

FIRST NATIONAL CORP /VA/  
Form 10-Q  
August 13, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2013

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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

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

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

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input checked="" type="checkbox"/>

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 9, 2013, 4,901,464 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

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

	(unaudited)	
	June 30, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 8,104	\$ 7,266
Interest-bearing deposits in banks	23,045	23,762
Securities available for sale, at fair value	105,163	89,456
Restricted securities, at cost	1,805	1,974
Loans held for sale		503
Loans, net of allowance for loan losses, 2013, \$12,478; 2012, \$13,075	365,035	370,519
Other real estate owned, net of valuation allowance, 2013, \$2,083; 2012, \$2,174	4,084	5,590
Premises and equipment, net	17,992	18,589
Accrued interest receivable	1,425	1,459
Bank owned life insurance	9,144	9,014
Other assets	4,942	4,565
<b>Total assets</b>	<b>\$ 540,739</b>	<b>\$ 532,697</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 91,946	\$ 85,118
Savings and interest-bearing demand deposits	232,763	221,601
Time deposits	151,249	160,198
Total deposits	\$ 475,958	\$ 466,917
Other borrowings	6,064	6,076
Trust preferred capital notes	9,279	9,279
Accrued interest and other liabilities	6,377	5,536
Total liabilities	\$ 497,678	\$ 487,808
<b>Shareholders Equity</b>		
Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding, net of discount	\$ 14,485	\$ 14,409
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2013 and 2012, 4,901,464 shares	6,127	6,127
Surplus	6,813	6,813
Retained earnings	19,188	18,399

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Accumulated other comprehensive loss, net	(3,552)	(859)
Total shareholders' equity	\$ 43,061	\$ 44,889
Total liabilities and shareholders' equity	\$ 540,739	\$ 532,697

*See Notes to Consolidated Financial Statements*

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

Three months ended June 30, 2013 and 2012

*(Dollars in thousands, except per share data)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 4,816	\$ 5,265
Interest on federal funds sold		6
Interest on deposits in banks	17	5
Interest and dividends on securities available for sale:		
Taxable interest	443	514
Tax-exempt interest	76	71
Dividends	19	19
<b>Total interest and dividend income</b>	<b>\$ 5,371</b>	<b>\$ 5,880</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 632	\$ 959
Interest on trust preferred capital notes	55	60
Interest on other borrowings	30	66
<b>Total interest expense</b>	<b>\$ 717</b>	<b>\$ 1,085</b>
<b>Net interest income</b>	<b>\$ 4,654</b>	<b>\$ 4,795</b>
Provision for loan losses	2,500	650
<b>Net interest income after provision for loan losses</b>	<b>\$ 2,154</b>	<b>\$ 4,145</b>
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 464	\$ 523
ATM and check card fees	365	387
Trust and investment advisory fees	375	368
Fees for other customer services	128	107
Gains on sale of loans	65	49
Net gains on sale of securities available for sale (includes net gains of \$0 and \$1 for the three months ended June 30, 2013 and 2012, respectively, related to accumulated other comprehensive income reclassifications for previously unrealized net gains on available-for-sale securities)		1
Losses on sale of premises and equipment, net	(3)	
Other operating income	640	27
<b>Total noninterest income</b>	<b>\$ 2,034</b>	<b>\$ 1,462</b>

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**Noninterest Expense**

Salaries and employee benefits	\$ 2,443	\$ 2,388
Occupancy	296	337
Equipment	288	307
Marketing	113	95
Stationery and supplies	81	86
Legal and professional fees	219	198
ATM and check card fees	168	163
FDIC assessment	180	179
Bank franchise tax	70	61
Other real estate owned, net	376	106
Telecommunications expense	78	61
Data processing	95	78
Other operating expense	350	375
Total noninterest expense	\$ 4,757	\$ 4,434

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

(Continued)

Three months ended June 30, 2013 and 2012

*(Dollars in thousands, except per share data)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
Income (loss) before income taxes	\$ (569)	\$ 1,173
Income tax expense (benefit)	(830)	479
<b>Net income</b>	<b>\$ 261</b>	<b>\$ 694</b>
Effective dividend on preferred stock	230	227
<b>Net income available to common shareholders</b>	<b>\$ 31</b>	<b>\$ 467</b>
<b>Earnings per common share, basic and diluted</b>	<b>\$ 0.01</b>	<b>\$ 0.16</b>

*See Notes to Consolidated Financial Statements*



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

Six months ended June 30, 2013 and 2012

*(Dollars in thousands, except per share data)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 9,749	\$ 10,812
Interest on federal funds sold		9
Interest on deposits in banks	27	8
Interest and dividends on securities available for sale:		
Taxable interest	815	1,048
Tax-exempt interest	149	173
Dividends	38	38
<b>Total interest and dividend income</b>	<b>\$ 10,778</b>	<b>\$ 12,088</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 1,338	\$ 1,945
Interest on trust preferred capital notes	111	122
Interest on other borrowings	59	146
<b>Total interest expense</b>	<b>\$ 1,508</b>	<b>\$ 2,213</b>
<b>Net interest income</b>	<b>\$ 9,270</b>	<b>\$ 9,875</b>
Provision for loan losses	2,250	2,650
<b>Net interest income after provision for loan losses</b>	<b>\$ 7,020</b>	<b>\$ 7,225</b>
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 923	\$ 1,025
ATM and check card fees	698	760
Trust and investment advisory fees	827	714
Fees for other customer services	216	205
Gains on sale of loans	124	92
Net gains on sale of securities available for sale (includes net gains of \$0 and \$1,118 for the six months ended June 30, 2013 and 2012, respectively, related to accumulated other comprehensive income reclassifications for previously unrealized net gains on available-for-sale securities)		1,118
Other operating income	747	62
<b>Total noninterest income</b>	<b>\$ 3,535</b>	<b>\$ 3,976</b>

**Noninterest Expense**

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Salaries and employee benefits	\$ 5,077	\$ 4,757
Occupancy	674	663
Equipment	587	613
Marketing	223	173
Stationery and supplies	156	167
Legal and professional fees	398	448
ATM and check card fees	326	319
FDIC assessment	521	357
Bank franchise tax	138	137
Other real estate owned, net	483	670
Telecommunications expense	140	122
Data processing	178	168
Loss on land lease termination	209	
Other operating expense	760	744
Total noninterest expense	\$ 9,870	\$ 9,338

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

(Continued)

Six months ended June 30, 2013 and 2012

*(Dollars in thousands, except per share data)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
Income before income taxes	\$ 685	\$ 1,863
Income tax expense (benefit)	(559)	694
<b>Net income</b>	<b>\$ 1,244</b>	<b>\$ 1,169</b>
Effective dividend on preferred stock	455	451
<b>Net income available to common shareholders</b>	<b>\$ 789</b>	<b>\$ 718</b>
<b>Earnings per common share, basic and diluted</b>	<b>\$ 0.16</b>	<b>\$ 0.24</b>

*See Notes to Consolidated Financial Statements*

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

Three months ended June 30, 2013 and 2012

*(Dollars in thousands, except per share data)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
Net income	\$ 261	\$ 694
Other comprehensive income (loss):		
Unrealized gain (loss) on available for sale securities	(2,561)	448
Reclassification adjustment		(1)
Other comprehensive income (loss)	(2,561)	447
Total comprehensive income (loss)	\$ (2,300)	\$ 1,141

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2013 and 2012

*(Dollars in thousands, except per share data)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
Net income	\$ 1,244	\$ 1,169
Other comprehensive loss:		
Unrealized gain (loss) on available for sale securities	(2,693)	327
Reclassification adjustment		(1,118)
Other comprehensive loss	(2,693)	(791)
Total comprehensive loss	\$ (1,449)	\$ (378)

