

FIRST NATIONAL CORP /VA/
Form 10-Q
August 10, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

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 54-1232965
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

112 West King Street, Strasburg, Virginia 22657
(Address of principal executive offices) (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, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth 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
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of August 10, 2018, 4,956,206 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

TABLE OF CONTENTS

	Page
<u>PART I – FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017</u>	3
<u>Consolidated Statements of Income for the three and six months ended June 30, 2018 and 2017</u>	4
<u>Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2018 and 2017</u>	6
<u>Consolidated Statements of Cash Flows for the six months ended June 30, 2018 and 2017</u>	7
<u>Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2018 and 2017</u>	9
<u>Notes to Consolidated Financial Statements</u>	10
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	50
Item 4. <u>Controls and Procedures</u>	50
<u>PART II – OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	51
Item 1A. <u>Risk Factors</u>	51
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	51
Item 3. <u>Defaults Upon Senior Securities</u>	51
Item 4. <u>Mine Safety Disclosures</u>	51
Item 5. <u>Other Information</u>	51
Item 6. <u>Exhibits</u>	51

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

(in thousands, except share and per share data)

	(unaudited) June 30, 2018	December 31, 2017*
Assets		
Cash and due from banks	\$ 13,501	\$ 11,358
Interest-bearing deposits in banks	27,762	28,628
Securities available for sale, at fair value	106,707	89,255
Securities held to maturity, at amortized cost (fair value, 2018, \$44,416; 2017, \$47,702)	45,701	48,208
Restricted securities, at cost	1,590	1,570
Loans held for sale	1,195	438
Loans, net of allowance for loan losses, 2018, \$5,039; 2017, \$5,326	525,894	516,875
Other real estate owned, net of valuation allowance, 2018, \$0; 2017, \$0	68	326
Premises and equipment, net	19,633	19,891
Accrued interest receivable	2,073	1,916
Bank owned life insurance	13,787	13,967
Core deposit intangibles, net	679	930
Other assets	4,774	5,748
Total assets	\$ 763,364	\$ 739,110
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	\$ 196,839	\$ 180,912
Savings and interest-bearing demand deposits	367,399	361,417
Time deposits	122,291	122,651
Total deposits	\$ 686,529	\$ 664,980
Subordinated debt	4,956	4,948
Junior subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	952	1,749
Total liabilities	\$ 701,716	\$ 680,956
Shareholders' Equity		
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, 2018, 4,953,356 shares; 2017, 4,945,702 shares	6,192	6,182
Surplus	7,346	7,260
Retained earnings	50,313	45,670
Accumulated other comprehensive loss, net	(2,203)	(958)
Total shareholders' equity	\$ 61,648	\$ 58,154
Total liabilities and shareholders' equity	\$ 763,364	\$ 739,110

*Derived from audited consolidated financial statements.

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Statements of Income (Unaudited)

(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Interest and Dividend Income				
Interest and fees on loans	\$6,546	\$ 5,933	\$12,851	\$11,579
Interest on deposits in banks	186	86	346	147
Interest and dividends on securities:				
Taxable interest	776	634	1,456	1,296
Tax-exempt interest	156	145	301	288
Dividends	22	21	44	41
Total interest and dividend income	\$7,686	\$ 6,819	\$14,998	\$13,351
Interest Expense				
Interest on deposits	\$665	\$ 405	\$1,255	\$788
Interest on subordinated debt	89	89	178	178
Interest on junior subordinated debt	101	76	187	144
Total interest expense	\$855	\$ 570	\$1,620	\$1,110
Net interest income	\$6,831	\$ 6,249	\$13,378	\$12,241
Provision for loan losses	—	—	100	—
Net interest income after provision for loan losses	\$6,831	\$ 6,249	\$13,278	\$12,241
Noninterest Income				
Service charges on deposit accounts	\$784	\$ 735	\$1,546	\$1,490
ATM and check card fees	555	527	1,074	1,028
Wealth management fees	409	355	816	702
Fees for other customer services	151	137	304	277
Income from bank owned life insurance	77	102	636	195
Net gains on securities available for sale	—	13	—	13
Net gains on sale of loans	15	34	24	67
Other operating income	76	75	300	147
Total noninterest income	\$2,067	\$ 1,978	\$4,700	\$3,919
Noninterest Expense				
Salaries and employee benefits	\$3,227	\$ 3,122	\$6,610	\$6,364
Occupancy	387	348	787	715
Equipment	420	400	843	808
Marketing	161	136	270	272
Supplies	88	105	168	196
Legal and professional fees	223	245	414	442
ATM and check card expense	211	229	414	391
FDIC assessment	66	77	148	156
Bank franchise tax	118	110	233	214
Telecommunications expense	98	108	134	218
Data processing expense	170	152	332	302
Postage expense	42	74	103	135
Amortization expense	120	160	251	329
Other real estate owned expense (income), net	1	4	(22)	6

Edgar Filing: FIRST NATIONAL CORP /VA/ - Form 10-Q

Other operating expense	532	435	1,045	908
Total noninterest expense	\$5,864	\$ 5,705	\$11,730	\$11,456

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Statements of Income (Unaudited)

(Continued)

(in thousands, except per share data)

	Three Months		Six Months	
	Ended		Ended	
	June 30,	June 30,	June 30,	June 30,
	2018	2017	2018	2017
Income before income taxes	\$3,034	\$ 2,522	\$6,248	\$ 4,704
Income tax expense	583	766	1,110	1,405
Net income	\$2,451	\$ 1,756	\$5,138	\$ 3,299
Earnings per common share				
Basic	\$0.49	\$ 0.36	\$1.04	\$ 0.67
Diluted	\$0.49	\$ 0.36	\$1.04	\$ 0.67

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Statements of Comprehensive Income (Unaudited)
(in thousands)

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Net income	\$2,451	\$1,756	\$5,138	\$3,299
Other comprehensive (loss) income, net of tax, Unrealized holding (losses) gains on available for sale securities, net of tax (\$75) and \$201 for the three months and (\$304) and \$397 for the six months ended June 30, 2018 and 2017, respectively	(284)	392	(1,146)	773
Reclassification adjustment for gains included in net income, net of tax \$0 and (\$4) for the three months and \$0 and (\$4) for the six months ended June 30, 2018 and 2017, respectively	—	(9)	—	(9)
Pension liability adjustment, net of tax \$0 and \$0 for the three months and (\$27) and \$0 for the six months ended June 30, 2018 and 2017, respectively	—	—	(99)	—
Total other comprehensive (loss) income	(284)	383	(1,245)	764
Total comprehensive income	\$2,167	\$2,139	\$3,893	\$4,063
See Notes to Consolidated Financial Statements				

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows (Unaudited)
(in thousands)

	Six Months Ended June 30, 2018		June 30, 2017	
Cash Flows from Operating Activities				
Net income	\$ 5,138		\$ 3,299	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization of premises and equipment	681		697	
Amortization of core deposit intangibles	251		329	
Amortization of debt issuance costs	8		9	
Origination of loans held for sale	(2,057)	)	(4,582))
Proceeds from sale of loans held for sale	1,324		3,987	
Net gains on sales of loans held for sale	(24)	)	(67))
Provision for loan losses	100		—	
Net gains on securities available for sale	—		(13))
Net gains on sale of other real estate owned	(24))	—)
Increase in cash value of bank owned life insurance	(167)	)	(187))
Accretion of discounts and amortization of premiums on securities, net	274		313	
Accretion of premium on time deposits	(43)	)	(56))
Stock-based compensation	89		76	
Excess tax benefits on stock-based compensation	(7)	)	(14))
	51		(157))

Deferred income tax expense (benefit)						
Changes in assets and liabilities:						
(Increase) decrease in interest receivable	(157	)	18		
Decrease in other assets	1,234		1			
Decrease in accrued expenses and other liabilities	(896	)	(412)	
Net cash provided by operating activities	\$	5,775	\$	3,241		
Cash Flows from Investing Activities						
Proceeds from maturities, calls, and principal payments of securities available for sale	\$	8,064	\$	7,103		
Proceeds from maturities, calls, and principal payments of securities held to maturity	2,413		2,468			
Purchases of securities available for sale	(27,146	)	(1,079)	
Net purchase of restricted securities	(20	)	(22)	
Purchase of premises and equipment	(423	)	(413)	
Proceeds from sale of other real estate owned	350		—			
Proceeds from cash value of bank owned life insurance	347		—			
Net increase in loans	(9,187	)	(17,643)	
Net cash used in investing activities	\$	(25,602)	\$	(9,586)
See Notes to Consolidated Financial Statements						

FIRST NATIONAL CORPORATION

Consolidated Statements of Cash Flows (Unaudited)

(Continued)

(in thousands)

	Six Months Ended	
	June 30, 2018	June 30, 2017
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	\$21,909	\$21,765
Net decrease in time deposits	(317)	(5,451)
Cash dividends paid on common stock, net of reinvestment	(464)	(323)
Repurchase of common stock	(24)	—
Net cash provided by financing activities	\$21,104	\$15,991
Increase in cash and cash equivalents	\$1,277	\$9,646
Cash and Cash Equivalents		
Beginning	\$39,986	\$41,092
Ending	\$41,263	\$50,738
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$1,656	\$1,174
Income Taxes	\$96	\$1,736
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized (losses) gains on securities available for sale	\$(1,450)	\$1,157
Change in pension liability	\$(126)	\$—
Transfer from loans to other real estate owned	\$68	\$—
Issuance of common stock, dividend reinvestment plan	\$31	\$23
See Notes to Consolidated Financial Statements		

FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands, except share and per share data)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2016	\$ —	—\$6,162	\$7,093	\$39,756	\$ (860)	\$52,151
Net income	—	—	—	3,299	—	3,299
Other comprehensive income	—	—	—	—	764	764
Cash dividends on common stock (\$0.07 per share)	—	—	—	(346)	—	(346)
Stock-based compensation	—	—	76	—	—	76
Issuance of 1,665 shares common stock, dividend reinvestment plan	—	2	21	—	—	23
Issuance of 10,536 shares common stock, stock incentive plan	—	13	(13)	—	—	—
Balance, June 30, 2017	\$ —	—\$6,177	\$7,177	\$42,709	\$ (96)	\$55,967

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2017	\$ —	—\$6,182	\$7,260	\$45,670	\$ (958)	\$58,154
Net income	—	—	—	5,138	—	5,138
Other comprehensive loss	—	—	—	—	(1,245)	(1,245)
Cash dividends on common stock (\$0.10 per share)	—	—	—	(495)	—	(495)
Stock-based compensation	—	—	89	—	—	89
Issuance of 1,632 shares common stock, dividend reinvestment plan	—	2	29	—	—	31
Issuance of 7,339 shares common stock, stock incentive plan	—	9	(9)	—	—	—
Repurchase of 1,317 shares of common stock, stock incentive plan	—	(1)	(23)	—	—	(24)
Balance, June 30, 2018	\$ —	—\$6,192	\$7,346	\$50,313	\$ (2,203)	\$61,648

See Notes to Consolidated Financial Statements

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 June 30, 2018 and December 31, 2017, the statements of income and comprehensive income for the three and six months ended June 30, 2018 and 2017 and the cash flows and changes in shareholders' equity for the six months ended June 30, 2018 and 2017. 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, 2017. Operating results for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

Adoption of ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606."

