 or other factors unrelated to the project.

Other real estate 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.

Commercial and industrial loans carry risks associated with the successful operation of a business because repayment of these loans may be dependent upon the profitability and cash flows of the business. 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 reliability.

Consumer and other loans carry risk associated with the continued creditworthiness of the borrower and the value of the collateral, i.e. rapidly depreciating assets such as automobiles, or lack thereof. Consumer loans are likely to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy, or other changes in circumstances.

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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 is ordered if a current one is not on file. Appraisals are 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 among other considerations.

The general component covers loans that are not considered impaired and is based on historical loss experience adjusted for qualitative factors. The historical loss experience is calculated by loan type and uses an average loss rate during the preceding twelve quarters. The qualitative factors are assigned by management based on delinquencies and asset quality, national and local economic trends, effects of the changes in the value of underlying collateral, trends in volume and nature of loans, effects of changes in the 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 type. The general allowance estimates 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. For further information regarding the allowance for loan losses see Note 4 to the Consolidated Financial Statements.

## Other Real Estate Owned (OREO)

Other real estate owned (OREO) consists of properties obtained through a foreclosure proceeding or through an in-substance foreclosure in satisfaction of loans and properties originally acquired for branch expansion but no longer intended to be used for that purpose. OREO is reported at the lower of cost or fair value less costs to sell, determined on the basis of current appraisals, comparable sales, and other estimates of fair value obtained principally from independent sources, adjusted for estimated selling costs. Management also considers other factors or recent developments, such as changes in absorption rates or market conditions from the time of valuation and anticipated sales values considering management's plans for disposition, which could result in adjustments to the collateral value estimates indicated in the appraisals. Significant judgments and complex estimates are required in estimating the fair value of other real estate, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. In response to market conditions and other economic factors, management may utilize liquidation sales as part of its distressed asset disposition strategy. As a result of the significant judgments required in estimating fair value and the variables involved in different methods of disposition, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other real estate. Management reviews the value of other real estate each quarter and adjusts the values as appropriate. Revenue and expenses from operations and changes in the valuation allowance are included in other real estate owned expenses.

## Business Combinations

Business combinations are accounted for under ASC 805, *Business Combinations*, using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company will continue to rely on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analyses or other valuation techniques. The determination of fair values requires management to make estimates about future cash flows, market conditions and other events, which are highly subjective in nature. Under the acquisition method of accounting, the Company will identify the acquirer and the closing date and apply applicable recognition principles and conditions.

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

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### **Lending Policies**

#### General

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 new loans up to their authority. The Board Loan Committee approves all loans which exceed the authority of the Management Loan Committee. The full Board of Directors must approve loans which exceed the authority of the Board Loan Committee, up to the Bank's legal lending limit. The Board Loan Committee currently consists of four directors, three of which are non-management directors. The Board Loan Committee approves the Bank's Loan Policy and reviews the loan watch list, concentrations of credit and other risk 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 real estate loan originations are obtained through direct solicitation and additional business from existing 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. Loan quality is analyzed based on the Bank's experience and credit underwriting guidelines depending on the type of loan involved. Real estate collateral is valued by independent appraisers who have been pre-approved by the Board Loan Committee.

As part of the ongoing 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 in order to ensure standards of quality are met. The Company also obtains an independent review of loans within the 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 which are disclosed but not reflected in its financial statements, including commitments to extend credit. At June 30, 2015, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$73.2 million.

#### Construction and Land Development 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. The majority of these loans has 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 sometimes involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated based on the completion of construction. Thus, there is risk associated with failure to complete construction and potential cost overruns. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of the 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, typically requires personal guarantees from the borrower's principal owners, and typically monitors the progress of the construction project during the draw period.

#### 1-4 Family Residential Real Estate Lending

1-4 family 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 payments 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. The valuation of residential collateral is generally provided by independent fee appraisers who have been approved by the Board Loan Committee. In addition to originating fixed rate mortgage loans with the intent to sell to correspondent lenders or broker to wholesale lenders, the Bank originates balloon and other mortgage loans for the portfolio. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans.

#### 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. Commercial real estate loan originations are obtained through direct solicitation of customers and potential

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customers. The valuation of commercial real estate collateral is provided by independent appraisers who have been approved by the Board Loan Committee. 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, the borrower's creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrower's principal owners and considers the valuation of the real estate collateral.

### **Commercial and Industrial Lending**

Commercial and industrial 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 reliability as residential 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.