*See Notes to Consolidated Financial Statements*

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

Six months ended June 30, 2013 and 2012

*(Dollars in thousands)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 1,244	\$ 1,169
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	492	570
Origination of loans held for sale	(2,567)	(3,452)
Proceeds from sale of loans held for sale	3,194	3,818
Gains on sale of loans held for sale	(124)	(92)
Provision for loan losses	2,250	2,650
Provision for other real estate owned	448	569
Net gains on sale of securities available for sale		(1,118)
Net gains on sale of other real estate owned	(64)	(250)
Income from bank owned life insurance	(130)	
Accretion of discounts and amortization of premiums on securities, net	504	369
Changes in assets and liabilities:		
Decrease in interest receivable	34	84
(Increase) decrease in other assets	(766)	165
Increase in other liabilities	841	85
Net cash provided by operating activities	\$ 5,356	\$ 4,567
<b>Cash Flows from Investing Activities</b>		
Proceeds from sales of securities available for sale	\$ 1,850	\$ 24,217
Proceeds from maturities, calls, and principal payments of securities available for sale	13,461	14,708
Purchase of securities available for sale	(34,216)	(34,598)
Proceeds from redemption of restricted securities	169	367
Purchase of premises and equipment	(122)	(284)
Proceeds from sale of premises and equipment	3	
Proceeds from sale of other real estate owned	1,927	3,815
Net decrease in loans	3,043	3,537
Net cash provided by (used in) investing activities	\$ (13,885)	\$ 11,762
<b>Cash Flows from Financing Activities</b>		
Net increase in demand deposits and savings accounts	\$ 17,990	\$ 10,964
Net decrease in time deposits	(8,949)	(21,442)
Principal payments on other borrowings	(12)	(5,012)
Net proceeds from issuance of common stock		7,601
Cash dividends paid on preferred stock	(379)	(379)

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Net cash provided by (used in) financing activities	\$ 8,650	\$ (8,268)
Increase in cash and cash equivalents	\$ 121	\$ 8,061
<b>Cash and Cash Equivalents</b>		
Beginning	\$ 31,028	\$ 29,524
Ending	\$ 31,149	\$ 37,585

*See Notes to Consolidated Financial Statements*

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

(Continued)

Six months ended June 30, 2013 and 2012

*(Dollars in thousands)*

	(unaudited) June 30, 2013	(unaudited) June 30, 2012
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 1,540	\$ 2,263
Income Taxes	\$ 310	\$ 430
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized loss on securities available for sale	\$ (2,693)	\$ (820)
Transfer from loans to other real estate owned	\$ 191	\$ 3,180
Transfer from premises and equipment to other real estate owned	\$ 224	\$
Transfer from other assets to other real estate owned	\$ 452	\$

*See Notes to Consolidated Financial Statements*



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

Six months ended June 30, 2013 and 2012

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

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
<b>Balance, December 31, 2011</b>	\$ 14,263	\$ 3,695	\$ 1,644	\$ 16,503	\$ 991	\$ 37,096
Net income				1,169		1,169
Other comprehensive loss					(791)	(791)
Issuance of common stock, net of offerings cost		2,432	5,169			7,601
Cash dividends on preferred stock				(379)		(379)
Accretion on preferred stock discount	72			(72)		
<b>Balance, June 30, 2012</b>	\$ 14,335	\$ 6,127	\$ 6,813	\$ 17,221	\$ 200	\$ 44,696

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
<b>Balance, December 31, 2012</b>	\$ 14,409	\$ 6,127	\$ 6,813	\$ 18,399	\$ (859)	\$ 44,889
Net income				1,244		1,244
Other comprehensive loss					(2,693)	(2,693)
Cash dividends on preferred stock				(379)		(379)
Accretion on preferred stock discount	76			(76)		
<b>Balance, June 30, 2013</b>	\$ 14,485	\$ 6,127	\$ 6,813	\$ 19,188	\$ (3,552)	\$ 43,061

*See Notes to Consolidated Financial Statements*

**Table of Contents**

**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements**

*(unaudited)*

**Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its subsidiaries, including First Bank (the Bank), have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP. All significant intercompany balances and transactions have been eliminated. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments and reclassifications of a normal and recurring nature considered necessary to present fairly the financial positions at June 30, 2013 and December 31, 2012, the results of operations and comprehensive income (loss) for the three and six months ended June 30, 2013 and 2012 and the cash flows and changes in shareholders' equity for the six months ended June 30, 2013 and 2012. 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, 2012. Operating results for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

**Recent Accounting Pronouncements**

In February 2013, the FASB issued ASU 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company has included the required disclosures from ASU 2013-02 in the consolidated financial statements.

**Table of Contents****FIRST NATIONAL CORPORATION****Notes to Consolidated Financial Statements***(unaudited)***Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. Amortized costs and fair values of securities available for sale at June 30, 2013 and December 31, 2012 were as follows:

	<i>(in thousands)</i> June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	\$ 87,578	\$ 774	\$ (1,769)	\$ 86,583
Obligations of states and political subdivisions	18,507	481	(411)	18,577
Corporate equity securities	1	2		3
	\$ 106,086	\$ 1,257	\$ (2,180)	\$ 105,163

	<i>(in thousands)</i> December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	\$ 72,129	\$ 1,325	\$ (236)	\$ 73,218
Obligations of states and political subdivisions	15,556	762	(83)	16,235
Corporate equity securities	1	2		3
	\$ 87,686	\$ 2,089	\$ (319)	\$ 89,456

At June 30, 2013 and December 31, 2012, investments in an unrealized loss position that were temporarily impaired were as follows:

	<i>(in thousands)</i> June 30, 2013					
	Less than 12 months Unrealized		12 months or more Unrealized		Total Unrealized	
	Fair Value	(Loss)	Fair Value	(Loss)	Fair Value	(Loss)
U.S. agency and mortgage-backed securities	\$ 59,441	\$ (1,769)	\$	\$	\$ 59,441	\$ (1,769)
Obligations of states and political subdivisions	7,758	(333)	1,342	(78)	9,100	(411)

\$ 67,199    \$ (2,102)    \$ 1,342    \$ (78)    \$ 68,541    \$ (2,180)

	<i>(in thousands)</i>					
	December 31, 2012					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 19,612	\$ (236)	\$	\$	\$ 19,612	\$ (236)
Obligations of states and political subdivisions	4,287	(83)			4,287	(83)
	\$ 23,899	\$ (319)	\$	\$	\$ 23,899	\$ (319)

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

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

At June 30, 2013, there were 36 U.S. agency and mortgage-backed securities and 18 obligations of state and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 4.5 years at June 30, 2013. At December 31, 2012, there were twelve U.S. agency and mortgage-backed securities and nine 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, 2012. The weighted-average re-pricing term of the portfolio was 3.6 years at December 31, 2012. The change in the unrealized gains and losses of investment securities from December 31, 2012 to June 30, 2013 was related to changes in market interest rates.

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, 2013, and no impairment has been recognized. Restricted securities are not part of the available for sale securities portfolio.

The composition of restricted securities at June 30, 2013 and December 31, 2012 was as follows:

	<i>(in thousands)</i>	
	June 30, 2013	December 31, 2012
Federal Home Loan Bank stock	\$ 909	\$ 1,078
Federal Reserve Bank stock	846	846
Community Bankers' Bank stock	50	50
	\$ 1,805	\$ 1,974

**Note 3. Loans**

Loans at June 30, 2013 and December 31, 2012 are summarized as follows:

	<i>(in thousands)</i>	
	June 30, 2013	December 31, 2012

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Real estate loans:		
Construction and land development	\$ 44,305	\$ 43,524
Secured by 1-4 family residential	145,628	134,964
Other real estate loans	159,834	176,573
Commercial and industrial loans	19,701	20,718
Consumer and other loans	8,045	7,815
Total loans	\$ 377,513	\$ 383,594
Allowance for loan losses	12,478	13,075
Loans, net	\$ 365,035	\$ 370,519

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

Consumer and other loans included \$99 thousand and \$153 thousand of demand deposit overdrafts at June 30, 2013 and December 31, 2012, 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 credit-worthiness 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 unrelated to the project.