On January 1, 2018, the Company adopted ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606." This ASU revised guidance for the recognition, measurement, and disclosure of revenue from contracts with customers. The original guidance was amended through subsequent accounting standard updates that resulted in technical corrections, improvements, and a one-year deferral of the effective date to January 1, 2018. The guidance, as amended, is applicable to all entities and replaces significant portions of existing industry and transaction-specific revenue recognition rules with a more principles-based recognition model. Most revenue associated with financial instruments, including interest income, loan origination fees, and credit card fees, is outside the scope of the guidance. Gains and losses on investment securities, derivatives, financial guarantees, and sales of financial instruments are similarly excluded from the scope. The guidance is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees, and merchant income. The Company adopted this guidance via the modified retrospective approach, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application.

Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, deposit related fees, interchange fees, and merchant income. The Company also completed an evaluation of certain costs related to these revenue streams to determine whether such costs should be presented gross versus net. Based on these assessments, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 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

Notes to Consolidated Financial Statements (Unaudited)

financial statements. The Company has analyzed its current lease commitments, along with reasonable assumptions to project lease activity in future periods, to measure the potential impact on net income and relevant capital and financial ratios.

In 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. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements. The Company has formed a committee to address the compliance requirements of this ASU and is currently in the process of analyzing gathered data, defining loan pools and segments, and selecting methods for applying the concepts included in this ASU. During 2018, the Company plans to test selected models, build policy and process documentation, and model the impact of the ASU on the capital and strategic plans. This guidance may result in material changes in the Company's accounting for credit losses of financial instruments.

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment”. The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit’s goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company does not expect the adoption of ASU 2017-08 to have a material impact on its consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.” The amendments in this ASU modify the designation and measurement

guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted, including adoption in any interim period. The Company is currently assessing the impact that ASU 2017-12 will have on its consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-03, “Technical Corrections and Improvements to Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.” The amendments provide targeted improvements to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Specifically, the amendments include clarifications related to: measurement elections, transition requirements, and adjustments associated with equity securities without readily determinable fair values; fair value measurement requirements for forward contracts and purchased options on equity securities; presentation requirements for hybrid financial liabilities for which the fair value option has been elected; and measurement requirements for liabilities denominated in a foreign currency for which the fair value option has been elected. The amendments are effective for fiscal years beginning after December 15, 2017,

Notes to Consolidated Financial Statements (Unaudited)

and interim periods within those fiscal years beginning after June 15, 2018. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-03 to have a material impact on its consolidated financial statements.

In June 2018, the FASB issued ASU No. 2018-07, "Compensation- Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting." The amendments expand the scope of Topic 718 to include share-based payments issued to non-employees for goods or services, which were previously excluded. The amendments will align the accounting for share-based payments to nonemployees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-07 to have a material impact on its consolidated financial statements.

Note 2. Securities

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, and corporate debt securities. Amortized costs and fair values of securities at June 30, 2018 and December 31, 2017 were as follows (in thousands):

	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	\$94,387	\$ 21	\$ (2,580)	\$91,828
Obligations of states and political subdivisions	15,109	46	(276)	14,879
Total securities available for sale	\$109,496	\$ 67	\$ (2,856)	\$106,707
Securities held to maturity:				
U.S. agency and mortgage-backed securities	\$29,678	\$ —	\$ (1,111)	\$28,567
Obligations of states and political subdivisions	14,523	17	(189)	14,351
Corporate debt securities	1,500	—	(2)	1,498
Total securities held to maturity	\$45,701	\$ 17	\$ (1,302)	\$44,416
Total securities	\$155,197	\$ 84	\$ (4,158)	\$151,123
	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available for sale:				
U.S. agency and mortgage-backed securities	\$76,074	\$ 67	\$ (1,337)	\$74,804
Obligations of states and political subdivisions	14,520	86	(155)	14,451
Total securities available for sale	\$90,594	\$ 153	\$ (1,492)	\$89,255
Securities held to maturity:				
U.S. agency and mortgage-backed securities	\$32,149	\$ —	\$ (551)	\$31,598
Obligations of states and political subdivisions	14,559	74	(45)	14,588
Corporate debt securities	1,500	16	—	1,516
Total securities held to maturity	\$48,208	\$ 90	\$ (596)	\$47,702
Total securities	\$138,802	\$ 243	\$ (2,088)	\$136,957

Notes to Consolidated Financial Statements (Unaudited)

At June 30, 2018 and December 31, 2017, investments in an unrealized loss position that were temporarily impaired were as follows (in thousands):

	June 30, 2018					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities available for sale:						
U.S. agency and mortgage-backed securities	\$61,734	\$ (1,200)	\$28,279	\$ (1,380)	\$90,013	\$ (2,580)
Obligations of states and political subdivisions	8,055	(129)	2,462	(147)	10,517	(276)
Total securities available for sale	\$69,789	\$ (1,329)	\$30,741	\$ (1,527)	\$100,530	\$ (2,856)
Securities held to maturity:						
U.S. agency and mortgage-backed securities	\$14,964	\$ (499)	\$13,603	\$ (612)	\$28,567	\$ (1,111)
Obligations of states and political subdivisions	11,155	(189)	—	—	11,155	(189)
Corporate debt securities	1,498	(2)	—	—	1,498	(2)
Total securities held to maturity	\$27,617	\$ (690)	\$13,603	\$ (612)	\$41,220	\$ (1,302)
Total securities	\$97,406	\$ (2,019)	\$44,344	\$ (2,139)	\$141,750	\$ (4,158)

	December 31, 2017					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities available for sale:						
U.S. agency and mortgage-backed securities	\$29,963	\$ (286)	\$30,362	\$ (1,051)	\$60,325	\$ (1,337)
Obligations of states and political subdivisions	4,469	(53)	1,961	(102)	6,430	(155)
Total securities available for sale	\$34,432	\$ (339)	\$32,323	\$ (1,153)	\$66,755	\$ (1,492)
Securities held to maturity:						
U.S. agency and mortgage-backed securities	\$18,301	\$ (205)	\$13,297	\$ (346)	\$31,598	\$ (551)
Obligations of states and political subdivisions	6,889	(45)	—	—	6,889	(45)
Total securities held to maturity	\$25,190	\$ (250)	\$13,297	\$ (346)	\$38,487	\$ (596)
Total securities	\$59,622	\$ (589)	\$45,620	\$ (1,499)	\$105,242	\$ (2,088)

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.

Notes to Consolidated Financial Statements (Unaudited)

At June 30, 2018, there were eighty-six out of ninety-one U.S. agency and mortgage-backed securities, fifty-eight out of eighty-one obligations of states and political subdivisions, and one corporate debt security in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 4.8 years at June 30, 2018. At December 31, 2017, there were sixty-eight out of eighty-two U.S. agency and mortgage-backed securities and thirty-nine out of eighty 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, 2017. The weighted-average re-pricing term of the portfolio was 4.7 years at December 31, 2017. The unrealized losses at June 30, 2018 in the U.S. agency and mortgage-backed securities portfolio, the obligations of states and political subdivisions portfolio, and the corporate debt securities portfolio were related to changes in market interest rates and not credit concerns of the issuers.

The amortized cost and fair value of securities at June 30, 2018 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.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	\$505	\$511	\$186	\$186
Due after one year through five years	8,982	8,919	6,918	6,790
Due after five years through ten years	14,164	13,723	14,282	14,034
Due after ten years	85,845	83,554	24,315	23,406
	\$109,496	\$106,707	\$45,701	\$44,416

Federal Home Loan Bank, Federal Reserve Bank, and Community Bankers' Bank stock are generally viewed as long-term investments and as restricted securities, which are carried at cost, because there is a minimal market for the stock. Therefore, when evaluating restricted securities for impairment, their value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider these investments to be other-than-temporarily impaired at June 30, 2018, and no impairment has been recognized.

The composition of restricted securities at June 30, 2018 and December 31, 2017 was as follows (in thousands):

	June 30, December 31,	
	2018	2017
Federal Home Loan Bank stock	\$ 665	\$ 645
Federal Reserve Bank stock	875	875
Community Bankers' Bank stock	50	50
	\$ 1,590	\$ 1,570

Notes to Consolidated Financial Statements (Unaudited)

Note 3. Loans

Loans at June 30, 2018 and December 31, 2017 are summarized as follows (in thousands):

	June 30, 2018	December 31, 2017
Real estate loans:		
Construction and land development	\$37,350	\$ 35,927
Secured by 1-4 family residential	211,101	208,177
Other real estate loans	224,362	222,256
Commercial and industrial loans	40,943	38,763
Consumer and other loans	17,177	17,078
Total loans	\$530,933	\$ 522,201
Allowance for loan losses	(5,039)	(5,326)
Loans, net	\$525,894	\$ 516,875

Net deferred loan fees included in the above loan categories were \$266 thousand and \$301 thousand at June 30, 2018 and December 31, 2017, respectively. Consumer and other loans included \$231 thousand and \$232 thousand of demand deposit overdrafts at June 30, 2018 and December 31, 2017, 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, if any. These loans are typically either unsecured or secured by rapidly depreciating assets such as automobiles. They are also likely to be immediately and adversely affected by job loss, divorce, illness, personal bankruptcy, or other changes in circumstances. Consumer and other loans also include purchased consumer loans which could have been originated outside of the Company's market area.

