

FIRST NATIONAL CORP /VA/  
Form 10-Q  
November 14, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2016**

**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)**

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

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

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

**22657**  
**(Zip Code)**

**(540) 465-9121**

**(Registrant's telephone number, including area code)**

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of November 14, 2016, 4,926,546 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)<br>September 30,<br>2016 | December 31,<br>2015* |
|---|--------------------------------------|-----------------------|
| <b>Assets</b>   |                                      |                       |
| Cash and due from banks   | \$ 8,955                             | \$ 8,247              |
| Interest-bearing deposits in banks  | 47,902                               | 31,087                |
| Securities available for sale, at fair value  | 88,323                               | 105,559               |
| Securities held to maturity, at carrying value (fair value, 2016, \$56,305; 2015, \$66,438) | 55,263                               | 66,519                |
| Restricted securities, at cost  | 1,548                                | 1,391                 |
| Loans held for sale   | 1,053                                | 323                   |
| Loans, net of allowance for loan losses, 2016, \$5,610; 2015, \$5,524                       | 465,224                              | 433,475               |
| Other real estate owned, net of valuation allowance, 2016, \$0; 2015, \$224                 | 250                                  | 2,679                 |
| Premises and equipment, net   | 20,852                               | 21,389                |
| Accrued interest receivable   | 1,631                                | 1,661                 |
| Bank owned life insurance   | 13,808                               | 11,742                |
| Core deposit intangibles, net   | 1,730                                | 2,322                 |
| Other assets  | 6,133                                | 5,927                 |
| <b>Total assets</b>   | <b>\$ 712,672</b>                    | <b>\$ 692,321</b>     |

**Liabilities and Shareholders Equity****Liabilities**

## Deposits:

|  |                   |                   |
|--|-------------------|-------------------|
| Noninterest-bearing demand deposits            | \$ 168,204        | \$ 157,070        |
| Savings and interest-bearing demand deposits   | 340,884           | 328,945           |
| Time deposits                                  | 131,654           | 141,101           |
| <b>Total deposits</b>                          | <b>\$ 640,742</b> | <b>\$ 627,116</b> |
| Subordinated debt                              | 4,926             | 4,913             |
| Junior subordinated debt                       | 9,279             | 9,279             |
| Accrued interest payable and other liabilities | 6,742             | 5,060             |
| <b>Total liabilities</b>                       | <b>\$ 661,689</b> | <b>\$ 646,368</b> |

**Shareholders Equity**

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|   |                   |                   |
|---|-------------------|-------------------|
| Preferred stock, par value \$1.25 per share; authorized 1,000,000 shares; none issued and outstanding   | \$                | \$                |
| Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2016, 4,926,546 shares; 2015, 4,916,130 shares | 6,158             | 6,145             |
| Surplus   | 7,046             | 6,956             |
| Retained earnings   | 38,223            | 34,440            |
| Accumulated other comprehensive loss, net   | (444)             | (1,588)           |
| <b>Total shareholders equity</b>  | <b>\$ 50,983</b>  | <b>\$ 45,953</b>  |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 712,672</b> | <b>\$ 692,321</b> |

\* Derived from audited consolidated financial statements.  
*See Notes to Consolidated Financial Statements*

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

Three months ended September 30, 2016 and 2015

*(in thousands, except per share data)*

|   | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|---|--------------------------------------|--------------------------------------|
| <b>Interest and Dividend Income</b>                           |                                      |                                      |
| Interest and fees on loans                                    | \$ 5,500                             | \$ 4,854                             |
| Interest on deposits in banks                                 | 73                                   | 61                                   |
| Interest and dividends on securities:                         |                                      |                                      |
| Taxable interest  | 613                                  | 713                                  |
| Tax-exempt interest   | 136                                  | 116                                  |
| Dividends   | 20                                   | 20                                   |
| Total interest and dividend income                            | \$ 6,342                             | \$ 5,764                             |
| <b>Interest Expense</b>                                       |                                      |                                      |
| Interest on deposits  | \$ 338                               | \$ 282                               |
| Interest on subordinated debt                                 | 91                                   |                                      |
| Interest on junior subordinated debt                          | 65                                   | 56                                   |
| Interest on other borrowings                                  | 1                                    |                                      |
| Total interest expense  | \$ 495                               | \$ 338                               |
| Net interest income   | \$ 5,847                             | \$ 5,426                             |
| Provision for loan losses                                     |                                      |                                      |
| Net interest income after provision for loan losses           | \$ 5,847                             | \$ 5,426                             |
| <b>Noninterest Income</b>                                     |                                      |                                      |
| Service charges on deposit accounts                           | \$ 941                               | \$ 897                               |
| ATM and check card fees                                       | 529                                  | 529                                  |
| Wealth management fees  | 339                                  | 477                                  |
| Fees for other customer services                              | 143                                  | 172                                  |
| Income from bank owned life insurance                         | 123                                  | 106                                  |
| Net gains on calls and sales of securities available for sale | 4                                    |                                      |
| Net gains on sale of loans                                    | 50                                   | 53                                   |
| Other operating income  | 182                                  | 10                                   |
| Total noninterest income                                      | \$ 2,311                             | \$ 2,244                             |

**Noninterest Expense**

|  |    |       |    |       |
|--|----|-------|----|-------|
| Salaries and employee benefits                   | \$ | 3,183 | \$ | 3,637 |
| Occupancy  |    | 380   |    | 396   |
| Equipment  |    | 406   |    | 400   |
| Marketing  |    | 125   |    | 176   |
| Supplies   |    | 108   |    | 116   |
| Legal and professional fees                      |    | 179   |    | 243   |
| ATM and check card fees                          |    | 229   |    | 236   |
| FDIC assessment                                  |    | 106   |    | 134   |
| Bank franchise tax                               |    | 89    |    | 131   |
| Telecommunications expense                       |    | 110   |    | 131   |
| Data processing expense                          |    | 160   |    | 130   |
| Postage expense                                  |    | 56    |    | 73    |
| Amortization expense                             |    | 187   |    | 226   |
| Other real estate owned expense, net             |    | 1     |    | 144   |
| Net losses on disposal of premises and equipment |    | 8     |    |       |
| Other operating expense                          |    | 526   |    | 528   |
| Total noninterest expense                        | \$ | 5,853 | \$ | 6,701 |

*See Notes to Consolidated Financial Statements*

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

(Continued)

Three months ended September 30, 2016 and 2015

*(in thousands, except per share data)*

|  | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|--|--------------------------------------|--------------------------------------|
| Income before income taxes                         | \$ 2,305                             | \$ 969                               |
| Income tax expense                                 | 611                                  | 243                                  |
| <b>Net income</b>                                  | <b>\$ 1,694</b>                      | <b>\$ 726</b>                        |
| Effective dividend on preferred stock              |                                      | 328                                  |
| <b>Net income available to common shareholders</b> | <b>\$ 1,694</b>                      | <b>\$ 398</b>                        |
| <b>Earnings per common share</b>                   |                                      |                                      |
| Basic  | \$ 0.34                              | \$ 0.08                              |
| Diluted  | \$ 0.34                              | \$ 0.08                              |

*See Notes to Consolidated Financial Statements*

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

Three months ended September 30, 2016 and 2015

*(in thousands)*

|  | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|--|--------------------------------------|--------------------------------------|
| Net income   | \$ 1,694                             | \$ 726                               |
| Other comprehensive income, net of tax,<br>Unrealized holding gains on available for sale securities, net of tax \$78 and<br>\$341, respectively | 155                                  | 660                                  |
| Reclassification adjustment for gains included in net income, net of tax (\$1)<br>and \$0, respectively  | (3)                                  |                                      |
| Total other comprehensive income   | 152                                  | 660                                  |
| Total comprehensive income   | \$ 1,846                             | \$ 1,386                             |

*See Notes to Consolidated Financial Statements*

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

Nine months ended September 30, 2016 and 2015

*(in thousands, except per share data)*

|  | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|--|--------------------------------------|--------------------------------------|
| <b>Interest and Dividend Income</b>                                    |                                      |                                      |
| Interest and fees on loans   | \$ 16,106                            | \$ 14,082                            |
| Interest on deposits in banks  | 183                                  | 134                                  |
| Interest and dividends on securities:                                  |                                      |                                      |
| Taxable interest   | 2,037                                | 1,611                                |
| Tax-exempt interest  | 425                                  | 258                                  |
| Dividends  | 60                                   | 59                                   |
| <br>Total interest and dividend income                                 | <br>\$ 18,811                        | <br>\$ 16,144                        |
| <b>Interest Expense</b>  |                                      |                                      |
| Interest on deposits   | \$ 1,000                             | \$ 848                               |
| Interest on federal funds purchased                                    | 3                                    | 2                                    |
| Interest on subordinated debt  | 270                                  |                                      |
| Interest on junior subordinated debt                                   | 190                                  | 165                                  |
| Interest on other borrowings   | 6                                    | 3                                    |
| <br>Total interest expense   | <br>\$ 1,469                         | <br>\$ 1,018                         |
| <br>Net interest income  | <br>\$ 17,342                        | <br>\$ 15,126                        |
| Recovery of loan losses  |                                      | (100)                                |
| <br>Net interest income after recovery of loan losses                  | <br>\$ 17,342                        | <br>\$ 15,226                        |
| <b>Noninterest Income</b>  |                                      |                                      |
| Service charges on deposit accounts                                    | \$ 2,635                             | \$ 2,196                             |
| ATM and check card fees  | 1,532                                | 1,375                                |
| Wealth management fees   | 1,009                                | 1,479                                |
| Fees for other customer services                                       | 427                                  | 463                                  |
| Income from bank owned life insurance                                  | 316                                  | 270                                  |
| Net gains (losses) on calls and sales of securities available for sale | 10                                   | (52)                                 |
| Net gains on sale of loans   | 102                                  | 158                                  |
| Bargain purchase gain  |                                      | 201                                  |
| Other operating income   | 335                                  | 54                                   |

|  |    |        |    |        |
|--|----|--------|----|--------|
| Total noninterest income                         | \$ | 6,366  | \$ | 6,144  |
| <b>Noninterest Expense</b>                       |    |        |    |        |
| Salaries and employee benefits                   | \$ | 10,042 | \$ | 10,359 |
| Occupancy  |    | 1,169  |    | 1,052  |
| Equipment  |    | 1,232  |    | 1,103  |
| Marketing  |    | 352    |    | 436    |
| Supplies   |    | 312    |    | 690    |
| Legal and professional fees                      |    | 646    |    | 886    |
| ATM and check card fees                          |    | 655    |    | 581    |
| FDIC assessment                                  |    | 354    |    | 265    |
| Bank franchise tax                               |    | 282    |    | 383    |
| Telecommunications expense                       |    | 339    |    | 316    |
| Data processing expense                          |    | 434    |    | 543    |
| Postage expense                                  |    | 182    |    | 270    |
| Amortization expense                             |    | 592    |    | 426    |
| Other real estate owned (income) expense, net    |    | (120)  |    | 260    |
| Net losses on disposal of premises and equipment |    | 8      |    |        |
| Other operating expense                          |    | 1,374  |    | 1,473  |
| Total noninterest expense                        | \$ | 17,853 | \$ | 19,043 |

*See Notes to Consolidated Financial Statements*

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

(Continued)

Nine months ended September 30, 2016 and 2015

*(in thousands, except per share data)*

|  | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|--|--------------------------------------|--------------------------------------|
| Income before income taxes                         | \$ 5,855                             | \$ 2,327                             |
| Income tax expense                                 | 1,629                                | 613                                  |
| <b>Net income</b>                                  | <b>\$ 4,226</b>                      | <b>\$ 1,714</b>                      |
| Effective dividend on preferred stock              |                                      | 985                                  |
| <b>Net income available to common shareholders</b> | <b>\$ 4,226</b>                      | <b>\$ 729</b>                        |
| <b>Earnings per common share</b>                   |                                      |                                      |
| Basic  | \$ 0.86                              | \$ 0.15                              |
| Diluted  | \$ 0.86                              | \$ 0.15                              |

*See Notes to Consolidated Financial Statements*

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

Nine months ended September 30, 2016 and 2015

*(in thousands)*

|   | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|---|--------------------------------------|--------------------------------------|
| Net income  | \$ 4,226                             | \$ 1,714                             |
| Other comprehensive income, net of tax,<br>Unrealized holding gains on available for sale securities, net of tax \$593 and<br>\$176, respectively | 1,151                                | 344                                  |
| Reclassification adjustment for (gains) losses included in net income, net of tax<br>(\$3) and \$18, respectively                                 | (7)                                  | 34                                   |
| <b>Total other comprehensive income</b>   | <b>1,144</b>                         | <b>378</b>                           |
| <b>Total comprehensive income</b>   | <b>\$ 5,370</b>                      | <b>\$ 2,092</b>                      |

