

FIRST NATIONAL CORP /VA/  
Form 10-Q  
November 15, 2010  
[Table of Contents](#)

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

**FORM 10-Q**

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

For the quarterly period ended September 30, 2010

or

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

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

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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<b>Virginia</b>	<b>54-1232965</b>
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
<b>112 West King Street, Strasburg, Virginia</b>	<b>22657</b>
(Address of principal executive offices)	(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 November 11, 2010, 2,945,044 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

**Table of Contents**

**TABLE OF CONTENTS**

	Page
<b><u>PART I FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets</u>	3
<u>Consolidated Statements of Income</u>	4
<u>Consolidated Statements of Cash Flows</u>	6
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	30
Item 4. <u>Controls and Procedures</u>	30
<b><u>PART II OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	30
Item 1A. <u>Risk Factors</u>	30
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	30
Item 3. <u>Defaults upon Senior Securities</u>	30
Item 4. <u>Removed and Reserved</u>	30
Item 5. <u>Other Information</u>	30
Item 6. <u>Exhibits</u>	30

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

	(unaudited) September 30, 2010	December 31, 2009
<b>Assets</b>		
Cash and due from banks	\$ 8,129	\$ 6,100
Interest-bearing deposits in banks	4,681	8,877
Securities available for sale, at fair value	57,468	60,129
Restricted securities, at cost	3,242	3,426
Loans held for sale	927	210
Loans, net of allowance for loan losses, 2010, \$8,594, 2009, \$7,106	429,642	436,129
Premises and equipment, net	19,969	21,148
Interest receivable	1,672	1,710
Other real estate owned, net of valuation allowance, 2010, \$853, 2009, \$994	6,599	6,261
Other assets	9,134	8,684
Total assets	\$ 541,463	\$ 552,674
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 79,998	\$ 81,101
Savings and interest-bearing demand deposits	164,351	146,056
Time deposits	208,774	236,729
Total deposits	\$ 453,123	\$ 463,886
Other borrowings	20,128	20,186
Company obligated mandatorily redeemable capital securities	9,279	9,279
Accrued expenses and other liabilities	2,934	4,516
Commitments and contingencies		
Total liabilities	\$ 485,464	\$ 497,867
<b>Shareholders' Equity</b>		
Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding	\$ 14,094	\$ 13,998

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Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2010, 2,945,044 shares, 2009, 2,931,721 shares	3,681	3,664
Surplus	1,536	1,418
Retained earnings	35,669	35,104
Unearned ESOP shares		(42)
Accumulated other comprehensive income, net	1,019	665
Total shareholders' equity	\$ 55,999	\$ 54,807
Total liabilities and shareholders' equity	\$ 541,463	\$ 552,674

*See Notes to Consolidated Financial Statements*

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

Three months ended September 30, 2010 and 2009

*(in thousands, except per share data)*

	(unaudited) September 30, 2010	(unaudited) September 30, 2009
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 6,239	\$ 6,239
Interest on federal funds sold	1	
Interest on deposits in banks	5	
Interest and dividends on securities available for sale:		
Taxable interest	398	547
Tax-exempt interest	132	147
Dividends	15	16
<b>Total interest and dividend income</b>	<b>\$ 6,790</b>	<b>\$ 6,949</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 1,397	\$ 1,844
Interest on federal funds purchased	1	26
Interest on company obligated mandatorily redeemable capital securities	112	113
Interest on other borrowings	104	192
<b>Total interest expense</b>	<b>\$ 1,614</b>	<b>\$ 2,175</b>
<b>Net interest income</b>	<b>\$ 5,176</b>	<b>\$ 4,774</b>
<b>Provision for loan losses</b>	<b>1,200</b>	<b>394</b>
<b>Net interest income after provision for loan losses</b>	<b>\$ 3,976</b>	<b>\$ 4,380</b>
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 668	\$ 662
ATM and check card fees	378	312
Trust and investment advisory fees	330	263
Fees for other customer services	75	76
Gains on sale of loans	76	38
Losses on sale of securities available for sale	(9)	
Gains on sale of other real estate owned	29	
Other operating income (loss)	(10)	25

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Total noninterest income	\$	1,537	\$	1,376
<b>Noninterest Expense</b>				
Salaries and employee benefits	\$	2,239	\$	2,172
Occupancy		358		338
Equipment		344		355
Marketing		142		122
Stationery and supplies		110		103
Legal and professional fees		210		228
ATM and check card fees		219		181
FDIC assessment		177		173
Bank franchise tax		109		82
Provision for other real estate owned		111		182
Other operating expense		516		655
Total noninterest expense	\$	4,535	\$	4,591
Income before income taxes	\$	978	\$	1,165
Income tax provision		284		347
<b>Net income</b>	\$	694	\$	818
Effective dividend on preferred stock		221		220
<b>Net income available to common shareholders</b>	\$	473	\$	598
<b>Earnings per common share, basic and diluted</b>	\$	0.16	\$	0.20

*See Notes to Consolidated Financial Statements*

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

Nine months ended September 30, 2010 and 2009

*(in thousands, except per share data)*

	(unaudited) September 30, 2010	(unaudited) September 30, 2009
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 18,728	\$ 18,374
Interest on federal funds sold	1	4
Interest on deposits in banks	9	
Interest and dividends on securities available for sale:		
Taxable interest	1,298	1,576
Tax-exempt interest	419	429
Dividends	43	32
<b>Total interest and dividend income</b>	<b>\$ 20,498</b>	<b>\$ 20,415</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 4,574	\$ 5,953
Interest on federal funds purchased	12	35
Interest on company obligated mandatorily redeemable capital securities	329	361
Interest on other borrowings	356	628
<b>Total interest expense</b>	<b>\$ 5,271</b>	<b>\$ 6,977</b>
<b>Net interest income</b>	<b>\$ 15,227</b>	<b>\$ 13,438</b>
<b>Provision for loan losses</b>	<b>2,611</b>	<b>2,054</b>
<b>Net interest income after provision for loan losses</b>	<b>\$ 12,616</b>	<b>\$ 11,384</b>
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 1,959	\$ 1,845
ATM and check card fees	1,058	887
Trust and investment advisory fees	934	852
Fees for other customer services	239	221
Gains on sale of loans	141	146
Gains (losses) on sale of securities available for sale, net	(7)	10
Gains on sale of premises and equipment		9
Losses on sale of other real estate owned, net	(23)	
Other operating income	46	42