### **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 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**

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, noninterest expense and income tax expense are the other components that determine net income. Noninterest income and expense primarily consists of income from service charges on deposit accounts; revenue from wealth management services; ATM and check card income; revenue from other customer services; income from bank owned life insurance; gains on sales of loans; general and administrative expenses and other real estate owned expenses.

#### Net Interest Income

Net interest income totaled \$5.1 million for the second quarter of 2015, which was a 9% increase when compared to \$4.6 million for the same period in 2014. The net interest margin decreased to 3.29% from 3.81% and average earning assets were \$128.9 million higher when comparing the periods. The impact of the higher interest-earning assets was partially offset by the impact of the lower net interest margin on net interest income. Interest-earning asset yields decreased 68 basis points while the cost of funds, including noninterest-bearing deposits, decreased 18 basis points, which resulted in a lower net interest margin



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for the second quarter of 2015 compared to the same quarter in 2014. The decrease in interest-earning asset yields was primarily attributable to a significant change in the earning asset mix that occurred from the receipt of cash in the Acquisition that the company has not yet deployed into higher yielding assets. Average interest-bearing deposits with other institutions increased \$85.8 million and average total securities increased \$9.0 million, compared to the same period in 2014. The increases in average interest-bearing deposits with other institutions and total securities were funded by cash received from the Acquisition. The decrease in the cost of funds was also primarily attributable to the Acquisition. Lower yields from deposits assumed in the Acquisition decreased the total cost of funds of the Company in the second quarter of 2015.

For the six months ended June 30, 2015, net interest income totaled \$9.7 million, which was a 7% increase when compared to the same period a year ago. The net interest margin decreased to 3.58% from 3.77% and average earning assets were \$59.8 million higher when comparing the periods. Interest-earning asset yields decreased 32 basis points while the cost of funds decreased 14 basis points. For the six month period, interest-earning asset yields decreased due to the changes in the earning asset mix, and the cost of funds decreased from lower yields on deposits assumed. Both of these decreases were primarily attributable to the Acquisition.

The following tables show interest income on earning assets and related average yields as well as interest expense on interest-bearing liabilities and related average rates paid for the periods indicated (dollars in thousands):

**Average Balances, Income and Expenses, Yields and Rates (Taxable Equivalent Basis)**

For the three months ended

	June 30, 2015			June 30, 2014		
	Average Balance	Interest Expense	Income/ Yield/ Rate	Average Balance	Interest Expense	Income/ Yield/ Rate
<b>Assets</b>						
Securities:						
Taxable	\$ 106,448	\$ 540	2.03%	\$ 97,872	\$ 562	2.30%
Tax-exempt <sup>(1)</sup>	12,781	118	3.71%	12,182	144	4.74%
Restricted	1,497	18	4.97%	1,636	21	5.12%
Total securities	\$ 120,726	\$ 676	2.25%	\$ 111,690	\$ 727	2.61%
Loans: <sup>(2)</sup>						
Taxable	\$ 387,219	\$ 4,637	4.80%	\$ 352,849	\$ 4,348	4.94%
Tax-exempt <sup>(1)</sup>	7,194	78	4.33%	7,518	83	4.43%
Total loans	\$ 394,413	\$ 4,715	4.79%	\$ 360,367	\$ 4,431	4.93%
Interest-bearing deposits with other institutions	110,058	68	0.25%	24,247	14	0.23%
Total earning assets	\$ 625,197	\$ 5,459	3.50%	\$ 496,304	\$ 5,172	4.18%
Less: allowance for loan losses	(6,698)			(10,553)		
Total non-earning assets	52,700			45,499		
Total assets	\$ 671,199			\$ 531,250		