*See Notes to Consolidated Financial Statements*

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

Nine months ended September 30, 2016 and 2015

*(in thousands)*

|   | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|---|--------------------------------------|--------------------------------------|
| <b>Cash Flows from Operating Activities</b>   |                                      |                                      |
| Net income  | \$ 4,226                             | \$ 1,714                             |
| Adjustments to reconcile net income to net cash provided by operating activities:               |                                      |                                      |
| Depreciation and amortization   | 1,010                                | 896                                  |
| Amortization of core deposit intangibles  | 592                                  | 426                                  |
| Amortization of debt issuance costs   | 13                                   |                                      |
| Origination of loans held for sale  | (7,331)                              | (11,493)                             |
| Proceeds from sale of loans held for sale   | 6,703                                | 11,508                               |
| Net gains on sales of loans held for sale   | (102)                                | (158)                                |
| Recovery of loan losses   |                                      | (100)                                |
| Net (gains) losses on sale of securities available for sale                                     | (10)                                 | 52                                   |
| Provision for other real estate owned   | 27                                   | 230                                  |
| Net gains on sale of other real estate owned  | (193)                                | (72)                                 |
| Income from bank owned life insurance   | (316)                                | (270)                                |
| Accretion of discounts and amortization of premiums on securities, net                          | 656                                  | 521                                  |
| Accretion of premium on time deposits   | (133)                                | (164)                                |
| Stock-based compensation  | 72                                   | 70                                   |
| Bargain purchase gain on branch acquisition   |                                      | (201)                                |
| Losses on disposal of premises and equipment  | 8                                    |                                      |
| Deferred income tax expense   | 347                                  | 223                                  |
| Changes in assets and liabilities:  |                                      |                                      |
| Decrease (increase) in interest receivable  | 30                                   | (282)                                |
| Increase in other assets  | (655)                                | (293)                                |
| Increase in other liabilities   | 1,195                                | 380                                  |
| Net cash provided by operating activities   | \$ 6,139                             | \$ 2,987                             |
| <b>Cash Flows from Investing Activities</b>   |                                      |                                      |
| Proceeds from maturities, calls, principal payments, and sales of securities available for sale | \$ 18,554                            | \$ 11,836                            |
| Proceeds from maturities, calls, principal payments, and sales of securities held to maturity   | 11,025                               | 1,220                                |
| Purchase of securities available for sale   |                                      | (37,638)                             |
| Purchase of securities held to maturity   |                                      | (55,569)                             |

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|   |            |           |
|---|------------|-----------|
| Net purchase of restricted securities                 | (157)      | (25)      |
| Purchase of premises and equipment                    | (754)      | (1,768)   |
| Proceeds from sale of premises and equipment          | 23         |           |
| Proceeds from sale of other real estate owned         | 2,882      | 354       |
| Purchase of bank owned life insurance                 | (2,000)    |           |
| Proceeds from cash value of bank owned life insurance | 250        |           |
| Net increase in loans                                 | (31,786)   | (30,430)  |
| Acquisition of branches, net of cash paid             |            | 179,501   |
| Net cash (used in) provided by investing activities   | \$ (1,963) | \$ 67,481 |

*See Notes to Consolidated Financial Statements*

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

(Continued)

Nine months ended September 30, 2016 and 2015

*(in thousands)*

|   | (unaudited)<br>September 30,<br>2016 | (unaudited)<br>September 30,<br>2015 |
|---|--------------------------------------|--------------------------------------|
| <b>Cash Flows from Financing Activities</b>                                   |                                      |                                      |
| Net increase (decrease) in demand deposits and savings accounts               | \$ 23,073                            | \$ (813)                             |
| Net decrease in time deposits   | (9,314)                              | (16,256)                             |
| Net decrease in other borrowings  |                                      | (19)                                 |
| Cash dividends paid on common stock, net of reinvestment                      | (412)                                | (341)                                |
| Repurchase of common stock  |                                      | (1)                                  |
| Cash dividends paid on preferred stock  |                                      | (985)                                |
| Decrease in federal funds purchased   |                                      | (52)                                 |
| Net cash provided by (used in) financing activities                           | \$ 13,347                            | \$ (18,467)                          |
| Increase in cash and cash equivalents   | \$ 17,523                            | \$ 52,001                            |
| <b>Cash and Cash Equivalents</b>  |                                      |                                      |
| Beginning   | \$ 39,334                            | \$ 24,845                            |
| Ending  | \$ 56,857                            | \$ 76,846                            |
| <b>Supplemental Disclosures of Cash Flow Information</b>                      |                                      |                                      |
| Cash payments for:  |                                      |                                      |
| Interest  | \$ 1,628                             | \$ 873                               |
| Income Taxes  | \$ 1,276                             | \$ 752                               |
| <b>Supplemental Disclosures of Noncash Investing and Financing Activities</b> |                                      |                                      |
| Unrealized gains on securities available for sale                             | \$ 1,734                             | \$ 572                               |
| Transfer from loans to other real estate owned                                | \$ 37                                | \$ 1,384                             |
| Transfer from premises and equipment to other real estate owned               | \$ 250                               | \$                                   |
| Issuance of common stock, dividend reinvestment plan                          | \$ 31                                | \$ 28                                |
| <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*

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

Nine months ended September 30, 2016 and 2015

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

|  | Preferred<br>Stock | Common<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total     |
|--|--------------------|-----------------|----------|----------------------|---|-----------|
| <b>Balance, December 31, 2014</b>                                    | \$ 14,595          | \$ 6,131        | \$ 6,835 | \$ 33,557            | \$ (1,554)                                    | \$ 59,564 |
| Net income   |                    |                 |          | 1,714                |   | 1,714     |
| Other comprehensive income   |                    |                 |          |                      | 378   | 378       |
| Cash dividends on common stock (\$0.075<br>per share)                |                    |                 |          | (369)                |   | (369)     |
| Stock-based compensation   |                    |                 | 70       |                      |   | 70        |
| Issuance of 3,081 shares common stock,<br>dividend reinvestment plan |                    | 4               | 24       |                      |   | 28        |
| Issuance of 5,142 shares common stock,<br>stock incentive plan       |                    | 6               | (6)      |                      |   |           |
| Repurchase of 138 shares common stock,<br>stock incentive plan       |                    |                 |          | (1)                  |   | (1)       |
| Cash dividends on preferred stock                                    |                    |                 |          | (985)                |   | (985)     |
| <b>Balance, September 30, 2015</b>                                   | \$ 14,595          | \$ 6,141        | \$ 6,922 | \$ 33,917            | \$ (1,176)                                    | \$ 60,399 |

|  | Preferred<br>Stock | Common<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total     |
|--|--------------------|-----------------|----------|----------------------|---|-----------|
| <b>Balance, December 31, 2015</b>                                    | \$                 | \$ 6,145        | \$ 6,956 | \$ 34,440            | \$ (1,588)                                    | \$ 45,953 |
| Net income   |                    |                 |          | 4,226                |   | 4,226     |
| Other comprehensive income   |                    |                 |          |                      | 1,144   | 1,144     |
| Cash dividends on common stock (\$0.09<br>per share)                 |                    |                 |          | (443)                |   | (443)     |
| Stock-based compensation   |                    |                 | 72       |                      |   | 72        |
| Issuance of 3,192 shares common stock,<br>dividend reinvestment plan |                    | 4               | 27       |                      |   | 31        |
| Issuance of 7,224 shares common stock,<br>stock incentive plan       |                    | 9               | (9)      |                      |   |           |

|                                    |    |          |          |           |    |       |           |
|------------------------------------|----|----------|----------|-----------|----|-------|-----------|
| <b>Balance, September 30, 2016</b> | \$ | \$ 6,158 | \$ 7,046 | \$ 38,223 | \$ | (444) | \$ 50,983 |
|------------------------------------|----|----------|----------|-----------|----|-------|-----------|

*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 subsidiary, 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 September 30, 2016 and December 31, 2015, the statements of income and comprehensive income for the three and nine months ended September 30, 2016 and 2015 and the cash flows and changes in shareholders' equity for the nine months ended September 30, 2016 and 2015. 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, 2015. Operating results for the three and nine month periods ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

**Recent Accounting Pronouncements**

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.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of ASU 2016-01 to have a material impact on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company does not expect the adoption of ASU 2016-02 to have a material impact on its consolidated financial statements.

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**Notes to Consolidated Financial Statements**

*(unaudited)*

In March 2016, the FASB issued ASU No. 2016-07, Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting. Among other things, the amendments in ASU 2016-07, eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. The amendments require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

During March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company does not expect the adoption of ASU 2016-09 to have a material impact on its consolidated financial statements.

During June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

During August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for

fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***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 September 30, 2016 and December 31, 2015 were as follows (in thousands):

|  | Amortized<br>Cost | September 30, 2016<br>Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair<br>Value     |
|--|-------------------|--|---------------------------------|-------------------|
| <b>Securities available for sale:</b>            |                   |  |                                 |                   |
| U.S. agency and mortgage-backed securities       | \$ 74,732         | \$ 1,092   | \$ (62)                         | \$ 75,762         |
| Obligations of states and political subdivisions | 12,148            | 402  |                                 | 12,550            |
| Corporate equity securities                      | 1                 | 10   |                                 | 11                |
| <b>Total securities available for sale</b>       | <b>\$ 86,881</b>  | <b>\$ 1,504</b>                                    | <b>\$ (62)</b>                  | <b>\$ 88,323</b>  |
| <b>Securities held to maturity:</b>              |                   |  |                                 |                   |
| U.S. agency and mortgage-backed securities       | \$ 39,118         | \$ 487   | \$                              | \$ 39,605         |
| Obligations of states and political subdivisions | 14,645            | 531  |                                 | 15,176            |
| Corporate debt securities                        | 1,500             | 24   |                                 | 1,524             |
| <b>Total securities held to maturity</b>         | <b>\$ 55,263</b>  | <b>\$ 1,042</b>                                    | <b>\$</b>                       | <b>\$ 56,305</b>  |
| <b>Total securities</b>                          | <b>\$ 142,144</b> | <b>\$ 2,546</b>                                    | <b>\$ (62)</b>                  | <b>\$ 144,628</b> |

|  | Amortized<br>Cost | December 31, 2015<br>Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair<br>Value     |
|--|-------------------|---|---------------------------------|-------------------|
| <b>Securities available for sale:</b>            |                   |   |                                 |                   |
| U.S. agency and mortgage-backed securities       | \$ 89,919         | \$ 261  | \$ (843)                        | \$ 89,337         |
| Obligations of states and political subdivisions | 15,931            | 333   | (50)                            | 16,214            |
| Corporate equity securities                      | 1                 | 7   |                                 | 8                 |
| <b>Total securities available for sale</b>       | <b>\$ 105,851</b> | <b>\$ 601</b>                                     | <b>\$ (893)</b>                 | <b>\$ 105,559</b> |
| <b>Securities held to maturity:</b>              |                   |   |                                 |                   |
| U.S. agency and mortgage-backed securities       | \$ 49,662         | \$ 36   | \$ (326)                        | \$ 49,372         |

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|  |            |        |            |            |
|--|------------|--------|------------|------------|
| Obligations of states and political subdivisions | 15,357     | 228    | (19)       | 15,566     |
| Corporate debt securities                        | 1,500      |        |            | 1,500      |
| Total securities held to maturity                | \$ 66,519  | \$ 264 | \$ (345)   | \$ 66,438  |
| Total securities                                 | \$ 172,370 | \$ 865 | \$ (1,238) | \$ 171,997 |

