

FIRST NATIONAL CORP /VA/  
Form 10-Q  
November 14, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2012

or

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

For the transition period from        to

Commission File Number: 0-23976

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of November 12, 2012, 4,901,464 shares of common stock, par value \$1.25 per share, of the registrant were outstanding.

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

	(unaudited) September 30, 2012	December 31, 2011
<b>Assets</b>		
Cash and due from banks	\$ 6,655	\$ 6,314
Interest-bearing deposits in banks	19,564	23,210
Securities available for sale, at fair value	95,839	91,665
Restricted securities, at cost	1,973	2,775
Loans held for sale		274
Loans, net of allowance for loan losses, 2012, \$14,049, 2011, \$12,937	366,703	379,503
Other real estate owned, net of valuation allowance, 2012, \$1,847, 2011, \$2,792	5,323	6,374
Premises and equipment, net	19,181	19,598
Interest receivable	1,581	1,620
Other assets	4,863	7,731
<b>Total assets</b>	<b>\$ 521,682</b>	<b>\$ 539,064</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 83,916	\$ 81,714
Savings and interest-bearing demand deposits	207,058	198,194
Time deposits	165,984	189,264
<b>Total deposits</b>	<b>\$ 456,958</b>	<b>\$ 469,172</b>
Other borrowings	6,082	19,100
Trust preferred capital notes	9,279	9,279
Other liabilities	4,540	4,417
<b>Total liabilities</b>	<b>\$ 476,859</b>	<b>\$ 501,968</b>
<b>Shareholders Equity</b>		
Preferred stock, \$1,000 liquidation preference; 14,595 shares issued and outstanding	\$ 14,372	\$ 14,263
Common stock, par value \$1.25 per share; authorized 8,000,000 shares; issued and outstanding, 2012, 4,901,464 shares, 2011, 2,955,649 shares	6,127	3,695
Surplus	6,813	1,644
Retained earnings	17,683	16,503

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Accumulated other comprehensive income (loss), net	(172)	991
Total shareholders' equity	\$ 44,823	\$ 37,096
Total liabilities and shareholders' equity	\$ 521,682	\$ 539,064

*See Notes to Consolidated Financial Statements*

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

Three months ended September 30, 2012 and 2011

*(in thousands, except per share data)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 5,189	\$ 5,666
Interest on federal funds sold	3	2
Interest on deposits in banks	11	3
Interest and dividends on securities available for sale:		
Taxable interest	494	595
Tax-exempt interest	55	121
Dividends	19	16
<b>Total interest and dividend income</b>	<b>\$ 5,771</b>	<b>\$ 6,403</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 928	\$ 1,204
Interest on trust preferred capital notes	60	109
Interest on other borrowings	47	42
<b>Total interest expense</b>	<b>\$ 1,035</b>	<b>\$ 1,355</b>
<b>Net interest income</b>	<b>\$ 4,736</b>	<b>\$ 5,048</b>
Provision for loan losses	805	5,575
<b>Net interest income (loss) after provision for loan losses</b>	<b>\$ 3,931</b>	<b>\$ (527)</b>
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 544	\$ 590
ATM and check card fees	369	391
Trust and investment advisory fees	365	350
Fees for other customer services	78	84
Gains on sale of loans	51	25
Gains on sale of securities available for sale, net	167	
Gains on sale of premises and equipment	2	
Other operating income	33	33
<b>Total noninterest income</b>	<b>\$ 1,609</b>	<b>\$ 1,473</b>
<b>Noninterest Expense</b>		
Salaries and employee benefits	\$ 2,398	\$ 2,299

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Occupancy	333	347
Equipment	294	325
Marketing	120	109
Stationery and supplies	67	88
Legal and professional fees	293	276
ATM and check card fees	161	162
FDIC assessment	176	181
Bank franchise tax	62	103
Provision for other real estate owned	26	927
Other real estate owned expense	99	133
Net gains on sale of other real estate owned	(47)	(36)
Telecommunications expense	62	63
Data processing	102	79
Other operating expense	511	332
Total noninterest expense	\$ 4,657	\$ 5,388

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

(Continued)

Three months ended September 30, 2012 and 2011

*(in thousands, except per share data)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Income (loss) before income taxes	\$ 883	\$ (4,442)
Income tax provision (benefit)	195	(1,556)
<b>Net income (loss)</b>	<b>\$ 688</b>	<b>\$ (2,886)</b>
Effective dividend on preferred stock	226	224
<b>Net income (loss) available to common shareholders</b>	<b>\$ 462</b>	<b>\$ (3,110)</b>
<b>Earnings (loss) per common share, basic and diluted</b>	<b>\$ 0.09</b>	<b>\$ (1.05)</b>