**Liabilities and Shareholders Equity**

Interest bearing deposits:							
Checking	\$ 140,007	\$ 45	0.13%	\$ 118,607	\$ 44	0.15%	
Regular savings	115,763	24	0.08%	103,075	22	0.09%	
Money market accounts	49,026	15	0.12%	18,793	5	0.11%	
Time deposits:							
\$100,000 and over	51,723	115	0.89%	48,302	153	1.27%	
Under \$100,000	89,559	67	0.30%	64,124	141	0.89%	
Brokered	600			4,981	7	0.54%	
<b>Total interest-bearing deposits</b>	<b>\$ 446,678</b>	<b>\$ 266</b>	<b>0.24%</b>	<b>\$ 357,882</b>	<b>\$ 372</b>	<b>0.42%</b>	
Federal funds purchased	385	1	0.64%	3			
Trust preferred capital notes	9,279	55	2.39%	9,279	54	2.35%	
Other borrowings	2,654	2	0.28%	6,043	30	1.99%	
<b>Total interest-bearing liabilities</b>	<b>\$ 458,996</b>	<b>\$ 324</b>	<b>0.28%</b>	<b>\$ 373,207</b>	<b>\$ 456</b>	<b>0.49%</b>	
Non-interest bearing liabilities							
Demand deposits	146,762			99,633			
Other liabilities	5,484			2,445			
<b>Total liabilities</b>	<b>\$ 611,242</b>			<b>\$ 475,285</b>			
Shareholders equity	59,957			55,965			
<b>Total liabilities and Shareholders equity</b>	<b>\$ 671,199</b>			<b>\$ 531,250</b>			
Net interest income		\$ 5,135			\$ 4,716		
Interest rate spread			3.22%			3.69%	
Cost of funds			0.21%			0.39%	
Interest expense as a percent of average earning assets			0.21%			0.37%	
Net interest margin			3.29%			3.81%	

- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was \$67 thousand and \$77 thousand for the three months ended June 30, 2015 and 2014, respectively.
- (2) Loans placed on a non-accrual status are reflected in the balances.

**Table of Contents****Average Balances, Income and Expenses, Yields and Rates (Taxable Equivalent Basis)**

For the six months ended

	June 30, 2015			June 30, 2014		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
<b>Assets</b>						
Securities:						
Taxable	\$ 90,779	\$ 898	1.99%	\$ 97,230	\$ 1,124	2.33%
Tax-exempt <sup>(1)</sup>	11,288	215	3.83%	12,012	288	4.83%
Restricted	1,479	39	5.36%	1,712	42	4.96%
Total securities	\$ 103,546	\$ 1,152	2.24%	\$ 110,954	\$ 1,454	2.64%
Loans: <sup>(2)</sup>						
Taxable	\$ 382,598	\$ 9,126	4.81%	\$ 349,602	\$ 8,508	4.91%
Tax-exempt <sup>(1)</sup>	7,181	155	4.35%	7,495	166	4.48%
Total loans	\$ 389,779	\$ 9,281	4.80%	\$ 357,097	\$ 8,674	4.90%
Federal funds sold	2					
Interest-bearing deposits with other institutions	59,916	73	0.25%	25,378	30	0.24%
Total earning assets	\$ 553,243	\$ 10,506	3.83%	\$ 493,429	\$ 10,158	4.15%
Less: allowance for loan losses	(6,729)			(10,566)		
Total non-earning assets	47,585			45,458		
Total assets	\$ 594,099			\$ 528,321		
<b>Liabilities and Shareholders Equity</b>						
Interest bearing deposits:						
Checking	\$ 124,737	\$ 86	0.14%	\$ 116,805	\$ 90	0.16%
Regular savings	109,818	46	0.08%	101,901	44	0.09%
Money market accounts	35,648	24	0.14%	19,410	11	0.11%
Time deposits:						
\$100,000 and over	48,151	240	1.01%	49,130	314	1.29%
Under \$100,000	71,469	167	0.47%	65,764	297	0.91%
Brokered	937	3	0.54%	4,881	16	0.66%
Total interest-bearing deposits	\$ 390,760	\$ 566	0.29%	\$ 357,891	\$ 772	0.44%
Federal funds purchased	421	2	0.72%	1		
Trust preferred capital notes	9,279	109	2.38%	9,279	108	2.35%
Other borrowings	2,434	3	0.27%	6,046	59	1.97%
Total interest-bearing liabilities	\$ 402,894	\$ 680	0.34%	\$ 373,217	\$ 939	0.51%
Non-interest bearing liabilities						
Demand deposits	126,196			97,279		
Other liabilities	5,055			2,596		

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Total liabilities	\$ 534,145	\$ 473,092
Shareholders equity	59,954	55,229
Total liabilities and Shareholders equity	\$ 594,099	\$ 528,321
Net interest income	\$ 9,826	\$ 9,219
Interest rate spread	3.49%	3.64%
Cost of funds	0.26%	0.40%
Interest expense as a percent of average earning assets	0.25%	0.38%
Net interest margin	3.58%	3.77%

- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was \$126 thousand and \$154 thousand for the six months ended June 30, 2015 and 2014, respectively.
- (2) Loans placed on a non-accrual status are reflected in the balances.