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

At September 30, 2016 and December 31, 2015, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

|  | Less than 12 months |                 | September 30, 2016<br>12 months or more |                 | Total             |                   |
|--|---------------------|-----------------|---|-----------------|-------------------|-------------------|
|  | Unrealized          |                 | Unrealized                              |                 | Unrealized        |                   |
|  | Fair Value          | (Loss)          | Fair Value                              | (Loss)          | Fair Value        | (Loss)            |
| <b>Securities available for sale:</b>            |                     |                 |   |                 |                   |                   |
| U.S. agency and mortgage-backed securities       | \$                  | \$              | \$ 6,022                                | \$ (62)         | \$ 6,022          | \$ (62)           |
| <b>Total securities available for sale</b>       | <b>\$</b>           | <b>\$</b>       | <b>\$ 6,022</b>                         | <b>\$ (62)</b>  | <b>\$ 6,022</b>   | <b>\$ (62)</b>    |
| <b>Total securities</b>                          | <b>\$</b>           | <b>\$</b>       | <b>\$ 6,022</b>                         | <b>\$ (62)</b>  | <b>\$ 6,022</b>   | <b>\$ (62)</b>    |
|  |                     |                 |   |                 |                   |                   |
|  | Less than 12 months |                 | December 31, 2015<br>12 months or more  |                 | Total             |                   |
|  | Unrealized          |                 | Unrealized                              |                 | Unrealized        |                   |
|  | Fair Value          | (Loss)          | Fair Value                              | (Loss)          | Fair Value        | (Loss)            |
| <b>Securities available for sale:</b>            |                     |                 |   |                 |                   |                   |
| U.S. agency and mortgage-backed securities       | \$ 50,185           | \$ (464)        | \$ 13,409                               | \$ (379)        | \$ 63,594         | \$ (843)          |
| Obligations of states and political subdivisions | 2,395               | (15)            | 1,053                                   | (35)            | 3,448             | (50)              |
| <b>Total securities available for sale</b>       | <b>\$ 52,580</b>    | <b>\$ (479)</b> | <b>\$ 14,462</b>                        | <b>\$ (414)</b> | <b>\$ 67,042</b>  | <b>\$ (893)</b>   |
| <b>Securities held to maturity:</b>              |                     |                 |   |                 |                   |                   |
| U.S. agency and mortgage-backed securities       | \$ 32,791           | \$ (326)        | \$                                      | \$              | \$ 32,791         | \$ (326)          |
| Obligations of states and political subdivisions | 3,052               | (19)            |   |                 | 3,052             | (19)              |
| <b>Total securities held to maturity</b>         | <b>\$ 35,843</b>    | <b>\$ (345)</b> | <b>\$</b>                               | <b>\$</b>       | <b>\$ 35,843</b>  | <b>\$ (345)</b>   |
| <b>Total securities</b>                          | <b>\$ 88,423</b>    | <b>\$ (824)</b> | <b>\$ 14,462</b>                        | <b>\$ (414)</b> | <b>\$ 102,885</b> | <b>\$ (1,238)</b> |

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 September 30, 2016, there were seven U.S. agency and mortgage-backed securities in an unrealized loss position. The Company did not have any obligations of a state and political subdivision in an unrealized loss position at September 30, 2016. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 4.0 years at September 30, 2016. At December 31, 2015, there were fifty-two U.S. agency and mortgage-backed securities and thirteen 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, 2015. The weighted-average re-pricing term of the portfolio was 4.6 years at December 31, 2015. The unrealized losses at September 30, 2016 in the U.S. agency and mortgage-backed securities portfolio were related to changes in market interest rates and not credit concerns of the issuers.

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

For the nine months ended September 30, 2016, the Company sold one security from the held to maturity portfolio. The Company recognized no gain or loss related to the sale as the carrying value of the security sold equaled the proceeds from the sale of \$657 thousand. The sale of this security was in response to credit deterioration of the issuer. There were no sales of securities from the held to maturity portfolio for the three months ended September 30, 2016 and the three and nine month periods ended September 30, 2015.

The amortized cost and fair value of securities at September 30, 2016 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.

|  | Available for Sale |               | Held to Maturity  |               |
|--|--------------------|---------------|-------------------|---------------|
|  | Amortized<br>Cost  | Fair<br>Value | Amortized<br>Cost | Fair<br>Value |
| Due within one year                    | \$                 | \$            | \$                | \$            |
| Due after one year through five years  | 9,871              | 10,014        | 1,780             | 1,818         |
| Due after five years through ten years | 12,564             | 12,926        | 16,687            | 17,144        |
| Due after ten years                    | 64,445             | 65,372        | 36,796            | 37,343        |
| Corporate equity securities            | 1                  | 11            |                   |               |
|  | \$ 86,881          | \$ 88,323     | \$ 55,263         | \$ 56,305     |

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 September 30, 2016, and no impairment has been recognized.

The composition of restricted securities at September 30, 2016 and December 31, 2015 was as follows (in thousands):

|                              | September 30,<br>2016 | December 31,<br>2015 |
|------------------------------|-----------------------|----------------------|
| Federal Home Loan Bank stock | \$ 623                | \$ 466               |
| Federal Reserve Bank stock   | 875                   | 875                  |
| Community Bankers Bank stock | 50                    | 50                   |

\$ 1,548      \$ 1,391

**Note 3. Loans**

Loans at September 30, 2016 and December 31, 2015 are summarized as follows (in thousands):

|                                   | September 30,<br>2016 | December 31,<br>2015 |
|-----------------------------------|-----------------------|----------------------|
| <b>Real estate loans:</b>         |                       |                      |
| Construction and land development | \$ 34,518             | \$ 33,135            |
| Secured by 1-4 family residential | 196,492               | 189,286              |
| Other real estate loans           | 202,843               | 181,447              |
| Commercial and industrial loans   | 25,851                | 24,048               |
| Consumer and other loans          | 11,130                | 11,083               |
| <b>Total loans</b>                | <b>\$ 470,834</b>     | <b>\$ 438,999</b>    |
| Allowance for loan losses         | (5,610)               | (5,524)              |
| <b>Loans, net</b>                 | <b>\$ 465,224</b>     | <b>\$ 433,475</b>    |

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**Notes to Consolidated Financial Statements**

*(unaudited)*

Net deferred loan fees included in the above loan categories were \$80 thousand at September 30, 2016 and net deferred loan costs included in the above loan categories were \$54 thousand at December 31, 2015. Consumer and other loans included \$260 thousand and \$257 thousand of demand deposit overdrafts at September 30, 2016 and December 31, 2015, 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.

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 tables provide a summary of loan classes and an aging of past due loans as of September 30, 2016 and December 31, 2015 (in thousands):

September 30, 2016  
Current

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|                                   | 30-59<br>Days Past<br>Due | 60-89<br>Days<br>Past Due | > 90<br>Days Past<br>Due | Total<br>Past Due | Total<br>Loans    | Non-accrual<br>Loans | 90<br>Days<br>or<br>More<br>Past<br>Due<br>and<br>Accruing |
|-----------------------------------|---------------------------|---------------------------|--------------------------|-------------------|-------------------|----------------------|--|
| <b>Real estate loans:</b>         |                           |                           |                          |                   |                   |                      |  |
| Construction and land development | \$ 260                    | \$ 1,735                  | \$                       | \$ 1,995          | \$ 32,523         | \$ 34,518            | \$ 1,632   |
| Secured by 1-4 family residential | 416                       | 265                       | 268                      | 949               | 195,543           | 196,492              | 339  |
| Other real estate loans           | 477                       | 381                       | 328                      | 1,186             | 201,657           | 202,843              | 1,471  |
| Commercial and industrial         | 82                        | 32                        | 55                       | 169               | 25,682            | 25,851               | 79   |
| Consumer and other loans          | 11                        | 8                         |                          | 19                | 11,111            | 11,130               |  |
| <b>Total</b>                      | <b>\$ 1,246</b>           | <b>\$ 2,421</b>           | <b>\$ 651</b>            | <b>\$ 4,318</b>   | <b>\$ 466,516</b> | <b>\$ 470,834</b>    | <b>\$ 3,521</b>  |

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

December 31, 2015

|                                   | 30-59<br>Days Past<br>Due | 60-89<br>Days Past<br>Due | > 90<br>Days Past<br>Due | Total<br>Past Due | Current           | Total<br>Loans    | Non-accrual<br>Loans | 90<br>Days<br>or<br>More<br>Past<br>Due<br>and<br>Accruing |
|-----------------------------------|---------------------------|---------------------------|--------------------------|-------------------|-------------------|-------------------|----------------------|--|
| <b>Real estate loans:</b>         |                           |                           |                          |                   |                   |                   |                      |  |
| Construction and land development | \$                        | \$                        | \$                       | \$                | \$ 33,135         | \$ 33,135         | \$ 1,269             | \$   |
| Secured by 1-4 family residential | 635                       | 18                        | 264                      | 917               | 188,369           | 189,286           | 346                  |  |
| Other real estate loans           | 387                       | 358                       | 790                      | 1,535             | 179,912           | 181,447           | 2,145                |  |
| Commercial and industrial         |                           |                           | 92                       | 92                | 23,956            | 24,048            | 94                   | 92   |
| Consumer and other loans          | 20                        |                           |                          | 20                | 11,063            | 11,083            |                      |  |
| <b>Total</b>                      | <b>\$ 1,042</b>           | <b>\$ 376</b>             | <b>\$ 1,146</b>          | <b>\$ 2,564</b>   | <b>\$ 436,435</b> | <b>\$ 438,999</b> | <b>\$ 3,854</b>      | <b>\$ 92</b>   |

**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 Bank

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.

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The following tables provide an analysis of the credit risk profile of each loan class as of September 30, 2016 and December 31, 2015 (in thousands):

|                                   | September 30, 2016 |                    |                  |           | Total             |
|-----------------------------------|--------------------|--------------------|------------------|-----------|-------------------|
|                                   | Pass               | Special<br>Mention | Substandard      | Doubtful  |                   |
| Real estate loans:                |                    |                    |                  |           |                   |
| Construction and land development | \$ 28,115          | \$ 2,543           | \$ 3,860         | \$        | \$ 34,518         |
| Secured by 1-4 family residential | 190,915            | 3,242              | 2,335            |           | 196,492           |
| Other real estate loans           | 189,522            | 8,060              | 5,261            |           | 202,843           |
| Commercial and industrial         | 25,310             | 393                | 148              |           | 25,851            |
| Consumer and other loans          | 11,130             |                    |                  |           | 11,130            |
| <b>Total</b>                      | <b>\$ 444,992</b>  | <b>\$ 14,238</b>   | <b>\$ 11,604</b> | <b>\$</b> | <b>\$ 470,834</b> |

|                                   | December 31, 2015 |                    |                  |           | Total             |
|-----------------------------------|-------------------|--------------------|------------------|-----------|-------------------|
|                                   | Pass              | Special<br>Mention | Substandard      | Doubtful  |                   |
| Real estate loans:                |                   |                    |                  |           |                   |
| Construction and land development | \$ 26,371         | \$ 2,587           | \$ 4,177         | \$        | \$ 33,135         |
| Secured by 1-4 family residential | 182,595           | 3,376              | 3,315            |           | 189,286           |
| Other real estate loans           | 165,310           | 9,977              | 6,160            |           | 181,447           |
| Commercial and industrial         | 23,351            | 432                | 265              |           | 24,048            |
| Consumer and other loans          | 11,083            |                    |                  |           | 11,083            |
| <b>Total</b>                      | <b>\$ 408,710</b> | <b>\$ 16,372</b>   | <b>\$ 13,917</b> | <b>\$</b> | <b>\$ 438,999</b> |

**Note 4. Allowance for Loan Losses**

The following tables present, as of September 30, 2016, December 31, 2015 and September 30, 2015, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology (in thousands):

|  | September 30, 2016          |                      |                      |                                 |                          | Total |
|--|-----------------------------|----------------------|----------------------|---------------------------------|--------------------------|-------|
|  | Construction<br>and<br>Land | Secured<br>by<br>1-4 | Other Real<br>Estate | Commercial<br>and<br>Industrial | Consumer<br>and<br>Other |       |

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|   | Development | Family Residential |          |        | Loans  |          |
|---|-------------|--------------------|----------|--------|--------|----------|
| <b>Allowance for loan losses:</b>       |             |                    |          |        |        |          |
| Beginning Balance, December 31, 2015    | \$ 1,532    | \$ 939             | \$ 2,534 | \$ 306 | \$ 213 | \$ 5,524 |
| Charge-offs                             |             | (53)               |          |        | (398)  | (451)    |
| Recoveries                              | 4           | 290                | 1        | 10     | 232    | 537      |
| Provision for (recovery of) loan losses | (1,084)     | (173)              | 1,002    | 13     | 242    |          |
| Ending Balance, September 30, 2016      | \$ 452      | \$ 1,003           | \$ 3,537 | \$ 329 | \$ 289 | \$ 5,610 |
| <b>Ending Balance:</b>                  |             |                    |          |        |        |          |
| Individually evaluated for impairment   |             | 33                 | 223      |        |        | 256      |
| Collectively evaluated for impairment   | 452         | 970                | 3,314    | 329    | 289    | 5,354    |
| <b>Loans:</b>                           |             |                    |          |        |        |          |
| Ending Balance                          | 34,518      | 196,492            | 202,843  | 25,851 | 11,130 | 470,834  |
| Individually evaluated for impairment   | 2,749       | 2,094              | 1,991    | 79     |        | 6,913    |
| Collectively evaluated for impairment   | 31,769      | 194,398            | 200,852  | 25,772 | 11,130 | 463,921  |

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|   | December 31, 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                             |                                   | (142)                             | (1,125)           | (59)                      | (512)                    | (1,838)  |
| Recoveries                              | 4                                 | 373                               | 2                 | 72                        | 293                      | 744      |
| Provision for (recovery of) loan losses | 125                               | (496)                             | (1)               | (17)                      | 289                      | (100)    |
| Ending Balance, December 31, 2015       | \$ 1,532                          | \$ 939                            | \$ 2,534          | \$ 306                    | \$ 213                   | \$ 5,524 |

**Ending Balance:**

|                                       |       |     |       |     |     |       |
|---------------------------------------|-------|-----|-------|-----|-----|-------|
| Individually evaluated for impairment | 326   | 23  | 195   |     |     | 544   |
| Collectively evaluated for impairment | 1,206 | 916 | 2,339 | 306 | 213 | 4,980 |