*See Notes to Consolidated Financial Statements*



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

Nine months ended September 30, 2012 and 2011

*(in thousands, except per share data)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
<b>Interest and Dividend Income</b>		
Interest and fees on loans	\$ 16,001	\$ 17,317
Interest on federal funds sold	12	13
Interest on deposits in banks	19	15
Interest and dividends on securities available for sale:		
Taxable interest	1,542	1,618
Tax-exempt interest	228	365
Dividends	57	50
<b>Total interest and dividend income</b>	<b>\$ 17,859</b>	<b>\$ 19,378</b>
<b>Interest Expense</b>		
Interest on deposits	\$ 2,874	\$ 3,810
Interest on trust preferred capital notes	182	327
Interest on other borrowings	192	175
<b>Total interest expense</b>	<b>\$ 3,248</b>	<b>\$ 4,312</b>
<b>Net interest income</b>	<b>\$ 14,611</b>	<b>\$ 15,066</b>
Provision for loan losses	3,455	9,395
<b>Net interest income after provision for loan losses</b>	<b>\$ 11,156</b>	<b>\$ 5,671</b>
<b>Noninterest Income</b>		
Service charges on deposit accounts	\$ 1,569	\$ 1,626
ATM and check card fees	1,129	1,172
Trust and investment advisory fees	1,079	1,076
Fees for other customer services	283	231
Gains on sale of loans	143	94
Gains on sale of securities available for sale, net	1,285	41
Gains on sale of premises and equipment	2	
Other operating income	95	58
<b>Total noninterest income</b>	<b>\$ 5,585</b>	<b>\$ 4,298</b>
<b>Noninterest Expense</b>		
Salaries and employee benefits	\$ 7,155	\$ 6,867

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Occupancy	996	1,019
Equipment	907	973
Marketing	293	314
Stationery and supplies	234	254
Legal and professional fees	741	746
ATM and check card fees	480	492
FDIC assessment	533	588
Bank franchise tax	199	312
Provision for other real estate owned	595	1,103
Other real estate owned expense	450	325
Net gains on sale of other real estate owned	(297)	(28)
Telecommunications expense	184	239
Data processing	270	220
Other operating expense	1,255	1,035
Total noninterest expense	\$ 13,995	\$ 14,459

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

(Continued)

Nine months ended September 30, 2012 and 2011

*(in thousands, except per share data)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Income (loss) before income taxes	\$ 2,746	\$ (4,490)
Income tax provision (benefit)	889	(1,662)
<b>Net income (loss)</b>	<b>\$ 1,857</b>	<b>\$ (2,828)</b>
Effective dividend on preferred stock	677	670
<b>Net income (loss) available to common shareholders</b>	<b>\$ 1,180</b>	<b>\$ (3,498)</b>
<b>Earnings (loss) per common share, basic and diluted</b>	<b>\$ 0.33</b>	<b>\$ (1.18)</b>

*See Notes to Consolidated Financial Statements*

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

Three months ended September 30, 2012 and 2011

*(in thousands, except per share data)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Net income (loss)	\$ 688	\$ (2,886)
Other comprehensive income (loss):		
Unrealized gain (loss) on available for sale securities, net of tax	(205)	515
Reclassification adjustment, net of tax	(167)	
Other comprehensive income (loss), net of tax	(372)	515
Total comprehensive income (loss)	\$ 316	\$ (2,371)

*See Notes to Consolidated Financial Statements*

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

Nine months ended September 30, 2012 and 2011

*(in thousands, except per share data)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
Net income (loss)	\$ 1,857	\$ (2,828)
Other comprehensive income (loss):		
Unrealized gain on available for sale securities, net of tax	122	1,481
Reclassification adjustment, net of tax	(1,285)	(27)
Other comprehensive income (loss)	(1,163)	1,454
Total comprehensive income (loss)	\$ 694	\$ (1,374)

