

FIRST NATIONAL CORP /VA/
Form 10-Q/A
May 17, 2011

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

FORM 10-Q/A
Amendment No. 1

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2011

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of
incorporation or organization)

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

112 West King Street, Strasburg, Virginia

22657

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(Address of principal executive offices)

(Zip Code)

(540) 465-9121

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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"/>	Smaller reporting company	<input checked="" type="checkbox"/>

(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of May 13, 2011, 2,952,303 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

EXPLANATORY NOTE

First National Corporation (the “Company”) hereby amends its Quarterly Report on Form 10-Q for the period ended March 31, 2011 as set forth in this Quarterly Report on Form 10-Q/A (Amendment No. 1) (the “Amendment”). The original filing, as well as Exhibits 31.1 and 32.1, were signed by the Company's previous Interim Chief Executive Officer. The Amendment is being filed solely for the purpose of providing a revised Signatures page and new Exhibits 31.1 and 32.1, signed by the Company's new President and Chief Executive Officer, who was appointed May 9, 2011.

No other information in the Form 10-Q for the period ended March 31, 2011 is being amended by the Amendment. For convenience, the entire Quarterly Report on Form 10-Q for the period ended March 31, 2011 has been re-filed in this Amendment. Pursuant to SEC Rule 12b-15, in connection with this filing, we have also re-filed Exhibits 31.2 and 32.2.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Balance Sheets

(in thousands, except share and per share data)

	(unaudited) March 31, 2011	December 31, 2010
Assets		
Cash and due from banks	\$ 7,329	\$ 5,048
Interest-bearing deposits in banks	14,912	10,949
Federal funds sold	15,000	7,500
Securities available for sale, at fair value	66,660	60,420
Restricted securities, at cost	3,153	3,153
Loans held for sale	150	271
Loans, net of allowance for loan losses, 2011, \$13,168, 2010, \$16,036	413,148	418,994
Other real estate owned, net of valuation allowance, 2011, \$3,026, 2010, \$3,341	5,428	3,961
Premises and equipment, net	20,020	20,302
Interest receivable	1,632	1,667
Other assets	12,803	12,364
Total assets	\$ 560,235	\$ 544,629
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing demand deposits	\$ 82,226	\$ 78,964
Savings and interest-bearing demand deposits	185,076	178,685
Time deposits	210,421	205,851
Total deposits	\$ 477,723	\$ 463,500
Other borrowings	20,117	20,122
Company obligated mandatorily redeemable capital securities	9,279	9,279
Accrued expenses and other liabilities	3,937	3,230
Commitments and contingencies	—	—
Total liabilities	\$ 511,056	\$ 496,131

Shareholders' Equity		
Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding	\$ 14,160	\$ 14,127
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2011, 2,952,303 shares, 2010, 2,948,901 shares	3,690	3,686
Surplus	1,614	1,582
Retained earnings	29,454	28,969
Accumulated other comprehensive income, net	261	134
 Total shareholders' equity	 \$ 49,179	 \$ 48,498
 Total liabilities and shareholders' equity	 \$ 560,235	 \$ 544,629

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Statements of Income

Three months ended March 31, 2011 and 2010

(in thousands, except per share data)

	(unaudited) March 31, 2011	(unaudited) March 31, 2010
Interest and Dividend Income		
Interest and fees on loans	\$ 5,833	\$ 6,260
Interest on federal funds sold	7	—
Interest on deposits in banks	7	2
Interest and dividends on securities available for sale:		
Taxable interest	451	468
Tax-exempt interest	123	145
Dividends	17	12
Total interest and dividend income	\$ 6,438	\$ 6,887
Interest Expense		
Interest on deposits	\$ 1,303	\$ 1,676
Interest on federal funds purchased	—	5
Interest on company obligated mandatorily redeemable capital securities	109	108
Interest on other borrowings	91	149
Total interest expense	\$ 1,503	\$ 1,938
Net interest income	\$ 4,935	\$ 4,949
Provision for loan losses	270	411
Net interest income after provision for loan losses	\$ 4,665	\$ 4,538
Noninterest Income		
Service charges on deposit accounts	\$ 501	\$ 609
ATM and check card fees	371	314
Trust and investment advisory fees	342	310
Fees for other customer services	73	73
Gains on sale of loans	47	40
Gains on sale of securities available for sale	—	2
Net losses on sale of other real estate owned	—	(52)
Other operating income	6	25