**Loans:**

|                                       |        |         |         |        |        |         |
|---------------------------------------|--------|---------|---------|--------|--------|---------|
| Ending Balance                        | 33,135 | 189,286 | 181,447 | 24,048 | 11,083 | 438,999 |
| Individually evaluated for impairment | 2,544  | 2,044   | 3,023   | 94     |        | 7,705   |
| Collectively evaluated for impairment | 30,591 | 187,242 | 178,424 | 23,954 | 11,083 | 431,294 |

|   | September 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)                              | (950)             | (59)                      | (364)                    | (1,420)  |
| Recoveries                              | 3                                 | 90                                | 2                 | 69                        | 213                      | 377      |
| Provision for (recovery of) loan losses | (150)                             | (368)                             | 288               | (68)                      | 198                      | (100)    |

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Ending Balance, September 30, 2015 \$ 1,256 \$ 879 \$ 2,998 \$ 252 \$ 190 \$ 5,575

**Ending Balance:**

Individually evaluated for impairment 132 22 596 750

Collectively evaluated for impairment 1,124 857 2,402 252 190 4,825

**Loans:**

Ending Balance 29,935 179,419 165,661 19,950 11,448 406,413

Individually evaluated for impairment 3,081 2,151 3,509 99 8,840

Collectively evaluated for impairment 26,854 177,268 162,152 19,851 11,448 397,573

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

Impaired loans and the related allowance at September 30, 2016, December 31, 2015 and September 30, 2015, were as follows (in thousands):

|                                   | September 30, 2016       |                                       |                                    |                           |                   |                             |                            |
|-----------------------------------|--------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|
|                                   | 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 | \$ 2,992                 | \$ 2,749                              | \$                                 | \$ 2,749                  | \$                | \$ 2,599                    | \$ 40                      |
| Secured by 1-4 family             | 2,114                    | 2,006                                 | 88                                 | 2,094                     | 33                | 2,045                       | 73                         |
| Other real estate loans           | 2,596                    | 1,447                                 | 544                                | 1,991                     | 223               | 2,808                       | 24                         |
| Commercial and industrial         | 97                       | 79                                    |                                    | 79                        |                   | 87                          |                            |
| Consumer and other loans          |                          |                                       |                                    |                           |                   |                             |                            |
| <b>Total</b>                      | <b>\$ 7,799</b>          | <b>\$ 6,281</b>                       | <b>\$ 632</b>                      | <b>\$ 6,913</b>           | <b>\$ 256</b>     | <b>\$ 7,539</b>             | <b>\$ 137</b>              |

|                                   | December 31, 2015        |                                       |                                    |                           |                   |                             |                            |
|-----------------------------------|--------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|
|                                   | 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 | \$ 2,741                 | \$ 2,206                              | \$ 338                             | \$ 2,544                  | \$ 326            | \$ 2,967                    | \$ 60                      |
| Secured by 1-4 family             | 2,116                    | 2,021                                 | 23                                 | 2,044                     | 23                | 2,526                       | 107                        |
| Other real estate loans           | 3,492                    | 2,463                                 | 560                                | 3,023                     | 195               | 4,933                       | 58                         |
| Commercial and industrial         | 107                      | 94                                    |                                    | 94                        |                   | 118                         |                            |
| Consumer and other loans          |                          |                                       |                                    |                           |                   |                             |                            |
| <b>Total</b>                      | <b>\$ 8,456</b>          | <b>\$ 6,784</b>                       | <b>\$ 921</b>                      | <b>\$ 7,705</b>           | <b>\$ 544</b>     | <b>\$ 10,544</b>            | <b>\$ 225</b>              |

|  | September 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 |
|  |                          |                                       |                                    |                           |                   |                             |                            |

|                                   |                 |                 |                 |                 |               |                  |               |
|-----------------------------------|-----------------|-----------------|-----------------|-----------------|---------------|------------------|---------------|
| Real estate loans:                |                 |                 |                 |                 |               |                  |               |
| Construction and land development | \$ 3,256        | \$ 2,416        | \$ 665          | \$ 3,081        | \$ 132        | \$ 3,127         | \$ 45         |
| Secured by 1-4 family             | 2,222           | 2,129           | 22              | 2,151           | 22            | 2,687            | 88            |
| Other real estate loans           | 3,961           | 2,000           | 1,509           | 3,509           | 596           | 5,563            | 49            |
| Commercial and industrial         | 111             | 99              |                 | 99              |               | 126              |               |
| Consumer and other loans          |                 |                 |                 |                 |               |                  |               |
| <b>Total</b>                      | <b>\$ 9,550</b> | <b>\$ 6,644</b> | <b>\$ 2,196</b> | <b>\$ 8,840</b> | <b>\$ 750</b> | <b>\$ 11,503</b> | <b>\$ 182</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.

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

As of September 30, 2016, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled \$162 thousand. At September 30, 2016, \$88 thousand of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were \$982 thousand in TDRs at December 31, 2015, \$317 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 was one loan secured by 1-4 family residential real estate classified as a TDR during the three and nine month periods ended September 30, 2016 because principal was forgiven as part of the loan modification. The recorded investment for this loan prior to modification totaled \$138 thousand and the recorded investment after the modification totaled \$88 thousand. There were no loans modified under TDRs during the three and nine month periods ended September 30, 2015.

For the three and nine months ended September 30, 2016 and 2015, 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 or charge-off of the loan during the twelve month period subsequent to the modification.

**Note 5. Other Real Estate Owned (OREO)**

Changes in the balance for OREO are as follows (in thousands):

|   | For the nine<br>months<br>ended<br>September 30,<br>2016 | For the year<br>ended<br>December 31,<br>2015 |
|---|--|---|
| Balance at the beginning of year, gross | \$ 2,903   | \$ 2,263                                      |
| Transfers in                            | 287  | 1,664   |
| Charge-offs                             | (251)  | (381)   |
| Sales proceeds                          | (2,882)  | (717)   |
| Gain on disposition                     | 193  | 74  |
| Balance at the end of period, gross     | \$ 250   | \$ 2,903                                      |
| Less: valuation allowance               |  | (224)   |
| Balance at the end of period, net       | \$ 250   | \$ 2,679                                      |

There were no residential real estate properties included in the ending OREO balances above at September 30, 2016. The carrying amounts of residential real estate properties included in the ending OREO balances above totaled \$627 thousand at December 31, 2015. The recorded investment of consumer mortgage loans secured by residential real

estate properties for which formal foreclosure proceedings were in process was \$100 thousand as of September 30, 2016.

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

|                              | For the nine<br>months ended |                       | For the<br>year<br>ended |
|------------------------------|------------------------------|-----------------------|--------------------------|
|                              | September 30,<br>2016        | September 30,<br>2015 | December 31,<br>2015     |
| Balance at beginning of year | \$ 224                       | \$ 375                | \$ 375                   |
| Provision for losses         | 27                           | 230                   | 230                      |
| Charge-offs, net             | (251)                        | (375)                 | (381)                    |
| Balance at end of period     | \$                           | \$ 230                | \$ 224                   |

Net expenses applicable to OREO, other than the provision for losses, were \$46 thousand and \$101 thousand for the nine months ended September 30, 2016 and 2015, respectively and \$196 thousand for the year ended December 31, 2015.

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**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 6. Other Borrowings**

The Bank had unused lines of credit totaling \$128.9 million and \$128.1 million available with non-affiliated banks at September 30, 2016 and December 31, 2015, respectively. These amounts primarily consist of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) in which the Bank can borrow up to 19% of its total assets. The unused line of credit with FHLB totaled \$85.7 million at September 30, 2016. The Bank had collateral pledged on the borrowing line at September 30, 2016 and December 31, 2015 including real estate loans totaling \$107.9 million and \$105.1 million, respectively, and Federal Home Loan Bank stock with a book value of \$623 thousand and \$466 thousand, respectively. The Bank did not have borrowings from the FHLB at September 30, 2016 and December 31, 2015.

**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.

The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective January 1, 2015, with full compliance of all the requirements being phased in over a multi-year schedule, and becoming fully phased in by January 1, 2019. As part of the new requirements, the common equity Tier 1 capital ratio is calculated and utilized in the assessment of capital for all institutions. The final rules also established a capital conservation buffer above the new regulatory minimum capital requirements. The capital conservation buffer is being phased-in over four years beginning on January 1, 2016.

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 September 30, 2016 and December 31, 2015, that the Bank met all capital adequacy requirements to which it is subject.

As of September 30, 2016, 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 September 30, 2016 and December 31, 2015 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>September 30, 2016:</b>                             |           |        |                             |       |  |        |
| Total Capital (to Risk-Weighted Assets)                | \$ 65,759 | 13.90% | \$ 37,843                   | 8.00% | \$ 47,304  | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets)               | \$ 60,149 | 12.72% | \$ 28,382                   | 6.00% | \$ 37,843  | 8.00%  |
| Common Equity Tier 1 Capital (to Risk-Weighted Assets) | \$ 60,149 | 12.72% | \$ 21,287                   | 4.50% | \$ 30,747  | 6.50%  |
| Tier 1 Capital (to Average Assets)                     | \$ 60,149 | 8.48%  | \$ 28,357                   | 4.00% | \$ 35,446  | 5.00%  |
| <b>December 31, 2015:</b>                              |           |        |                             |       |  |        |
| Total Capital (to Risk-Weighted Assets)                | \$ 61,513 | 13.86% | \$ 35,497                   | 8.00% | \$ 44,372  | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets)               | \$ 55,989 | 12.62% | \$ 26,623                   | 6.00% | \$ 35,497  | 8.00%  |
| Common Equity Tier 1 Capital (to Risk-Weighted Assets) | \$ 55,989 | 12.62% | \$ 19,967                   | 4.50% | \$ 28,842  | 6.50%  |
| Tier 1 Capital (to Average Assets)                     | \$ 55,989 | 8.12%  | \$ 27,571                   | 4.00% | \$ 34,464  | 5.00%  |

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**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 8. Subordinated Debt**

On October 30, 2015, the Company entered into a Subordinated Loan Agreement (the Agreement) pursuant to which the Company issued an interest only subordinated term note due 2025 in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum. The Note qualifies as Tier 2 capital for regulatory capital purposes and at September 30, 2016, the total amount of subordinated debt issued was included in the Company's Tier 2 capital. Unamortized debt issuance costs related to the Note were \$74 thousand and \$87 thousand at September 30, 2016 and December 31, 2015, respectively.

The Note has a maturity date of October 1, 2025. Subject to regulatory approval, the Company may prepay the Note, in part or in full, beginning on October 30, 2020. The Note is an unsecured, subordinated obligation of the Company and ranks junior in right of payment to the Company's senior indebtedness and to the Company's obligations to its general creditors. The Note ranks equally with all other unsecured subordinated debt, except any which by its terms is expressly stated to be subordinated to the Note. The Note ranks senior to all current and future junior subordinated debt obligations, preferred stock and common stock of the Company.

The Note is not convertible into common stock or preferred stock. The Agreement contains customary events of default such as the bankruptcy of the Company and the non-payment of principal or interest when due. The holder of the Note may accelerate the repayment of the Note only in the event of bankruptcy or similar proceedings and not for any other event of default.

**Note 9. Junior Subordinated Debt**

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 September 30, 2016 and December 31, 2015 was 3.46% and 3.13%, 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 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 junior subordinated debt.

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 September 30, 2016 and December 31, 2015 was 2.25% and 1.93%, 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 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 junior subordinated debt.

While these securities are debt obligations of the Company, they are included in capital for regulatory capital ratio calculations. Under present regulations, the junior subordinated debt 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 junior subordinated debt. The portion of the junior subordinated debt not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At September 30, 2016 and December 31, 2015, the total amount of junior subordinated debt issued by the Trusts was included in the Company's Tier 1 capital.

**Note 10. 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.

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On September 14, 2016, the defined benefit pension plan was amended to be terminated and the amendment will be submitted to the Internal Revenue Service and the Pension Benefit Guarantee Corporation for approval. Under the amendment, benefit accruals will cease as of November 30, 2016. Although an application for termination approval is in process, the date of possible Internal Revenue Service approval is unknown and there can be no assurance that the plan will be terminated during 2016. The funding status of the plan upon termination cannot yet be reasonably estimated.