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

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

The following table provides a summary of loan classes and an aging of past due loans as of June 30, 2013 and December 31, 2012:

	June 30, 2013 <i>(in thousands)</i>				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				
<b>Real estate loans:</b>								
Construction and land development	\$ 1,873	\$	\$ 4,546	\$ 6,419	\$ 37,886	\$ 44,305	\$ 2,678	\$ 1,889
1-4 family residential	1,731	445	89	2,265	143,363	145,628	1,577	
Other real estate loans	1,173	1,415	74	2,662	157,172	159,834	4,745	
Commercial and industrial	261	24	79	364	19,337	19,701	90	
Consumer and other loans	77	3		80	7,965	8,045	2	

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Total	\$ 5,115	\$ 1,887	\$ 4,788	\$ 11,790	\$ 365,723	\$ 377,513	\$ 9,092	\$ 1,889
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**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

	December 31, 2012 (in thousands)							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
<b>Real estate loans:</b>								
Construction and land development	\$ 77	\$ 701	\$ 89	\$ 867	\$ 42,657	\$ 43,524	\$ 646	\$
1-4 family residential	2,741		476	3,217	131,747	134,964	968	129
Other real estate loans	1,347	686	1,476	3,509	173,064	176,573	6,752	
Commercial and industrial	428	408	99	935	19,783	20,718	14	99
Consumer and other loans	43	5	8	56	7,759	7,815	13	
<b>Total</b>	<b>\$ 4,636</b>	<b>\$ 1,800</b>	<b>\$ 2,148</b>	<b>\$ 8,584</b>	<b>\$ 375,010</b>	<b>\$ 383,594</b>	<b>\$ 8,393</b>	<b>\$ 228</b>

**Credit Quality Indicators**

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

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

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

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

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

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



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

The following tables provide an analysis of the credit risk profile of each loan class as of June 30, 2013 and December 31, 2012:

	June 30, 2013 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction and land development	\$ 25,627	\$ 4,851	\$ 13,827	\$	\$ 44,305
Secured by 1-4 family residential	130,940	6,461	8,227		145,628
Other real estate loans	122,778	14,259	22,797		159,834
Commercial and industrial	18,163	791	747		19,701
Consumer and other loans	7,975	70			8,045
<b>Total</b>	<b>\$ 305,483</b>	<b>\$ 26,432</b>	<b>\$ 45,598</b>	<b>\$</b>	<b>\$ 377,513</b>

	December 31, 2012 (in thousands)				Total
	Pass	Special Mention	Substandard	Doubtful	
<b>Real estate loans:</b>					
Construction and land development	\$ 22,384	\$ 5,176	\$ 15,964	\$	\$ 43,524
Secured by 1-4 family residential	120,692	6,055	8,217		134,964
Other real estate loans	134,701	14,513	27,359		176,573
Commercial and industrial	18,831	798	1,089		20,718
Consumer and other loans	7,743	72			7,815
<b>Total</b>	<b>\$ 304,351</b>	<b>\$ 26,614</b>	<b>\$ 52,629</b>	<b>\$</b>	<b>\$ 383,594</b>

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the six months ended June 30, 2013 and 2012 and for the year ended December 31, 2012 were as follows:

	(in thousands)		
	June 30, 2013	December 31, 2012	June 30, 2012
Balance at beginning of year	\$ 13,075	\$ 12,937	\$ 12,937
Provision charged to operating expense	2,250	3,555	2,650

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Loan recoveries	498	376	196
Loan charge-offs	(3,345)	(3,793)	(1,784)
Balance at end of period	\$ 12,478	\$ 13,075	\$ 13,999

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

The following tables present, as of June 30, 2013, December 31, 2012 and June 30, 2012, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

	June 30, 2013 <i>(in thousands)</i>					Total
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2012	\$ 2,481	\$ 3,712	\$ 6,163	\$ 608	\$ 111	\$ 13,075
Charge-offs	(2,308)	(172)	(798)		(67)	(3,345)
Recoveries		6	206	176	110	498
Provision for loan losses	3,097	179	(561)	(399)	(66)	2,250
Ending Balance, June 30, 2013	\$ 3,270	\$ 3,725	\$ 5,010	\$ 385	\$ 88	\$ 12,478
<b>Ending Balance:</b>						
Individually evaluated for impairment	747	195	161	19		1,122
Collectively evaluated for impairment	2,523	3,530	4,849	366	88	11,356
<b>Loans:</b>						
Ending Balance	44,305	145,628	159,834	19,701	8,045	377,513
Individually evaluated for impairment	3,595	1,940	5,219	90		10,844
Collectively evaluated for impairment	40,710	143,688	154,615	19,611	8,045	366,669

	December 31, 2012 <i>(in thousands)</i>					Total
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2011	\$ 2,843	\$ 3,766	\$ 5,192	\$ 963	\$ 173	\$ 12,937
Charge-offs	(431)	(761)	(2,154)	(261)	(186)	(3,793)
Recoveries	1	68	64	35	208	376
Provision for (recovery of) loan losses	68	639	3,061	(129)	(84)	3,555
Ending Balance, December 31, 2012	\$ 2,481	\$ 3,712	\$ 6,163	\$ 608	\$ 111	\$ 13,075
<b>Ending Balance:</b>						
Individually evaluated for impairment	567	306	930	35		1,838

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Collectively evaluated for impairment	1,914	3,406	5,233	573	111	11,237
<b>Loans:</b>						
Ending Balance	43,524	134,964	176,573	20,718	7,815	383,594
Individually evaluated for impairment	2,516	3,776	10,528	160		16,980
Collectively evaluated for impairment	41,008	131,188	166,045	20,558	7,815	366,614

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

	June 30, 2012 <i>(in thousands)</i>					
	Commercial and Industrial	Other Real Estate	Construction and Land Development	Secured by 1-4 Family Residential	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2011	\$ 963	\$ 5,192	\$ 2,843	\$ 3,766	\$ 173	\$ 12,937
Charge-offs	(74)	(674)	(369)	(562)	(105)	(1,784)
Recoveries	16	52	1	2	125	196
Provision for loan losses	(264)	1,285	700	993	(64)	2,650
Ending Balance, June 30, 2012	\$ 641	\$ 5,855	\$ 3,175	\$ 4,199	\$ 129	\$ 13,999

<b>Ending Balance:</b>						
Individually evaluated for impairment	55	1,033	1,145	972		3,205
Collectively evaluated for impairment	586	4,822	2,030	3,227	129	10,794

<b>Loans:</b>						
Ending Balance	24,937	174,212	47,843	128,229	8,914	384,135
Individually evaluated for impairment	402	10,813	5,256	5,460		21,931
Collectively evaluated for impairment	24,535	163,399	42,587	122,769	8,914	362,204

Impaired loans and the related allowance at June 30, 2013 and December 31, 2012, were as follows:

	June 30, 2013 <i>(in thousands)</i>						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>Real estate loans:</b>							
Construction and land development	\$ 6,245	\$ 2,678	\$ 917	\$ 3,595	\$ 747	\$ 5,059	\$ 20
Secured by 1-4 family	2,864	856	1,084	1,940	195	3,047	14
Other real estate loans	6,242	3,877	1,342	5,219	161	8,682	90
Commercial and industrial	91		90	90	19	87	2
Consumer and other loans							
<b>Total</b>	<b>\$ 15,442</b>	<b>\$ 7,411</b>	<b>\$ 3,433</b>	<b>\$ 10,844</b>	<b>\$ 1,122</b>	<b>\$ 16,875</b>	<b>\$ 126</b>

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

	December 31, 2012 <i>(in thousands)</i>						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>Real estate loans:</b>							
Construction and land development	\$ 2,947	\$ 622	\$ 1,894	\$ 2,516	\$ 567	\$ 5,691	\$ 99
Secured by 1-4 family	4,706	1,690	2,086	3,776	306	4,821	163
Other real estate loans	14,861	4,886	5,642	10,528	930	10,148	276
Commercial and industrial	161		160	160	35	330	10
Consumer and other loans							
	\$ 22,675	\$ 7,198	\$ 9,782	\$ 16,980	\$ 1,838	\$ 20,990	\$ 548

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

As of June 30, 2013, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled \$2.2 million. At June 30, 2013, \$838 thousand of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were \$6.3 million in TDRs at December 31, 2012, \$1.6 million of which were performing under the restructured terms. Modified terms under TDRs may include rate reductions, extension of terms that are considered to be below market, conversion to interest only, and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. There were no new loans modified as TDRs during the three and six month periods ended June 30, 2013 and 2012.

For the three and six months ended June 30, 2013 and 2012, 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 during the twelve month period subsequent to the modification.

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

At June 30, 2013 and December 31, 2012, OREO totaled \$4.1 million and \$5.6 million, respectively. OREO is primarily comprised of residential lots, raw land, non-residential properties and residential properties associated with commercial relationships, and are located primarily in the Commonwealth of Virginia. Changes in the balance for OREO are as follows:

	<i>(in thousands)</i>	
	For the six months ended June 30, 2013	For the year ended December 31, 2012
Balance at the beginning of year, gross	\$ 7,764	\$ 9,166
Transfers in	867	5,578



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Charge-offs	(601)	(1,808)
Sales proceeds	(1,927)	(5,438)
Gain on disposition	64	268
Depreciation		(2)
Balance at the end of period, gross	\$ 6,167	\$ 7,764
Less: allowance for losses	(2,083)	(2,174)
Balance at the end of period, net	\$ 4,084	\$ 5,590

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

Changes in the allowance for OREO losses are as follows:

	<i>(in thousands)</i>		
	For the six		For the year
	months ended		ended
	June 30, 2013	June 30, 2012	December 31, 2012
Balance at beginning of year	\$ 2,174	\$ 2,792	\$ 2,792
Provision for losses	448	569	1,190
Transfer in	62		
Charge-offs, net	(601)	(1,274)	(1,808)
<b>Balance at end of period</b>	<b>\$ 2,083</b>	<b>\$ 2,087</b>	<b>\$ 2,174</b>

Net expenses applicable to OREO, other than the provision for losses, were \$99 thousand and \$351 thousand for the six months ended June 30, 2013 and 2012, respectively.