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Total noninterest income	\$	1,340	\$	1,321
Noninterest Expense				
Salaries and employee benefits	\$	2,288	\$	2,227
Occupancy		341		344
Equipment		325		348
Marketing		105		124
Stationery and supplies		79		97
Legal and professional fees		201		226
ATM and check card fees		171		177
FDIC assessment		190		187
Bank franchise tax		105		100
Provision for other real estate owned		130		—
Other real estate owned expense		126		66
Telecommunications expense		90		64
Other operating expense		404		437
Total noninterest expense	\$	4,555	\$	4,397
Income before income taxes	\$	1,450	\$	1,462
Income tax provision		447		447
Net income	\$	1,003	\$	1,015
Effective dividend on preferred stock		223		221
Net income available to common shareholders	\$	780	\$	794
Earnings per common share, basic and diluted	\$	0.26	\$	0.27

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Consolidated Statements of Cash Flows
Three months ended March 31, 2011 and 2010
(in thousands)

	(unaudited) March 31, 2011	(unaudited) March 31, 2010
Cash Flows from Operating Activities		
Net income	\$ 1,003	\$ 1,015
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	298	318
Origination of loans held for sale	(3,170)	(2,838)
Proceeds from sale of loans held for sale	3,338	2,963
Gains on sale of loans held for sale	(47)	(40)
Provision for loan losses	270	411
Provision for other real estate owned	130	—
Gains on sale of securities available for sale, net	—	(2)
Losses on sale of other real estate owned, net	—	52
Accretion of security discounts	(10)	(10)
Amortization of security premiums	114	92
Shares acquired by leveraged ESOP	—	34
Changes in assets and liabilities:		
(Increase) decrease in interest receivable	35	(10)
Increase in other assets	(439)	(148)
Increase (decrease) in accrued expenses and other liabilities	542	(527)
Net cash provided by operating activities	\$ 2,064	\$ 1,310
Cash Flows from Investing Activities		
Proceeds from maturities, calls, and principal payments of securities available for sale	\$ 2,733	\$ 2,679
Purchase of securities available for sale	(8,885)	—
Increase in federal funds sold	(7,500)	(2,220)
Purchase of premises and equipment	(16)	(37)
Proceeds from sale of other real estate owned	182	756
Net (increase) decrease in loans	3,897	(626)
Net cash used in investing activities	\$ (9,589)	\$ (552)
Cash Flows from Financing Activities		
Net increase in demand deposits and savings accounts	\$ 9,653	\$ 4,043

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Net increase (decrease) in time deposits	4,570	(11,782)
Proceeds from other borrowings	10,000	23,600
Principal payments on other borrowings	(10,005)	(23,639)
Cash dividends paid on common stock	(259)	(356)
Cash dividends paid on preferred stock	(190)	(190)
Shares issued to leveraged ESOP	—	(26)
Net cash provided by (used in) financing activities	\$ 13,769	\$ (8,350)
Increase (decrease) in cash and cash equivalents	\$ 6,244	\$ (6,488)
Cash and Cash Equivalents		
Beginning	\$ 15,997	\$ 14,977
Ending	\$ 22,241	\$ 8,489

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
 Consolidated Statements of Cash Flows
 (Continued)
 Three months ended March 31, 2011 and 2010
 (in thousands)

	(unaudited) March 31, 2011	(unaudited) March 31, 2010
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$ 1,514	\$ 2,028
Income taxes	\$ —	\$ 1,446
Supplemental Disclosures of Noncash Investing and Financing Activities		
Unrealized gain on securities available for sale	\$ 192	\$ 294
Transfer from loans to other real estate owned	\$ 2,292	\$ 1,101
Loan originated from sale of other real estate owned	\$ 640	\$ —
Issuance of common stock, dividend reinvestment plan	\$ 36	\$ 54

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION

Consolidated Statements of Changes in Shareholders' Equity

Three months ended March 31, 2011 and 2010

(in thousands, except share and per share data)