Components of the net periodic benefit cost of the plan for the three and nine months ended September 30, 2016 and 2015 were as follows (in thousands):

|                                  | For the three months<br>ended September 30, |               | For the nine months<br>ended September 30, |               |
|----------------------------------|---|---------------|--|---------------|
|                                  | 2016  | 2015          | 2016                                       | 2015          |
| Service cost                     | \$ 102                                      | \$ 111        | \$ 307                                     | \$ 334        |
| Interest cost                    | 83  | 76            | 249  | 227           |
| Expected return on plan assets   | (74)  | (79)          | (223)                                      | (236)         |
| Amortization of net loss         | 21  | 22            | 63   | 65            |
| <b>Net periodic benefit cost</b> | <b>\$ 132</b>                               | <b>\$ 130</b> | <b>\$ 396</b>                              | <b>\$ 390</b> |

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2015, that it expected to make no contribution to its pension plan during the year ended December 31, 2016. 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. On September 14, 2016, the ESOP was amended to freeze the plan to new participants and to cease all contributions, effective December 31, 2016. The amendment also directs matching contributions and certain other retirement contributions made by the Company to the 401(k) plan. The ESOP shall be maintained as a frozen plan and continue to be invested in Company stock and such other assets as permitted under the ESOP and Trust Agreement for the benefit of participants and their beneficiaries.

See Note 13 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 for additional information about the Company's benefit plans.

**Note 11. 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.

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The following table presents the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2016 and 2015 (dollars in thousands, except per share data):

|   | For the three months ended |                       | For the nine months ended |                       |
|---|----------------------------|-----------------------|---------------------------|-----------------------|
|   | September 30,<br>2016      | September 30,<br>2015 | September 30,<br>2016     | September 30,<br>2015 |
| <b>(Numerator):</b>                                       |                            |                       |                           |                       |
| Net income  | \$ 1,694                   | \$ 726                | \$ 4,226                  | \$ 1,714              |
| Effective dividend on preferred stock                     |                            | 328                   |                           | 985                   |
| Net income available to common shareholders               | \$ 1,694                   | \$ 398                | \$ 4,226                  | \$ 729                |
| <b>(Denominator):</b>                                     |                            |                       |                           |                       |
| Weighted average shares outstanding basic                 | 4,925,753                  | 4,911,604             | 4,923,598                 | 4,909,470             |
| Potentially dilutive common shares restricted stock units | 4,169                      | 1,857                 | 2,782                     | 2,481                 |
| Weighted average shares outstanding diluted               | 4,929,922                  | 4,913,461             | 4,926,380                 | 4,911,951             |
| <b>Income per common share</b>                            |                            |                       |                           |                       |
| Basic   | \$ 0.34                    | \$ 0.08               | \$ 0.86                   | \$ 0.15               |
| Diluted   | \$ 0.34                    | \$ 0.08               | \$ 0.86                   | \$ 0.15               |

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**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 12. Fair Value Measurements**

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

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

**Fair Value Hierarchy**

In accordance with this guidance, the Company groups its 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).

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

The following tables present the balances of assets measured at fair value on a recurring basis as of September 30, 2016 and December 31, 2015 (in thousands).

| Description                                      | Fair Value Measurements at September 30, 2016 |  |   |  |
|--|---|--|---|--|
|  | Balance as of<br>September 30,<br>2016        | Quoted<br>Prices<br>in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Securities available for sale                    |   |  |   |  |
| U.S. agency and mortgage-backed securities       | \$ 75,762                                     | \$   | \$ 75,762   | \$   |
| Obligations of states and political subdivisions | 12,550  |  | 12,550  |  |
| Corporate equity securities                      | 11  | 11   |   |  |
|  | \$ 88,323                                     | \$ 11  | \$ 88,312   | \$   |

| Description                                      | Fair Value Measurements at December 31, 2015 |  |   |  |
|--|--|--|---|--|
|  | Balance as of<br>December<br>31,<br>2015     | Quoted<br>Prices<br>in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Securities available for sale                    |  |  |   |  |
| U.S. agency and mortgage-backed securities       | \$ 89,337                                    | \$   | \$ 89,337   | \$   |
| Obligations of states and political subdivisions | 16,214                                       |  | 16,214  |  |
| Corporate equity securities                      | 8  | 8  |   |  |
|  | \$ 105,559                                   | \$ 8   | \$ 105,551  | \$   |

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 nine months ended September 30, 2016 and the year ended December 31, 2015.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***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 (or recovery of) 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. Any fair value adjustments are recorded in the period incurred as other real estate owned expense on the Consolidated Statements of Income.

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 | Balance as of<br>September 30,<br>2016 | Fair Value Measurements at September 30, 2016  |  |  |
|-------------|--|--|--|--|
|             |  | Quoted<br>Prices<br>in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|             |  |  |  |  |

|                              |    |     |    |    |    |     |
|------------------------------|----|-----|----|----|----|-----|
| Impaired loans, net          | \$ | 376 | \$ | \$ | \$ | 376 |
| Other real estate owned, net |    | 250 |    |    |    | 250 |

| Description                  | Fair Value Measurements at December 31, 2015 |  |   |   |
|------------------------------|--|--|---|---|
|                              | Balance as of December 31, 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          | \$ 377                                       | \$   | \$  | \$ 377                                    |
| Other real estate owned, net | 2,679  |  |   | 2,679                                     |

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*Quantitative information about Level 3 Fair Value Measurements for September 30, 2016  
Range (Weighted-

|                              | Fair Value | Valuation Technique | Unobservable Input | Average) |
|------------------------------|------------|---------------------|--------------------|----------|
| Impaired loans, net          | \$ 376     | Property appraisals | Selling cost       | 10%      |
| Other real estate owned, net | \$ 250     | Property appraisals | Selling cost       | 0%       |

The amount disclosed as fair value of other real estate owned at September 30, 2016 represents the carrying value of the property. Since the appraised value of the property, net of selling costs, exceeded the Company's carrying value on the date the property was transferred from premises and equipment to other real estate owned, the Company did not adjust the carrying value for selling costs.

Quantitative information about Level 3 Fair Value Measurements for December 31, 2015  
Range (Weighted-

|                              | Fair Value | Valuation Technique | Unobservable Input | Average)   |
|------------------------------|------------|---------------------|--------------------|------------|
| Impaired loans, net          | \$ 377     | Property appraisals | Selling cost       | 2-10% (5%) |
| Other real estate owned, net | \$ 2,679   | Property appraisals | Selling cost       | 7%         |

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 provisions.

**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.

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**Notes to Consolidated Financial Statements**

*(unaudited)*

**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-rate 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 September 30, 2016 and December 31, 2015, fair value of loan commitments and standby letters of credit was immaterial.

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

The carrying values and estimated fair values of the Company's financial instruments at September 30, 2016 and December 31, 2015 are as follows (in thousands):

|                                 | Fair Value Measurements at September 30, 2016 Using |  |   |   |            |
|---------------------------------|---|--|---|---|------------|
|                                 | Carrying Amount                                     | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Fair Value |
| <b>Financial Assets</b>         |   |  |   |   |            |
| Cash and short-term investments | \$ 56,857   | \$ 56,857  | \$  | \$                                      | \$ 56,857  |
| Securities available for sale   | 88,323  | 11   | 88,312                                      |   | 88,323     |
| Securities held to maturity     | 55,263  |  | 54,781                                      | 1,524                                   | 56,305     |
| Restricted securities           | 1,548   |  | 1,548                                       |   | 1,548      |
| Loans held for sale             | 1,053   |  | 1,053                                       |   | 1,053      |
| Loans, net                      | 465,224   |  |   | 471,778                                 | 471,778    |
| Bank owned life insurance       | 13,808  |  | 13,808                                      |   | 13,808     |
| Accrued interest receivable     | 1,631   |  | 1,631                                       |   | 1,631      |
| <b>Financial Liabilities</b>    |   |  |   |   |            |
| Deposits                        | \$ 640,742  | \$   | \$ 509,088                                  | \$ 131,611                              | \$ 640,699 |
| Subordinated debt               | 4,926   |  |   | 4,986                                   | 4,986      |
| Junior subordinated debt        | 9,279   |  |   | 8,109                                   | 8,109      |
| Accrued interest payable        | 91  |  | 91  |   | 91         |

|                                 | Fair Value Measurements at December 31, 2015 Using |  |   |   |            |
|---------------------------------|--|--|---|---|------------|
|                                 | Carrying Amount                                    | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Fair Value |
| <b>Financial Assets</b>         |  |  |   |   |            |
| Cash and short-term investments | \$ 39,334  | \$ 39,334  | \$  | \$                                      | \$ 39,334  |
| Securities available for sale   | 105,559  | 8  | 105,551                                     |   | 105,559    |
| Securities held to maturity     | 66,519   |  | 64,938                                      | 1,500                                   | 66,438     |
| Restricted securities           | 1,391  |  | 1,391                                       |   | 1,391      |

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|                              |            |    |            |    |                       |
|------------------------------|------------|----|------------|----|-----------------------|
| Loans held for sale          | 323        |    | 323        |    | 323                   |
| Loans, net                   | 433,475    |    | 438,392    |    | 438,392               |
| Bank owned life insurance    | 11,742     |    | 11,742     |    | 11,742                |
| Accrued interest receivable  | 1,661      |    | 1,661      |    | 1,661                 |
| <b>Financial Liabilities</b> |            |    |            |    |                       |
| Deposits                     | \$ 627,116 | \$ | \$ 486,015 | \$ | \$ 140,306 \$ 626,321 |
| Subordinated debt            | 4,913      |    | 4,913      |    | 4,913                 |
| Junior subordinated debt     | 9,279      |    | 8,141      |    | 8,141                 |
| Accrued interest payable     | 117        |    | 117        |    | 117                   |

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**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 13. Preferred Stock**

On November 6, 2015, the Company redeemed all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A at par for \$13.9 million and all 695 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series B at par for \$695 thousand.

Prior to redemption, the Company had (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 paid 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 14. 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 the Board of Directors and compensation cost equal to the fair value of the award is recognized over the vesting period.

**Stock Awards**

Whenever the Company deems it appropriate to grant a stock award, the recipient receives a specified number of unrestricted shares of employer stock. Stock awards may be made by the Company at its discretion without cash consideration and may be granted as settlement of a performance-based compensation award.

The Company did not grant any stock awards during the nine month period ended September 30, 2016. Compensation expense related to stock awards totaled \$8 thousand for the nine months ended September 30, 2015.

**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 2016, 9,130 restricted stock units were granted to employees, with 3,047 units vesting immediately and 6,083 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.

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

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

|                               | September 30, 2016 | Weighted<br>Average<br>Grant Date<br>Fair<br>Value |
|-------------------------------|--------------------|--|
|                               | Shares             | Value  |
| Unvested, beginning of period | 8,353              | \$ 9.00  |
| Granted                       | 9,130              | 8.80   |
| Vested                        | (7,224)            | 8.92   |
| Forfeited                     |                    |  |
| Unvested, end of period       | 10,259             | \$ 8.88  |

At September 30, 2016, 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 \$50 thousand. This expense is expected to be recognized through 2018. Compensation expense related to restricted stock unit awards recognized for the nine months ended September 30, 2016 and 2015 totaled \$72 thousand and \$62 thousand, respectively. As of September 30, 2016, the Company does not expect the forfeiture of any unvested restricted stock units.

**Note 15. Accumulated Other Comprehensive Loss**

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

|   | Net<br>Unrealized<br>Gains (Losses)<br>on<br>Securities | Adjustments<br>Related to<br>Pension<br>Benefits | Accumulated<br>Other<br>Comprehensive<br>Loss |
|---|---|--|---|
| <b>Balance at December 31, 2014</b>                 | \$ (133)  | \$ (1,421)                                       | \$ (1,554)                                    |
| Unrealized holding gains (net of tax,<br>\$176)     | 344   |  | 344   |
| Reclassification adjustment (net of tax,<br>(\$18)) | 34  |  | 34  |
| Change during period                                | 378   |  | 378   |

|   |              |            |              |
|---|--------------|------------|--------------|
| <b>Balance at September 30, 2015</b>          | \$ 245       | \$ (1,421) | \$ (1,176)   |
| <b>Balance at December 31, 2015</b>           | \$ (192)     | \$ (1,396) | \$ (1,588)   |
| Unrealized holding gains (net of tax, \$593)  | 1,151        |            | 1,151        |
| Reclassification adjustment (net of tax, \$3) | (7)          |            | (7)          |
| <b>Change during period</b>                   | <b>1,144</b> |            | <b>1,144</b> |
| <b>Balance at September 30, 2016</b>          | \$ 952       | \$ (1,396) | \$ (444)     |

The following tables present information related to reclassifications from accumulated other comprehensive loss for the three and nine month periods ended September 30, 2016 and 2015 (in thousands).

| Details About Accumulated Other Comprehensive Loss | Amount Reclassified from Accumulated Other Comprehensive Loss |      | Affected Line Item in the Consolidated Statements of Income   |
|--|---|------|---|
|  | For the three months ended September 30, 2016                 | 2015 |   |
| Securities available for sale:                     |   |      |   |
| Net securities gains reclassified into earnings    | \$ (4)  | \$   | Net gains on calls and sales of securities available for sale |
| Related income tax expense                         | 1   |      | Income tax expense  |
| Total reclassifications                            | \$ (3)  | \$   | Net of tax  |

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

| Details About Accumulated Other<br>Comprehensive Loss    | Amount Reclassified from<br>Accumulated Other<br>Comprehensive Loss<br><b>For the nine months<br/>ended September 30,<br/>2016                      2015</b> |       | Affected Line Item in the Consolidated<br>Statements of Income         |
|--|--|-------|--|
| <b>Securities available for sale:</b>                    |  |       |  |
| Net securities (gains) losses reclassified into earnings | \$ (10)  | \$ 52 | Net gains (losses) on calls and sales of securities available for sale |
| Related income tax expense (benefit)                     | 3  | (18)  | Income tax expense   |
| Total reclassifications                                  | \$ (7)   | \$ 34 | Net of tax   |

**Note 16. 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. 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 an assessment of the consideration transferred, assets purchased, and the liabilities assumed (in thousands):

|                            | As Recorded<br>by Bank of<br>America | Fair Value and<br>Other<br>Merger<br>Related<br>Adjustments | As Recorded<br>by the<br>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                       |

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|  |                   |                 |                   |
|--|-------------------|-----------------|-------------------|
| 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> |
| <b>Liabilities assumed:</b>                                      |                   |                 |                   |
| 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> |
| <b>Net identifiable assets acquired over liabilities assumed</b> | <b>\$ 2,262</b>   | <b>\$ 4,557</b> | <b>\$ 6,819</b>   |
| <b>Goodwill (bargain purchase gain)</b>                          |                   |                 | <b>\$ (201)</b>   |

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.