Total noninterest income	\$	4,347	\$	4,012
<b>Noninterest Expense</b>				
Salaries and employee benefits	\$	6,756	\$	6,584
Occupancy		1,053		989
Equipment		1,035		1,052
Marketing		394		391
Stationery and supplies		292		398
Legal and professional fees		630		619
ATM and check card fees		605		552
FDIC assessment		548		603
Bank franchise tax		318		248
Provision for other real estate owned		151		818
Other operating expense		1,675		1,709
Total noninterest expense	\$	13,457	\$	13,963
Income before income taxes	\$	3,506	\$	1,433
Income tax provision		1,044		341
<b>Net income</b>	\$	2,462	\$	1,092
Effective dividend on preferred stock		664		484
<b>Net income available to common shareholders</b>	\$	1,798	\$	608
<b>Earnings per common share, basic and diluted</b>	\$	0.61	\$	0.21

*See Notes to Consolidated Financial Statements*

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

Nine months ended September 30, 2010 and 2009

*(in thousands)*

	(unaudited) September 30, 2010	(unaudited) September 30, 2009
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 2,462	\$ 1,092
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	933	956
Origination of loans held for sale	(10,745)	(12,985)
Proceeds from sale of loans available for sale	10,169	12,931
Gains on sale of loans	(141)	(146)
Provision for loan losses	2,611	2,054
Provision for other real estate owned	151	818
(Gains) losses on sale of securities available for sale, net	7	(10)
Gains on sale of premises and equipment		(9)
Losses on sale of other real estate owned, net	23	
Accretion of security discounts	(31)	(52)
Amortization of security premiums	274	196
Shares acquired by leveraged ESOP	42	118
Changes in assets and liabilities:		
Decrease in interest receivable	38	64
(Increase) decrease in other assets	43	(302)
Increase (decrease) in accrued expenses and other liabilities	(1,764)	86
Net cash provided by operating activities	\$ 4,072	\$ 4,811
<b>Cash Flows from Investing Activities</b>		
Proceeds from sales of securities available for sale	\$ 1,509	\$
Proceeds from maturities, calls, and principal payments of securities available for sale	8,103	10,932
Purchase of securities available for sale	(6,664)	(19,650)
Proceeds from sales of restricted securities	184	2,070
Purchase of restricted securities		(2,049)
Proceeds from sale of premises and equipment		225
Purchase of premises and equipment	(248)	(546)
Proceeds from sale of other real estate owned	2,353	
Net (increase) decrease in loans	1,011	(438)
Net cash provided by (used in) investing activities	\$ 6,248	\$ (9,456)

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**Cash Flows from Financing Activities**

Net increase (decrease) in demand deposits and savings accounts	\$ 17,192	\$ (4,291)
Net increase (decrease) in time deposits	(27,955)	3,879
Proceeds from other borrowings	23,601	46,000
Principal payments on other borrowings	(23,659)	(56,133)
Proceeds from issuance of preferred stock		13,900
Cash dividends paid on common stock	(1,072)	(1,172)
Cash dividends paid on preferred stock	(568)	(320)
Increase in federal funds purchased		339
Shares issued to leveraged ESOP	(26)	(58)
Net cash provided by (used in) financing activities	\$ (12,487)	\$ 2,144

Decrease in cash and cash equivalents	\$ (2,167)	\$ (2,501)
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**Cash and Cash Equivalents**

Beginning	\$ 14,977	\$ 10,490
Ending	\$ 12,810	\$ 7,989

*See Notes to Consolidated Financial Statements*

**Table of Contents**

**FIRST NATIONAL CORPORATION**

**Consolidated Statements of Cash Flows**

(Continued)

Nine months ended September 30, 2010 and 2009

(in thousands)

	(unaudited) September 30, 2010	(unaudited) September 30, 2009
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 5,459	\$ 7,106
Income taxes	\$ 3,061	\$ 285
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized gain on securities available for sale	\$ 537	\$ 1,196
Transfer from loans to other real estate	\$ 2,865	\$ 2,141
Issuance of common stock, dividend reinvestment plan	\$ 161	\$ 53

*See Notes to Consolidated Financial Statements*

## Table of Contents

### FIRST NATIONAL CORPORATION

#### Consolidated Statements of Changes in Shareholders' Equity

Nine months ended September 30, 2010 and 2009

(in thousands, except share and per share data)

(unaudited)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
<b>Balance, December 31, 2008</b>	\$	\$ 3,653	\$ 1,409	\$ 35,196	\$ (232)	\$ (841)		\$ 39,185
Comprehensive income:								
Net income				1,092			\$ 1,092	1,092
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, \$410)							796	
Reclassification adjustment (net of tax, \$3)							(7)	
Other comprehensive income (net of tax, \$407)						789	\$ 789	789
Total comprehensive income							\$ 1,881	
Shares acquired by leveraged ESOP			(58)		118			60
Cash dividends on common stock (\$0.42 per share)				(1,225)				(1,225)
Issuance of 3,692 shares common stock, dividend reinvestment plan		5	48					53
Issuance of 13,900 shares of preferred stock	13,900							13,900
Cash dividends on preferred stock				(320)				(320)
Accretion on preferred stock discount	67			(67)				
<b>Balance, September 30, 2009</b>	\$ 13,967	\$ 3,658	\$ 1,399	\$ 34,676	\$ (114)	\$ (52)		\$ 53,534

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
<b>Balance, December 31, 2009</b>	\$ 13,998	\$ 3,664	\$ 1,418	\$ 35,104	\$ (42)	\$ 665		\$ 54,807
Comprehensive income:								

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Net income	2,462				\$	2,462	2,462
Other comprehensive income, net of tax:							
Unrealized holding gains arising during the period (net of tax, \$181)						349	
Reclassification adjustment (net of tax, \$2)						5	
Other comprehensive income (net of tax, \$183)					354	\$	354
							354
Total comprehensive income					\$	2,816	
Shares acquired by leveraged ESOP	(26)		42				16
Cash dividends on common stock (\$0.42 per share)			(1,233)				(1,233)
Issuance of 13,323 shares common stock, dividend reinvestment plan	17	144					161
Cash dividends on preferred stock			(568)				(568)
Accretion on preferred stock discount	96		(96)				
<b>Balance, September 30, 2010</b>	\$ 14,094	\$ 3,681	\$ 1,536	\$ 35,669	\$	\$ 1,019	\$ 55,999

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 September 30, 2010 and December 31, 2009, the results of operations for the three and nine months ended September 30, 2010 and 2009 and cash flows and changes in shareholders' equity for the nine months ended September 30, 2010 and 2009. 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, 2009. Operating results for the three and nine month periods ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

**Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions, corporate equity securities and restricted securities. Amortized costs and fair values of securities available for sale at September 30, 2010 and December 31, 2009 were as follows:

<i>(in thousands)</i>				
September 30, 2010				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	\$ 41,859	\$ 1,679	\$ (27)	\$ 43,511
Obligations of states and political subdivisions	13,148	682	(59)	13,771
Corporate equity securities	19	167		186
	\$ 55,026	\$ 2,528	\$ (86)	\$ 57,468