Notes to Consolidated Financial Statements (Unaudited)

The following tables provide a summary of loan classes and an aging of past due loans as of June 30, 2018 and December 31, 2017 (in thousands):

	June 30, 2018				Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due				
Real estate loans:								
Construction and land development	\$ 170	\$ —	\$ 355	\$ 525	\$ 36,825	\$ 37,350	\$ —	\$ 355
Secured by 1-4 family residential	1,218	292	359	1,869	209,232	211,101	375	76
Other real estate loans	1,426	319	1,587	3,332	221,030	224,362	1,755	—
Commercial and industrial	—	210	75	285	40,658	40,943	200	75
Consumer and other loans	88	53	43	184	16,993	17,177	—	43
Total	\$ 2,902	\$ 874	\$ 2,419	\$ 6,195	\$ 524,738	\$ 530,933	\$ 2,330	\$ 549

	December 31, 2017				Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due				
Real estate loans:								
Construction and land development	\$ 986	\$ 30	\$ 40	\$ 1,056	\$ 34,871	\$ 35,927	\$ 269	\$ 40
Secured by 1-4 family residential	606	203	148	957	207,220	208,177	267	106
Other real estate loans	2,042	170	10	2,222	220,034	222,256	401	10
Commercial and industrial	184	25	—	209	38,554	38,763	—	—
Consumer and other loans	51	49	27	127	16,951	17,078	—	27
Total	\$ 3,869	\$ 477	\$ 225	\$ 4,571	\$ 517,630	\$ 522,201	\$ 937	\$ 183

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.

16

Notes to Consolidated Financial Statements (Unaudited)

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.

The following tables provide an analysis of the credit risk profile of each loan class as of June 30, 2018 and December 31, 2017 (in thousands):

	June 30, 2018				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$34,862	\$ 751	\$ 1,737	\$ —	—\$37,350
Secured by 1-4 family residential	207,451	1,896	1,754	—	211,101
Other real estate loans	220,695	1,314	2,353	—	224,362
Commercial and industrial	40,632	27	284	—	40,943
Consumer and other loans	17,177	—	—	—	17,177
Total	\$520,817	\$ 3,988	\$ 6,128	\$ —	—\$530,933

	December 31, 2017				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction and land development	\$31,553	\$ 2,268	\$ 2,106	\$ —	—\$35,927
Secured by 1-4 family residential	204,166	1,933	2,078	—	208,177
Other real estate loans	215,773	971	5,512	—	222,256
Commercial and industrial	38,606	53	104	—	38,763
Consumer and other loans	17,078	—	—	—	17,078
Total	\$507,176	\$ 5,225	\$ 9,800	\$ —	—\$522,201

Notes to Consolidated Financial Statements (Unaudited)

Note 4. Allowance for Loan Losses

The following tables present, as of June 30, 2018, December 31, 2017 and June 30, 2017, the total allowance for loan losses, the allowance by impairment methodology, and loans by impairment methodology (in thousands):

	June 30, 2018					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2017	\$414	\$775	\$2,948	\$418	\$771	\$5,326
Charge-offs	—	(24)	—	(8)	(468)	(500)
Recoveries	—	8	1	5	99	113
Provision for (recovery of) loan losses	(8)	32	(285)	10	351	100
Ending Balance, June 30, 2018	\$406	\$791	\$2,664	\$425	\$753	\$5,039
Ending Balance:						
Individually evaluated for impairment	—	—	—	—	—	—
Collectively evaluated for impairment	406	791	2,664	425	753	5,039
Loans:						
Ending Balance	\$37,350	\$211,101	\$224,362	\$40,943	\$17,177	\$530,933
Individually evaluated for impairment	865	1,330	2,029	257	—	4,481
Collectively evaluated for impairment	36,485	209,771	222,333	40,686	17,177	526,452
	December 31, 2017					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2016	\$441	\$1,019	\$3,142	\$380	\$339	\$5,321
Charge-offs	—	(126)	—	—	(607)	(733)
Recoveries	11	302	50	10	265	638
Provision for (recovery of) loan losses	(38)	(420)	(244)	28	774	100
Ending Balance, December 31, 2017	\$414	\$775	\$2,948	\$418	\$771	\$5,326
Ending Balance:						
Individually evaluated for impairment	—	—	—	—	—	—
Collectively evaluated for impairment	414	775	2,948	418	771	5,326
Loans:						
Ending Balance	\$35,927	\$208,177	\$222,256	\$38,763	\$17,078	\$522,201
Individually evaluated for impairment	1,150	1,307	1,289	65	—	3,811
Collectively evaluated for impairment	34,777	206,870	220,967	38,698	17,078	518,390

Notes to Consolidated Financial Statements (Unaudited)

	June 30, 2017					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2016	\$441	\$1,019	\$3,142	\$ 380	\$ 339	\$5,321
Charge-offs	—	(25)	—	—	(242)	(267)
Recoveries	2	238	47	7	96	390
Provision for (recovery of) loan losses	39	(360)	(115)	(12)	448	—
Ending Balance, June 30, 2017	\$482	\$872	\$3,074	\$ 375	\$ 641	\$5,444
Ending Balance:						
Individually evaluated for impairment	—	57	—	—	—	57
Collectively evaluated for impairment	482	815	3,074	375	641	5,387
Loans:						
Ending Balance	\$36,783	\$205,114	\$215,742	\$ 31,201	\$ 14,993	\$503,833
Individually evaluated for impairment	1,613	1,772	1,355	67	—	4,807
Collectively evaluated for impairment	35,170	203,342	214,387	31,134	14,993	499,026

Notes to Consolidated Financial Statements (Unaudited)

Impaired loans and the related allowance at June 30, 2018, December 31, 2017 and June 30, 2017, were as follows (in thousands):

	June 30, 2018						
	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	\$984	\$ 865	\$ —	\$ 865	\$ —	\$ 1,063	\$ 27
Secured by 1-4 family	1,415	1,330	—	1,330	—	1,300	28
Other real estate loans	2,029	2,029	—	2,029	—	1,140	30
Commercial and industrial	270	257	—	257	—	65	2
Total	\$4,698	\$ 4,481	\$ —	\$ 4,481	\$ —	\$ 3,568	\$ 87

	December 31, 2017						
	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	\$1,627	\$ 1,150	\$ —	\$ 1,150	\$ —	\$ 1,814	\$ 63
Secured by 1-4 family	1,387	1,307	—	1,307	—	1,637	64
Other real estate loans	1,483	1,289	—	1,289	—	1,137	95
Commercial and industrial	78	65	—	65	—	68	10
Total	\$4,575	\$ 3,811	\$ —	\$ 3,811	\$ —	\$ 4,656	\$ 232

	June 30, 2017						
	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	\$2,066	\$ 1,613	\$ —	\$ 1,613	\$ —	\$ 1,955	\$ 26
Secured by 1-4 family	1,820	1,348	424	1,772	57	1,667	31
Other real estate loans	1,540	1,355	—	1,355	—	958	49
Commercial and industrial	86	67	—	67	—	71	2
Total	\$5,512	\$ 4,383	\$ 424	\$ 4,807	\$ 57	\$ 4,651	\$ 108

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. Only loan classes with balances are included in the tables above.

As of June 30, 2018, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled \$321 thousand. At June 30, 2018, \$273 thousand of the loans classified as TDRs were

performing under the restructured terms and were not considered non-performing assets. There were \$333 thousand in TDRs at December 31, 2017, \$282 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

Notes to Consolidated Financial Statements (Unaudited)

minimize the economic loss and to avoid foreclosure or repossession of the collateral. There were no loans modified under TDRs during the three and six month periods ended June 30, 2018 and 2017.

For the three and six months ended June 30, 2018 and 2017, 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):

	Six Months Year Ended Ended June 30, December 31, 2018 2017	
Balance at the beginning of year, gross	\$ 326	\$ 250
Transfers in	68	326
Charge-offs	—	—
Sales proceeds	(350)	(441)
Gain on disposition	24	191
Balance at the end of period, gross	\$ 68	\$ 326
Less: valuation allowance	—	—
Balance at the end of period, net	\$ 68	\$ 326

The carrying amounts of residential real estate properties included in the ending OREO balances above totaled \$68 thousand at June 30, 2018. There were no residential real estate properties included in the ending OREO balances above at December 31, 2017. The recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings were in process was \$86 thousand as of June 30, 2018.

Net expenses applicable to OREO, other than the provision for losses, were \$2 thousand and \$6 thousand for the six months ended June 30, 2018 and 2017, respectively, and \$5 thousand for the year ended December 31, 2017.

Note 6. Other Borrowings

The Bank had unused lines of credit totaling \$130.0 million and \$134.1 million available with non-affiliated banks at June 30, 2018 and December 31, 2017, 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 \$77.2 million at June 30, 2018. The Bank had collateral pledged on the borrowing line at June 30, 2018 and December 31, 2017 including real estate loans totaling \$112.2 million and \$117.7 million, respectively, and Federal Home Loan Bank stock with a book value of \$665 thousand and \$645 thousand, respectively. The Bank did not have borrowings from the FHLB at June 30, 2018 and December 31, 2017.

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.

Notes to Consolidated Financial Statements (Unaudited)

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, which began 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 June 30, 2018 and December 31, 2017, that the Bank met all capital adequacy requirements to which it is subject.