**Note 6. Other Borrowings**

The Bank had unused lines of credit totaling \$106.5 million and \$105.4 million available with non-affiliated banks at June 30, 2013 and December 31, 2012, respectively. This amount primarily consists of a blanket floating lien agreement with the Federal Home Loan Bank of Atlanta (FHLB) under which the Bank can borrow up to 19% of its total assets. The unused line of credit with FHLB totaled \$30.0 million at June 30, 2013.

At June 30, 2013 and December 31, 2012, the Bank had borrowings from the FHLB system totaling \$6.0 million which mature through December 28, 2018. The interest rate on these notes payable ranged from 1.78% to 2.04% and the weighted average rate was 1.91%. The Bank also had a letter of credit from the FHLB totaling \$30.0 million at June 30, 2013 and December 31, 2012. The Bank had collateral pledged on these borrowings and letter of credit at June 30, 2013 and December 31, 2012 including real estate loans totaling \$89.9 million and \$100.0 million, respectively, and Federal Home Loan Bank stock with a book value of \$909 thousand and \$1.1 million, respectively.

At June 30, 2013 and December 31, 2012, the Bank had a note payable totaling \$64 and \$76 thousand, respectively, secured by a deed of trust, which requires monthly payments of \$2 thousand and matures January 3, 2016. The fixed interest rate on this loan is 4.00%.

**Note 7. Capital Requirements**

A comparison of the capital of the Company and the Bank at June 30, 2013 and December 31, 2012 with the minimum regulatory guidelines were as follows:

Actual

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			<i>(dollars in thousands)</i> Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>June 30, 2013:</b>						
<b>Total Capital (to Risk Weighted Assets):</b>						
Consolidated	\$ 60,623	15.94%	\$ 30,433	8.00%	N/A	N/A
First Bank	\$ 54,198	14.26%	\$ 30,399	8.00%	\$ 37,999	10.00%
<b>Tier 1 Capital (to Risk Weighted Assets):</b>						
Consolidated	\$ 55,773	14.66%	\$ 15,216	4.00%	N/A	N/A
First Bank	\$ 49,353	12.99%	\$ 15,199	4.00%	\$ 22,799	6.00%
<b>Tier 1 Capital (to Average Assets):</b>						
Consolidated	\$ 55,773	10.33%	\$ 21,598	4.00%	N/A	N/A
First Bank	\$ 49,353	9.13%	\$ 21,616	4.00%	\$ 27,020	5.00%

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

## December 31, 2012:

## Total Capital (to Risk Weighted Assets):

Consolidated	\$ 59,876	15.34%	\$ 31,220	8.00%	N/A	N/A
First Bank	\$ 52,980	13.59%	\$ 31,197	8.00%	\$ 38,996	10.00%

## Tier 1 Capital (to Risk Weighted Assets):

Consolidated	\$ 54,897	14.07%	\$ 15,610	4.00%	N/A	N/A
First Bank	\$ 48,004	12.31%	\$ 15,599	4.00%	\$ 23,398	6.00%

## Tier 1 Capital (to Average Assets):

Consolidated	\$ 54,897	10.47%	\$ 20,971	4.00%	N/A	N/A
First Bank	\$ 48,004	9.15%	\$ 20,974	4.00%	\$ 26,218	5.00%

On June 29, 2012, the Company completed the sale of 1,945,815 shares of common stock in a rights offering and to certain standby investors. The Company's existing shareholders exercised subscription rights to purchase 1,520,815 shares at a subscription price of \$4.00 per share, and the standby investors purchased an additional 425,000 shares at the same price of \$4.00 per share. In total, the Company raised net proceeds of \$7.6 million.

**Note 8. Trust Preferred Capital Notes**

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On June 17, 2004, \$5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at June 30, 2013 and December 31, 2012 was 2.87% and 2.91%, respectively. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions that began September 17, 2009. The principal asset of Trust II is \$5.2 million of the Company's junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the trust preferred securities.

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, 2013 and December 31, 2012 was 1.88% and 1.96%, respectively. The securities have a mandatory redemption date of October 1, 2036, and are subject to varying call provisions beginning October 1, 2011. The principal asset of Trust III is \$4.1 million of the Company's junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company. The Company is current on its interest payments on the trust preferred securities.

While these securities are debt obligations of the Company, they are included in capital for regulatory capital ratio calculations. Under present regulations, the trust preferred securities may be included in Tier 1 capital for regulatory capital adequacy purposes as long as their amount does not exceed 25% of Tier 1 capital, including total trust preferred securities. The portion of the trust preferred securities not considered as Tier 1 capital, if any, may be included in Tier 2 capital. At June 30, 2013 and December 31, 2012, the total amount of trust preferred securities issued by the Trusts was included in the Company's Tier 1 capital.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 9. Benefit Plans**

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service and hired prior to May 1, 2011. Effective May 1, 2011, the plan was frozen to new participants. Only individuals employed on or before April 30, 2011 are eligible to become participants in the plan upon satisfaction of the eligibility requirements. Benefits are generally based upon years of service and average compensation for the five highest-paid consecutive years of service. The Bank's funding practice has been to make at least the minimum required annual contribution permitted by the Employee Retirement Income Security Act of 1974, as amended, and the Internal Revenue Code of 1986, as amended.

Components of the net periodic benefit cost of the plan for the three and six months ended June 30, 2013 and 2012 were as follows:

	<i>(in thousands)</i>			
	For the three months ended June 30,		For the six months ended June 30,	
	2013	2012	2013	2012
Service cost	\$ 118	\$ 107	\$ 236	\$ 214
Interest cost	70	67	140	135
Expected return on plan assets	(76)	(69)	(152)	(138)
Amortization of prior service cost		1		1
Amortization of net loss	27	21	54	43
Net periodic benefit cost	\$ 139	\$ 127	\$ 278	\$ 255

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2012, that it expected to contribute \$500 thousand to its pension plan during the year ended December 31, 2013. The Company made a contribution of \$500 thousand for the 2013 plan year during the first quarter of 2013.

In addition to the defined benefit pension plan, the Company maintains a 401(k) plan and an employee stock ownership plan (ESOP) for eligible employees. In May 2013, the Bank terminated its Split Dollar Life Insurance Plan that provided life insurance coverage to insurable directors and recorded a gain of \$543 thousand from the termination of the postretirement benefit liability. See Note 11 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for additional information about the Company's benefit plans.

**Note 10. Earnings per Common Share**

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. There are no potential common shares that would have a dilutive effect. The average number of common shares outstanding used to calculate basic and diluted earnings per common share were 4,901,464 and 2,998,414 for the three months ended June 30, 2013 and 2012, respectively, and 4,901,464 and 2,977,032 for the six months ended June 30, 2013 and 2012, respectively.

**Note 11. Fair Value Measurements**

**Determination of Fair Value**

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.

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

*(unaudited)*

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

### **Fair Value Hierarchy**

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

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

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

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

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

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

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

The following tables present the balances of financial assets measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012.

Description	Fair Value Measurements at June 30, 2013 <i>(in thousands)</i>			
	Balance as of June 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 86,583	\$	\$ 86,583	\$
Obligations of states and political subdivisions	18,577		18,577	
Corporate equity securities	3	3		
	\$ 105,163	\$ 3	\$ 105,160	\$

Description	Fair Value Measurements at December 31, 2012 <i>(in thousands)</i>			
	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 73,218	\$	\$ 73,218	\$
Obligations of states and political subdivisions	16,235		16,235	
Corporate equity securities	3	3		
	\$ 89,456	\$ 3	\$ 89,453	\$



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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 at June 30, 2013 or December 31, 2012.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***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. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal of one year or less conducted by an independent, licensed appraiser, using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the 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.