(unaudited)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated		Comprehensive Income	Comprehensive Income	Total
					Unearned ESOP Shares	Other			
Balance, December 31, 2009	\$ 13,998	\$ 3,664	\$ 1,418	\$ 35,104	\$ (42)	\$	665		\$ 54,807
Comprehensive income:									
Net income	—	—	—	1,015	—	—	—	\$ 1,015	1,015
Other comprehensive income, net of tax:									
Unrealized holding gains arising during the period (net of tax, \$101)	—	—	—	—	—	—	—	195	—
Reclassification adjustment (net of tax, \$1)	—	—	—	—	—	—	—	(1)	—
Other comprehensive income (net of tax, \$100)	—	—	—	—	—	—	194	\$ 194	194
Total comprehensive income							\$	1,209	
Shares acquired by leveraged ESOP	—	—	(26)	—	34	—	—	—	8
Cash dividends on common stock (\$0.14 per share)	—	—	—	(410)	—	—	—	—	(410)
Issuance of 5,210 shares common stock, dividend reinvestment plan	—	7	47	—	—	—	—	—	54
Cash dividends on preferred stock	—	—	—	(190)	—	—	—	—	(190)
Accretion on preferred stock	31	—	—	(31)	—	—	—	—	—

discount

Balance, March 31, 2010	\$ 14,029	\$ 3,671	\$ 1,439	\$ 35,488	\$ (8)	\$ 859		\$ 55,478
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	Preferred Stock	Common Stock	Surplus	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income	Comprehensive Income	Total
Balance, December 31, 2010	\$ 14,127	\$ 3,686	\$ 1,582	\$ 28,969	\$ —	\$ 134		\$ 48,498
Comprehensive income:								
Net income	—	—	—	1,003	—	—	\$ 1,003	1,003
Other comprehensive income, net of tax:								
Unrealized holding gains arising during the period (net of tax, \$65)	—	—	—	—	—	127	127	127
Total comprehensive income							\$ 1,130	
Cash dividends on common stock (\$0.10 per share)	—	—	—	(295)	—	—		(295)
Issuance of 3,402 shares common stock, dividend reinvestment plan	—	4	32	—	—	—		36
Cash dividends on preferred stock	—	—	—	(190)	—	—		(190)
Accretion on preferred stock discount	33	—	—	(33)	—	—		—
Balance, March 31, 2011	\$ 14,160	\$ 3,690	\$ 1,614	\$ 29,454	\$ —	\$ 261		\$ 49,179

See Notes to Consolidated Financial Statements

FIRST NATIONAL CORPORATION
Notes to Consolidated Financial Statements
(unaudited)

Note 1. General

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its 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 March 31, 2011 and December 31, 2010, the results of operations for the three months ended March 31, 2011 and 2010 and cash flows and changes in shareholders' equity for the three months ended March 31, 2011 and 2010. 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, 2010. Operating results for the three month period ended March 31, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

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. Restricted securities include required equity investments in certain correspondent banks which have no readily determinable market value. Amortized costs and fair values of securities available for sale at March 31, 2011 and December 31, 2010 were as follows:

	(in thousands)			
	March 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. agency and mortgage-backed securities	\$ 51,904	\$ 1,475	\$ (153)	\$ 53,226
Obligations of states and political subdivisions	13,061	338	(153)	13,246
Corporate equity securities	23	165	—	188
	\$ 64,988	\$ 1,978	\$ (306)	\$ 66,660

	(in thousands)			
	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value

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U.S. agency and mortgage-backed securities	\$ 45,627	\$ 1,508	\$ (211)	\$ 46,924
Obligations of states and political subdivisions	13,290	225	(214)	13,301
Corporate equity securities	23	172	—	195
	\$ 58,940	\$ 1,905	\$ (425)	\$ 60,420

At March 31, 2011 and December 31, 2010, investments in an unrealized loss position that were temporarily impaired were as follows:

	(in thousands)					
	Less than 12 months		March 31, 2011 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 13,004	\$ (153)	\$ —	\$ —	\$ 13,004	\$ (153)
Obligations of states and political subdivisions	1,300	(104)	929	(49)	2,229	(153)
	\$ 14,304	\$ (257)	\$ 929	\$ (49)	\$ 15,233	\$ (306)

Notes to Consolidated Financial Statements
(unaudited)

	(in thousands)					
	Less than 12 months		December 31, 2010 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage-backed securities	\$ 11,286	\$ (211)	\$ —	\$ —	\$ 11,286	\$ (211)
Obligations of states and political subdivisions	2,923	(128)	893	(86)	3,816	(214)
	\$ 14,209	\$ (339)	\$ 893	\$ (86)	\$ 15,102	\$ (425)

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.