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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 Company 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 Company'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 Company'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, 2015.

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 September 30, 2016 and statements of income of the Company for the three and nine month periods ended September 30, 2016 and 2015 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, 2015. The statements of income for the three and nine month periods ended September 30, 2016 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 and are not included in the Company's consolidated financial statements in accordance with authoritative accounting guidance because management has determined that the Trusts qualify as variable interest entities.

#### Debt Issuance and Preferred Stock Redemption

During 2015, the Bank declared and paid cash dividends to the Company totaling \$13.5 million. In addition, the Company entered into a Subordinated Loan Agreement on October 30, 2015 pursuant to which the Company issued an interest only subordinated term note in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum with a maturity date of October 1, 2025. On November 6, 2015, the Company used the proceeds from the dividends and from the issuance of the Note to redeem all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A, totaling \$13.9 million, and all 695 shares of outstanding Fixed Rate Perpetual Preferred Stock, Series B, totaling \$695 thousand.

#### 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 \$4.5 million of premises and equipment and the assumption of \$186.8 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 appointed 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 existing loan production office in the city of Harrisonburg, 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, money market accounts, individual retirement accounts, certificates of deposit and cash management accounts.

The Bank's wealth management department offers estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. The Bank's mortgage department originates residential mortgage loans to customers. Loans originated through this department may be sold to investors in the secondary market or held in the Bank's loan portfolio. Mortgage services are offered to customers throughout the Bank's market area.

The Bank's office locations are well-positioned in attractive 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 its mobile banking platform, its website, [www.fbvirginia.com](http://www.fbvirginia.com), a network of ATMs located throughout its market area, two loan production offices, a customer service center in a retirement

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village, and 14 bank branch office locations located throughout the Shenandoah Valley and central regions of Virginia. The branch offices are comprised of 13 full service retail banking offices and one drive-thru express banking office. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2015.

## 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.

Primary expense categories are salaries and employee benefits, which comprised 56% of noninterest expenses for the nine month period ended September 30, 2016, followed by occupancy and equipment expense, which comprised 13% of noninterest expenses. Historically, the provision for loan losses has also been a primary expense of the Bank. 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 loan losses.

## Quarterly Performance

Net income available to common shareholders increased by \$1.3 million to \$1.7 million, or \$0.34 per basic and diluted share, for the three months ended September 30, 2016, compared to \$398 thousand, or \$0.08 per basic and diluted share, for the same period in 2015. Return on average assets was 0.95% and return on average equity was 13.44% for the third quarter of 2016, compared to 0.42% and 4.80%, respectively, for the same period in 2015.

The \$1.3 million increase in net income available to common shareholders for the three month period ended September 30, 2016 resulted from a \$421 thousand, or 8%, increase in net interest income, a \$67 thousand, or 3%, increase in noninterest income, and an \$848 thousand, or 13%, decrease in noninterest expenses, compared to the same period of 2015. These improvements were partially offset by a \$368 thousand increase in the related income tax expense. Net income available to common shareholders also increased due to a \$328 thousand decrease in the effective dividend on preferred stock, when comparing the periods.

Net interest income increased from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 3%, and the net interest margin increased 5%, or 17 basis points, to 3.57% for the third quarter of 2016, compared to 3.40% for the same period in 2015. Noninterest expense decreased primarily from lower salaries and employee benefits expense and expenses related to other real estate owned. A provision for (or recovery of) loan losses was not recorded during the third quarter of 2016 or 2015. For a more detailed discussion of the provision for (or recovery of) loan losses, see Provision for (Recovery of) Loan Losses below.

## Year-to-Date Performance

Net income available to common shareholders increased by \$3.5 million to \$4.2 million, or \$0.86 per basic and diluted share, for the nine months ended September 30, 2016, compared to \$729 thousand, or \$0.15 per basic and diluted share, for the same period in 2015. Return on average assets was 0.80% and return on average equity was 11.62% for the nine months ended September 30, 2016, compared to 0.37% and 3.82%, respectively, for the same period in 2015.

The \$3.5 million increase in net income available to common shareholders for the nine month period ended September 30, 2016 resulted from a \$2.2 million, or 15%, increase in net interest income, a \$222 thousand, or 4%, increase in noninterest income, and a \$1.2 million, or 6%, decrease in noninterest expenses, compared to the same period of 2015. These improvements were partially offset by a \$100 thousand decrease in recovery of loan losses and a \$1.0 million increase in income tax expense. Net income available to common shareholders also increased due to a \$985 thousand decrease in the effective dividend on preferred stock, when comparing the periods.

Net interest income increased from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 12% and the net interest margin increased 3%, or 9 basis points, to 3.61% for the nine months ended September 30, 2016, compared to 3.52% for the same period in 2015. Noninterest expense decreased primarily from lower salaries and employee benefit expense, lower supplies expense, lower legal and professional fees, and lower expenses related to other real estate owned. The decrease in the effective dividend and accretion on preferred stock

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resulted from the redemption of all outstanding preferred stock in the prior year. Based on management's analysis and the supporting allowance for loan loss calculation, a provision for (or recovery of) loan losses was not recorded during the nine month period ended September 30, 2016, compared to a recovery of loan losses of \$100 thousand for the same period one year ago.

**Non-GAAP Financial Measures**

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO income/(expense), amortization of intangibles, losses on disposal of premises and equipment, and acquisition and integration related expenses, 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<br>ended |                       | For the nine months ended |                       |
|  | September 30,<br>2016         | September 30,<br>2015 | September 30,<br>2016     | September 30,<br>2015 |
| Noninterest expense  | \$ 5,853                      | \$ 6,701              | \$ 17,853                 | \$ 19,043             |
| Add/(Subtract): other real estate owned<br>income/(expense), net | (1)                           | (144)                 | 120                       | (260)                 |
| Subtract: amortization of intangibles                            | (187)                         | (226)                 | (592)                     | (426)                 |
| Subtract: losses on disposal of premises and<br>equipment, net   | (8)                           |                       | (8)                       |                       |
| Subtract: acquisition and integration related<br>expenses        |                               | (20)                  |                           | (897)                 |
|  | \$ 5,657                      | \$ 6,311              | \$ 17,373                 | \$ 17,460             |
| Tax-equivalent net interest income                               | \$ 5,943                      | \$ 5,512              | \$ 17,637                 | \$ 15,338             |
| Noninterest income   | 2,311                         | 2,244                 | 6,366                     | 6,144                 |
| Add/(Subtract): securities (gains)/losses, net                   | (4)                           |                       | (10)                      | 52                    |
| Subtract: bargain purchase gain                                  |                               |                       |                           | (201)                 |
|  | \$ 8,250                      | \$ 7,756              | \$ 23,993                 | \$ 21,333             |
| Efficiency ratio   | 68.57%                        | 81.37%                | 72.41%                    | 81.85%                |

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 both 2016 and 2015 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).

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

|  | For the three months ended |                    | For the nine months ended |                    |
|--|----------------------------|--------------------|---------------------------|--------------------|
|  | September 30, 2016         | September 30, 2015 | September 30, 2016        | September 30, 2015 |
| <b>GAAP measures:</b>  |                            |                    |                           |                    |
| Interest income - loans  | \$ 5,500                   | \$ 4,854           | \$ 16,106                 | \$ 14,082          |
| Interest income - investments and other                                    | 842                        | 910                | 2,705                     | 2,062              |
| Interest expense - deposits  | (338)                      | (282)              | (1,000)                   | (848)              |
| Interest expense - other borrowings  | (1)                        |                    | (6)                       | (3)                |
| Interest expense - subordinated debt                                       | (91)                       |                    | (270)                     |                    |
| Interest expense - junior subordinated debt                                | (65)                       | (56)               | (190)                     | (165)              |
| Interest expense - federal funds purchased                                 |                            |                    | (3)                       | (2)                |
| <b>Total net interest income</b>   | <b>\$ 5,847</b>            | <b>\$ 5,426</b>    | <b>\$ 17,342</b>          | <b>\$ 15,126</b>   |
| <b>Non-GAAP measures:</b>  |                            |                    |                           |                    |
| Tax benefit realized on non-taxable interest income - loans                | \$ 26                      | \$ 26              | \$ 76                     | \$ 79              |
| Tax benefit realized on non-taxable interest income - municipal securities | 70                         | 60                 | 219                       | 133                |
| <b>Total tax benefit realized on non-taxable interest income</b>           | <b>\$ 96</b>               | <b>\$ 86</b>       | <b>\$ 295</b>             | <b>\$ 212</b>      |
| <b>Total tax-equivalent net interest income</b>                            | <b>\$ 5,943</b>            | <b>\$ 5,512</b>    | <b>\$ 17,637</b>          | <b>\$ 15,338</b>   |

**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 losses 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 (or recovery of) 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.

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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.

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, fair value of collateral less estimated costs to sell 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.

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### **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 initially recorded at fair value less estimated costs to sell to establish a new cost basis. OREO is subsequently 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 owned 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 (income) expense.

### **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 relies 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 system 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. 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.

### **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 risk management reports, including watch list reports and concentrations of credit. 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 mortgage 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.

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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 September 30, 2016, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$84.8 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 have an average life of approximately one year and re-price monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans 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 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.

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### **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, subordinated debt and junior subordinated debt. 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 (or recovery of) loan losses, noninterest income and noninterest expense are the other components that determine net income. Noninterest income and expense primarily consists of income from service charges on deposit accounts; revenue from wealth management services; ATM and check card income; revenue from other customer services; income from bank owned life insurance; general and administrative expenses and other real estate owned income or expense.

#### **Net Interest Income**

For the three months ended September 30, 2016, net interest income increased \$412 thousand, or 8%, to \$5.8 million, compared to \$5.4 million for the third quarter of 2015. The increase resulted from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 3%, and the net interest margin increased 5%, or 17 basis points, to 3.57% for the third quarter of 2016, compared to 3.40% for the same period one year ago. The 17 basis point increase in the net interest margin resulted from a 26 basis point increase in the yield on total earning assets, which was partially offset by a 9 basis point increase in interest expense as a percent of average earning assets. The higher yield on earning assets was attributable to the change in the composition of earning assets, as average loan balances increased to 71% of average earning assets in the third quarter of 2016, compared to 62% of average earning assets in the third quarter of 2015. Securities and interest-bearing deposits with other institutions decreased as a percentage of average earning assets, comparing the same periods. The change in the earning asset composition had a favorable impact on the total earning asset yield as loan rates were greater than rates earned on securities and interest-bearing deposits with other institutions.

For the nine months ended September 30, 2016, net interest income increased \$2.2 million, or 15%, to \$17.3 million, compared to \$15.1 million for the same period in 2015. The increase resulted from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 12% and the net interest margin increased 3%, or 9 basis points, to 3.61% for the nine months ended September 30, 2016, compared to 3.52% for the same period in 2015. The 9 basis point increase in the net interest margin resulted from a 16 basis point increase in the yield on total earning assets, which was partially offset by a 7 basis point increase in interest expense as a percent of average earning assets. The higher yield on earning assets was attributable to the change in the composition of earning assets, as average loan balances increased to 70% of average earning assets for the nine months ended September 30, 2016, compared to 67% of average earning assets for the same period in 2015. Interest-bearing deposits with other institutions decreased as a percentage of average earning assets, comparing the same periods.