<i>(in thousands)</i>				
December 31, 2009				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	\$ 42,654	\$ 1,593	\$ (32)	\$ 44,215
Obligations of states and political subdivisions	15,551	326	(171)	15,706
Corporate equity securities	19	189		208

\$ 58,224	\$ 2,108	\$ (203)	\$ 60,129
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**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)*

At September 30, 2010 and December 31, 2009, investments in an unrealized loss position that were temporarily impaired were as follows:

	<i>(in thousands)</i>					
	<i>September 30, 2010</i>					
	Less than 12 months	Unrealized	Less than 12 months	Unrealized	Total	Unrealized
	Fair Value	(Loss)	Fair Value	(Loss)	Fair Value	(Loss)
U.S. agency and mortgage-backed securities	\$ 2,558	\$ (27)	\$	\$	\$ 2,558	\$ (27)
Obligations of states and political subdivisions	974	(20)	941	(39)	1,915	(59)
	\$ 3,532	\$ (47)	\$ 941	\$ (39)	\$ 4,473	\$ (86)

	<i>(in thousands)</i>					
	<i>December 31, 2009</i>					
	Less than 12 months	Unrealized	Less than 12 months	Unrealized	Total	Unrealized
	Fair Value	(Loss)	Fair Value	(Loss)	Fair Value	(Loss)
U.S. agency and mortgage-backed securities	\$ 2,101	\$ (32)	\$	\$	\$ 2,101	\$ (32)
Obligations of states and political subdivisions	1,558	(17)	1,785	(154)	3,343	(171)
	\$ 3,659	\$ (49)	\$ 1,785	\$ (154)	\$ 5,444	\$ (203)

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

During the first nine months of 2010, there were no obligations of state and political subdivisions that experienced a rating downgrade. At September 30, 2010, there were three U.S. agency and mortgage-backed securities and three 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 3.2 years at September 30, 2010.

The Company's investment in FHLB stock totaled \$2.4 million at September 30, 2010. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider this investment to be other-than-temporarily impaired at September 30, 2010, and no impairment has been recognized. FHLB stock is shown in restricted securities on the balance sheet and is not part of the available for sale securities portfolio.



**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 3. Loans**

Loans at September 30, 2010 and December 31, 2009 are summarized as follows:

	<i>(in thousands)</i>	
	September 30, 2010	December 31, 2009
Mortgage loans on real estate:		
Construction	\$ 54,175	\$ 55,057
Secured by farm land	6,234	1,281
Secured by 1-4 family residential	120,897	118,675
Other real estate loans	201,954	200,001
Loans to farmers (except those secured by real estate)	3,449	3,530
Commercial and industrial loans (except those secured by real estate)	37,030	48,746
Consumer loans	13,157	13,619
Deposit overdrafts	396	157
All other loans	944	2,169
<b>Total loans</b>	<b>\$ 438,236</b>	<b>\$ 443,235</b>
Allowance for loan losses	8,594	7,106
<b>Loans, net</b>	<b>\$ 429,642</b>	<b>\$ 436,129</b>

The Company has a credit concentration of loans secured by real estate. These loans totaled \$383.3 million, or 87% of total loans, and \$375.0 million, or 85% of total loans, at September 30, 2010 and December 31, 2009, respectively. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations may be impacted by local economic conditions. Construction loans totaled \$54.2 million, or 12% of total loans, and \$55.1 million, or 12% of total loans, at September 30, 2010 and December 31, 2009, respectively.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$41.7 million at September 30, 2010, representing 74% of total equity and 10% of total loans. At December 31, 2009, this concentration totaled \$42.9 million representing 78% of total equity and 10% of total loans. These loans are included in other real estate loans in the above table. The Company experienced no loan losses related to this concentration of credit risk during the nine month period ended September 30, 2010 and the year ended December 31, 2009.

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the nine months ended September 30, 2010 and 2009 and for the year ended December 31, 2009 were as follows:

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	<i>(in thousands)</i>		
	September 30, 2010	December 31, 2009	September 30, 2009
Balance at beginning of year	\$ 7,106	\$ 5,650	\$ 5,650
Provision charged to operating expense	2,611	2,300	2,054
Loan recoveries	197	298	250
Loan charge-offs	(1,320)	(1,142)	(773)
Balance at end of period	\$ 8,594	\$ 7,106	\$ 7,181

Impaired loans totaled \$28.6 million at September 30, 2010 and \$8.1 million at December 31, 2009. The related allowance for loan losses provided for these loans totaled \$2.5 million and \$1.5 million at September 30, 2010 and December 31, 2009, respectively. The average recorded investment in impaired loans during the nine months ended September 30, 2010 and the year ended December 31, 2009 was \$18.0 million and \$11.2 million, respectively.

**Note 5. Other Borrowings**

The Bank had unused lines of credit totaling \$128.0 million available with non-affiliated banks at September 30, 2010. 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.

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

At September 30, 2010, the Bank had borrowings from the FHLB system totaling \$20.0 million which mature through March 28, 2013. The interest rate on these notes payable ranged from 1.25% to 2.44% and the weighted average rate was 2.01%. The Bank had collateral pledged on these borrowings, including real estate loans totaling \$68.9 million and FHLB stock with a book value of \$2.4 million.

At September 30, 2010, the Bank had a \$128 thousand note payable, secured by a deed of trust, which requires monthly payments of \$2 thousand and matures January 3, 2016. The fixed interest rate on this loan is 4.00%.

**Note 6. Capital Requirements**

A comparison of the capital of the Company and the Bank at September 30, 2010 and December 31, 2009 with the minimum regulatory guidelines were as follows:

			<i>(dollars in thousands)</i>		Minimum	
	Actual		Minimum Capital Requirement		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2010:						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 69,636	15.35%	\$ 36,287	8.00%	N/A	N/A
First Bank	\$ 69,030	15.22%	\$ 36,281	8.00%	\$ 45,351	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 63,930	14.09%	\$ 18,144	4.00%	N/A	N/A
First Bank	\$ 63,325	13.96%	\$ 18,140	4.00%	\$ 27,210	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 63,930	11.73%	\$ 21,796	4.00%	N/A	N/A
First Bank	\$ 63,325	11.63%	\$ 21,776	4.00%	\$ 27,220	5.00%
December 31, 2009:						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 68,892	14.96%	\$ 36,848	8.00%	N/A	N/A
First Bank	\$ 68,296	14.84%	\$ 36,815	8.00%	\$ 46,019	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 63,118	13.70%	\$ 18,424	4.00%	N/A	N/A
First Bank	\$ 62,527	13.59%	\$ 18,408	4.00%	\$ 27,611	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 63,118	11.50%	\$ 21,961	4.00%	N/A	N/A
First Bank	\$ 62,527	11.37%	\$ 21,995	4.00%	\$ 27,494	5.00%

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 7. Company Obligated Mandatorily Redeemable Capital Securities**

On September 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 September 17, 2004, \$5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at September 30, 2010 was 2.89%. The securities have a mandatory redemption date of September 17, 2034, and were subject to varying call provisions that began September 17, 2009. The principal asset of Trust II is \$5.2 million of the Company's junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

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

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 September 30, 2010, the total amount of trust preferred securities issued by the Trusts was included in the Company's Tier 1 capital.