At March 31, 2011, there were eight U.S. agency and mortgage-backed securities and four obligations of state and political subdivisions in an unrealized loss position. One hundred percent of the Company's investment portfolio is considered investment grade. The weighted-average re-pricing term of the portfolio was 3.8 years at March 31, 2011.

The Company's investment in FHLB stock totaled \$2.3 million at March 31, 2011. FHLB stock is generally viewed as a long-term investment and as a restricted security, which is carried at cost, because there is a minimal market for the stock. 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 March 31, 2011, 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.

Note 3. Loans

Loans at March 31, 2011 and December 31, 2010 are summarized as follows:

	(in thousands)	
	March 31, 2011	December 31, 2010
Real estate loans:		

Construction	\$ 50,655	\$ 52,591
Secured by 1-4 family residential	120,863	121,506
Other real estate loans	202,208	207,371
Commercial and industrial loans	39,659	40,683
Consumer loans	12,931	12,879
Total loans	\$ 426,316	\$ 435,030
Allowance for loan losses	13,168	16,036
Loans, net	\$ 413,148	\$ 418,994

Consumer loans included \$128 thousand and \$231 thousand of demand deposit overdrafts at March 31, 2011 and December 31, 2010, respectively.

The Company has a credit concentration of loans secured by real estate. These loans totaled \$373.7 million, or 88% of total loans, and \$381.5 million, or 88% of total loans, at March 31, 2011 and December 31, 2010, 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.

The Company has a concentration of credit risk within the loan portfolio involving loans secured by hotels. This concentration totaled \$42.5 million at March 31, 2011, representing 86% of total equity and 10% of total loans. At December 31, 2010, this concentration totaled \$41.6 million representing 86% 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 three month period ended March 31, 2011 and charged down \$147 thousand related to these loans during the year ended December 31, 2010.

Notes to Consolidated Financial Statements
(unaudited)

The following table provides a summary of loan classes and an aging of past due loans as of March 31, 2011 and December 31, 2010:

	March 31, 2011 (in thousands)							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction	\$ 555	\$ 190	\$ 3,345	\$ 4,090	\$ 46,565	\$ 50,655	\$ 3,172	\$ 173
1-4 family residential	2,014	440	74	2,528	118,335	120,863	784	—
Other real estate loans	1,535	551	6,202	8,288	193,920	202,208	7,032	1,481
Commercial and industrial	689	504	—	1,193	38,466	39,659	23	—
Consumer	85	16	5	106	12,825	12,931	5	—
Total	\$ 4,878	\$ 1,701	\$ 9,626	\$ 16,205	\$ 410,111	\$ 426,316	\$ 11,016	\$ 1,654

	December 31, 2010 (in thousands)							
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due	Current	Total Loans	Nonaccrual loans	90 Days or More Past Due and Accruing
Real estate loans:								
Construction	\$ 525	\$ —	\$ 3,665	\$ 4,190	\$ 48,401	\$ 52,591	\$ 5,780	\$ —
1-4 family residential	2,642	178	315	3,135	118,371	121,506	628	315
Other real estate loans	10,225	3,475	751	14,451	192,920	207,371	4,407	283
Commercial and industrial	1,033	3	—	1,036	39,647	40,683	—	—
Consumer	168	10	1	179	12,700	12,879	2	—

Total	\$ 14,593	\$ 3,666	\$ 4,732	\$ 22,991	\$ 412,039	\$ 435,030	\$ 10,817	\$ 598
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Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including trends related to the risk grading of specified classes of loans.