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

Description	Carrying Value at June 30, 2013 (in thousands)			
	Balance as of June 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Impaired loans, net	\$ 2,311	\$	\$	\$ 2,311
Other real estate owned, net	4,084			4,084

Description	Carrying Value at December 31, 2012 (in thousands)			

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	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Impaired loans, net	\$ 7,944	\$	\$	\$ 7,944
Other real estate owned, net	5,590			5,590

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

The following table displays quantitative information about Level 3 Fair Value Measurements for June 30, 2013 and December 31, 2012:

Quantitative information about Level 3 Fair Value Measurements for June 30, 2013  
(dollars in thousands)

	Fair Value	Valuation Technique	Unobservable Input	Range
<b>Assets</b>				
Impaired loans	\$ 2,311	Property appraisals	Selling cost	10%
Other real estate owned	\$ 4,084	Property appraisals	Selling cost	7%

Quantitative information about Level 3 Fair Value Measurements for December 31, 2012  
(dollars in thousands)

	Fair Value	Valuation Technique	Unobservable Input	Range
<b>Assets</b>				
Impaired loans	\$ 7,944	Property appraisals	Selling cost	10%
			Discount for lack of marketability and age of appraisal	0%-30%
Other real estate owned	\$ 5,590	Property appraisals	Selling cost	7%
			Discount for lack of marketability and age of appraisal	0%-25%

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

**Cash and Cash Equivalents**

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

**Loans**

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

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

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

**Accrued Interest**

The carrying amounts of accrued interest approximate fair value.

**Borrowings**

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

**Bank Owned Life Insurance**

The carrying amounts of bank owned life insurance approximate fair value.

**Commitments and Unfunded Credits**

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

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At June 30, 2013 and December 31, 2012, fair value of loan commitments and standby letters of credit was immaterial.

The carrying values and estimated fair values of the Company's financial instruments at June 30, 2013 and December 31, 2012 are as follows:

	Carrying Amount	<i>(in thousands)</i> Fair Value Measurements at June 30, 2013 Using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>Financial Assets</b>					
Cash and short-term investments	\$ 31,149	\$ 31,149	\$	\$	\$ 31,149

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Securities	105,163	3	105,160	105,163
Loans, net	365,035		370,775	370,775
Bank owned life insurance	9,144	9,144		9,144
Accrued interest receivable	1,425	1,425		1,425
<b>Financial Liabilities</b>				
Deposits	\$ 475,958	\$ 324,709	\$ 152,552	\$ 477,261
Other borrowings	6,064		5,837	5,837
Trust preferred capital notes	9,279		8,738	8,738
Accrued interest payable	254	254		254

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

*(in thousands)*

Fair Value Measurements at December 31, 2012 Using

	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
<b>Financial Assets</b>					
Cash and short-term investments	\$ 31,028	\$ 31,028	\$	\$	\$ 31,028
Securities	89,456	3	89,453		89,456
Loans held for sale	503		503		503
Loans, net	370,519			375,941	375,941
Bank owned life insurance	9,014	9,014			9,014
Accrued interest receivable	1,459	1,459			1,459
<b>Financial Liabilities</b>					
Deposits	\$ 466,917	\$ 306,719	\$	\$ 162,151	\$ 468,870
Other borrowings	6,076			6,220	6,220
Trust preferred capital notes	9,279			8,735	8,735
Accrued interest payable	286	286			286

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

**Note 12. Capital Purchase Program**

On March 13, 2009, the Company entered into a Letter Agreement and Securities Purchase Agreement – Standard Terms (collectively, the Purchase Agreement) with the Treasury Department, pursuant to which the Company sold (i) 13,900 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$1.25 per share and liquidation preference \$1,000 per share (the Preferred Stock) and (ii) a warrant (the Warrant) to purchase 695 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the Warrant Preferred Stock), at an exercise price of \$1.25 per share, for an aggregate purchase price of \$13.9 million in cash. The Treasury immediately exercised the Warrant and, after net settlement, received 695 shares of the Company's Warrant Preferred Stock, which has a liquidation preference amount of \$1,000 per share. Closing of the sale occurred on March 13, 2009 and increased Tier 1 and total capital by \$13.9 million. The Preferred Stock pays cumulative dividends at a rate of 5% per annum until March 13, 2014, and thereafter at a rate of 9% per annum. The Warrant Preferred Stock pays cumulative dividends at a rate of 9% per annum from the date of issuance. The discount on the Preferred Stock is amortized over a five year period using the constant effective yield method.





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

On August 29, 2012, the Treasury sold its preferred stock in the Company to private investors. The Treasury sold all 13,900 shares of Preferred Stock at a price of \$882.50 per share and all 695 shares of Warrant Preferred Stock at a price of \$912.50 per share. Each series of preferred stock was sold pursuant to an effective shelf registration statement previously filed by the Company with the Securities and Exchange Commission. Terms of the preferred stock did not change as a result of the sale to new investors, including dividends which are payable on the full face value.

**Note 13. Accumulated Other Comprehensive Income (Loss)**

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

	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income (Loss)
<b>Balance at December 31, 2011</b>	\$ 3,166	\$ (2,175)	\$ 991
Net unrealized gains on investment securities	327		327
Reclassification adjustment	(1,118)		(1,118)
<b>Balance at June 30, 2012</b>	\$ 2,375	\$ (2,175)	\$ 200
<b>Balance at December 31, 2012</b>	\$ 1,770	\$ (2,629)	\$ (859)
Net unrealized losses on investment securities	(2,693)		(2,693)
<b>Balance at June 30, 2013</b>	\$ (923)	\$ (2,629)	\$ (3,552)

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

**Cautionary Statement Regarding Forward-Looking Statements**

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

the ability to raise capital as needed;

adverse economic conditions in the market area and the impact on credit quality and risks inherent in the loan portfolio such as repayment risk and fluctuating collateral values;

additional future losses if our levels of non-performing assets do not moderate and if the proceeds we receive upon liquidation of assets are less than the carrying value of such assets;

further increases of non-performing assets may reduce interest income and increase net charge-offs, provision for loan losses, and operating expenses;

the adequacy of the allowance for loan losses related to specific reserves on impaired loans, and changes in factors considered such as general economic and business conditions in the market area and overall asset quality;

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

loss or retirement of key executives;

the ability to compete effectively in the highly competitive banking industry;

legislative or regulatory changes, including changes in accounting standards, may adversely affect the businesses that the Company is engaged in;

the ability to implement various technologies into our operations may impact the Company's ability to operate profitably;

the ability of the Company to implement its disaster recovery plan in the event of a natural disaster;

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risks related to the timing of the recoverability of the deferred tax asset, which is subject to considerable judgment, and the risk that even after the recovery of the deferred tax asset balance under GAAP, there will remain limitations on the ability to include our deferred tax assets for regulatory capital purposes;

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

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

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

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

other factors identified in Item 1A. Risk Factors of the Company's Form 10-K for the year ending December 31, 2012.

Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition at June 30, 2013 and results of operations of the Company for the three and six month periods ended June 30, 2013 and 2012 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, 2012. The results of operations for the three and six month periods ended June 30, 2013 may not be indicative of the results to be achieved for the year.

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### **Executive Overview**

#### **The Company**

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

First Bank (the Bank). The Bank owns:

First Bank Financial Services, Inc.

Shen-Valley Land Holdings, LLC

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

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

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

#### **Products, Services, Customers and Locations**

The Bank's primary market area is located within an hour commute of the Washington, D.C. Metropolitan Area. The Bank's office locations are well-positioned in strong markets along the Interstate 81 and Interstate 66 corridors in the northern Shenandoah Valley region of Virginia, which include the City of Winchester, Frederick County, Warren County and Shenandoah County. Within the market area there are various types of industry including medical and professional services, manufacturing, retail and higher education. Customers include individuals, small and medium-sized businesses, local governmental entities and non-profit organizations.

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

The Bank's Trust and Asset Management Department offers a variety of trust and asset management services including estate planning, investment management of assets, trustee under an agreement, trustee under a will, individual retirement accounts, estate settlement, 401(k) and benefit plans. The Bank offers financial planning and brokerage services for its customers through its investment division, First Financial Advisors.

The Bank's products and services are provided through 10 branch offices, 26 ATMs and its website, [www.fbvirginia.com](http://www.fbvirginia.com). The Bank operates six of its offices under the Financial Center concept. A Financial Center offers all of the Bank's financial services at one location. This concept allows loan, deposit, trust and investment advisory personnel to be readily available to serve customers throughout the Bank's market area. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2012.

#### **Revenue Sources and Expense Factors**

The primary source of revenue is from net interest income earned by the Bank. Net interest income is the difference between interest income and interest expense and typically represents between 75% to 80% of the Company's total revenue. Interest income is determined by the amount of interest-earning assets outstanding during the period and the interest rates earned on those assets. The Bank's interest expense is a function of the

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amount of interest-bearing liabilities outstanding during the period and the interest rates paid. In addition to net interest income, noninterest income is the other source of revenue for the Company. Noninterest income is derived primarily from service charges on loans and deposits, fees earned from trust and investment advisory services, and the origination and sale of residential mortgages.