**Note 8. Benefit Plans**

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service. 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 nine months ended September 30, 2010 and 2009 were as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2010	2009	2010	2009
	<i>(in thousands)</i>			
Service cost	\$ 77	\$ 76	\$ 231	\$ 228
Interest cost	71	68	213	204
Expected return on plan assets	(78)	(57)	(234)	(171)
Amortization of prior service cost	1	1	3	3
Amortization of net obligation at transition	(1)	(1)	(3)	(3)
Amortization of net loss	5	19	15	57

Net periodic benefit cost	\$ 75	\$ 106	\$ 225	\$ 318
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The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2009, that it expected to contribute \$298 thousand to its pension plan for the 2010 plan year. The Company did not make a contribution to the pension plan for the 2010 plan year during the first nine months of 2010. The Company is planning to make the contribution for the 2010 plan year during the fourth quarter of 2010.

In addition to the defined benefit pension plan, the Company maintains a 401(k) plan and an employee stock ownership plan (ESOP) for eligible employees. The Bank also maintains a Split Dollar Life Insurance Plan that provides life insurance coverage to insurable directors. See Note 11 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for additional information about the Company's benefit plans.

## **Table of Contents**

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

(unaudited)

#### **Note 9. Earnings per Common Share**

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. There are no potential common shares that would have a dilutive effect. Shares not committed to be released under the Company's leveraged ESOP are not considered to be outstanding. See Note 11 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for additional information about the Company's leveraged ESOP. The average number of common shares outstanding used to calculate basic and diluted earnings per common share were 2,941,750 and 2,921,309 for the three months ended September 30, 2010 and 2009, respectively, and 2,937,402 and 2,919,123 for the nine months ended September 30, 2010 and 2009, respectively.

#### **Note 10. Fair Value Measurements**

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

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

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

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



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fair value requires a significant management judgment or estimation.

An asset's or liability's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

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

### Securities available for sale

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

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

The following tables present the balances of financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2010 and December 31, 2009.

		Fair Value Measurements at September 30, 2010 (in thousands)		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description	Balance as of September 30, 2010			
Assets				
Securities available for sale	\$ 57,468	\$ 186	\$ 57,282	\$

Description	Balance as of December 31, 2009	Fair Value Measurements at December 31, 2009 (in thousands)		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Securities available for sale	\$ 60.129	\$ 208	\$ 59.921	\$

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

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

**Loans held for sale**

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using

observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the nine months ended September 30, 2010.

#### Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans or the present value of expected future cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement 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 fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that

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

contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. Any fair value adjustments to other real estate owned are recorded in the period incurred and expensed against current earnings.

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

Description	Carrying Value at September 30, 2010 (in thousands)			
	Balance as of September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Impaired loans	\$ 26,317	\$	\$ 19,299	\$ 7,018

Description	Carrying Value at December 31, 2009 (in thousands)			
	Balance as of December 31, 2009	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	\$ 5,806	\$	\$ 5,771	\$ 35

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

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Description	Carrying Value at September 30, 2010 (in thousands)			
	Balance as of September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Other real estate owned	\$ 6,599	\$	\$ 6,599	\$

Description	Carrying Value at December 31, 2009 (in thousands)			
	Balance as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Other real estate owned	\$ 6,261	\$	\$ 6,261	\$

## **Table of Contents**

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

*(unaudited)*

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

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

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

#### **Loans**

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

#### **Deposit Liabilities**

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

#### **Accrued Interest**

The carrying amounts of accrued interest approximate fair value.

#### **Borrowings**

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

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

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

The fair value of stand-by letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At September 30, 2010 and December 31, 2009, fair value of loan commitments and standby letters of credit was immaterial.



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

The estimated fair values of the Company's financial instruments at September 30, 2010 and December 31, 2009 were as follows:

	<i>(in thousands)</i>			
	<b>September 30, 2010</b>		<b>December 31, 2009</b>	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets</b>				
Cash and short-term investments	\$ 12,810	\$ 12,810	\$ 14,977	\$ 14,977
Securities	57,468	57,468	60,129	60,129
Loans, net	429,642	428,981	436,129	434,457
Loans held for sale	927	927	210	210
Accrued interest receivable	1,672	1,672	1,710	1,710
<b>Financial Liabilities</b>				
Deposits	\$ 453,123	\$ 431,374	\$ 463,886	\$ 421,115
Other borrowings	20,128	20,494	20,186	20,527
Company obligated mandatorily redeemable capital securities	9,279	9,570	9,279	9,784
Accrued interest payable	636	636	824	824

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

**Note 11. Capital Purchase Program**

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

**Note 12. Subsequent Events**



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The Company evaluated subsequent events that have occurred after the balance sheet date, but before the financial statements were issued. There are two types of subsequent events (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) nonrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

Based on the evaluation, the Company did not identify any recognized or nonrecognized subsequent events that would have required adjustment to or disclosure in the financial statements.

**Table of Contents**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Cautionary Statement Regarding Forward-Looking Statements**

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

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

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

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

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

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

potential impact on the Company of legislation;

the ability to continue paying common dividends;

difficult market conditions in the Company's industry;

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

the ability to raise capital as needed;

the successful management of interest rate risk;

the limited trading market in the Company's common stock; and

other factors identified in Item 1A. Risk Factors of the Company's Form 10-K for the year ending December 31, 2009.

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Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition and results of operations of the Company for the three and nine month periods ended September 30, 2010 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, 2009. The results of operations for the three and nine month periods ended September 30, 2010 may not be indicative of the results to be achieved for the year.

### Executive Overview

#### The Company

First National Corporation (the Company) is the financial 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 I (Trust I)

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

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

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

#### Products, Services, Customers and Locations

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

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

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

## **Table of Contents**

The Bank's products and services are provided through 11 branch offices, 31 ATMs and its website, [www.therespowerinone.com](http://www.therespowerinone.com). The Bank operates six of its offices under the "Financial Center" concept. A Financial Center offers all of the Bank's financial services at one location. This concept allows loan, deposit, trust and investment advisory personnel to be readily available to serve customers throughout the Bank's market area. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2009.

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

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

The provision for loan losses and noninterest expense are the two major expense categories. The provision is determined by factors that include loan growth, asset quality, net charge-offs and economic conditions. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company's control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for loan losses. The largest component of noninterest expense for the nine month period ended September 30, 2010 was salaries and employee benefits, comprising 50% of noninterest expenses, followed by occupancy and equipment expense, comprising 16% of noninterest expenses.