As of June 30, 2018, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum risk-based capital and leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

A comparison of the capital of the Bank at June 30, 2018 and December 31, 2017 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
June 30, 2018						
Total Capital (to Risk-Weighted Assets)	\$71,026	13.47%	\$42,169	8.00%	\$52,711	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	\$65,987	12.52%	\$31,627	6.00%	\$42,169	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$65,987	12.52%	\$23,720	4.50%	\$34,262	6.50%
Tier 1 Capital (to Average Assets)	\$65,987	8.66%	\$30,469	4.00%	\$38,086	5.00%
December 31, 2017						
Total Capital (to Risk-Weighted Assets)	\$67,624	13.12%	\$41,239	8.00%	\$51,548	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	\$62,298	12.09%	\$30,929	6.00%	\$41,239	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	\$62,298	12.09%	\$23,197	4.50%	\$33,506	6.50%
Tier 1 Capital (to Average Assets)	\$62,298	8.46%	\$29,457	4.00%	\$36,821	5.00%

In addition to the regulatory minimum risk-based capital amounts presented above, the Bank must maintain a capital conservation buffer as required by the Basel III final rules. The buffer began applying to the Bank on January 1, 2016, and is subject to phase-in from 2016 to 2019 in equal annual installments of 0.625%. Accordingly, the Bank was required to maintain a capital conservation buffer of 1.875% and 1.25% at June 30, 2018 and December 31, 2017, respectively. Under the final rules, an institution is subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. As of June 30, 2018 and December 31, 2017, the capital conservation buffer of the Bank was 5.47% and 5.12%, respectively.

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 June 30, 2018, 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 \$44 thousand and \$52 thousand at June 30, 2018 and December 31, 2017, respectively.

Notes to Consolidated Financial Statements (Unaudited)

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 June 30, 2018 and December 31, 2017 was 4.93% and 4.20%, 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 June 30, 2018 and December 31, 2017 was 3.91% and 2.94%, 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 June 30, 2018 and December 31, 2017, 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 had 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 were generally based upon years of service and average compensation for the five highest-paid consecutive years of service. The Bank's funding practice was 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.

On September 14, 2016, the defined benefit pension plan was amended to be terminated. Under the amendment, benefit accruals ceased as of November 30, 2016. The Internal Revenue Service approved the termination on October 16, 2017 and the Company distributed all plan assets on March 8, 2018. The funding status of the plan on March 8, 2018 was not significantly different from the funded status disclosed in Note 13 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. The benefit obligation and the fair value of assets did not change significantly prior to the distribution of plan assets. Pension plan assets remained in cash and equivalents through the distribution date.

Notes to Consolidated Financial Statements (Unaudited)

Components of the net periodic benefit cost of the plan for the three and six months ended June 30, 2018 and 2017 were as follows (in thousands):

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Interest cost	\$ 20	\$ 41
Expected return on plan assets	—(9)	—(18)
Net periodic benefit cost	\$ 11	\$ 23

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2017, that it made a contribution of \$205 thousand upon the final distribution of plan assets on March 8, 2018.

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 directed matching contributions and certain other retirement contributions made by the Company to the 401(k) plan. On December 31, 2017, the ESOP was amended to be terminated and the Internal Revenue Service approved the termination on May 3, 2018. The Company plans to distribute all assets of the ESOP to participants or beneficiaries and terminate the plan prior to December 31, 2018. The ESOP continued 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 at June 30, 2018.

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, 2017 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.

The following table presents the computation of basic and diluted earnings per share for the three and six months ended June 30, 2018 and 2017 (dollars in thousands, except per share data):

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
(Numerator):				
Net income	\$2,451	\$ 1,756	\$5,138	\$ 3,299
(Denominator):				
Weighted average shares outstanding – basic	4,952,714	4,940,904	4,950,924	4,938,178
Potentially dilutive common shares – restricted stock units	1,553	1,822	2,406	2,013
Weighted average shares outstanding – diluted	4,954,267	4,942,726	4,953,330	4,940,191
Income per common share				

Edgar Filing: FIRST NATIONAL CORP /VA/ - Form 10-Q

Basic	\$0.49	\$ 0.36	\$1.04	\$ 0.67
Diluted	\$0.49	\$ 0.36	\$1.04	\$ 0.67

24

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.

Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity Level 1 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.

Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset Level 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.

Valuation is based on unobservable inputs that are supported by little or no market activity and that are Level 3 - 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

25

Notes to Consolidated Financial Statements (Unaudited)

corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). The following tables present the balances of assets measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017 (in thousands).

Description	Balance as of June 30, 2018	Fair Value Measurements at June 30, 2018		
		Quoted Prices for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 91,828	\$ 91,828	\$	—
Obligations of states and political subdivisions	14,879	—	14,879	—
	\$ 106,707	\$ 91,828	\$ 14,879	\$ —

Description	Balance as of December 31, 2017	Fair Value Measurements at December 31, 2017		
		Quoted Prices for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 74,804	\$ 74,804	\$	—
Obligations of states and political subdivisions	14,451	—	14,451	—
	\$ 89,255	\$ 74,804	\$ 14,451	\$ —

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

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

Loans held for sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a

nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the six months ended June 30, 2018 and the year ended December 31, 2017.

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 less estimated costs to sell. 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

Notes to Consolidated Financial Statements (Unaudited)

approach based on an appraisal conducted by an independent, licensed appraiser using observable market data (Level 2) within the last twelve months. However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Other real estate owned

Loans are transferred to other real estate owned when the collateral securing them is foreclosed on or acquired through a deed in lieu of foreclosure. The measurement of loss associated with other real estate owned is based on the appraisal documents and assessed the same way as impaired loans described above. Any fair value adjustments are recorded in the period incurred as other real estate owned (income) 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 June 30, 2018	Fair Value Measurements at June 30, 2018		
		Quoted Prices for Significant Other Observable Inputs (Level 1)	Significant Unobservable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Other real estate owned	\$ 68	\$ —	\$ —	\$ 68

Description	Balance as of December 31, 2017	Fair Value Measurements at December 31, 2017		
		Quoted Prices for Significant Other Observable Inputs (Level 1)	Significant Unobservable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Other real estate owned	\$ 326	\$ —	\$ —	\$ 326

Quantitative information about Level 3 Fair Value Measurements for June 30, 2018

Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Other real estate owned \$ 68	Property appraisals	Selling cost	7 %

Quantitative information about Level 3 Fair Value Measurements for December 31, 2017

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted-Average)
Other real estate owned	\$ 326	Contract Price	Selling cost	7 %

27

Notes to Consolidated Financial Statements (Unaudited)

Accounting guidance requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. For short-term financial assets such as cash and short-term investments, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For non-marketable equity securities such as Federal Home Loan Bank, Federal Reserve Bank and Community Bankers' Bank stock, the carrying amount is a reasonable estimate of fair value as these securities can only be redeemed or sold at their par value and only to the respective issuing government supported institution or to another member institution. Bank owned life insurance policies are carried at their cash surrender value, which approximates the fair value. The fair value of accrued interest receivable and payable are estimated to equal the carrying amount due to the short-term nature of these financial instruments. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

The carrying values and estimated fair values of the Company's financial instruments at June 30, 2018 and December 31, 2017 are as follows (in thousands):

	Carrying Amount	Fair Value Measurements at June 30, 2018			Fair Value
		Using Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
Financial Assets					
Cash and short-term investments	\$41,263	\$41,263	\$ —	\$ —	\$41,263
Securities available for sale	106,707	—	106,707	—	106,707
Securities held to maturity	45,701	—	42,918	1,498	44,416
Restricted securities	1,590	—	1,590	—	1,590
Loans held for sale	1,195	—	1,195	—	1,195
Loans, net ⁽¹⁾	525,894	—	—	523,078	523,078
Bank owned life insurance	13,787	—	13,787	—	13,787
Accrued interest receivable	2,073	—	2,073	—	2,073
Financial Liabilities					
Deposits	\$686,529	\$—	\$ 564,238	\$ 119,605	\$683,843
Subordinated debt	4,956	—	—	4,890	4,890
Junior subordinated debt	9,279	—	—	9,702	9,702
Accrued interest payable	105	—	105	—	105

Notes to Consolidated Financial Statements (Unaudited)

	Carrying Amount	Fair Value Measurements at December 31, 2017 Using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
Financial Assets					
Cash and short-term investments	\$39,986	\$39,986	\$ —	\$ —	\$39,986
Securities available for sale	89,255	—	89,255	—	89,255
Securities held to maturity	48,208	—	46,186	1,516	47,702
Restricted securities	1,570	—	1,570	—	1,570
Loans held for sale	438	—	438	—	438
Loans, net ⁽¹⁾	516,875	—	—	514,013	514,013
Bank owned life insurance	13,967	—	13,967	—	13,967
Accrued interest receivable	1,916	—	1,916	—	1,916
Financial Liabilities					
Deposits	\$664,980	\$—	\$ 542,329	\$ 120,834	\$663,163
Subordinated debt	4,948	—	—	5,004	5,004
Junior subordinated debt	9,279	—	—	9,653	9,653
Accrued interest payable	98	—	98	—	98

In accordance with the prospective adoption of ASU No. 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," the fair value of loans as of ⁽¹⁾June 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

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. 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 have compensation expense related to stock awards for the six months ended June 30, 2018. Compensation expense related to stock awards totaled \$30 thousand for the six months ended June 30, 2017.

Notes to Consolidated Financial Statements (Unaudited)

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 2018, 8,989 restricted stock units were granted to employees, with 2,999 units vesting immediately and 5,990 units subject to a two year vesting schedule with one half of the units vesting each year on the grant date anniversary. The recipient does not have any stockholder rights, including voting, dividend, or liquidation rights, with respect to the shares underlying awarded restricted stock units until vesting has occurred and the recipient becomes the record holder of those shares. The unvested restricted stock units will vest on the established schedule if the employees remain employed by the Company on future vesting dates.