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

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

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

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

Notes to Consolidated Financial Statements
(unaudited)

The following tables provide an analysis of the credit risk profile of each loan class as of March 31, 2011 and December 31, 2010:

	March 31, 2011 (in thousands)				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction	\$ 20,546	\$ 8,453	\$ 19,588	\$ 2,068	\$ 50,655
Secured by 1-4 family residential	103,939	5,573	11,183	168	120,863
Other real estate loans	145,160	13,617	38,649	4,782	202,208
Commercial and industrial	33,879	4,004	1,753	23	39,659
Consumer	12,840	85	6	—	12,931
Total	\$ 316,364	\$ 31,732	\$ 71,179	\$ 7,041	\$ 426,316

	December 31, 2010 (in thousands)				
	Pass	Special Mention	Substandard	Doubtful	Total
Real estate loans:					
Construction	\$ 21,212	\$ 5,237	\$ 21,471	\$ 4,671	\$ 52,591
Secured by 1-4 family residential	106,722	4,435	10,349	—	121,506
Other real estate loans	143,874	17,915	43,443	2,139	207,371
Commercial and industrial	34,619	4,033	2,031	—	40,683
Consumer	12,864	13	1	1	12,879
Total	\$ 319,291	\$ 31,633	\$ 77,295	\$ 6,811	\$ 435,030

Note 4. Allowance for Loan Losses

Transactions in the allowance for loan losses for the three months ended March 31, 2011 and 2010 and for the year ended December 31, 2010 were as follows:

	(in thousands)		
	March 31, 2011	December 31, 2010	March 31, 2010
Balance at beginning of year	\$ 16,036	\$ 7,106	\$ 7,106
	270	11,731	411

Provision charged to operating expense			
Loan recoveries	87	261	80
Loan charge-offs	(3,225)	(3,062)	(432)
Balance at end of period	\$ 13,168	\$ 16,036	\$ 7,165

Notes to Consolidated Financial Statements
(unaudited)

The following tables present, as of March 31, 2011 and December 31, 2010, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

	March 31, 2010 (in thousands)					
	Commercial and Industrial	Other Real Estate	Construction	Secured by 1-4 Family Residential	Consumer Loans	Total
Allowance for loan losses:						
Beginning Balance, December 31, 2010	\$ 858	\$ 9,187	\$ 4,050	\$ 1,681	\$ 260	\$ 16,036
Charge-offs	—	(349)	(2,556)	(235)	(85)	(3,225)
Recoveries	—	—	—	—	87	87
Provision for loan losses	16	176	32	41	5	270
Ending Balance, March 31, 2011	\$ 874	\$ 9,014	\$ 1,526	\$ 1,487	\$ 267	\$ 13,168
Ending Balance:						
Individually evaluated for impairment	23	4,917	485	612	—	6,037
Collectively evaluated for impairment	851	4,097	1,041	875	267	7,131
Loans:						
Ending Balance	\$ 39,659	\$ 202,208	\$ 50,655	\$ 120,863	\$ 12,931	\$ 426,316
Individually evaluated for impairment	39	25,979	5,847	6,331	—	38,196
Collectively evaluated for impairment	39,620	176,229	44,808	114,532	12,931	388,120
	December 31, 2010 (in thousands)					
	Commercial and Industrial	Other Real Estate	Construction	Secured by 1-4 Family Residential	Consumer Loans	Total
Allowance for loan losses:						
Ending Balance	\$ 858	\$ 9,187	\$ 4,050	\$ 1,681	\$ 260	\$ 16,036

Ending Balance:						
Individually evaluated for impairment	36	5,020	3,006	536	—	8,597
Collectively evaluated for impairment	822	4,167	1,044	1,145	260	7,439
Loans:						
Ending Balance	40,683	207,371	52,591	121,506	12,879	435,030
Ending Balance:						
Individually evaluated for impairment	48	28,426	9,709	5,682	—	43,865
Collectively evaluated for impairment	40,635	178,945	42,882	115,824	12,879	391,165

Notes to Consolidated Financial Statements
(unaudited)

Impaired loans and the related allowance at March 31, 2011 and December 31, 2010, were as follows:

	March 31, 2011 (in thousands)						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction	\$ 7,860	\$ 3,380	\$ 2,467	\$ 5,847	\$ 485	\$ 8,792	\$ 38
Secured by 1-4 family	6,353	3,450	2,881	6,331	612	6,124	62
Other real estate loans	26,491	9,606	16,373	25,979	4,917	27,529	240
Commercial and industrial	39	17	22	39	23	54	—
Consumer	—	—	—	—	—	—	—
Total	\$ 40,744	\$ 16,453	\$ 21,743	\$ 38,196	\$ 6,037	\$ 42,500	\$ 340

	December 31, 2010 (in thousands)						
	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real estate loans:							
Construction	\$ 10,440	\$ 1,217	\$ 8,492	\$ 9,709	\$ 3,006	\$ 2,920	\$ 374
Secured by 1-4 family	5,701	595	5,087	5,682	536	795	222
Other real estate loans	29,480	7,904	20,522	28,426	5,020	18,432	1,345
Commercial and industrial	48	—	48	48	36	163	4
Consumer	—	—	—	—	—	—	—
Total	\$ 45,669	\$ 9,716	\$ 34,149	\$ 43,865	\$ 8,597	\$ 22,310	\$ 1,945

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

During the first quarter of 2011, the Bank adjusted its allowance for loan losses methodology by expanding the historical loss period that is applied to the general component of the allowance from one year to three years. The Company decreased the loss history to one year after significant deterioration in economic conditions in 2008. Since then, the Company has been operating in a stable market and has determined that a three-year loss history is more appropriate to reflect a reasonable loss inherent in the loan portfolio. For further information on the Company’s allowance for loan losses methodology, see the “Allowance for Loan Losses” section included in Part I, Item 2 of this Form 10-Q.

Note 5. Other Borrowings

The Bank had unused lines of credit totaling \$126.2 million available with non-affiliated banks at March 31, 2011. 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.

At March 31, 2011, 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 0.36% to 1.91% and the weighted average rate was 0.97%. The Bank had collateral pledged on these borrowings, including real estate loans totaling \$63.1 million and FHLB stock with a book value of \$2.3 million.

At March 31, 2011, the Bank had a \$117 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%.

Notes to Consolidated Financial Statements
(unaudited)

Note 6. Capital Requirements

A comparison of the capital of the Company and the Bank at March 31, 2011 and December 31, 2010 with the minimum regulatory guidelines were as follows:

	Actual		(dollars in thousands) Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
March 31, 2011:						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 63,648	14.40%	\$ 35,368	8.00%	N/A	N/A
First Bank	\$ 63,014	14.29%	\$ 35,280	8.00%	\$ 44,100	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 58,027	13.13%	\$ 17,684	4.00%	N/A	N/A
First Bank	\$ 57,407	13.02%	\$ 17,640	4.00%	\$ 26,460	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 58,027	10.50%	\$ 22,111	4.00%	N/A	N/A
First Bank	\$ 57,407	10.40%	\$ 22,090	4.00%	\$ 27,612	5.00%
December 31, 2010:						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 63,163	14.18%	\$ 35,624	8.00%	N/A	N/A
First Bank	\$ 62,550	14.06%	\$ 35,584	8.00%	\$ 44,480	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 57,467	12.91%	\$ 17,812	4.00%	N/A	N/A
First Bank	\$ 56,861	12.78%	\$ 17,792	4.00%	\$ 26,688	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 57,467	10.54%	\$ 21,810	4.00%	N/A	N/A
First Bank	\$ 56,861	10.40%	\$ 21,859	4.00%	\$ 27,324	5.00%

Note 7. Company Obligated Mandatorily Redeemable Capital Securities

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On June 17, 2004, \$5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at March 31, 2011 was 2.91%. The securities have a mandatory redemption date of June 17, 2034, and were subject to varying call provisions that began September 17, 2009. The principal asset of Trust II is \$5.2 million of the Company's junior subordinated debt securities with maturities and interest rates comparable to the trust preferred securities. The Trust's obligations under the trust preferred securities are fully and unconditionally guaranteed by the Company.

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.