### **Quarterly Performance**

Third quarter 2010 net income was \$124 thousand lower than the same quarter of 2009:

Provision for loan losses was \$806 thousand or 205% higher

Net interest income was \$402 thousand or 8% higher

Noninterest income was \$161 thousand or 12% higher

Noninterest expense was \$56 thousand or 1% lower

Net income totaled \$694 thousand for the quarter ended September 30, 2010 compared to \$818 thousand for the same quarter in 2009. After the effective dividend on preferred stock, net income available to common shareholders was \$473 thousand, or \$0.16 per basic and diluted share compared to \$598 thousand, or \$0.20 per basic and diluted share, for the same period in 2009. The decrease in third quarter 2010 earnings compared to the same period in 2009 was primarily the result of higher provision for loan losses offset by an 8% increase in net interest income and a 12% increase in noninterest income. Noninterest expense decreased slightly when comparing the two periods. Return on assets and return on equity were 0.51% and 4.92%, respectively, for the third quarter of 2010 compared to 0.59% and 6.11% for the same quarter in 2009.

Comparing the quarter ended September 30, 2010 to the same period in 2009, net interest income increased 8% to \$5.2 million. The net interest margin was 37 basis points higher and average interest-earning assets were \$7.9 million lower when comparing the two periods. The net interest margin was 4.10% for the third quarter of 2010, compared to 3.73% for the same period in 2009. The improvement in the margin resulted from lower funding costs.

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The provision for loan losses totaled \$1.2 million in the third quarter of 2010 compared to \$394 thousand for the same period in 2009. The higher provision was primarily attributable to allocating specific reserves on impaired loans during the quarter. The Company has focused on actively identifying and reserving for troubled loans. Net charge-offs were \$240 thousand for both the third quarter of 2010 and for the same period in 2009. The allowance for loan losses totaled \$8.6 million or 1.96% of total loans at September 30, 2010, compared to \$7.2 million or 1.60% of total loans at September 30, 2009. Management regularly evaluates the loan portfolio, economic conditions and other factors to determine an appropriate allowance for loan losses. As a result of those evaluations, management believes the allowance for loan losses was adequate at September 30, 2010.

Noninterest income increased 12% to \$1.5 million for the third quarter of 2010 compared to \$1.4 million for the same quarter of 2009. The increase in noninterest income resulted primarily from higher trust and investment advisory fees and ATM and check card fees. Noninterest expense decreased 1% to \$4.5 million for the third quarter of 2010 compared to \$4.6 million for the same quarter of 2009.

## **Table of Contents**

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

Net income was \$1.4 million higher than the previous year:

Net interest income was \$1.8 million or 13% higher

Provision for loan losses was \$557 thousand or 27% higher

Noninterest expense was \$506 thousand or 4% lower

Noninterest income was \$335 thousand or 8% or higher

For the nine months ended September 30, 2010, net income was \$2.5 million compared to \$1.1 million for the same period in 2009. After the effective dividend on preferred stock, net income available to common shareholders was \$1.8 million, or \$0.61 per basic and diluted share, compared to \$608 thousand, or \$0.21 per basic and diluted share, for the same period in 2009. The increase in earnings for the nine months ended September 30, 2010 was primarily the result of a 13% increase in net interest income and a 4% decrease in noninterest expense. Return on assets was 0.60% for the nine months ended September 30, 2010 compared to 0.27% for the same period in 2009, and return on equity was 5.91% for the nine months ended September 30, 2010 compared to 2.97% for the same period in 2009.

Net interest income increased 13% to \$15.2 million for the nine months ended September 30, 2010 compared to \$13.4 million for the same period in 2009. The net interest margin was 52 basis points higher while average interest-earning assets were \$7.9 million lower when comparing the two periods. The net interest margin was 4.07% for the nine months ended September 30, 2010, compared to 3.55% for the same period in 2009.

The provision for loan losses was higher during the nine months ended September 30, 2010 and 2009, when compared to previous years. During 2010, the provision for loan losses totaled \$2.6 million, which was a result of higher net charge-offs and allocating specific reserves on impaired loans. Net charge-offs were \$1.1 million for the first nine months of 2010 compared to \$523 thousand for the same period in 2009. During 2009, the provision for loan losses totaled \$2.1 million, which resulted from unfavorable economic conditions, declines in collateral values and specific reserves on impaired loans.

Noninterest income increased 8% to \$4.3 million for the nine months ended September 30, 2010 from \$4.0 million for the same period in 2009. This increase was attributable to more overdraft and ATM and check card fee income. Noninterest expense decreased 4% to \$13.5 million for the nine months ended September 30, 2010, compared to \$14.0 million for the same period in 2009. The decrease in noninterest expense was primarily the result of lower provision for other real estate owned. The provision for other real estate owned totaled \$151 thousand for the nine months ended September 30, 2010 compared to \$818 thousand for the same period in 2009.

### **Management Outlook**

The Company expects no significant change in net interest income, noninterest income and noninterest expense for the remainder of 2010 and for 2011. Earning asset balances and the net interest margin are expected to remain stable. Based on anticipated economic conditions, the Company does not expect significant deposit growth or loan demand. The higher net interest margin has been primarily the result of lower funding costs. The Company does not expect funding costs to increase significantly. In the June 30, 2010 Form 10-Q, management reported uncertainty about the impact of overdraft protection legislation on noninterest income. The legislation, which was effective after August 15, 2010, did not have a significant impact on overdraft income during the last half of the third quarter of 2010. As a result, it does not appear that a considerable change in noninterest income will occur for the remainder of 2010 and for 2011. The Company plans to contain noninterest expense as part of its efforts to improve profitability.

The amount of provision for loan losses and provision for other real estate owned for future periods will be influenced by factors including net charge-offs, collateral values, economic conditions and the regulatory environment. In addition, changes in collateral values could potentially impact gains and losses on the sale of other real estate owned.

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

The Company measures the net interest margin as an indicator of profitability. The net interest margin is calculated by dividing tax-equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax-equivalent net interest income is considered in the calculation of this ratio. Tax-equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for 2010 and 2009 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.