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

	Six Months Ended June 30, 2018	
Shares	Weighted Average Grant Date Fair Value	
Unvested, beginning of year	5,662	\$ 11.76
Granted	8,989	18.50
Vested	(7,339)	13.90
Forfeited	(24)	15.20
Unvested, end of period	7,288	\$ 17.91

At June 30, 2018, 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 \$102 thousand. This expense is expected to be recognized through 2020. Compensation expense related to restricted stock unit awards recognized for the six months ended June 30, 2018 and 2017 totaled \$89 thousand and \$46 thousand, respectively.

Note 14. Accumulated Other Comprehensive Loss

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

	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Loss
Balance at December 31, 2016	\$ (860)	\$ —	\$ (860)
Unrealized holding gains (net of tax, \$397)	773	—	773
Reclassification adjustment (net of tax, (\$4))	(9)	—	(9)
Change during period	764	—	764
Balance at June 30, 2017	\$ (96)	\$ —	\$ (96)

Edgar Filing: FIRST NATIONAL CORP /VA/ - Form 10-Q

Balance at December 31, 2017	\$ (1,057)	\$ 99	\$ (958)
Unrealized holding losses (net of tax, (\$304))	(1,146)	—	(1,146)
Pension liability adjustment (net of tax, (\$27))	—	(99)	(99)
Change during period	(1,146)	(99)	(1,245)
Balance at June 30, 2018	\$ (2,203)	\$ —	\$ (2,203)

30

Notes to Consolidated Financial Statements (Unaudited)

The following tables present information related to reclassifications from accumulated other comprehensive loss for the three and six month periods ended June 30, 2018 and 2017 (in thousands).

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss Three Months Ended June 30, June 30, 2018 2017	Affected Line Item in the Consolidated Statements of Income
--	---	--

Securities available for sale:

Net securities gains reclassified into earnings	\$ — \$ (13)	Net gains on securities available for sale
Related income tax expense	— 4	Income tax expense
Total reclassifications	\$ — \$ (9)	Net of tax

Details About Accumulated Other Comprehensive Loss	Amount Reclassified from Accumulated Other Comprehensive Loss Six Months Ended June 30, June 30, 2018 2017	Affected Line Item in the Consolidated Statements of Income
--	---	--

Securities available for sale:

Net securities gains reclassified into earnings	\$ — \$ (13)	Net gains on securities available for sale
Related income tax expense	— 4	Income tax expense
Total reclassifications	\$ — \$ (9)	Net of tax

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 or phrases 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 new or acquired bank branches or entities with the Company's own operations;
- the Company's inability to successfully obtain the expected benefits of new or acquired bank branches or entities;
- intense competition from other businesses both in making loans and attracting deposits;
- the composition of the loan and deposit portfolio, including the types of accounts and customers, may change, which could impact the amount of net interest income and noninterest income in future periods, including revenue from service charges on 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 and theft of customer account information;
- 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;
- the effects of changes in tax laws, including the Tax Cuts and Jobs Act, on our business, some of which is uncertain and subject to interpretation, guidance, and regulations that may be promulgated;
- 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, 2017.

Because of these and other uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition at June 30, 2018 and statements of income of the Company for the three and six month periods ended June 30, 2018 and 2017 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, 2017. The statements of income for the three and six month periods ended June 30, 2018 may not be indicative of the results to be achieved for the year.

Executive Overview

The Company

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

First Bank (the Bank). The Bank owns:

First Bank Financial Services, Inc.

Shen-Valley Land Holdings, LLC

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

First National (VA) Statutory Trust III (Trust III and, together with Trust II, the Trusts)

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.

Products, Services, Customers and Locations

The Bank offers loan, deposit, and wealth management products and services. Loan products and services include consumer loans, residential mortgages, home equity loans, and commercial loans. Deposit products and services include checking accounts, treasury management solutions, savings accounts, money market accounts, certificates of deposit, and individual retirement accounts. Wealth management services include estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, and estate settlement. Customers include small and medium-sized businesses, individuals, estates, local governmental entities, and non-profit organizations. 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, warehousing, Federal government, hospitality, and higher education.

The Bank's products and services are delivered through 15 bank branch offices located throughout the Shenandoah Valley and central regions of Virginia, a loan production office, and a customer service center in a retirement village. The branch offices are comprised of 14 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, 2017. The Bank recently entered a new market in the central region of Virginia by opening a branch office in the city of Richmond during the fourth quarter of 2017. Many of the Bank's services are also delivered through the Bank's mobile banking platform, its website, www.fbvirginia.com, and a network of ATMs located throughout its market area.

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 six month period ended June 30, 2018, followed by occupancy and equipment expense, which comprised 14% 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.

Overview of Quarterly Financial Performance

Net income increased by \$695 thousand to \$2.5 million, or \$0.49 per basic and diluted share, for the three months ended June 30, 2018, compared to \$1.8 million, or \$0.36 per basic and diluted share, for the same period in 2017. Return on average assets was 1.29% and return on average equity was 16.23% for the second quarter of 2018, compared to 0.96% and 12.79%, respectively, for the same period in 2017.

The \$695 thousand increase in net income for the three month period ended June 30, 2018 resulted primarily from a \$582 thousand, or 9%, increase in net interest income, an \$89 thousand, or 4%, increase in noninterest income, and a \$183 thousand, or 24%, decrease in income tax expense, compared to the same period of 2017. These favorable variances were partially offset by a \$159 thousand, or 3%, increase in noninterest expenses.

Net interest income increased from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 5%, and the net interest margin increased 13 basis points to 3.86% for the second quarter of 2018, compared to 3.73% for the same period in 2017. Noninterest income increased primarily from higher service charges on deposit accounts and higher wealth management revenue. Noninterest expense increased primarily from higher salaries and employee benefits expense, higher occupancy expense, and higher other operating expense. For a more detailed discussion of the increases in other operating expense, see "Noninterest Expense" below.

Based on management's analysis and the supporting allowance for loan loss calculation, a provision for loan losses was not required during the second quarter of 2018 or 2017. For a more detailed discussion of the provision for loan losses, see "Provision for Loan Losses" below.

Overview of Year-to-Date Financial Performance

Net income increased by \$1.8 million to \$5.1 million, or \$1.04 per basic and diluted share, for the six months ended June 30, 2018, compared to \$3.3 million, or \$0.67 per basic and diluted share, for the same period in 2017. Return on average assets was 1.37% and return on average equity was 17.33% for the six months ended June 30, 2018, compared to 0.92% and 12.29%, respectively, for the same period in 2017.

The \$1.8 million increase in net income for the six month period ended June 30, 2018 resulted primarily from a \$1.1 million, or 9%, increase in net interest income, a \$781 thousand, or 20%, increase in noninterest income, and a \$295 thousand, or 21%, decrease in income tax expense, compared to the same period of 2017. These favorable variances were partially offset by a \$274 thousand, or 2%, increase in noninterest expenses.

Net interest income increased from a higher net interest margin and from higher average earning asset balances. Average earning asset balances increased 5%, and the net interest margin increased 12 basis points to 3.83% for the six months ended June 30, 2018, compared to 3.71% for the same period in 2017. Noninterest income increased primarily from higher service charges on deposit accounts, higher income from bank owned life insurance, higher wealth management revenue, and higher other operating income. Noninterest expense increased primarily from higher salaries and employee benefits expense, higher occupancy expense, and higher other operating expense. For a more detailed discussion of the increases in other operating income and other operating expense, see "Noninterest Income" and "Noninterest Expense" below.

Based on management's analysis and the supporting allowance for loan loss calculation, a provision for loan losses of \$100 thousand was recorded during the six month period ended June 30, 2018. A provision for loan losses was not required during the six month period ended June 30, 2017. For a more detailed discussion of the provision for loan losses, see "Provision for Loan Losses" below.

Non-GAAP Financial Measures

This report refers to the efficiency ratio, which is computed by dividing noninterest expense, excluding OREO (expense)/income and amortization of intangibles, by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding securities gains. 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).

	Efficiency Ratio			
	Three Months		Six Months Ended	
	Ended			Ended
	June 30,	June 30,	June 30,	June 30,
	2018	2017	2018	2017
Noninterest expense	\$5,864	\$5,705	\$11,730	\$11,456
Add/(Subtract): other real estate owned (expense)/income, net	(1)	(4)	22	(6)
Subtract: amortization of intangibles	(120)	(160)	(251)	(329)
	\$5,743	\$5,541	\$11,501	\$11,121
Tax-equivalent net interest income	\$6,883	\$6,341	\$13,479	\$12,426
Noninterest income	2,067	1,978	4,700	3,919
Subtract: securities gains, net	—	(13)	—	(13)
	\$8,950	\$8,306	\$18,179	\$16,332
Efficiency ratio	64.17 %	66.71 %	63.27 %	68.09 %

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 is 21% for 2018 and 34% for 2017. The reconciliation of tax equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below (in thousands).

	Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income			
	Three Months		Six Months Ended	
	Ended			Ended
	June 30,	June 30,	June 30,	June 30,
	2018	2017	2018	2017
GAAP measures:				
Interest income – loans	\$6,546	\$5,933	\$12,851	\$11,579
Interest income – investments and other	1,140	886	2,147	1,772
Interest expense – deposits	(665)	(405)	(1,255)	(788)
Interest expense – subordinated debt	(89)	(89)	(178)	(178)
Interest expense – junior subordinated debt	(101)	(76)	(187)	(144)
Total net interest income	\$6,831	\$6,249	\$13,378	\$12,241
Non-GAAP measures:				
Tax benefit realized on non-taxable interest income – loans	\$11	\$18	\$21	\$37
Tax benefit realized on non-taxable interest income – municipal securities	41	74	80	148
Total tax benefit realized on non-taxable interest income	\$52	\$92	\$101	\$185
Total tax-equivalent net interest income	\$6,883	\$6,341	\$13,479	\$12,426

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 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 to the Consolidated Financial Statements included in this Form 10-Q.