Provision for Loan Losses

The Bank recorded recovery of loan losses of \$100 thousand during the second quarter, which resulted in a total allowance for loan losses of \$6.1 million, or 1.56% of total loans, at June 30, 2015. This compared to a recovery of loan losses of \$400 thousand and an allowance for loan losses of \$10.0 million, or 2.72% of total loans, at the end of the same quarter in 2014. The recovery of loan losses during the second quarter of 2015 was primarily attributable to a decrease in the general component of the allowance for loan losses, which resulted from loan balances that decreased during the quarter, increased collateral values on residential real estate properties, and improved asset quality, as evidenced by lower substandard and past due loan amounts in multiple loan categories, during the quarter. Net charge-offs totaled \$542 thousand for the second quarter of 2015 compared to \$123 thousand of net recoveries for the same period in 2014.

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For the six months ended June 30, 2015, recovery of loan losses totaled \$100 thousand, compared to recovery of loan losses of \$600 thousand for the same period in 2014. The recovery of loan losses in 2014 was primarily the result of a decrease in the general component of the allowance for loan losses from lower historical losses, partially offset by increases in specific reserves from December 31, 2013. Net charge-offs totaled \$489 thousand for the six months ended June 30, 2015 compared to \$38 thousand for the same period in 2014.

## Noninterest Income

Noninterest income increased \$584 thousand, or 34%, to \$2.3 million for the second quarter compared to \$1.7 million for the same period one year ago. Revenue from service charges on deposit accounts increased by \$109 thousand, or 17%, ATM and check card fees increased by \$132 thousand, or 36%, and other operating income increased by \$229 thousand. The increases in revenue from service charges on deposit accounts and ATM and check card fees were driven by the increase in the number of deposit accounts following the Acquisition. Other operating income increased primarily from a \$201 thousand gain recorded from the Acquisition.

For the six months ended June 30, 2015, noninterest income increased \$559 thousand, or 17%, to \$3.9 million compared to \$3.3 million for the same period one year ago. Revenue from ATM and check card fees increased by \$146 thousand, or 21%, fees for other customer services increased by \$78 thousand, or 37%, net gains on sale of loans increased by \$105 thousand, and other operating income increased by \$231 thousand. The increases in fees for other customer services and net gains on sale of loans resulted from increased volume of loan originations from the Bank's mortgage division. The mortgage division began operations in the second quarter of 2014 and did not originate and sell loans until the third quarter of 2014. These increases were partially offset by net losses on sale of securities available for sale of \$52 thousand. As noted above, the primary reason for the increase in other operating income was related to the gain recorded in connection with the Acquisition.

## Noninterest Expense

Noninterest expense increased \$2.3 million, or 51%, to \$6.9 million for the quarter compared to \$4.5 million for the same quarter of 2014. The increase in noninterest expense was primarily due to a \$1.0 million, or 41% increase in expenses related to salaries and employee benefits, a \$135 thousand increase in stationery and supplies expense, a \$184 thousand, or 74% increase in legal and professional fees, a \$92 thousand, or 69% increase in data processing expense, a \$192 thousand increase in amortization expense, and a \$222 thousand increase in other real estate owned expense, when comparing the periods. Increases in salaries and employee benefits were impacted by the launch of the new mortgage division, along with the addition of a chief credit officer and additional commercial lenders subsequent to the second quarter of 2014. Salaries and employee benefits were also higher from increased staffing to accommodate the larger organization following the Acquisition, including the additions of a regional president and two market executives for the Bank's new south region. Amortization expense increased due to the amortization of the core deposit intangible resulting from the acquired deposits. Increases in expenses related to other real estate owned resulted primarily from decreased gains on the sale of OREO property and higher write-downs in the carrying value of OREO property, when comparing the periods. These increases were partially offset by a \$58 thousand, or 48% decrease in FDIC assessment expenses due to lower assessment levels.

Included in the increases in stationery and supplies expense, legal and professional fees, and data processing expense in the paragraph above, were integration expenses related to the Acquisition of \$67 thousand, \$230 thousand, and \$72 thousand, respectively. Total integration expenses related to the Acquisition totaled \$458 thousand for the quarter.