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

	For the three months ended		For the nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
<b>GAAP measures:</b>				
Interest income - loans	\$ 6,239	\$ 6,239	\$ 18,728	\$ 18,374
Interest income - investments and other	551	710	1,770	2,041
Interest expense - deposits	1,397	1,844	4,574	5,953
Interest expense - other borrowings	104	192	356	628
Interest expense - other	113	139	341	396
<b>Total net interest income</b>	<b>\$ 5,176</b>	<b>\$ 4,774</b>	<b>\$ 15,227</b>	<b>\$ 13,438</b>
<b>Non-GAAP measures:</b>				
Tax benefit realized on non-taxable interest income - loans	\$ 13	\$ 10	\$ 33	\$ 31
Tax benefit realized on non-taxable interest income - municipal securities	69	76	216	221
<b>Total tax benefit realized on non-taxable interest income</b>	<b>\$ 82</b>	<b>\$ 86</b>	<b>\$ 249</b>	<b>\$ 252</b>
<b>Total tax-equivalent net interest income</b>	<b>\$ 5,258</b>	<b>\$ 4,860</b>	<b>\$ 15,476</b>	<b>\$ 13,690</b>

**Critical Accounting Policies****General**

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

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

**Allowance for Loan Losses**

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.



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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 borrowers' ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are classified as doubtful or substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows or collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors.

## **Table of Contents**

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the 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 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 value of the collateral, net of selling costs, if the loan repayment is collateral dependent. The Company does not separately identify individual consumer and residential loans for impairment disclosures.

## **Lending Policies**

### **General**

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

In an effort to manage the risk, the Bank's loan policy authorizes loan amount approval limits for individual loan officers based on their position within the Bank and level of experience. The Bank's Board of Directors and its Loan Committee approve all loan relationships greater than \$1.5 million. The President and CEO and the Executive Vice President - Loan Administration can combine their lending limits to approve loan relationships up to \$1.5 million. All loan relationships greater than \$750 thousand are reported to the Board or its Loan Committee. The Loan Committee consists of five non-management directors and the President and CEO. The Committee approves the Bank's Loan Policy and reviews loans that have been charged-off. It also reviews the allowance for loan loss adequacy calculation as well as the loan watch list and other management reports. The 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 broker referrals, direct solicitation of developers and continued business from customers. All completed loan applications are reviewed by the Bank's loan officers. As part of the application process, information is obtained concerning the income, financial condition, employment and credit history of the applicant. If commercial real estate is involved, information is also obtained concerning cash flow available for debt service. Loan quality is analyzed based on the Bank's experience and credit underwriting guidelines as well as the guidelines issued by the purchasers of loans, depending on the type of loan involved. Real estate collateral is appraised by independent fee appraisers who have been pre-approved by the Board Loan Committee.

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 September 30, 2010, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$65.9 million.

### **Commercial Business Lending**

Commercial business loans generally have a higher degree of risk than loans secured by real estate, but typically have higher yields. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as real estate. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers. At September 30, 2010 and December 31, 2009, commercial loans not secured by real estate totaled \$37.0 million or 8% of total loans and \$48.7 million, or 11% of total loans, respectively.

### **Commercial Real Estate Lending**

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Commercial real estate loans are secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches. At September 30, 2010, commercial real estate loans totaled \$208.2 million or 48% of the Bank's total loans, as compared to \$201.3 million, or 45%, at December 31, 2009. 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 fee 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

## **Table of Contents**

loans secured by income producing properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or in the economy, in general. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrowers' principal owners and carefully evaluates the location and environmental condition of the real estate collateral. To further mitigate risk, the Company monitors loan concentrations within the commercial real estate portfolio, including hotel loans, which totaled \$41.7 million, or 10%, of the Bank's total loans at September 30, 2010 compared to \$42.9 million, or 10%, of total loans at December 31, 2009.

### **Construction Lending**

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. Construction and land development loans outstanding at September 30, 2010 and December 31, 2009, were \$54.2 million, or 12% of total loans, and \$55.1 million, or 12% of total loans, respectively. The majority of these loans have an average life of approximately one year and re-price monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans often involve larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is attributable to the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated prior to the completion of construction. Thus, it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank typically obtains a first lien on the property as security for its construction loans, requires personal guarantees from the borrower's principal owners, and monitors the progress of the construction project during the draw period.

### **Residential Real Estate Lending**

Residential lending activity may be generated by Bank loan officer solicitations, referrals by real estate professionals, and existing or new bank customers. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant. Residential mortgage loans generally are made on the basis of the borrower's ability to make repayment from employment and other income and are secured by real estate whose value tends to be readily ascertainable. In addition to the Bank's underwriting standards, loan quality may be analyzed based on guidelines issued by a secondary market investor. The valuation of residential collateral is provided by independent fee appraisers who have been approved by the Board Loan Committee. Typically, the Bank originates all fixed rate mortgage loans with the intent to sell to correspondent lenders. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans. At September 30, 2010, \$120.9 million, or 28%, of total loans consisted of residential real estate loans as compared to \$118.7 million, or 27%, at December 31, 2009.

In connection with residential real estate loans, the Bank requires title insurance, hazard insurance and, where applicable, flood insurance. Flood determination letters with life of loan tracking are obtained on all federally related transactions with improvements serving as security for the transaction. The Bank does not require escrows for real estate taxes and insurance for secondary market loans.

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

### **Consumer Lending**

The Bank offers various secured and unsecured consumer loans, including unsecured personal loans and lines of credit, automobile loans, deposit account loans and installment and demand loans. At September 30, 2010, consumer loans, including deposit overdraft balances, were \$13.6 million, or 3% of total loans, as compared to \$13.8 million, or 3% of total loans, at December 31, 2009. 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.

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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.

## **Table of Contents**

### **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, premises and equipment and other real estate owned; general and administrative expenses; and income tax expense.

Net income totaled \$694 thousand for the quarter ended September 30, 2010. After the effective dividend on preferred stock, net income available to common shareholders was \$473 thousand, or \$0.16 per basic and diluted share compared to \$598 thousand, or \$0.20 per basic and diluted share, for the same period in 2009. The decrease in third quarter 2010 earnings compared to the same period in 2009 was primarily the result of higher provision for loan losses offset by an 8% increase in net interest income and a 12% increase in noninterest income. Noninterest expense decreased slightly when comparing the two periods. Return on assets and return on equity were 0.51% and 4.92%, respectively, for the third quarter of 2010, compared to 0.59% and 6.11% for the same quarter in 2009.

#### **Net Interest Income**

Comparing the quarter ended September 30, 2010 to the same quarter in 2009, net interest income increased 8% to \$5.2 million compared to \$4.8 million for the same period in 2009. This resulted from a 37 basis point increase in the net interest margin and a \$7.9 million decrease in average interest-earning assets when comparing the two periods. The net interest margin was 4.10% for the third quarter of 2010, compared to 3.73% for the same period in 2009. The margin improved primarily as a result of a decline in the cost of funding earning assets. The decline in the cost of funding earning assets was the result of a favorable change in the funding mix and lower cost of time deposits.