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The Company performs regular credit reviews of the loan portfolio to review credit quality and adherence to underwriting standards. The credit reviews consist of reviews by its internal credit administration department and reviews performed by an independent third party. Upon origination, each loan is assigned a risk rating ranging from one to nine, with loans closer to one having less risk. This risk rating scale is our primary credit quality indicator. The Company has various committees that review and ensure that the allowance for loans losses methodology is in accordance with GAAP and loss factors used appropriately reflect the risk characteristics of the loan portfolio. The allowance represents an amount that, in management's judgment, will be adequate to absorb any losses on existing loans that may become uncollectible. Management's judgment in determining the level of the allowance is based on evaluations of the collectability of loans while taking into consideration such factors as trends in delinquencies and charge-offs, changes in the nature and volume of the loan portfolio, current economic conditions that may affect a borrower's ability to repay and the value of the collateral, overall portfolio quality, and review of specific potential losses. The evaluation also considers the following risk characteristics of each loan portfolio class:

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

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

Other real estate loans carry risks associated with the successful operation of a business or a real estate project, in addition to other risks associated with the ownership of real estate, because repayment of these loans may be dependent upon the profitability and cash flows of the business or project.

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

Consumer and other loans carry risk associated with the continued creditworthiness of the borrower and the value of the collateral, if any. These loans are typically either unsecured or secured by rapidly depreciating assets such as automobiles. They are also likely to be immediately and adversely affected by job loss, divorce, illness, 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 included in this Form 10-Q.

Other-Than-Temporary Impairment of Securities

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either the Company (1) intends to sell the security or (2) it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more-than-likely that it will be required to sell the security before recovery, the Company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss). For equity securities carried at cost, such as restricted securities, impairment is considered to be other-than-temporary based on the Company's ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in income. The Company regularly reviews each security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, the Company's intention with regard to holding the security to maturity, and the likelihood that the Company would be required to sell the security before recovery.

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 and referrals by employees, real estate professionals, and customers. Commercial real estate loan originations and commercial and industrial loan originations are primarily 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. The Bank also participates in commercial real estate loans and commercial and industrial loans originated by other financial institutions that are typically outside its market area. Loan quality is analyzed based on the Bank's experience and credit underwriting guidelines depending on the type of loan involved. Except for loan participations with other financial institutions, real estate collateral is valued by independent appraisers who have been pre-approved by the Board Loan Committee.

As part of the ongoing monitoring of the credit quality of the Company's loan portfolio, certain appraisals are analyzed by management or by an outsourced appraisal review specialist throughout the year in order to ensure standards of quality are met. The Company also obtains an independent review of loans within the portfolio on an annual basis to analyze loan risk ratings and validate specific reserves on impaired loans.

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities which are disclosed but not reflected in its financial statements, including commitments to extend credit. At June 30, 2018, commitments to extend credit, stand-by letters of credit, and rate lock commitments totaled \$99.2 million.

Construction and Land Development Lending

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. The majority of these loans have an average life of approximately one year and re-price as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction and land development loans sometimes involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction and land development 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 this type of lending, the Bank generally limits loan amounts relative to the appraised value and/or cost of the collateral, in addition to analyzing the cost of the project and 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 and 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, office and retail buildings, hotels, industrial buildings, and religious facilities. Commercial real estate loan originations are primarily 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 borrowers' 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. The loans may be unsecured or 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, any collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much reliability as real estate.

Consumer Lending

Loans to individual borrowers may be secured or unsecured, and include unsecured consumer loans and lines of credit, automobile loans, deposit account loans, and installment and demand loans. These consumer loans may entail greater risk than residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by rapidly depreciating 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.

Also included in this category are loans purchased through a third-party lending program. These portfolios include consumer loans and carry risks associated with the borrower, changes in the economic environment, and the vendor itself. The Company manages these risks through policies that require minimum credit scores and other underwriting requirements, robust analysis of actual performance versus expected performance, as well as ensuring compliance with the Company's vendor management program.

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 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, amortization expense, and other real estate owned expense or income.

Net Interest Income

For the three months ended June 30, 2018, net interest income increased \$582 thousand, or 9%, to \$6.8 million for the quarter ended June 30, 2018, compared to \$6.2 million for the second quarter of 2017. The increase resulted from a higher net interest margin and higher average earning asset balances. Average earning asset balances increased 5%, and the net interest margin increased 13 basis points to 3.86% for the quarter ended June 30, 2018, compared to 3.73% for the same period in 2017. The

increase in the net interest margin resulted from a 28 basis point increase in the yield on total earning assets, which was partially offset by a 15 basis point increase in interest expense as a percent of average earning assets.

The higher yield on earning assets was attributable to an increase in yields on loans, securities, and interest-bearing deposits in banks, which all benefited from increases in market rates. The 28 basis point increase in the yield on loans had the largest impact on the increase in the yield on earning assets, when comparing the periods.

The increase in interest expense as a percent of average earning assets was primarily attributable to higher interest rates paid on interest-bearing deposits. The cost of interest-bearing checking accounts and money market accounts had the largest impact as their costs increased by 25 basis points and 53 basis points, respectively, when comparing the periods.

For the six months ended June 30, 2018, net interest income increased \$1.1 million, or 9%, to \$13.4 million, compared to \$12.2 million for the same period in 2017. The increase resulted from a higher net interest margin and higher average earning asset balances. Average earning asset balances increased 5%, and the net interest margin increased 12 basis points to 3.83% for the six months ended June 30, 2018, compared to 3.71% for the same period in 2017. The increase in the net interest margin resulted from a 24 basis point increase in the yield on total earning assets, which was partially offset by a 13 basis point increase in interest expense as a percent of average earning assets.

The higher yield on earning assets was attributable to an increase in yields on loans, securities, and interest-bearing deposits in banks, which all benefited from increases in market rates. The 26 basis point increase in the yield on loans had the largest impact on the increase in the yield on earning assets, when comparing the periods.

The increase in interest expense as a percent of average earning assets was primarily attributable to higher interest rates paid on interest-bearing deposits. The cost of interest-bearing checking accounts and money market accounts had the largest impact as their costs increased by 20 basis points and 51 basis points, respectively, when comparing the periods.

Edgar Filing: FIRST NATIONAL CORP /VA/ - Form 10-Q

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)

	Three Months Ended			June 30, 2017		
	June 30, 2018			June 30, 2017		
	Average Balance	Interest Expense	Income/Yield/Rate	Average Balance	Interest Expense	Income/Yield/Rate
Assets						
Securities:						
Taxable	\$121,004	\$ 776	2.57%	\$117,218	\$ 634	2.17%
Tax-exempt (1)	26,237	197	3.00%	24,745	219	3.55%
Restricted	1,590	22	5.63%	1,570	21	5.23%
Total securities	\$148,831	\$ 995	2.68%	\$143,533	\$ 874	2.44%
Loans: (2)						
Taxable	\$517,508	\$ 6,504	5.04%	\$496,013	\$ 5,899	4.77%
Tax-exempt (1)	4,785	53	4.49%	4,945	52	4.23%
Total loans	\$522,293	\$ 6,557	5.04%	\$500,958	\$ 5,951	4.76%
Interest-bearing deposits with other institutions	44,039	186	1.69%	37,641	86	0.92%
Total earning assets	\$715,163	\$ 7,738	4.34%	\$682,132	\$ 6,911	4.06%
Less: allowance for loan losses	(5,225)			(5,408)		
Total non-earning assets	52,688			54,114		
Total assets	\$762,626			\$730,838		
Liabilities and Shareholders' Equity						
Interest bearing deposits:						
Checking	\$161,741	\$ 260	0.64%	\$169,108	\$ 167	0.39%
Regular savings	124,851	24	0.08%	129,137	25	0.08%
Money market accounts	87,837	165	0.75%	59,570	32	0.22%
Time deposits:						
\$100,000 and over	49,060	120	0.98%	43,011	82	0.76%
Under \$100,000	73,912	96	0.52%	81,424	98	0.48%
Brokered	550	—	0.11%	550	1	0.10%
Total interest-bearing deposits	\$497,951	\$ 665	0.54%	\$482,800	\$ 405	0.34%
Federal funds purchased	3	—	2.20%	3	—	1.30%
Subordinated debt	4,954	89	7.26%	4,937	89	7.28%
Junior subordinated debt	9,279	101	4.33%	9,279	76	3.26%
Total interest-bearing liabilities	\$512,187	\$ 855	0.67%	\$497,019	\$ 570	0.46%
Non-interest bearing liabilities						
Demand deposits	188,666			174,906		
Other liabilities	1,181			3,845		
Total liabilities	\$702,034			\$675,770		
Shareholders' equity	60,592			55,068		
Total liabilities and Shareholders' equity	\$762,626			\$730,838		
Net interest income		\$ 6,883			\$ 6,341	
Interest rate spread			3.67%			3.60%
Cost of funds			0.49%			0.34%
Interest expense as a percent of average earning assets			0.48%			0.33%
Net interest margin			3.86%			3.73%

Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 21% for 2018 and 34% (1) for 2017. The tax-equivalent adjustment was \$52 thousand and \$92 thousand for the three months ended June 30, 2018 and 2017, respectively.

(2) Loans placed on a non-accrual status are reflected in the balances.