The provision for loan losses and noninterest expense are the two major expense categories. The provision is determined by factors that include 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. The largest component of noninterest expense for the six month period ended June 30, 2013 was salaries and employee benefits, comprising 51% of noninterest expenses, followed by occupancy and equipment expense, comprising 13% of expenses.

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### **Quarterly Performance**

For the three months ended June 30, 2013, net income totaled \$261 thousand compared to \$694 thousand for the same period in 2012. After the effective dividend on preferred stock, net income available to common shareholders was \$31 thousand, or \$0.01 per basic and diluted share, compared to \$467 thousand, or \$0.16 per basic and diluted share, for the same period in 2012. Return on average assets and return on average equity were 0.19% and 2.32%, respectively, for the second quarter of 2013 compared to 0.53% and 7.21% for the same quarter in 2012.

Net interest income decreased 3%, or \$141 thousand, compared to the second quarter of 2012. The net interest margin was 3.71% for the second quarter of 2013 compared to 3.88% for the same period in 2012. The provision for loan losses was \$1.9 million higher when comparing the quarters. The provision for loan losses totaled \$2.5 million compared to \$650 thousand for the same quarter one year ago. Noninterest income increased \$572 thousand, or 39%, to \$2.0 million compared to \$1.5 million for the same period one year ago. The Company recorded a \$543 thousand gain from the termination of a liability related to the Company's split dollar life insurance plan during the quarter. Noninterest income, excluding the gain on termination of the split dollar liability and gains on sales of securities, remained relatively unchanged at \$1.5 million when comparing the periods. Noninterest expense increased 7%, or \$323 thousand, when comparing the two periods.

### **Year-to-Date Performance**

Net income totaled \$1.2 million for the six months ended June 30, 2013 and for the same period in 2012. After the effective dividend on preferred stock, net income available to common shareholders was \$788 thousand, or \$0.16 per basic and diluted share, compared to \$718 thousand, or \$0.24 per basic and diluted share, for the same period in 2012. Return on average assets and return on average equity were 0.47% and 5.57%, respectively, for the six months ended June 30, 2013 compared to 0.44% and 6.17% for the same period in 2012.

For the six months ended June 30, 2013, net interest income decreased 6%, or \$605 thousand, compared to the same period of 2012. The net interest margin was 3.75% for the six months ended June 30, 2013 compared to 4.01% for the same period in 2012. The provision for loan losses was \$400 thousand lower when comparing the two periods. Noninterest income decreased \$441 thousand, or 11%, to \$3.5 million compared to \$4.0 million for the same period one year ago. Noninterest income, excluding gains on sales of securities and the termination of the split dollar liability, increased 5%, or \$134 thousand, to \$3.0 million compared to \$2.9 million for the same period one year ago. Noninterest expense increased 6%, or \$532 thousand, when comparing the two periods.

### **Non-GAAP Financial Measures**

This report refers to the efficiency ratio, which is computed by dividing adjusted noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income excluding securities and premises and equipment gains and losses and gain on termination of the split dollar liability. 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 table below.

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	<b>Efficiency Ratio</b>			
	<i>(in thousands)</i>			
	For the three months ended		For the six months ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Noninterest expense	\$ 4,757	\$ 4,434	\$ 9,870	\$ 9,338
Less: other real estate owned expense, net	376	106	483	670
Less: loss on land lease termination			209	
	\$ 4,381	\$ 4,328	\$ 9,178	\$ 8,668
Tax-equivalent net interest income	\$ 4,717	\$ 4,839	\$ 9,384	\$ 9,979
Noninterest income	2,034	1,462	3,535	3,976
Less: securities gains		1		1,118
Less: losses on premises and equipment	(3)			
Less: gain on termination of postretirement benefit obligation	543		543	
	\$ 6,211	\$ 6,300	\$ 12,376	\$ 12,837
Efficiency ratio	70.54%	68.70%	74.14%	67.52%

This report also refers to net interest margin, which is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for each of 2013 and 2012 is 34%. The reconciliation of tax equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below.

	<b>Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income</b>			
	<i>(in thousands)</i>			
	For the three months ended		For the six months ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
<b>GAAP measures:</b>				
Interest income loans	\$ 4,815	\$ 5,265	\$ 9,749	\$ 10,812
Interest income investments and other	556	615	1,029	1,276
Interest expense deposits	632	959	1,338	1,945
Interest expense other borrowings	30	66	59	146
Interest expense trust preferred capital notes	55	60	111	122
Total net interest income	\$ 4,654	\$ 4,795	\$ 9,270	\$ 9,875
<b>Non-GAAP measures:</b>				
Tax benefit realized on non-taxable interest income loans	\$ 24	\$ 7	\$ 38	\$ 15
Tax benefit realized on non-taxable interest income municipal securities	39	37	76	89
Total tax benefit realized on non-taxable interest income	\$ 63	\$ 44	\$ 114	\$ 104
Total tax-equivalent net interest income	\$ 4,717	\$ 4,839	\$ 9,384	\$ 9,979

**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



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historical loss factors as one factor in determining the inherent loss that may be present in the loan portfolio. Actual losses could differ significantly from the historical factors used. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact transactions could change.

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

### Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management determines that the loan balance is uncollectible. Subsequent recoveries, if any, are credited to the allowance. For further information about the Company's loans and the allowance for loan losses, see Notes 3 and 4 in this Form 10-Q.

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

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

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

1-4 family residential mortgage loans carry risks associated with the continued credit-worthiness 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 unrelated to the project.

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

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

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The allowance consists of specific and general components. The specific allowance is used to individually allocate an allowance for impaired loans. For impaired loans, an allowance is established when the discounted cash flows, net collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all the

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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. 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 for commercial and construction loans by either: (1) the present value of expected future cash flows discounted at the loan's effective interest rate, (2) the loan's obtainable market price or (3) the fair value of the collateral, net of selling costs, if the loan repayment is collateral dependent. 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 Company typically does not separately identify individual consumer and residential loans for impairment disclosures unless they were part of a troubled debt restructuring.

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 terms of loans, effects of changes in lending policy, the experience and depth of management, concentrations of credit, quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The factors assigned differ by loan type. The general allowance recognizes potential losses whose impact on the portfolio has yet to be recognized by a specific allowance. Allowance factors and the overall size of the allowance may change from period to period based on management's assessment of the above described factors and the relative weights given to each factor. For further information regarding the allowance for loan losses see Notes 1 and 4 to the Consolidated Financial Statements.

**Other Real Estate Owned (OREO)**

Other real estate owned, consisting of properties obtained through a foreclosure proceeding or through an in-substance foreclosure in satisfaction of loans, is reported at the lower of cost or fair value less costs to sell, determined on the basis of current appraisals, comparable sales, and other estimates of fair value obtained principally from independent sources, adjusted for estimated selling costs. Management also considers other factors or recent developments, such as changes in absorption rates or market conditions from the time of valuation and anticipated sales values considering management's plans for disposition, which could result in adjustments to the collateral value estimates indicated in the appraisals. Significant judgments and complex estimates are required in estimating the fair value of other real estate, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. In response to market conditions and other economic factors, management may utilize liquidation sales as part of its distressed asset disposition strategy. As a result of the significant judgments required in estimating fair value and the variables involved in different methods of disposition, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other real estate. Management reviews the value of other real estate each quarter and adjusts the values as appropriate.

**Deferred Tax Asset Valuation Allowance**

A valuation allowance is required for deferred tax assets (DTA) if, based on available evidence, it is more likely than not that all or some portion of the asset may not be realized due to the inability to generate sufficient taxable income in the period and/or of the character necessary to utilize the benefit of the deferred tax asset. In making this assessment, all sources of taxable income available to realize the deferred tax asset are considered, including taxable income in prior carry-back years, future reversals of existing temporary differences, tax planning strategies, and future taxable income exclusive of reversing temporary differences and carry-forwards. The predictability that future taxable income, exclusive of reversing temporary differences, will occur is the most subjective of these four sources. The presence of cumulative losses in recent years is considered significant negative evidence, making it difficult for a company to rely on future taxable income, exclusive of reversing temporary differences and carry-forwards, as a reliable source of taxable income to realize a deferred tax asset. Judgment is a critical element in making this assessment. Changes in the valuation allowance that result from favorable changes in those circumstances that cause a change in judgment about the realization of deferred tax assets in future years are recorded through income tax expense.