Notes to Consolidated Financial Statements
(unaudited)

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 March 31, 2011, 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 and hired prior to May 1, 2011. 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 months ended March 31, 2011 and 2010 were as follows:

	(in thousands)	
	For the three months ended March 31,	
	2011	2010
Service cost	\$ 90	\$ 77
Interest cost	76	71
Expected return on plan assets	(85)	(78)
Amortization of prior service cost	1	1
Amortization of net obligation at transition	—	(1)
Amortization of net loss	9	5
Net periodic benefit cost	\$ 91	\$ 75

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2010, that it expected to contribute \$366 thousand to its pension plan for the 2011 plan year. The Company is planning to make the contribution for the 2011 plan year during the fourth quarter of 2011.

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, 2010 for additional information about the Company's benefit plans.

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, 2010 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 2,949,166 and 2,932,879 for the three months ended March 31, 2011 and 2010, 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.

Notes to Consolidated Financial Statements
(unaudited)

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

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 fair value requires a significant management judgment or estimation.

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

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

Securities available for sale

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

The following tables present the balances of financial assets measured at fair value on a recurring basis as of March 31, 2011 and December 31, 2010.

Description	Balance as of March 31, 2011	Fair Value Measurements at March 31, 2011 (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				
U.S. agency and mortgage-backed securities	\$ 53,226	\$ —	\$ 53,226	\$ —
Obligations of states and political subdivisions	13,246	—	13,246	—
Corporate equity securities	188	188	—	—
	\$ 66,660	\$ 188	\$ 66,472	\$ —

Notes to Consolidated Financial Statements
(unaudited)

Description	Fair Value Measurements at December 31, 2010 (in thousands)			
	Balance as of December 31, 2010	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				
U.S. agency and mortgage-backed securities	\$ 46,924	\$ —	\$ 46,924	\$ —
Obligations of states and political subdivisions	13,301	—	13,301	—
Corporate equity securities	195	195	—	—
	\$ 60,420	\$ 195	\$ 60,225	\$ —

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 three months ended March 31, 2011.

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 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.

Notes to Consolidated Financial Statements
(unaudited)

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 March 31, 2011 (in thousands)			
	Balance as of March 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Impaired loans	\$ 15,706	\$ —	\$ 15,418	\$ 288

Description	Carrying Value at December 31, 2010 (in thousands)			
	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Impaired loans	\$ 25,552	\$ —	\$ 17,584	\$ 7,968

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

Carrying Value at March 31, 2011
(in thousands)

Description	Balance as of March 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Other real estate owned	\$ 5,428	\$ —	\$ 5,428	\$ —

Carrying Value at December 31, 2010
(in thousands)

Description	Balance as of December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Other real estate owned	\$ 3,961	\$ —	\$ 3,961	\$ —

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

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March 31, 2011 and December 31, 2010, fair value of loan commitments and standby letters of credit was immaterial.

The estimated fair values of the Company's financial instruments at March 31, 2011 and December 31, 2010 were as follows:

	(in thousands)			
	March 31, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and short-term investments	\$ 37,241	\$ 37,241	\$ 23,497	\$ 23,497
Securities	66,660	66,660	60,420	60,420
Loans, net	413,148	413,955	418,994	420,011
Loans held for sale	150	150	271	271
Accrued interest receivable	1,632	1,632	1,667	1,667
Financial Liabilities				
Deposits	\$ 477,723	\$ 442,709	\$ 463,500	\$ 433,300
Other borrowings	20,117	20,325	20,122	20,400
Company obligated mandatorily redeemable capital securities	9,279	9,279	9,279	9,279
Accrued interest payable	540	540	551	551

Notes to Consolidated Financial Statements
(unaudited)

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

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.

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 words or terms are intended to identify forward-looking statements. These forward-looking statements are subject to significant uncertainties because they are based upon or are affected by factors including:

- 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 or to certain industry;
- the adequacy of the valuation allowance for other real estate owned related to changes in economic conditions and local real estate activity;
- 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;
- potential impact on the Company of legislation;
- difficult market conditions in the Company's industry; and
- other factors identified in Item 1A. Risk Factors of the Company's Form 10-K for the year ending December 31, 2010.