Edgar Filing: FIRST NATIONAL CORP /VA/ - Form 10-Q

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

	Six Months Ended			Six Months Ended		
	June 30, 2018			June 30, 2017		
	Average Balance	Interest Expense	Income/Yield/Rate	Average Balance	Interest Expense	Income/Yield/Rate
Assets						
Securities:						
Taxable	\$ 116,816	\$ 1,456	2.51%	\$ 119,375	\$ 1,296	2.19%
Tax-exempt (1)	25,812	381	2.97%	24,677	436	3.56%
Restricted	1,581	44	5.59%	1,560	41	5.31%
Total securities	\$ 144,209	\$ 1,881	2.63%	\$ 145,612	\$ 1,773	2.46%
Loans: (2)						
Taxable	\$ 516,796	\$ 12,770	4.98%	\$ 490,797	\$ 11,508	4.73%
Tax-exempt (1)	4,808	102	4.29%	5,138	108	4.24%
Total loans	\$ 521,604	\$ 12,872	4.98%	\$ 495,935	\$ 11,616	4.72%
Interest-bearing deposits with other institutions	44,270	346	1.58%	33,152	147	0.89%
Total earning assets	\$ 710,083	\$ 15,099	4.29%	\$ 674,699	\$ 13,536	4.05%
Less: allowance for loan losses	(5,246)			(5,389)		
Total non-earning assets	52,122			53,510		
Total assets	\$ 756,959			\$ 722,820		
Liabilities and Shareholders' Equity						
Interest bearing deposits:						
Checking	\$ 160,179	\$ 472	0.59%	\$ 163,442	\$ 316	0.39%
Regular savings	124,847	47	0.08%	128,967	51	0.08%
Money market accounts	87,063	312	0.72%	60,666	62	0.21%
Time deposits:						
\$100,000 and over	48,644	230	0.95%	43,892	166	0.76%
Under \$100,000	75,076	193	0.52%	81,941	191	0.47%
Brokered	556	1	0.40%	583	2	0.50%
Total interest-bearing deposits	\$ 496,365	\$ 1,255	0.51%	\$ 479,491	\$ 788	0.33%
Federal funds purchased	3	—	2.14%	2	—	1.22%
Subordinated debt	4,952	178	7.26%	4,934	178	7.29%
Junior subordinated debt	9,279	187	4.05%	9,279	144	3.12%
Total interest-bearing liabilities	\$ 510,599	\$ 1,620	0.64%	\$ 493,706	\$ 1,110	0.45%
Non-interest bearing liabilities						
Demand deposits	185,160			171,029		
Other liabilities	1,401			3,967		
Total liabilities	\$ 697,160			\$ 668,702		
Shareholders' equity	59,799			54,118		
Total liabilities and Shareholders' equity	\$ 756,959			\$ 722,820		
Net interest income		\$ 13,479			\$ 12,426	
Interest rate spread			3.65%			3.60%
Cost of funds			0.47%			0.34%
Interest expense as a percent of average earning assets			0.46%			0.33%
Net interest margin			3.83%			3.71%

(1)

Income and yields are reported on a taxable-equivalent basis assuming a federal tax rate of 21% for 2018 and 34% for 2017. The tax-equivalent adjustment was \$101 thousand and \$185 thousand for the six months ended June 30, 2018 and 2017, respectively.

(2) Loans placed on a non-accrual status are reflected in the balances.

Provision for Loan Losses

The Bank did not record a provision for loan losses during the second quarter of 2018 or 2017, which resulted in a total allowance for loan losses of \$5.0 million, or 0.95% of total loans, at June 30, 2018. This compared to an allowance for loan losses of \$5.4 million, or 1.08% of total loans, at June 30, 2017. The allowance for loan losses was \$5.3 million, or 1.02% of total loans, at December 31, 2017.

For the quarter ended June 30, 2018, the Bank did not record a provision for loan losses as net charge-offs on loans were offset by a decrease in the general reserve component of the allowance for loan losses. Net charge-offs totaled \$233 thousand for the second quarter of 2018, compared to \$7 thousand of net charge-offs for the same period of 2017. The general reserve decreased primarily from improvements in both the historical loss rate of the loan portfolio and the qualitative adjustment factors. Improvements in qualitative adjustment factors resulted from improved asset quality in the construction and land development loan class, as evidenced by lower substandard and past due loan amounts in this respective class, and improved economic conditions. Although impaired loans increased during the second quarter, there was no required increase to the specific reserve component of the allowance for loan losses.

A provision for loan losses was not recorded during the second quarter of 2017 as a decrease in the general reserve component of the allowance for loan losses was offset by an increase in the specific reserve component. The decrease in the general reserve resulted primarily from an improvement in the qualitative adjustment factors for improved economic conditions. The specific reserve increased during the quarter primarily from the addition of a newly identified impaired loan for which a specific reserve was calculated.

For the six months ended June 30, 2018, the Bank recorded a provision for loan losses of \$100 thousand as net charge-offs on loans were only partially offset by a decrease in the general reserve component of the allowance for loan losses. Net charge-offs totaled \$387 thousand for the first six months of 2018, compared to \$123 thousand of net recoveries for the same period of 2017. The general reserve decreased primarily from improvements in both the historical loss rate of the loan portfolio and the qualitative adjustment factors. Improvements in qualitative adjustment factors resulted from improved asset quality in the construction and land development loan class, as evidenced by lower substandard and past due loan amounts in this respective class, and improved economic conditions. There was no change to the specific reserve component of the allowance for loan losses during the six months ended June 30, 2018.

The Bank did not record a provision for loan losses for the six month period ended June 30, 2017 as increases in the general and specific reserve components of the allowance for loan losses were offset by the net recoveries on loans charged off in prior periods. The increase in the general reserve resulted primarily from the impact of loan growth during the first six months of 2017. The impact of loan growth on the general reserve was partially offset by improvements in the historical loss rate of the loan portfolio and qualitative adjustment factors. Improvements in qualitative adjustment factors resulted from improved asset quality in the 1-4 family residential, other real estate, and commercial and industrial loan classes and improved economic conditions. The specific reserve component increased primarily from the addition of a newly identified impaired loan for which a specific reserve was calculated.

Noninterest Income

Noninterest income increased \$89 thousand, or 4%, to \$2.1 million for the three months ended June 30, 2018, compared to \$2.0 million for the same period in 2017. The increase in noninterest income was primarily attributable to a \$49 thousand, or 7%, increase in service charges on deposit accounts, a \$28 thousand, or 5%, increase in ATM and check card fees, and a \$54 thousand, or 15%, increase in wealth management fees, when comparing the periods. The increase in service charges on deposit accounts was a result of higher overdraft revenue. The increase in ATM and check card fees was primarily attributable to the volume of customer check card usage. The increase in wealth

management fees resulted primarily from higher balances of assets under management during the second quarter of 2018 compared to the same period one year ago. These increases were partially offset by a \$25 thousand, or 25%, decrease in income from bank owned life insurance and a \$19 thousand, or 56%, decrease in net gains on sale of loans. The decrease in income from bank owned life insurance resulted primarily from the timing of annual dividend payments received.

For the six months ended June 30, 2018, noninterest income increased \$781 thousand, or 20%, to \$4.7 million, compared to \$3.9 million for the same period in 2017. The increase in noninterest income was primarily attributable to a \$56 thousand, or 4%, increase in service charges on deposit accounts, a \$46 thousand, or 4%, increase in ATM and check card fees, a \$114 thousand, or 16%, increase in wealth management fees, a \$441 thousand increase in income from bank owned life insurance, and a \$153 thousand increase in other operating income, when comparing the periods. The decrease in service charges on deposit accounts was a result of higher overdraft revenue. The increase in ATM and check card fees was primarily attributable

to the volume of customer check card usage. The increase in wealth management fees resulted primarily from higher balances of assets under management during the first six months of 2018 compared to the same period one year ago. The increase in income from bank owned life insurance resulted from life insurance benefits recorded during the first quarter of 2018 due to the death of an employee. The increase in other operating income was primarily attributable to the termination of the pension plan and the subsequent distribution of plan assets, which resulted in a one-time increase in other operating income of \$126 thousand. These increases were partially offset by a \$43 thousand, or 64%, decrease in net gains on sale of loans.

Noninterest Expense

Noninterest expense increased \$159 thousand, or 3%, to \$5.9 million for the quarter ended June 30, 2018, compared to \$5.7 million for the same period in 2017. The increase in noninterest expense was primarily attributable to a \$105 thousand, or 3%, increase in salaries and employee benefits, a \$39 thousand, or 11%, increase in occupancy expense, and a \$97 thousand, or 22%, increase in other operating expense, when comparing the periods. These increases were partially offset by a \$32 thousand, or 43%, decrease in postage expense and a \$40 thousand, or 25%, decrease in amortization expense.

The increases in salaries and employee benefits and occupancy expense resulted primarily from the Company's expansion into the Richmond, Virginia market during the fourth quarter of 2017. Expense categories most likely impacted in future periods as a result of the new branch office include salaries and employee benefits, occupancy, and equipment. The increase in other operating expense was primarily attributable to a combination of higher check fraud and debit card losses experienced during the quarter, higher loan servicing fees on purchased consumer loans, and higher fees required by the Virginia State Corporation Commission for examination, supervision, and regulation. The decrease in postage expense resulted primarily from efforts to lower operating costs. Amortization expense continued to decrease as a result of the accelerated amortization method of core deposit intangibles.

For the six months ended June 30, 2018, noninterest expense increased \$274 thousand, or 2%, to \$11.7 million, compared to \$11.5 million for the same period in 2017. The increase in noninterest expense was primarily attributable to a \$246 thousand, or 4%, increase in salaries and employee benefits, a \$72 thousand, or 10%, increase in occupancy expense, and a \$137 thousand, or 15%, increase in other operating expense, when comparing the periods. These increases were partially offset by an \$84 thousand, or 39%, decrease in telecommunications expense and a \$78 thousand, or 24%, decrease in amortization expense.

The increases in salaries and employee benefits and occupancy expense resulted primarily from the Company's expansion into the Richmond, Virginia market. The increase in other operating expense was primarily attributable to a combination of higher check fraud losses, higher loan servicing fees on purchased consumer loans, and higher fees required by the Virginia State Corporation Commission for examination, supervision, and regulation. The increase in other operating expense also includes a \$50 thousand death benefit payment to the beneficiary in relation to the life insurance benefits discussed in "Noninterest Income" above.

Telecommunications expense decreased as a result of a refund of over-billed services in prior periods. The decrease in amortization expense was due to the accelerated amortization method of core deposit intangibles.

Income Taxes

Income tax expense decreased by \$183 thousand, or 24%, for the second quarter of 2018 and decreased by \$295 thousand, or 21%, for the six months ended June 30, 2018, compared to the same periods one year ago. The decreases in income tax expense resulted from the new 21% federal corporate tax rate established by the Tax Cuts and Jobs Act enacted in December 2017.