For the six months ended June 30, 2015, noninterest expense increased \$3.2 million, or 35%, to \$12.3 million compared to \$9.2 million for the same period in the prior year. The increase in noninterest expense was primarily due

to a \$1.7 million, or 33% increase in expenses related to salaries and employee benefits, a \$400 thousand increase in stationery and supplies expense, a \$194 thousand, or 43% increase in legal and professional fees, a \$164 thousand, or 66% increase in data processing expense, a \$108 thousand increase in postage expense, a \$192 thousand increase in amortization expense, and a \$155 thousand increase in other real estate owned expense, when comparing the periods. These increases were partially offset by a \$163 thousand, or 55% decrease in FDIC assessment expenses.

Included in the increases in stationery and supplies expense, legal and professional fees, data processing expense, and postage expense in the paragraph above, were integration expenses related to the Acquisition of \$325 thousand, \$238 thousand, \$134 thousand, and \$70 thousand, respectively. Total integration expenses related to the Acquisition totaled \$877 thousand for the six months ended June 30, 2015.

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### 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, 2015 and 2014. 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 10 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

### **Financial Condition**

#### General

Assets totaled \$695.8 million at June 30, 2015 compared to \$518.2 million at December 31, 2014. The increase in assets during the period was a result of the Acquisition. Assets under management of the wealth management division of the Bank increased by \$2.6 million, or 1%, to \$315.9 million at June 30, 2015 compared to \$313.3 million at December 31, 2014. Assets managed by the wealth management division are not reflected on the Company's consolidated balance sheet.

#### Loans

Loans, net of the allowance for loan losses, increased \$13.9 million or 4% to \$385.6 million at June 30, 2015, compared to \$371.7 million at December 31, 2014. Growth of the loan portfolio was led by residential real estate loans with balances that increased \$9.5 million during the first six months of 2015, followed by other real estate loans with balances that increased by \$3.6 million.

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 and industrial loans, and consumer and other loans. Real estate loans are further divided into the following classes: Construction and Land Development; 1-4 Family Residential; and Other Real Estate Loans. Descriptions of the Company's loan classes are as follows:

**Real Estate Loans – Construction and Land Development:** 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. In addition to traditional residential mortgage loans secured by a first or junior lien on the property, the Bank offers home equity lines of credit.

**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.

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

**Consumer and Other 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.

A substantial portion of the loan portfolio is represented by residential and commercial loans secured by real estate located in the Bank's market area. The ability of the Bank's debtors to honor their contracts may be impacted by the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal 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 non-accrual 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 non-accrual status, payments are first applied to principal



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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 non-accrual 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 deemed uncollectible is charged-off in full. Any secured loan that 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.

## Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect 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 generally evaluates substandard and doubtful loans greater than \$250 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 typically does not separately identify individual consumer, residential and certain small commercial loans that are less than \$250 thousand for impairment disclosures, except for troubled debt restructurings (TDRs) as noted below. The recorded investment in impaired loans totaled \$10.8 million and \$13.9 million at June 30, 2015 and December 31, 2014, respectively.

## Troubled Debt Restructurings (TDR)

In situations where, for economic or legal reasons related to a borrower's financial condition, management grants 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 non-accrual status at the time of the TDR, the loan will remain on non-accrual status following the modification and may be returned to accrual status based on the policy for returning loans to accrual status as noted above. There were \$1.6 million and \$1.9 million in loans classified as TDRs as of June 30, 2015 and December 31, 2014, respectively.

## Asset Quality

Management classifies as non-performing assets non-accrual loans and other real estate owned (OREO). OREO represents real property taken by the Bank when its customers do not meet the contractual obligation of their loans, either through foreclosure or through a deed in lieu thereof from the borrower and properties originally acquired for branch expansion but no longer intended to be used for that purpose. OREO is recorded at the lower of cost or fair value, less estimated selling costs, and is marketed by the Bank through brokerage channels. The Bank had \$2.4 million and \$1.9 million in OREO, net of the valuation allowance, at June 30, 2015 and December 31, 2014, respectively. The valuation allowance for other real estate owned totaled \$137 thousand and \$375 thousand at June 30, 2015 and December 31, 2014, respectively.

Non-performing assets were \$9.1 million at June 30, 2015 and \$9.9 million at December 31, 2014, representing 1.30% and 1.91% of total assets, respectively. Non-performing assets included \$6.7 million in non-accrual loans and \$2.4 million in OREO, net of the valuation allowance at June 30, 2015. This compares to \$8.0 million in non-accrual loans and \$1.9 million in OREO, net of the valuation allowance at December 31, 2014.