Net interest income increased 13% to \$15.2 million for the nine months ended September 30, 2010, compared to \$13.4 million for the same period in 2009. The net interest margin was 52 basis points higher while average interest-earning assets were \$7.9 million lower when comparing the two periods. The net interest margin was 4.07% for the nine months ended September 30, 2010, compared to 3.55% for the same period in 2009. The higher margin was primarily the result of a decline in the cost of funding earning assets. The decline in the cost of funding earning assets was the result of a favorable change in the funding mix and lower cost of time deposits.

The Company expects no significant change in net interest income for the remainder of 2010 and for 2011. Earning asset balances and the net interest margin are expected to remain stable.

#### **Provision for Loan Losses**

The provision for loan losses totaled \$1.2 million in the third quarter of 2010 compared to \$394 thousand for the same period in 2009. The higher provision was primarily attributable to allocating specific reserves on impaired loans during the quarter. The Company has focused on actively identifying and reserving for troubled loans. Net charge-offs were \$240 thousand for both the third quarter of 2010 and for the same period in 2009. The allowance for loan losses totaled \$8.6 million or 1.96% of total loans at September 30, 2010, compared to \$7.2 million or 1.60% of total loans at September 30, 2009. Management regularly evaluates the loan portfolio, economic conditions and other factors to determine an appropriate allowance for loan losses. As a result of those evaluations, management believes the allowance for loan losses was adequate at September 30, 2010.

The amount of provision for loan losses for future periods will be influenced by factors including net charge-offs, collateral values, economic conditions and the regulatory environment.

#### **Noninterest Income**

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Noninterest income increased \$161 thousand, or 12%, in the third quarter of 2010 to \$1.5 million compared to \$1.4 million for the third quarter of 2009. Trust and investment advisory fees increased \$67 thousand, or 25%, to \$330 thousand for the third quarter of 2010 compared to \$263 thousand for the same quarter of 2009. In addition, ATM and check card fees increased \$66 thousand, or 21%, to \$378 thousand for the third quarter of 2010, compared to \$312 thousand for the same period in 2009. This was related to an increase in ATM and check card transactions during the quarter.

Noninterest income increased 8% to \$4.3 million for the nine months ended September 30, 2010 from \$4.0 million for the same period in 2009. This increase was attributable to a 6% increase in service charges on deposit accounts, primarily from more overdraft fee income, and a 19% increase in ATM and check card fee income from increased transactions.

In the June 30, 2010 Form 10-Q, management reported uncertainty about the impact of overdraft protection legislation on noninterest income. The legislation, which was effective after August 15, 2010, did not have a significant impact on overdraft income during the last half of the third quarter of 2010. As a result, it does not appear that a considerable change in noninterest income will occur for the remainder of 2010 and for 2011.

## **Table of Contents**

### **Noninterest Expense**

Noninterest expense decreased \$56 thousand, or 1%, to \$4.5 million for the third quarter of 2010 compared to \$4.6 million for the same period in 2009.

Noninterest expense decreased 4% to \$13.5 million for the nine months ended September 30, 2010, compared to \$14.0 million for the same period in 2009. The decrease in noninterest expense was primarily the result of lower provisions for other real estate owned during the first nine months of 2010. The provision for other real estate owned totaled \$151 thousand for the nine months ended September 30, 2010 compared to \$818 thousand for the same period in 2009.

The Company expects no significant change in noninterest expense, excluding provision for other real estate owned, for the remainder of 2010 and for 2011. The Company plans to contain noninterest expense as part of its efforts to improve profitability. The amount of provision for other real estate owned for future periods will be influenced by factors including collateral values and economic conditions.

### **Income Taxes**

The Company's income tax provision differed from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the three and nine month periods ended September 30, 2010 and 2009. The difference was a result of net permanent tax deductions, primarily comprised of tax-exempt interest income. A more detailed discussion of the Company's tax calculation is contained in Note 9 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

## **Financial Condition**

### **General**

Total assets were \$541.5 million at September 30, 2010 compared to \$552.7 million at December 31, 2009. The Company's trust and investment advisory group had assets under management of \$193.3 million at September 30, 2010 compared to \$194.9 million at December 31, 2009. Assets managed by the trust and investment advisory group are not held on the Company's balance sheet.

The Company does not expect significant balance sheet growth during the remainder of 2010 and for 2011 based on current and anticipated economic conditions. It is believed that the contraction of the housing market, rising unemployment rates and other factors will limit the ability to increase loan and deposit balances.

### **Loans**

The Bank is an active lender with a loan portfolio that includes commercial and residential real estate loans, commercial loans, consumer loans, construction loans and home equity loans. The Bank's lending activity is concentrated on individuals, small and medium-sized businesses, local governmental and non-profit entities in its market area. As a provider of community-oriented financial services, the Bank does not attempt to diversify its loan portfolio by undertaking significant lending activity outside its market area. Loans, net of the allowance for loan losses, were \$429.6 million and \$436.1 at September 30, 2010 and December 31, 2009, respectively. The decrease in loans was primarily a result of a continued decrease in loan demand during 2010.

The Company has a credit concentration in mortgage loans on real estate. These loans totaled \$383.3 million, or 87% of total loans at September 30, 2010 and \$375.0 million, or 85% of total loans at December 31, 2009. Although the Company believes that its underwriting standards are generally conservative, the ability of its borrowers to meet their mortgage obligations is influenced by local economic conditions.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$41.7 million at September 30, 2010, representing 74% of total equity and 10% of total loans. At December 31, 2009, this concentration totaled \$42.9 million representing 78% of total shareholders' equity and 10% of total loans. These loans are included in other real estate loans in the table found in Note 3 of the notes to consolidated financial statements of this Form 10-Q. The Company experienced no loan losses related to this concentration of credit risk during the nine month period ended September 30, 2010 and the year ended December 31, 2009. The Company analyzes this concentration by performing interest rate and vacancy rate stress tests on a quarterly basis.



Asset Quality

Management classifies as nonperforming assets non-accrual loans, repossessed assets and other real estate owned (OREO). OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. OREO is recorded at the lower of cost or market, less estimated selling costs, and is actively marketed by the Bank through brokerage channels. The Bank had \$6.6 million in OREO, net of the valuation allowance, at September 30, 2010 and \$6.3 million at December 31, 2009.

## **Table of Contents**

Nonperforming assets were \$15.5 million at September 30, 2010, \$14.5 million at December 31, 2009 and \$16.3 million at September 30, 2009, representing 2.86%, 2.63% and 2.96% of total assets, respectively. Nonperforming assets included \$8.8 million in nonaccrual loans, \$6.6 million in OREO, net of the valuation allowance, and \$30 thousand in repossessed assets at September 30, 2010.