In assessing the need for a valuation allowance, the Company considered all available evidence about the realization of DTAs, both positive and negative, that could be objectively verified. The Company's positive evidence considered in support of its

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use of forecasted future earnings as a source of realizing DTAs was insufficient to overcome the negative evidence associated with its pre-tax cumulative loss position. Therefore, the Company continues to maintain a full valuation allowance on its net deferred tax assets. The total valuation allowance on deferred income tax assets was \$7.0 million at June 30, 2013.

Reversal of the DTA valuation allowance balance is subject to considerable judgment. However, the Company expects to reverse the DTA valuation allowance once it has demonstrated a sustainable return to profitability and experienced consecutive profitable quarters coupled with a forecast of sufficient continuing profitability. This reversal could occur as a single event or over a period of time depending upon the level of forecasted taxable income, the degree of probability related to realizing the forecasted taxable income, and the estimated risk related to credit quality. In that event, there will remain limitations on the ability to include the deferred tax assets for regulatory capital purposes. Pursuant to regulatory requirements, as taxes paid in carryback periods are exhausted, financial institutions must deduct from Tier I capital the greater of (1) the amount by which net deferred tax assets exceed what they would expect to realize within one year or (2) the amount by which the net deferred tax assets exceeds 10% of Tier I capital.

## **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 three non-management directors. The Board Loan Committee approves the Bank's Loan Policy and reviews the loan watch list, concentrations of credit and other risk management reports. The Board Loan Committee meets on a monthly basis and the Chairman of the Committee then reports to the Board of Directors.

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

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

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities that are disclosed but not reflected in its financial statements, including commitments to extend credit. At June 30, 2013, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$65.9 million.

### **Commercial and Industrial Lending**

Commercial and industrial loans generally have a higher degree of risk than loans secured by real estate, but typically have higher yields. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much reliability as residential real estate. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers.

### **Commercial Real Estate Lending**

Commercial real estate loans are secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches. Commercial real estate loan originations are obtained through direct solicitation of customers and potential



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customers. In its underwriting of commercial real estate, the Bank may lend, under federal regulation, up to 85% of the secured property's appraised value, although the Bank's loan to original appraised value ratio on such properties is typically 80% or less. 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.

### Construction and Land Development Lending

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. The majority of these loans have an average life of approximately one year and re-price monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans sometimes involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated based on the completion of construction. Thus, there is risk associated with failure to complete construction and potential cost overruns. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of the appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank typically obtains a first lien on the property as security for its construction loans, typically requires personal guarantees from the borrower's principal owners, and typically monitors the progress of the construction project during the draw period.

### 1-4 Family Residential Real Estate Lending

1-4 family residential lending activity may be generated by Bank loan officer solicitations, referrals by real estate professionals and existing or new bank customers. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant. Residential mortgage loans generally are made on the basis of the borrower's ability to make payments from employment and other income and are secured by real estate whose value tends to be readily ascertainable. In addition to the Bank's underwriting standards, loan quality may be analyzed based on guidelines issued by a secondary market investor. The valuation of residential collateral is generally provided by independent fee appraisers who have been approved by the Board Loan Committee. In addition to originating fixed rate mortgage loans with the intent to sell to correspondent lenders or broker to wholesale lenders, the Bank originates balloon and other mortgage loans for the portfolio. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans.

### Consumer Lending

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

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

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### **Results of Operations**

#### General

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

#### Net Interest Income

Net interest income totaled \$4.7 million for the second quarter of 2013, which was a 3% decrease when compared to the same period a year ago. The net interest margin decreased to 3.71% from 3.88% and average earning assets were \$8.4 million higher when comparing the periods. Interest-earning asset yields decreased 48 basis points while the cost of funds decreased 31 basis points.

For the six months ended June 30, 2013, net interest income totaled \$9.3 million, which was a 6% decrease when compared to the same period a year ago. The net interest margin decreased to 3.75% from 4.01% and average earning assets were \$3.6 million higher when comparing the periods. Interest-earning asset yields decreased 54 basis points while the cost of funds decreased 28 basis points.

For both the three month and six month periods ended June 30, 2013, interest-earning assets decreased from lower yields earned on loans and securities, as well as higher balances of securities and lower balances of loans, when comparing to the same periods in 2012. Although funding costs also fell during those periods, the decreases in the cost of funds were less than the decreases in the yields on interest-earning assets, which resulted in lower net interest margins for the 2013 periods compared to the 2012 periods.

#### Provision for Loan Losses

The Bank recorded provision for loan losses of \$2.5 million during the second quarter, which resulted in a total allowance for loan losses of \$12.5 million or 3.31% of total loans at June 30, 2013. This compared to a provision for loan losses of \$650 thousand and an allowance for loan losses of \$14.0 million, or 3.64% of total loans, at the end of the same quarter in 2012.

The provision for loan losses was primarily driven by a charge-off totaling \$2.3 million on one large loan relationship during the quarter. Net charge-offs increased to \$2.8 million for the second quarter of 2013 compared to \$287 thousand for the same period in 2012.

For the six months ended June 30, 2013, provision for loan losses totaled \$2.3 million, compared to \$2.7 million for the same period in 2012. The provision for loan losses in 2013 was primarily the result of the charge-off of one large loan relationship. In 2012, the provision for loan losses resulted from specific reserves on impaired loans and general reserves driven by the loss history component of the allowance for loan losses.

#### Noninterest Income

Noninterest income increased \$572 thousand, or 39%, to \$2.0 million compared to \$1.5 million for the same period one year ago. The increase in noninterest income was primarily the result of a \$543 thousand one-time gain recorded on the termination of a liability related to the Company's split dollar life insurance plan. Noninterest income, excluding the gain on termination of the split dollar liability and gains on sales of securities, remained relatively unchanged at \$1.5 million when comparing the periods. Revenues from bank owned life insurance increased while service charges on deposit accounts and ATM and check card fees decreased.

For the six months ended June 30, 2013, noninterest income decreased \$441 thousand, or 11%, to \$3.5 million compared to \$4.0 million for the same period one year ago. For the six months ended June 30, 2013, noninterest income, excluding gains on sale of securities and the termination of the split dollar liability, increased 5% to \$3.0 million compared to \$2.9 for the same period one year ago. Revenues from trust and investment advisory fees and bank owned life insurance increased while service charges on deposit accounts decreased.





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### Noninterest Expense

Noninterest expense increased 7% to \$4.8 million for the second quarter of 2013 compared to \$4.4 million for the same quarter of 2012. The increase in noninterest expense was primarily due to an increase in expenses related to other real estate owned from \$106 thousand for the second quarter of 2012 to \$376 thousand for the second quarter of 2013.

For the six months ended June 30, 2013, noninterest expense increased 6% to \$9.9 million compared to \$9.3 million for the same period in 2012. Salaries and employee benefits increased \$320 thousand to \$5.1 million for the six months ended June 30, 2013, compared to \$4.8 million for the same period one year ago. The decision to terminate a land lease for branch expansion earlier this year resulted in a one-time loss of \$209 thousand for the first six months of 2013. These increased expenses were partially offset by a decrease in other real estate owned expense from \$670 thousand in 2012 to \$483 thousand in 2013.

### Income Taxes

The Company's income tax provision differed from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income (loss) for the three and six month periods ended June 30, 2013 and 2012. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income and from the full valuation allowance on the Company's net deferred tax asset. A more detailed discussion of the Company's tax calculation is contained in Note 10 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

## **Financial Condition**

### General

Total assets were \$540.7 million at June 30, 2013 compared to \$532.7 million at December 31, 2012. The Company's trust and investment advisory group had assets under management of \$250.7 million at June 30, 2013 compared to \$236.0 million at December 31, 2012. Assets managed by the trust and investment advisory group are not reflected on the Company's consolidated balance sheet.

### Loans

Gross loan balances decreased \$6.1 million to \$377.5 million at June 30, 2013, compared to \$383.6 million at December 31, 2012. The decrease was reflective of a \$16.7 million or 9% decrease in other real estate loans, an \$10.7 million or 8% increase in 1-4 family residential loans, a \$1.0 million or 5% decrease in commercial and industrial loans, a \$781 or 2% increase in construction and land development loans, and a \$229 thousand or 3% increase in consumer and other loans.

The Company, through its banking subsidiary, grants mortgage, commercial and consumer loans to customers. The bank segments its loan portfolio into real estate loans, commercial loans, and consumer 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:

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

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

**Real Estate Loans - 1-4 Family:** This class of loans includes loans secured by one to four family residential properties. The Bank originates mortgage loans that are either retained in its loan portfolio or sold to correspondent lenders.

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

**Consumer and Other Loans:** Consumer and other 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. This class also includes obligations of states and political subdivisions.