The levels of non-performing assets at June 30, 2015 and December 31, 2014 were primarily attributable to business customers involved in commercial real estate and construction and land development that have not been able to meet their

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debt requirements because they have not fully recovered from the recent recession. At June 30, 2015, 51% of non-performing assets related to commercial real estate loans, 40% related to construction and land development loans, 8% related to residential real estate loans, and 1% related to commercial and industrial loans. Non-performing assets could increase due to other loans identified by management as potential problem loans. 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 \$10.9 million and \$15.8 million at June 30, 2015 and December 31, 2014, respectively. The amount of other potential problem loans in future periods may be dependent on economic conditions and other factors influencing our customers' ability to meet their debt requirements.

Loans greater than 90 days past due and still accruing increased to \$600 thousand at June 30, 2015. There were no loans greater than 90 days past due and still accruing at December 31, 2014. The increase was primarily attributable to two loan relationships which were in the renewal process at June 30, 2015. The two loans remained on accrual status because they are expected to return to current status during the third quarter of 2015.

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 current 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 \$6.1 million at June 30, 2015 and \$6.7 million at December 31, 2014, representing 1.56% and 1.77% of total loans, respectively. The decrease in the allowance was primarily attributable to a decrease in the general allocation due to an upgrade in the qualitative adjustment factors resulting from increased collateral values on residential real estate properties and improvements experienced in asset quality, as evidenced by lower substandard and past due loan amounts in multiple loan categories, during the second quarter of 2015. Recoveries of loan losses of \$314 thousand, \$16 thousand, and \$55 thousand were experienced in the 1-4 Family Residential, Other Real Estate, and Commercial and Industrial loan classes, respectively, during the six month period ended June 30, 2015. The recoveries of loan losses in the 1-4 Family Residential, Other Real Estate, and Commercial and Industrial loan classes were primarily attributable to decreases in the general allocation from improvements in the historical loss experience and qualitative adjustment factors.

Impaired loans totaled \$10.8 million and \$13.9 million at June 30, 2015 and December 31, 2014, respectively. The related allowance for loan losses provided for these loans totaled \$1.6 million and \$1.9 million at June 30, 2015 and December 31, 2014, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2015 and the year ended December 31, 2014 was \$13.0 million and \$19.2 million, respectively. Included in the impaired loans total at June 30, 2015 are loans classified as TDRs totaling \$1.6 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, 2015, \$324 thousand of these TDRs were performing under the restructured terms and were not considered non-performing 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 qualitative factors 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](#).

Securities

The securities portfolio plays a primary role in the management of the Company's interest rate sensitivity. In addition, the portfolio serves as a source of liquidity and is used as needed to meet collateral requirements, such as those related to secure public deposits and balances with the Reserve Bank. The investment portfolio consists of held to maturity and available for sale securities. Securities are classified as available for sale or held to maturity based on the Company's investment strategy and management's assessment of the intent and ability to hold the securities until maturity. Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold the investment securities to maturity, they are classified as investment securities held to maturity and are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts using the interest method. Investment securities which the Company may not hold to maturity are classified as investment securities available for sale, as management has the intent and ability to hold such investment securities for an indefinite period of time, but not necessarily to maturity. Securities available for sale may be sold in response to changes in market interest rates, changes in prepayment risk, increases in loan demand, general liquidity needs and other similar factors and are carried at estimated fair value.

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Total securities were \$149.8 million at June 30, 2015, an increase of \$66.5 million or 80% from \$83.3 million at December 31, 2014. The increase in the investment portfolio during the first six months of 2015 was the result of investing excess liquidity that resulted from increases in total deposits from the Acquisition. 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, 2015, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios. Gross unrealized gains in the available for sale portfolio totaled \$548 thousand and \$704 thousand at June 30, 2015 and December 31, 2014, respectively. Gross unrealized losses in the available for sale portfolio totaled \$1.2 million and \$906 thousand at June 30, 2015 and December 31, 2014, respectively. Gross unrealized gains and gross unrealized losses in the held to maturity portfolio totaled \$2 thousand and \$494 thousand at June 30, 2015, respectively. Neither the Company nor the Bank designated any securities as held to maturity at December 31, 2014; therefore, there were no gross unrealized gains or losses in the held to maturity portfolio at December 31, 2014. Investments in an unrealized loss position were considered temporarily impaired at June 30, 2015 and December 31, 2014. The change in the unrealized gains and losses of investment securities from December 31, 2014 to June 30, 2015 was related to changes in market interest rates.