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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 |                  |                     |                    |                  |                     |
|---|----------------------------|------------------|---------------------|--------------------|------------------|---------------------|
|   | September 30, 2016         |                  |                     | September 30, 2015 |                  |                     |
|   | Average Balance            | Interest Expense | Income/ Yield/ Rate | Average Balance    | Interest Expense | Income/ Yield/ Rate |
| <b>Assets</b>                                     |                            |                  |                     |                    |                  |                     |
| Securities:                                       |                            |                  |                     |                    |                  |                     |
| Taxable   | \$ 124,634                 | \$ 613           | 1.95%               | \$ 141,049         | \$ 713           | 2.01%               |
| Tax-exempt <sup>(1)</sup>                         | 23,102                     | 206              | 3.54%               | 19,523             | 176              | 3.58%               |
| Restricted  | 1,569                      | 20               | 5.18%               | 1,391              | 20               | 5.58%               |
| Total securities                                  | \$ 149,305                 | \$ 839           | 2.23%               | \$ 161,963         | \$ 909           | 2.23%               |
| Loans: <sup>(2)</sup>                             |                            |                  |                     |                    |                  |                     |
| Taxable   | \$ 462,888                 | \$ 5,452         | 4.69%               | \$ 390,082         | \$ 4,802         | 4.88%               |
| Tax-exempt <sup>(1)</sup>                         | 6,799                      | 74               | 4.33%               | 7,103              | 78               | 4.33%               |
| Total loans                                       | \$ 469,687                 | \$ 5,526         | 4.68%               | \$ 397,185         | \$ 4,880         | 4.87%               |
| Interest-bearing deposits with other institutions | 42,632                     | 73               | 0.68%               | 83,086             | 61               | 0.29%               |
| Total earning assets                              | \$ 661,624                 | \$ 6,438         | 3.87%               | \$ 642,234         | \$ 5,850         | 3.61%               |
| Less: allowance for loan losses                   | (5,686)                    |                  |                     | (6,072)            |                  |                     |
| Total non-earning assets                          | 54,067                     |                  |                     | 54,959             |                  |                     |
| Total assets                                      | \$ 710,005                 |                  |                     | \$ 691,121         |                  |                     |
| <b>Liabilities and Shareholders Equity</b>        |                            |                  |                     |                    |                  |                     |
| Interest bearing deposits:                        |                            |                  |                     |                    |                  |                     |
| Checking  | \$ 152,441                 | \$ 102           | 0.27%               | \$ 147,842         | \$ 52            | 0.14%               |
| Regular savings                                   | 127,472                    | 27               | 0.08%               | 117,923            | 24               | 0.08%               |
| Money market accounts                             | 62,979                     | 26               | 0.17%               | 55,325             | 18               | 0.13%               |
| Time deposits:                                    |                            |                  |                     |                    |                  |                     |
| \$100,000 and over                                | 44,659                     | 84               | 0.74%               | 51,871             | 115              | 0.88%               |
| Under \$100,000                                   | 86,780                     | 98               | 0.45%               | 96,466             | 72               | 0.30%               |
| Brokered  | 601                        | 1                | 0.45%               | 600                | 1                | 0.45%               |
| Total interest-bearing deposits                   | \$ 474,932                 | \$ 338           | 0.28%               | \$ 470,027         | \$ 282           | 0.24%               |
| Federal funds purchased                           |                            |                  |                     | 3                  |                  |                     |
| Subordinated debt                                 | 4,924                      | 91               | 7.32%               |                    |                  |                     |
| Junior subordinated debt                          | 9,279                      | 65               | 2.78%               | 9,279              | 56               | 2.40%               |
| Other borrowings                                  | 489                        | 1                | 0.97%               | 10                 |                  |                     |

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|   |            |          |       |            |          |       |
|---|------------|----------|-------|------------|----------|-------|
| Total interest-bearing liabilities                      | \$ 489,624 | \$ 495   | 0.40% | \$ 479,319 | \$ 338   | 0.28% |
| Non-interest bearing liabilities                        |            |          |       |            |          |       |
| Demand deposits   | 164,254    |          |       | 147,121    |          |       |
| Other liabilities                                       | 5,967      |          |       | 4,638      |          |       |
| Total liabilities                                       | \$ 659,845 |          |       | \$ 631,078 |          |       |
| Shareholders' equity                                    | 50,160     |          |       | 60,043     |          |       |
| Total liabilities and Shareholders' equity              | \$ 710,005 |          |       | \$ 691,121 |          |       |
|   |            |          |       |            |          |       |
| Net interest income                                     |            | \$ 5,943 |       |            | \$ 5,512 |       |
|   |            |          |       |            |          |       |
| Interest rate spread                                    |            |          | 3.47% |            |          | 3.33% |
| Cost of funds   |            |          | 0.30% |            |          | 0.21% |
| Interest expense as a percent of average earning assets |            |          | 0.30% |            |          | 0.21% |
| Net interest margin                                     |            |          | 3.57% |            |          | 3.40% |

- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was \$96 thousand and \$86 thousand for the three months ended September 30, 2016 and 2015, 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 nine months ended |                  |                     |                    |                  |                     |
|---|---------------------------|------------------|---------------------|--------------------|------------------|---------------------|
|   | September 30, 2016        |                  |                     | September 30, 2015 |                  |                     |
|   | Average Balance           | Interest Expense | Income/ Yield/ Rate | Average Balance    | Interest Expense | Income/ Yield/ Rate |
| <b>Assets</b>                                     |                           |                  |                     |                    |                  |                     |
| Securities:                                       |                           |                  |                     |                    |                  |                     |
| Taxable   | \$ 133,659                | \$ 2,037         | 2.04%               | \$ 107,868         | \$ 1,611         | 2.00%               |
| Tax-exempt <sup>(1)</sup>                         | 24,131                    | 644              | 3.57%               | 13,915             | 391              | 3.75%               |
| Restricted  | 1,570                     | 60               | 5.12%               | 1,450              | 59               | 5.43%               |
| Total securities                                  | \$ 159,360                | \$ 2,741         | 2.30%               | \$ 123,233         | \$ 2,061         | 2.24%               |
| Loans: <sup>(2)</sup>                             |                           |                  |                     |                    |                  |                     |
| Taxable   | \$ 451,142                | \$ 15,960        | 4.73%               | \$ 385,120         | \$ 13,929        | 4.84%               |
| Tax-exempt <sup>(1)</sup>                         | 6,853                     | 222              | 4.33%               | 7,154              | 232              | 4.34%               |
| Total loans                                       | \$ 457,995                | \$ 16,182        | 4.72%               | \$ 392,274         | \$ 14,161        | 4.83%               |
| Federal funds sold                                | 1                         |                  |                     | 1                  |                  |                     |
| Interest-bearing deposits with other institutions | 35,847                    | 183              | 0.68%               | 67,725             | 134              | 0.27%               |
| Total earning assets                              | \$ 653,203                | \$ 19,106        | 3.91%               | \$ 583,233         | \$ 16,356        | 3.75%               |
| Less: allowance for loan losses                   | (5,586)                   |                  |                     | (6,508)            |                  |                     |
| Total non-earning assets                          | 55,556                    |                  |                     | 50,184             |                  |                     |
| Total assets                                      | \$ 703,173                |                  |                     | \$ 626,909         |                  |                     |
| <b>Liabilities and Shareholders Equity</b>        |                           |                  |                     |                    |                  |                     |
| Interest bearing deposits:                        |                           |                  |                     |                    |                  |                     |
| Checking  | \$ 150,042                | \$ 279           | 0.25%               | \$ 132,523         | \$ 138           | 0.14%               |
| Regular savings                                   | 125,671                   | 78               | 0.08%               | 112,549            | 70               | 0.08%               |
| Money market accounts                             | 61,109                    | 76               | 0.17%               | 42,279             | 42               | 0.13%               |
| Time deposits:                                    |                           |                  |                     |                    |                  |                     |
| \$100,000 and over                                | 46,157                    | 281              | 0.81%               | 49,405             | 356              | 0.96%               |
| Under \$100,000                                   | 88,692                    | 284              | 0.43%               | 79,893             | 239              | 0.40%               |
| Brokered  | 601                       | 2                | 0.45%               | 824                | 3                | 0.52%               |
| Total interest-bearing deposits                   | \$ 472,272                | \$ 1,000         | 0.28%               | \$ 417,473         | \$ 848           | 0.27%               |
| Federal funds purchased                           | 447                       | 3                | 1.03%               | 280                | 2                | 0.72%               |
| Subordinated debt                                 | 4,919                     | 270              | 7.33%               |                    |                  |                     |
| Junior subordinated debt                          | 9,279                     | 190              | 2.73%               | 9,279              | 165              | 2.39%               |
| Other borrowings                                  | 1,650                     | 6                | 0.49%               | 1,618              | 3                | 0.28%               |
| Total interest-bearing liabilities                | \$ 488,567                | \$ 1,469         | 0.40%               | \$ 428,650         | \$ 1,018         | 0.32%               |
| Non-interest bearing liabilities                  |                           |                  |                     |                    |                  |                     |
| Demand deposits                                   | 160,152                   |                  |                     | 133,302            |                  |                     |
| Other liabilities                                 | 5,882                     |                  |                     | 4,916              |                  |                     |

|   |                   |                   |
|---|-------------------|-------------------|
| Total liabilities                                       | \$ 654,601        | \$ 566,868        |
| Shareholders' equity                                    | 48,572            | 60,041            |
| <b>Total liabilities and Shareholders' equity</b>       | <b>\$ 703,173</b> | <b>\$ 626,909</b> |
| Net interest income                                     | \$ 17,637         | \$ 15,338         |
| Interest rate spread                                    | 3.51%             | 3.43%             |
| Cost of funds   | 0.30%             | 0.24%             |
| Interest expense as a percent of average earning assets | 0.30%             | 0.23%             |
| Net interest margin                                     | 3.61%             | 3.52%             |

- (1) Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 34%. The tax-equivalent adjustment was \$295 thousand and \$212 thousand for the nine months ended September 30, 2016 and 2015, respectively.
- (2) Loans placed on a non-accrual status are reflected in the balances.

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**Table of Contents****Provision for (Recovery of) Loan Losses**

The Bank did not record a provision for (or recovery of) loan losses during the third quarter of 2016 or 2015, which resulted in a total allowance for loan losses of \$5.6 million, or 1.19% of total loans, at September 30, 2016. This compared to an allowance for loan losses of \$5.6 million, or 1.37% of total loans, at the end of the same quarter in 2015 and 1.26% of total loans at December 31, 2015. The Bank did not record a provision for (or recovery of) loan losses during the quarter as a decrease in the general reserve component of the allowance for loan losses was offset by an increase in the specific reserve component. Net charge-offs totaled \$124 thousand for the third quarter of 2016 compared to \$554 thousand of net charge-offs for the same period in 2015.

For the nine months ended September 30, 2016, the Bank did not record a provision for (or recovery of) loan losses, compared to recovery of loan losses of \$100 thousand for the same period in 2015. Although total loans increased by \$31.8 million during the nine months ended September 30, 2016, no provision for loan loss was required during the year as specific reserves on impaired loans decreased, historical loss rates improved, and the Bank experienced net recoveries of loans that were previously charged-off. The recovery of loan losses in 2015 was attributable to decreases in both the general and specific reserve components of the allowance for loan losses. The decrease in the general component of the allowance for loan loss resulted from improving value trends on residential real estate properties and improved asset quality during the period. Net recoveries totaled \$86 thousand for the nine months ended September 30, 2016 compared to net charge-offs of \$1.0 million for the same period in 2015.

**Noninterest Income**

For the three months ended September 30, 2016, noninterest income increased \$67 thousand, or 3%, to \$2.3 million, compared to \$2.2 million for the same period in 2015. Revenue categories that increased when comparing the same periods were service charges on deposit accounts, income from bank-owned life insurance and other operating income. The increase in service charges on deposits was attributable to higher deposit balances. Income from bank-owned life insurance increased as a result of a higher balance of bank-owned life insurance on the Company's balance sheet during 2016. The increase in other operating income was primarily attributable to a \$102 thousand life insurance benefit recorded during the quarter, which was offset by a \$100 thousand death benefit payment to the beneficiary recorded in other operating expense. These increases were partially offset by a \$138 thousand decrease in wealth management fees and fees for other customer services. The decrease in wealth management fees was attributable to the elimination of brokerage services at the beginning of 2016.

For the nine months ended September 30, 2016, noninterest income increased \$222 thousand, or 4%, to \$6.4 million, compared to \$6.1 million for the same period a year ago. Revenue categories that increased when comparing the same periods included service charges on deposits, ATM and check card fees and other operating income. The increases in service charges on deposits, and ATM and check card fees were primarily attributable to the Acquisition and the related increase in deposit balances. The increase in other operating income resulted primarily from a life insurance benefit recorded in 2016 and revenue that resulted from a three-year not-to-compete agreement with former employees, which was related to the elimination of brokerage services on January 1, 2016. These increases were partially offset by a \$470 thousand, or 32%, decrease in wealth management fees and a \$201 thousand decrease in bargain purchase gain. The decrease in wealth management fees was attributable to the elimination of brokerage services referred to above. The bargain purchase gain recorded in 2015 resulted from the Acquisition.