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

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

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

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

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

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 \$500 thousand for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair market value of the collateral, net of selling costs, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company typically does not separately identify individual consumer, residential and certain small commercial loans that are less than \$500 thousand for impairment disclosures, except for troubled debt restructurings (TDRs) as noted below.

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

## Asset Quality

Management classifies as non-performing assets non-accrual loans and other real estate owned (OREO). OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower and properties originally acquired for branch expansion but no longer intended to be used for that purpose. OREO is recorded at fair value, less estimated selling costs, and is actively marketed by the Bank through brokerage channels. The Bank had \$4.1 million in OREO, net of the valuation allowance, at June 30, 2013 and \$5.6 million at December 31, 2012. The valuation allowance for other real estate owned totaled \$2.1 million at June 30, 2013 and \$2.2 million at December 31, 2012.



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Non-performing assets were \$13.2 million at June 30, 2013 and \$14.0 million at December 31, 2012, representing 2.44% and 2.62% of total assets, respectively. Non-performing assets included \$9.1 million in non-accrual loans and \$4.1 million in OREO, net of the valuation allowance at June 30, 2013. This compares to \$8.4 million in non-accrual loans and \$5.6 million in OREO, net of the valuation allowance at December 31, 2012. The construction and land development loan category contributed to the increase in non-accrual loans and the increase in loans past due greater than 90 days when comparing the periods. The Bank is in the process of working with customers for the repayment of loans in this loan category.

The levels of non-performing assets at June 30, 2013 and December 31, 2012 were primarily attributable to weak local economic conditions that negatively impacted the ability of certain borrowers to service debt. Borrowers that have not been able to meet their debt requirements are primarily business customers involved in hotel and mini-storage operations, commercial and residential rental real estate and residential real estate development. At June 30, 2013, 42% of non-performing assets related to commercial real estate loans, 39% related to construction and land development loans, 14% related to residential real estate loans, 4% related to properties originally acquired for branch expansion no longer intended to be used for that purpose and 1% related to commercial and industrial loans. Non-performing assets could increase due to other loans identified by management as potential problem loans. Other potential problem loans are defined as performing loans that possess certain risks, including the borrower's ability to pay and the collateral value securing the loan, that management has identified that may result in the loans not being repaid in accordance with their terms. Other potential problem loans totaled \$34.5 million and \$44.6 million at June 30, 2013 and December 31, 2012, 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.

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 \$12.5 million at June 30, 2013 and \$13.1 million at December 31, 2012, representing 3.31% and 3.41% of total loans, respectively.

Impaired loans totaled \$10.8 million and \$17.0 million at June 30, 2013 and December 31, 2012, respectively. The related allowance for loan losses provided for these loans totaled \$1.1 million and \$1.8 million at June 30, 2013 and December 31, 2012, respectively. The average recorded investment in impaired loans during the six months ended June 30, 2013 and the year ended December 31, 2012 was \$16.9 million and \$21.0 million, respectively. Included in the impaired loans total at June 30, 2013 are loans classified as TDRs totaling \$2.2 million. These loans represent situations in which a modification to the contractual interest rate or repayment structure has been granted to address a financial hardship. As of June 30, 2013, \$838 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 economic assumptions underlying management's estimates and judgments, adverse developments in the economy, on a national basis or in the Company's market area, or changes in the circumstances of particular borrowers. For further discussion regarding the allowance for loan losses, see "Critical Accounting Policies" above.

**Securities**

Securities at June 30, 2013 were \$105.2 million, an increase of \$15.7 million from \$89.5 million at December 31, 2012. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. As of June 30, 2013, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios. Gross unrealized gains in the securities portfolio totaled \$1.3 million and \$2.1 million at June 30, 2013 and December 31, 2012, respectively. Gross unrealized losses totaled \$2.2 million and \$319 thousand at June 30, 2013 and December 31, 2012, respectively. Investments in an unrealized loss position were considered temporarily impaired at June 30, 2013 and December 31, 2012. The change in the unrealized gains and losses of investment securities from December 31, 2012 to June 30, 2013 was related to changes in market interest rates.

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### Deposits

Deposits were \$476.0 million at June 30, 2013, an increase of \$9.1 million from \$466.9 million at December 31, 2012. Non-interest bearing demand deposits increased \$6.8 million or 8% to \$91.9 million during the first six months of 2013 from \$85.1 million at December 31, 2012. Savings and interest-bearing demand deposits increased \$11.2 million or 5% to \$232.8 million at June 30, 2013 compared to \$221.6 million at December 31, 2012. Time deposits, which include brokered deposits, decreased \$9.0 million or 6% during the first six months of 2013 to \$151.2 million compared to \$160.2 million at December 31, 2012.

### 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, 2013, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled \$120.6 million. At June 30, 2013, 23% or \$88.7 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled \$106.4 million at June 30, 2013, which included \$66.6 million available from FHLB, \$37.0 million of unsecured federal funds lines of credit with other correspondent banks and \$2.8 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 currently does not pay cash dividends on common stock in order to maintain solid capital levels in light of the current economic environment.

The Board of Governors of the Federal Reserve System has adopted capital guidelines to supplement the existing definitions of capital for regulatory purposes and to establish minimum capital standards. Specifically, the guidelines categorize assets and off-balance sheet items into four risk-weighted categories. The minimum ratio of qualifying total capital to risk-weighted assets is 8.00%, of which at least 4.00% must be Tier 1 capital, composed of common equity, retained earnings and a limited amount of perpetual preferred stock, less certain goodwill items. The Company had a ratio of total capital to risk-weighted assets of 15.94% at June 30, 2013 and a ratio of Tier 1 capital to risk-weighted assets of 14.66%. The Bank had a ratio of total capital to risk-weighted assets of 14.26% and a ratio of Tier 1 capital to risk-weighted assets of 12.99% at June 30, 2013. All of these exceed the capital requirements adopted by the federal regulatory agencies.

On March 13, 2009, the Company received an investment by the U.S. Treasury through the purchase of the Company's preferred stock totaling \$13.9 million from the Company's participation in the TARP Capital Purchase Program. As a result of this investment, capital ratios increased during 2009. The Series A Preferred Stock pays a dividend of 5% per annum until March 13, 2014 and 9% thereafter. The Series B Preferred Stock pays a dividend of 9% per annum. On August 29, 2012, the Treasury sold its preferred stock in the Company to private investors. The Treasury sold all 13,900 shares of Series A Preferred Stock at a price of \$882.50 per share and all 695 shares of Series B Preferred Stock at a price of \$912.50 per share. Each series of preferred stock was sold pursuant to an effective shelf registration statement previously filed by the Company with the Securities and Exchange Commission. Terms of the preferred stock did not change as result of the sale to new investors, including dividends which are payable on the full face value. The Company is current on its dividend payments on each series of preferred stock.

On June 29, 2012, the Company completed the sale of 1,945,815 shares of common stock in a rights offering and to certain standby investors. The Company's existing shareholders exercised subscription rights to purchase 1,520,815 shares at a subscription price of \$4.00 per share, and the standby investors purchased an additional 425,000 shares at the same price of \$4.00 per share. In total, the Company raised net proceeds of \$7.6 million.



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### **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, 2012.

### **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 \$57.6 million at June 30, 2013, and \$52.8 million at December 31, 2012, are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

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

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. At June 30, 2013 and December 31, 2012, the Bank had \$8.1 million and \$8.3 million in outstanding standby letters of credit, respectively.

The Company had \$2.2 million in locked-rate commitments to originate mortgage loans at June 30, 2013 and \$806 thousand at December 31, 2012. 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, 2013 was carried out under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer. Based on and as of the date of such evaluation, the aforementioned officers concluded that the Company's disclosure controls and procedures were effective.

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





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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2012.

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

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

The following documents are attached hereto as Exhibits:

- 3.1 By-laws of First National Corporation (as restated in electronic format as of May 14, 2013), attached as Exhibit 3.1 to the Current Report on Form 8-K filed May 15, 2013 and incorporated by reference herein.
- 31.1 Certification of Chief Executive Officer, Section 302 Certification
- 31.2 Certification of Chief Financial Officer, Section 302 Certification
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
- 101 The following materials from First National Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2013 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Comprehensive Income (iv) Consolidated Statements of Cash

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Flows, (v) Consolidated Statements of Shareholders' Equity, and (vi) Notes to Consolidated Financial Statements.

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**SIGNATURES**

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

**FIRST NATIONAL CORPORATION**

(Registrant)

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

August 13, 2013  
Date

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

August 13, 2013  
Date

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**EXHIBIT INDEX**

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