## Deposits

Deposits totaled \$620.9 million at June 30, 2015, an increase of \$176.6 million or 40% from \$444.3 million at December 31, 2014. Non-interest bearing demand deposits increased \$42.8 million or 41% to \$147.8 million during the first six months of 2015 from \$105.0 million at December 31, 2014. Savings and interest-bearing demand deposits increased \$84.6 million or 36% to \$322.2 million at June 30, 2015 compared to \$237.6 million at December 31, 2014. Time deposits, which include brokered deposits, increased \$49.1 million or 48% during the first six months of 2015 to \$150.9 million compared to \$101.7 million at December 31, 2014. The increases in all deposit categories during the first six months of 2015 resulted from the Acquisition.

## 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 part of the Bank's liquidity risk management, stress tests and cash flow modeling are performed quarterly.

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.

At June 30, 2015, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled \$176.7 million. At June 30, 2015, 17% or \$65.5 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled \$154.3 million at June 30, 2015, which included \$109.1 million available from Federal Home Loan Bank of Atlanta (FHLB), \$42.0 million of unsecured federal funds lines of credit with other correspondent banks and \$3.2 million available through the Federal Reserve Discount Window.

## 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. The Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board's Small Bank Holding Company Policy Statement issued in February 2015, and is no longer obligated to report consolidated regulatory capital.

In July 2013, the U.S. banking regulators adopted a final rule which implements the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision, and certain changes required by the Dodd-Frank Act. The final rule established an integrated regulatory capital framework and introduces the Standardized Approach for risk-weighted assets, which replaces the Basel I risk-based guidance for determining risk-weighted assets as of January 1, 2015, the date the Bank became subject to the new rules. Based on the Bank's current capital composition and levels, the Bank believes it is in compliance with the requirements as set forth in the final rules.

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The rules include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019, and refine the definition of what constitutes capital for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Bank under the final rules are as follows: a new common equity Tier 1 capital ratio of 4.5%; a Tier 1 capital ratio of 6% (increased from 4%); a total capital ratio of 8% (unchanged from previous rules); and a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a capital conservation buffer above the new regulatory minimum capital requirements. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: a common equity Tier 1 capital ratio of 7.0%, a Tier 1 capital ratio of 8.5%, and a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

The following table shows the Bank's regulatory capital ratios at June 30, 2015:

	First Bank
Total capital to risk-weighted assets	18.28%
Tier 1 capital to risk-weighted assets	17.03%
Common equity Tier 1 capital to risk-weighted assets	17.03%
Tier 1 capital to average assets	10.06%

The final rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are now required to meet the following increased capital level requirements in order to qualify as well capitalized: a new common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8% (increased from 6%); a total capital ratio of 10% (unchanged from previous rules); and a Tier 1 leverage ratio of 5% (unchanged from previous rules).

The Company's Preferred Stock includes Series A Preferred Stock which paid a dividend of 5% per annum until May 14, 2014 and 9% thereafter, and Series B Preferred Stock which pays a dividend of 9% per annum. The Company is current on its dividend payments on each series of preferred stock.

**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, 2014.

**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 \$60.6 million at June 30, 2015, and \$60.0 million at December 31, 2014, 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 usually do not contain a specified maturity date and may or may not be drawn upon to the total extent to which the Bank is committed.



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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, 2015 and December 31, 2014, the Bank had \$8.1 million and \$9.8 million in outstanding standby letters of credit, respectively.

At June 30, 2015, the Bank had \$4.5 million in locked-rate commitments to originate mortgage loans. 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.

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

Not required.

**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 and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2015 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.

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**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**

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, 2014.

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

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

The following documents are attached hereto as Exhibits:

- 3.1 By-laws of First National Corporation (as restated in electronic format as of May 11, 2015), attached as Exhibit 3.1 to the Current Report on Form 8-K filed May 15, 2015 and incorporated by reference herein.
- 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, 2015 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income (iv) Consolidated Statements of Cash Flows, (v) Consolidated Statements of Shareholders' Equity, and (vi) Notes to Consolidated Financial Statements.

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**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	August 14, 2015
Scott C. Harvard	Date
President and Chief Executive Officer	

/s/ M. Shane Bell	August 14, 2015
M. Shane Bell	Date
Executive Vice President and Chief Financial Officer	

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**EXHIBIT INDEX**

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