The Company's income tax expense differed from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the three and six month periods ended June 30, 2018 and 2017. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income and income from

bank owned life insurance. A more detailed discussion of the Company's tax calculation is contained in Note 11 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Financial Condition

General

Total assets increased by \$24.3 million to \$763.4 million at June 30, 2018 compared to \$739.1 million at December 31, 2017. The increase was primarily attributable to a \$15.0 million increase in securities and a \$9.0 million increase in net loans, when comparing the periods.

At June 30, 2018, total liabilities increased by \$20.8 million to \$701.7 million compared to \$681.0 million at December 31, 2017. The increase was primarily attributable to a \$21.5 million increase in total deposits, since December 31, 2017. Noninterest-bearing demand deposits and savings and interest-bearing deposits increased \$15.9 million and \$6.0 million, respectively, when comparing the periods. These increases were partially offset by a \$360 thousand decrease in time deposits since December 31, 2017.

Total shareholders' equity increased by \$3.5 million to \$61.6 million at June 30, 2018 compared to \$58.2 million at December 31, 2017. The Company's capital ratios continue to exceed the minimum capital requirements for regulatory purposes.

Loans

Loans, net of the allowance for loan losses, increased \$9.0 million to \$525.9 million at June 30, 2018, compared to \$516.9 million at December 31, 2017. Growth of the loan portfolio was led by residential real estate loans with balances that increased by \$2.9 million during the first six months of 2018, followed by commercial and industrial loans and other real estate loans with balances that increased by \$2.2 million and \$2.1 million, respectively.

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 commercial buildings, 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, office and retail buildings, industrial and warehouse buildings, hotels, and religious facilities.

Commercial and Industrial Loans: Commercial loans may be unsecured or secured with non-real estate commercial property. The Company's banking subsidiary makes commercial loans to businesses located within its market area and also to businesses outside of its market area through loan participations with other financial institutions.

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. The Company's banking subsidiary makes consumer loans to individuals located within its market area and also to individuals outside its market through the purchase of loans from another financial institution.

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

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances less the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued and credited to income based on the unpaid principal balance. Loan origination

fees, net of certain origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

A loan's past due status is based on the contractual due date of the most delinquent payment due. Loans are generally placed on non-accrual status when the collection of principal or interest is 90 days or more past due, or earlier, if collection is uncertain based on an evaluation of the net realizable value of the collateral and the financial strength of the borrower. Loans greater than 90 days past due may remain on accrual status if management determines it has adequate collateral to cover the principal and interest. Loans greater than 90 days past due and still accruing totaled \$549 thousand at June 30, 2018, compared to \$183 thousand at December 31, 2017. 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. When a loan is returned to accrual status, interest income is recognized based on the new effective yield to maturity of the loan.

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 \$4.5 million and \$3.8 million at June 30, 2018 and December 31, 2017, 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 \$321 thousand and \$333 thousand in loans classified as TDRs as of June 30, 2018 and December 31, 2017, respectively.

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 operations or 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 totaled \$68 thousand at June 30, 2018 and \$326 thousand at December 31, 2017. There was not a valuation allowance for other real estate owned at June 30, 2018 or December 31, 2017.

Non-performing assets totaled \$2.4 million at June 30, 2018 and \$1.3 million at December 31, 2017, representing 0.31% and 0.17% of total assets, respectively. Non-performing assets included \$2.3 million in non-accrual loans and \$68 thousand in OREO at June 30, 2018. This compares to \$937 thousand in non-accrual loans and \$326 thousand in OREO at December 31, 2017.

At June 30, 2018, 73% of non-performing assets related to commercial real estate loans, 19% related to residential real estate loans, and 8% 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 \$3.8 million and \$8.9 million at June 30, 2018 and December 31, 2017, 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 \$549 thousand at June 30, 2018, which was comprised of four loans expected to pay all principal and interest amounts contractually due to the Bank and two purchased consumer loans. Consumer loans purchased at origination are charged-off when they are greater than 120 days past due. There were \$183 thousand of loans greater than 90 days past due and still accruing at December 31, 2017. The allowance for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for loan losses is based upon management's current estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio. The allowance for loan losses totaled \$5.0 million at June 30, 2018 and \$5.3 million at December 31, 2017, representing 0.95% and 1.02% of total loans, respectively. For further discussion regarding the allowance for loan losses, see "Provision for Loan Losses" above. Recoveries of loan losses of \$8 thousand and \$285 thousand were recorded in the construction and land development and other real estate loan classes, respectively, during the six month period ended June 30, 2018. The recovery of loan losses in the construction and land development loan class resulted from improvements in qualitative adjustment factors. The recovery of loan losses in the other real estate loan class resulted primarily from improvements in the historical loss rate and qualitative adjustment factors. These recoveries were offset by provision for loan losses totaling \$393 thousand in the 1-4 family residential, commercial and industrial, and consumer and other loan classes. For more detailed information regarding the provision for loan losses, see Note 4 to the Consolidated Financial Statements.

Impaired loans totaled \$4.5 million and \$3.8 million at June 30, 2018 and December 31, 2017, respectively. There was not a related allowance for loan losses provided for these loans at June 30, 2018 or December 31, 2017. The average recorded investment in impaired loans during the six months ended June 30, 2018 and the year ended December 31, 2017 was \$3.6 million and \$4.7 million, respectively. Included in the impaired loans total are loans classified as TDRs totaling \$321 thousand and \$333 thousand at June 30, 2018 and December 31, 2017, respectively. 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 June 30, 2018, \$273 thousand of these TDRs were performing under the restructured terms and were not considered non-performing assets.

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

economy, on a national basis or in the Company's market area, loan growth, or changes in the circumstances of particular borrowers. For further discussion regarding the allowance for loan losses, see "Critical Accounting Policies" above.

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 June 30, 2018 totaled \$154.0 million, an increase of \$15.0 million, or 11%, from \$139.0 million at December 31, 2017. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate debt securities, and restricted securities. As of June 30, 2018, neither the Company nor the Bank held any derivative financial instruments in their respective investment security portfolios. Gross unrealized gains in the available for sale portfolio totaled \$67 thousand and \$153 thousand at June 30, 2018 and December 31, 2017, respectively. Gross unrealized losses in the available for sale portfolio totaled \$2.9 million and \$1.5 million at June 30, 2018 and December 31, 2017, respectively. Gross unrealized gains in the held to maturity portfolio totaled \$17 thousand and \$90 thousand at June 30, 2018 and December 31, 2017, respectively. Gross unrealized losses in the held to maturity portfolio totaled \$1.3 million and \$596 thousand at June 30, 2018 and December 31, 2017, respectively. Investments in an unrealized loss position were considered temporarily impaired at June 30, 2018 and December 31, 2017. The change in the unrealized gains and losses of investment securities from December 31, 2017 to June 30, 2018 was related to changes in market interest rates and was not related to credit concerns of the issuers.

Deposits

At June 30, 2018, deposits totaled \$686.5 million, an increase of \$21.5 million, from \$665.0 million at December 31, 2017. There was a slight change in the deposit mix when comparing the periods. At June 30, 2018, noninterest-bearing demand deposits, savings and interest-bearing demand deposits, and time deposits composed 29%, 53%, and 18% of total deposits, respectively, compared to 27%, 54%, and 19% at December 31, 2017.

Liquidity

Liquidity represents the ability to meet present and future financial obligations through either the sale or maturity of existing assets or with borrowings from correspondent banks or other deposit markets. The Company classifies cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, investment securities, and loans maturing within one year as liquid assets. As part of the Bank's liquidity risk management, stress tests and cash flow modeling are performed quarterly.

As a result of the Bank's management of liquid assets and the ability to generate liquidity through liability funding, management believes that the Bank maintains overall liquidity sufficient to satisfy its depositors' requirements and to meet its customers' borrowing needs.

At June 30, 2018, cash, interest-bearing and noninterest-bearing deposits with banks, securities and loans maturing within one year totaled \$97.9 million. At June 30, 2018, 11% or \$55.9 million of the loan portfolio matures within one year. Non-deposit sources of available funds totaled \$130.0 million at June 30, 2018, which included \$77.2 million available from Federal Home Loan Bank of Atlanta (FHLB), \$42.0 million of unsecured federal funds lines of credit with other correspondent banks, and \$10.8 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, which began on January 1, 2016, as follows: the maximum buffer was 0.625% of risk-weighted assets for 2016 and 1.25% for 2017, is 1.875% for 2018, and will be 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 June 30, 2018 and December 31, 2017, 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 June 30, 2018:

	First Bank
Total capital to risk-weighted assets	13.47 %
Tier 1 capital to risk-weighted assets	12.52 %
Common equity Tier 1 capital to risk-weighted assets	12.52 %
Tier 1 capital to average assets	8.66 %
Capital conservation buffer ratio(1)	5.47 %

Calculated by subtracting the regulatory minimum capital ratio requirements from the Company's actual ratio for (1) 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).

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, 2017.

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 \$85.4 million at June 30, 2018, and \$78.0 million at December 31, 2017, 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 June 30, 2018 and December 31, 2017, the Bank had \$10.3 million and \$10.4 million in outstanding standby letters of credit, respectively.

At June 30, 2018, the Bank had \$3.5 million in locked-rate commitments to originate mortgage loans. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Bank does not expect any counterparty to fail to meet its obligations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not required.

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to provide assurance that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods required by the SEC and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2018 was carried out under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer. Based on and as of the date of such evaluation, the aforementioned officers concluded that the Company's disclosure controls and procedures were effective.

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

are reasonably likely to materially affect, internal control over financial reporting.

50

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, 2017.

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

The following materials from First National Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, 101 (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.

SIGNATURES

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

FIRST NATIONAL CORPORATION

(Registrant)

/s/ Scott C. Harvard

August 10, 2018

Scott C. Harvard

Date

President and Chief Executive Officer

/s/ M. Shane Bell

August 10, 2018

M. Shane Bell

Date

Executive Vice President and Chief Financial Officer

EXHIBIT INDEX

Number Document

31.1 Certification of Chief Executive Officer, Section 302 Certification

31.2 Certification of Chief Financial Officer, Section 302 Certification

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

101 The following materials from First National Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018 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.

53