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 month period ended March 31, 2011 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, 2010. The results of operations for the three month period ended March 31, 2011 may not be indicative of the results to be achieved for the year.

Executive Overview

The Company

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

- First Bank (the Bank). The Bank owns:
 - First Bank Financial Services, Inc.
 - Shen-Valley Land Holdings, LLC
- First National (VA) Statutory Trust 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.

The Bank's products and services are provided through 10 branch offices, 31 ATMs and its website, 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, 2010.

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 three month period ended March 31, 2011 was salaries and employee benefits, comprising 50% of noninterest expenses, followed by occupancy and equipment expense, comprising 15% of noninterest expenses.

Quarterly Performance

First quarter 2011 earnings of \$1.0 million were consistent with the same quarter of 2010. After the effective dividend on preferred stock, net income available to common shareholders was \$780 thousand, or \$0.26 per basic and diluted share compared to \$794 thousand, or \$0.27 per basic and diluted share, for the same period in 2010. Net interest income and noninterest income were relatively unchanged, while noninterest expense increased 4% when comparing the two periods. Return on assets and return on equity were 0.74% and 8.31%, respectively, for the first quarter of 2011 compared to 0.75% and 7.45% for the same quarter in 2010.

Comparing the quarter ended March 31, 2011 to the same period in 2010, net interest income remained relatively unchanged at \$4.9 million. The net interest margin was 12 basis points lower and average interest-earning assets were \$13.2 million higher when comparing the two periods. The net interest margin was 3.89% for the first quarter of 2011, compared to 4.01% for the same period in 2010. The decline in the margin resulted from a change in the earning asset mix.

The provision for loan losses totaled \$270 thousand in the first quarter of 2011 compared to \$411 thousand for the same period in 2010. Net charge-offs were \$3.1 million for the first quarter of 2011 compared to \$352 thousand for the same period in 2010. The allowance for loan losses totaled \$13.2 million or 3.09% of total loans at March 31, 2011, compared to \$7.2 million or 1.62% of total loans at March 31, 2010. 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 March 31, 2011.

Noninterest income totaled \$1.3 million for the first quarter of 2011, which was consistent with the same quarter of 2010. A decrease in overdraft fee income was offset by increases in ATM, check card and trust and investment

advisory fees. Noninterest expense was slightly higher for the first quarter of 2011 when compared to the same quarter of 2010, primarily due to the provision for other real estate owned.

Management Outlook

The Company expects that there will not be a significant change in net interest income, noninterest income or noninterest expense (excluding the provision for OREO) for the remainder of the year when compared to first quarter results. Net interest income is expected to be relatively unchanged as the net interest margin and average earning asset balances are projected to remain stable. The Company is not planning for economic conditions to improve significantly in the local market, which should result in low loan demand and deposit growth. As a result, the earning asset mix is expected to change as loan balances continue decreasing while balances of securities increase. Even though net interest margin pressure is expected from this change in the earning asset mix, the Company plans to reallocate investments from interest-bearing deposits in banks and federal funds sold to investment securities, which will lessen the impact of the mix change. In addition, interest-bearing liabilities are expected to re-price slightly lower throughout the year which should also alleviate margin pressure.

Noninterest income and noninterest expense levels are not expected to change significantly for the remainder of the year, when compared to first quarter results. Higher levels of ATM and check card fee income, and trust and advisory fee income are expected to continue offsetting lower levels of income from service charges on deposit accounts.

Management believes that the allowance for loan losses provides prudent coverage of the risks in the loan portfolio, and that the carrying value of other real estate owned reflects current market conditions. However, the amount of provision for loan losses and provision for other real estate owned will be influenced by collateral values and economic conditions, among other factors. In addition, gains or losses that may occur from the sale of other real estate owned will be impacted by changes in market values.

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 2011 and 2010 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.

Reconciliation of Net Interest
Income to Tax-Equivalent Net
Interest Income
(in thousands)
For the three months ended
March 31, March 31,
2011 2010

GAAP measures:

Interest income - loans	\$ 5,833	\$ 6,260
Interest income - investments and other	605	627
Interest expense - deposits	1,303	1,676
Interest expense - other borrowings	91	149
Interest expense - other	109	113