**Noninterest Expense**

For the three months ended September 30, 2016, noninterest expense decreased \$848 thousand, or 13%, to \$5.9 million, compared to \$6.7 million for the same period in 2015. The decrease in noninterest expense was primarily

from a \$454 thousand, or 12% decrease in salaries and employee benefits expense, and a \$143 thousand decrease in net other real estate owned expense. Salaries and employee benefits decreased primarily from a decrease in the number of employees when comparing the periods as a result of the Company's efforts to operate more efficiently. Expenses related to other real estate owned decreased primarily from lower adjustments to the carrying value of OREO property.

For the nine months ended September 30, 2016, noninterest expense decreased \$1.2 million, or 6%, to \$17.9 million, compared to \$19.0 million for the same period in 2015. The decrease in noninterest expense was primarily attributable to a \$317 thousand, or 3%, decrease in salaries and employee benefits expense, a \$378 thousand decrease in supplies expense, a \$240 thousand decrease in legal and professional fees, a \$109 thousand decrease in data processing expense, an \$88 thousand decrease in postage expense, a \$101 thousand decrease in bank franchise tax, and a \$380 thousand decrease in net other real estate owned expense. The decreases in supplies expense, legal and professional fees, data processing expense, and postage expense resulted primarily from integration expenses incurred during the first nine months of 2015 related to the Acquisition,

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which totaled \$325 thousand, \$258 thousand, \$134 thousand, and \$70 thousand for these categories, respectively. Total integration expenses related to the Acquisition were \$897 thousand for the nine months ended September 30, 2015. Bank franchise tax decreased due to the Bank's lower taxable capital, which resulted from the redemption of preferred stock during 2015. Decreases in expenses related to other real estate owned resulted primarily from increased gains on the sale of OREO property and lower adjustments to the carrying value of OREO property.

The decreases described in the paragraph above were partially offset by a \$117 thousand, or 11% increase in occupancy expense, a \$129 thousand, or 12% increase in equipment expense, a \$74 thousand, or 13% increase in ATM and check card fees, an \$89 thousand, or 34% increase in FDIC assessment expenses, and a \$166 thousand, or 39% increase in amortization expense. The increases in these categories were primarily a result of the Acquisition, which increased the number of banking locations and customer deposit balances for a full nine month period during 2016, compared to only a portion of the same period in 2015.

## 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 nine month periods ended September 30, 2016 and 2015. 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 11 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

## **Financial Condition**

### General

Total assets increased by \$20.4 million to \$712.7 million at September 30, 2016 compared to \$692.3 million at December 31, 2015. The increase was primarily attributable to a \$31.7 million increase in net loans and a \$16.8 million increase in interest-bearing deposits in banks, when comparing the periods. The increases in net loans and interest-bearing deposits in banks were partially offset by a \$28.3 million decrease in securities since December 31, 2015.

Total deposits increased by \$13.6 million to \$640.7 million at September 30, 2016 compared to \$627.1 million at December 31, 2015. Noninterest-bearing demand deposits and savings and interest-bearing deposits increased \$11.1 million and \$11.9 million, respectively, when comparing the periods. These increases were partially offset by a \$9.4 million decrease in time deposits since December 31, 2015.

### Loans

Loans, net of the allowance for loan losses, increased \$31.7 million, or 7% to \$465.2 million at September 30, 2016, compared to \$433.5 million at December 31, 2015. Growth of the loan portfolio was led by other real estate loans with balances that increased \$21.4 million during the first nine months of 2016, followed by residential real estate loans with balances that increased by \$7.2 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.

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**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 throughout the Shenandoah Valley region of Virginia. 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. Loans greater than 90 days past due and still accruing totaled \$59 thousand at September 30, 2016, compared to \$92 thousand at December 31, 2015. For those loans that are carried on non-accrual status, payments are first applied to principal outstanding. A loan may be returned to accrual status if the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms of the loan and there is reasonable assurance the borrower will continue to make payments as agreed. These policies are applied consistently across the loan portfolio.

All interest accrued but not collected for loans that are placed on 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 \$6.9 million and \$7.7 million at September 30, 2016 and December 31, 2015, 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 \$162 thousand and \$982 thousand in loans classified as TDRs as of September 30, 2016 and December 31, 2015, respectively.

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**Table of Contents****Asset Quality**

Management classifies non-performing assets as 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's OREO, net of valuation allowance, totaled \$250 thousand at September 30, 2016 and \$2.7 million at December 31, 2015. There was not a valuation allowance for other real estate owned at September 30, 2016. The valuation allowance for other real estate owned totaled \$224 thousand at December 31, 2015.

Non-performing assets were \$3.8 million at September 30, 2016 and \$6.5 million at December 31, 2015, representing 0.53% and 0.94% of total assets, respectively. Non-performing assets included \$3.5 million in non-accrual loans and \$250 thousand in OREO, net of the valuation allowance at September 30, 2016. This compares to \$3.9 million in non-accrual loans and \$2.7 million in OREO, net of the valuation allowance at December 31, 2015.

The levels of non-performing assets at September 30, 2016 and December 31, 2015 were primarily attributable to business customers involved in commercial real estate and construction and land development that have not been able to meet their debt requirements because they have not fully recovered from the recent recession. At September 30, 2016, 43% of non-performing assets related to construction and land development loans, 39% related to commercial real estate loans, 9% related to residential real estate loans, 7% related to properties originally acquired for branch expansion no longer intended to be used for that purpose, and 2% 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 \$8.3 million and \$10.3 million at September 30, 2016 and December 31, 2015, 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 totaled \$59 thousand at September 30, 2016, which was comprised of two loans expected to pay all principal and interest amounts contractually due to the Bank. There were \$92 thousand of loans greater than 90 days past due and still accruing at December 31, 2015.

The allowance for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for (or recovery of) 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 \$5.6 million at September 30, 2016 and \$5.5 million at December 31, 2015, representing 1.19% and 1.26% of total loans, respectively. Although total loans increased by \$31.8 million during the nine months ended September 30, 2016, no provision for loan loss was required during the year as specific reserves on impaired loans decreased, historical loss rates improved, and the Bank experienced net recoveries of loans that were previously charged-off. Specific reserves decreased from improvements in collateral positions of impaired loans.

Recoveries of loan losses of \$1.1 million and \$173 thousand were experienced in the Construction and Land Development and 1-4 Family Residential loan classes, respectively, during the nine month period ended September 30, 2016. The recovery of loan losses in the Construction and Land Development loan class was primarily attributable to decreases in the specific reserve and decreases in the general allocation from improvements in the historical loss experience. The recoveries of loan losses in the 1-4 Family Residential loan class resulted from net

recoveries of loans charged-off in prior periods. These recoveries were offset by provision for loan losses experienced in the Other Real Estate, Commercial and Industrial, and Consumer and Other loan classes. The provision for loan losses in the Other Real Estate loan class was attributable to increases in the general reserve requirement due to growth in the loan portfolio and an increase in the historical loss experience. The provision for loan losses in the Commercial and Industrial and Consumer and Other loan classes resulted primarily from increases in the general reserve requirement due to growth in the loan portfolio.

Impaired loans totaled \$6.9 million and \$7.7 million at September 30, 2016 and December 31, 2015, respectively. The related allowance for loan losses provided for these loans totaled \$256 and \$544 thousand at September 30, 2016 and December 31, 2015, respectively. The average recorded investment in impaired loans during the nine months ended September 30, 2016 and the year ended December 31, 2015 was \$7.5 million and \$10.5 million, respectively. Included in the impaired loans total at September 30, 2016 are loans classified as TDRs totaling \$162 thousand. Loans classified as TDRs represent situations in which a modification to the contractual interest rate or repayment structure has been granted to address a financial hardship. As of September 30, 2016, \$88 thousand of these TDRs were performing under the restructured terms and were not considered non-performing assets.

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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 (or recovery of) loan losses charged to (income) or 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 (or recovery of) 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 and serves as a source of liquidity. The portfolio 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, available for sale, and restricted 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. Restricted securities, including Federal Home Loan Bank, Federal Reserve Bank, and Community Bankers' Bank stock, are generally viewed as long-term investments because there is minimal market for the stock and are carried at cost.

Securities at September 30, 2016 totaled \$145.1 million, a decrease of \$28.3 million or 16% from \$173.5 million at December 31, 2015. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. As of September 30, 2016, 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 \$1.5 million and \$601 thousand at September 30, 2016 and December 31, 2015, respectively. Gross unrealized losses in the available for sale portfolio totaled \$62 thousand and \$893 thousand at September 30, 2016 and December 31, 2015, respectively. Gross unrealized gains in the held to maturity portfolio totaled \$1.0 million and \$264 thousand at September 30, 2016 and December 31, 2015, respectively. Gross unrealized losses in the held to maturity portfolio totaled \$345 thousand at December 31, 2015. There were no gross unrealized losses in the held to maturity portfolio at September 30, 2016. Investments in an unrealized loss position were considered temporarily impaired at September 30, 2016 and December 31, 2015. The change in the unrealized gains and losses of investment securities from December 31, 2015 to September 30, 2016 was related to changes in market interest rates.

## Deposits

At September 30, 2016, deposits totaled \$640.7 million, an increase of \$13.6 million, from \$627.1 million at December 31, 2015. There was not a significant change in the deposit mix when comparing the periods. At September 30, 2016, noninterest-bearing demand deposits, savings and interest-bearing demand deposits, and time

deposits composed 26%, 53%, and 21% of total deposits, respectively, compared to 25%, 52%, and 23% at December 31, 2015.

### 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.

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At September 30, 2016, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled \$113.5 million. At September 30, 2016, 12% or \$56.6 million of the loan portfolio matures within one year. Non-deposit sources of available funds totaled \$128.9 million at September 30, 2016, which included \$85.7 million available from Federal Home Loan Bank of Atlanta (FHLB), \$42 million of unsecured federal funds lines of credit with other correspondent banks and \$1.2 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 replaced 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.

The rules included new risk-based capital and leverage ratios, which are being phased in from 2015 to 2019, and refined 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 were 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 established a capital conservation buffer above the new regulatory minimum capital requirements. The capital conservation buffer is being 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. Management believes, as of September 30, 2016 and December 31, 2015, that the Bank met all capital adequacy requirements to which it is subject, including the capital conservation buffer.

The following table shows the Bank's regulatory capital ratios at September 30, 2016:

|  | First Bank |
|--|------------|
| Total capital to risk-weighted assets                | 13.90%     |
| Tier 1 capital to risk-weighted assets               | 12.72%     |
| Common equity Tier 1 capital to risk-weighted assets | 12.72%     |
| Tier 1 capital to average assets                     | 8.48%      |
| Capital conservation buffer ratio <sup>(1)</sup>     | 5.90%      |

- (1) Calculated by subtracting the regulatory minimum capital ratio requirements from the Company's actual ratio for Common equity Tier 1, Tier 1, and Total risk based capital. The lowest of the three measures represents the Bank's capital conservation buffer ratio.

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).

On November 6, 2015, the Company redeemed all 13,900 outstanding shares of its Fixed Rate Perpetual Preferred Stock, Series A totaling \$13.9 million, and all 695 shares of outstanding Fixed Rate Perpetual Preferred Stock, Series B totaling \$695 thousand. While the preferred stock was outstanding, the Company's Series A Preferred Stock paid a dividend of 5% per annum until May 14, 2014 and 9% thereafter, and the Series B Preferred Stock which paid a dividend of 9% per annum.

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During 2015, the Bank declared and paid cash dividends to the Company totaling \$13.5 million. In addition, the Company entered into a Subordinated Loan Agreement on October 30, 2015 to which the Company issued a subordinated term note in the aggregate principal amount of \$5.0 million (the Note). The Note bears interest at a fixed rate of 6.75% per annum. The Note is intended to qualify as Tier 2 capital for regulatory capital purposes. The Note has a maturity date of October 1, 2025. The Company used the proceeds from the dividends and from the issuance of the Note to redeem all outstanding 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, 2015.

## 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 \$69.7 million at September 30, 2016, and \$61.1 million at December 31, 2015, 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.

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 September 30, 2016 and December 31, 2015, the Bank had \$9.4 million and \$7.7 million in outstanding standby letters of credit, respectively.

At September 30, 2016, the Bank had \$5.7 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 September 30, 2016 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.

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

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

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, 2015.

**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:

- 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 September 30, 2016 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  
Scott C. Harvard  
President and Chief Executive Officer

November 14, 2016  
Date

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

November 14, 2016  
Date

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**EXHIBIT INDEX**

| Number | Document  |
|--------|---|
| 31.1   | Certification of Chief Executive Officer, Section 302 Certification   |
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