Nonperforming assets were 5% lower compared to one year ago and, at September 30, 2010, consisted of 56% related to residential development loans, 39% related to commercial real estate loans and 5% related to residential real estate loans. Nonperforming assets could increase due to other potential problem loans identified by management. Other potential problem loans are defined as performing loans that possess certain risks, including the borrower's ability to pay and the collateral value securing the loan, that management has identified that may result in the loans not being repaid in accordance with their terms. At September 30, 2010, other potential problem loans totaled \$73.3 million, of which \$55.0 million are currently performing and are generally considered well-secured. Other potential problem loans totaled \$36.8 million at December 31, 2009. The increase in other potential problem loans during 2010 was due to management's decision to downgrade certain loans. These loans were primarily downgraded because of declining trends in the borrowers' financial condition. The amount of other potential problem loans in future periods will be dependent on economic conditions.

The allowance for loan losses represents management's analysis of the existing loan portfolio and related credit risks. The provision for loan losses is based upon management's estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio. The allowance for loan losses totaled \$8.6 million at September 30, 2010 and \$7.1 million at December 31, 2009, representing 1.96% and 1.60% of total loans, respectively.

Impaired loans totaled \$28.6 million and \$8.1 million at September 30, 2010 and December 31, 2009, respectively. The related allowance for loan losses provided for these loans totaled \$2.5 million and \$1.5 million at September 30, 2010 and December 31, 2009, respectively. The average recorded investment in impaired loans during the nine months ended September 30, 2010 and the year ended December 31, 2009 was \$18.0 million and \$11.2 million, respectively. Included in the impaired loans total at September 30, 2010 are loans classified as troubled debt restructurings (TDRs) totaling \$10.1 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. TDRs totaled 2.30% of the loan portfolio and consisted mainly of commercial real estate loans that are currently performing under the restructured terms. TDRs are not considered nonperforming assets.

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

## **Securities**

Securities at September 30, 2010 were \$57.5 million, a decrease of \$2.6 million, or 4%, from \$60.1 million at December 31, 2009. Investment securities are comprised of U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. As of September 30, 2010, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios.

## **Deposits**

Deposits were \$453.1 million at September 30, 2010, a decrease of 2% from \$463.9 million at December 31, 2009. Time deposits, which include brokered deposits, decreased \$27.9 million or 12% during the first nine months of 2010 to \$208.8 million compared to \$236.7 million at December 31, 2009. The Company was successful in its initiative to increase savings and interest-bearing demand deposits during the first nine months of 2010. As a result, the Company was not aggressive in time deposit pricing which led to the decline in time deposit balances during the nine months ended September 30, 2010. Savings and interest-bearing demand deposits increased \$18.3 million or 13% to \$164.4 million at September 30, 2010 compared to \$146.1 million at December 31, 2009. Non-interest bearing demand deposits decreased slightly to \$80.0 million during the first nine months of 2010 from \$81.1 million at December 31, 2009.

## **Liquidity**

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

## **Table of Contents**

At September 30, 2010, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, loans maturing within one year, and expected maturities, calls and principal repayments from the securities portfolio within one year totaled \$159.9 million. At September 30, 2010, 33% or \$146.7 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled \$128.0 million at September 30, 2010, which included \$82.8 million available from FHLB, \$40.0 million of unsecured federal funds lines of credit with other correspondent banks and \$5.2 million available through the Federal Reserve Discount Window. During the first nine months of 2010, other borrowing activity included repayment of two fixed rate advances from FHLB totaling \$10.0 million and borrowing two adjustable rate advances from FHLB totaling \$10.0 million. The Bank also borrowed and repaid Daily Rate Credit advances as an alternative to purchasing federal funds.

## **Capital Resources**

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

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 15.32% at September 30, 2010 and a ratio of Tier 1 capital to risk-weighted assets of 14.06%. Both of these exceed the capital requirements adopted by the federal regulatory agencies.

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

## **Contractual Obligations**

There have been no material changes outside the ordinary course of business to the contractual obligations disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

## **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 \$55.8 million at September 30, 2010, and \$46.2 million at December 31, 2009, 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.

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Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. At September 30, 2010 and December 31, 2009, the Bank had \$8.8 million and \$6.0 million in outstanding standby letters of credit, respectively.

## **Table of Contents**

At September 30, 2010, the Company had entered into locked-rate commitments to originate mortgage loans amounting to \$1.3 million. At December 31, 2009, the Company had no locked-rate commitments. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Bank does not expect any counterparty to fail to meet its obligations.

### **Recent Accounting Pronouncements**

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as SFAS No. 166, *Accounting for Transfers of Financial Assets*, an amendment to SFAS No. 140, was adopted into Codification in December 2009 through the issuance of Accounting Standards Update (ASU) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. ASU 2009-16 was effective for transfers on or after January 1, 2010. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In June 2009, the FASB issued new guidance relating to variable interest entities. The new guidance, which was issued as SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, was adopted into Codification in December 2009. The objective of the guidance is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167 was effective as of January 1, 2010. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In January 2010, the FASB issued ASU 2010-04, *Accounting for Various Topics - Technical Corrections to SEC Paragraphs*. ASU 2010-04 makes technical corrections to existing SEC guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements - subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

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

In February 2010, the FASB issued ASU 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*. ASU 2010-09 addresses both the interaction of the requirements of Topic 855 with the SEC's reporting requirements and the intended breadth of the reissuance disclosures provisions related to subsequent events. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. ASU 2010-09 is effective immediately. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

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

On September 15, 2010, the SEC issued Release No. 33-9142, *Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Non-Accelerated Filers*. This release issued a final rule adopting amendments to its rules and forms to conform them to Section 404(c) of the Sarbanes-Oxley Act of 2002 (SOX), as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act. SOX Section 404(c) provides that Section 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934. Release No. 33-9142 was effective September 21, 2010.

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On September 17, 2010, the SEC issued Release No. 33-9144, Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis. This interpretive release is intended to improve discussion of liquidity and capital resources in Management's Discussion and Analysis of Financial Condition and Results of Operations in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant. This release was issued in conjunction with a proposed rule, Short-Term Borrowings Disclosures, that would require public companies to disclose additional information to investors about their short-term borrowing arrangements. Release No. 33-9144 was effective on September 28, 2010.

**Table of Contents**

**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. An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2010 was carried out under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer. Based on and as of the date of such evaluation, the aforementioned officers concluded that the Company's disclosure controls and procedures were effective.

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

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

Not required.

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

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Removed and Reserved**

None

**Item 5. Other Information**

None



**Item 6. Exhibits**

The following documents are attached hereto as Exhibits:

- 31.1 Certification of Chief Executive Officer, Section 302 Certification
- 31.2 Certification of Chief Financial Officer, Section 302 Certification
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

**Table of Contents**

**SIGNATURES**

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

**FIRST NATIONAL CORPORATION**

(Registrant)

/s/ Harry S. Smith  
Harry S. Smith  
President and Chief Executive Officer

November 15, 2010  
Date

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

November 15, 2010  
Date

**Table of Contents**

**EXHIBIT INDEX**

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