*See Notes to Consolidated Financial Statements*

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

Nine months ended September 30, 2012 and 2011

*(in thousands)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
<b>Cash Flows from Operating Activities</b>		
Net income (loss)	\$ 1,857	\$ (2,828)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	836	896
Origination of loans held for sale	(5,279)	(6,277)
Proceeds from sale of loans held for sale	5,696	6,642
Gains on sale of loans held for sale	(143)	(94)
Provision for loan losses	3,455	9,395
Provision for other real estate owned	595	1,103
Gains on sale of securities available for sale, net	(1,285)	(41)
Net gains on sale of other real estate owned	(297)	(28)
Accretion of discounts and amortization of premiums on securities, net	586	339
Changes in assets and liabilities:		
Decrease in interest receivable	39	7
(Increase) decrease in other assets	2,868	(1,233)
Increase (decrease) in other liabilities	152	(231)
<b>Net cash provided by operating activities</b>	<b>\$ 9,080</b>	<b>\$ 7,650</b>
<b>Cash Flows from Investing Activities</b>		
Proceeds from sales of securities available for sale	\$ 26,158	\$ 2,557
Proceeds from maturities, calls, and principal payments of securities available for sale	19,274	11,075
Purchase of securities available for sale	(50,100)	(36,768)
Proceeds from redemption of restricted securities	832	264
Purchase of restricted securities	(30)	
Decrease in federal funds sold		7,500
Purchase of premises and equipment	(419)	(251)
Proceeds from sale of other real estate owned	5,041	784
Net decrease in loans	5,058	15,520
<b>Net cash provided by investing activities</b>	<b>\$ 5,814</b>	<b>\$ 681</b>
<b>Cash Flows from Financing Activities</b>		
Net increase in demand deposits and savings accounts	\$ 11,066	\$ 14,575
Net decrease in time deposits	(23,280)	(20,053)
Proceeds from other borrowings		33,001
Principal payments on other borrowings	(13,018)	(28,017)
Net proceeds from issuance of common stock	7,601	

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Cash dividends paid on common stock		(541)
Cash dividends paid on preferred stock	(568)	(568)
<b>Net cash used in financing activities</b>	<b>\$ (18,199)</b>	<b>\$ (1,603)</b>
Increase (decrease) in cash and cash equivalents	\$ (3,305)	\$ 6,728
<b>Cash and Cash Equivalents</b>		
Beginning	\$ 29,524	\$ 15,997
Ending	\$ 26,219	\$ 22,725

*See Notes to Consolidated Financial Statements*

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

(Continued)

Nine months ended September 30, 2012 and 2011

*(in thousands)*

	(unaudited) September 30, 2012	(unaudited) September 30, 2011
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for:		
Interest	\$ 3,299	\$ 4,422
Income taxes	\$ 940	\$
<b>Supplemental Disclosures of Noncash Investing and Financing Activities</b>		
Unrealized gain (loss) on securities available for sale	\$ (1,193)	\$ 2,202
Transfer from loans to other real estate owned	\$ 4,287	\$ 3,373
Loan originated from sale of other real estate owned	\$	\$ 640
Issuance of common stock, dividend reinvestment plan	\$	\$ 71

*See Notes to Consolidated Financial Statements*



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

Nine months ended September 30, 2012 and 2011

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

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total
<b>Balance, December 31, 2010</b>	\$ 14,127	\$ 3,686	\$ 1,582	\$ 28,969	\$ 134	\$ 48,498
Net loss				(2,828)		(2,828)
Other comprehensive income					1,454	1,454
Cash dividends on common stock (\$0.20 per share)				(612)		(612)
Issuance of 6,748 shares common stock, dividend reinvestment plan		9	62			71
Cash dividends on preferred stock				(568)		(568)
Accretion on preferred stock discount	102			(102)		
<b>Balance, September 30, 2011</b>	\$ 14,229	\$ 3,695	\$ 1,644	\$ 24,859	\$ 1,588	\$ 46,015

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
<b>Balance, December 31, 2011</b>	\$ 14,263	\$ 3,695	\$ 1,644	\$ 16,503	\$ 991	\$ 37,096
Net income				1,857		1,857
Other comprehensive loss					(1,163)	(1,163)
Issuance of common stock, net of offering costs		2,432	5,169			7,601
Cash dividends on preferred stock				(568)		(568)
Accretion on preferred stock discount	109			(109)		
<b>Balance, September 30, 2012</b>	\$ 14,372	\$ 6,127	\$ 6,813	\$ 17,683	\$ (172)	\$ 44,823

*See Notes to Consolidated Financial Statements*

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**FIRST NATIONAL CORPORATION**

**Notes to Consolidated Financial Statements**

*(unaudited)*

**Note 1. General**

The accompanying unaudited consolidated financial statements of First National Corporation (the Company) and its 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, 2012 and December 31, 2011, the results of operations and comprehensive income for the three and nine months ended September 30, 2012 and 2011 and the cash flows and changes in shareholders' equity for the nine months ended September 30, 2012 and 2011. 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, 2011. Operating results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

**Recent Accounting Pronouncements**

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements*. The amendments in this ASU removed from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU were effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. GAAP (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments were effective for interim and annual periods beginning after December 15, 2011 with prospective application. The Company has included the required disclosures in its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220) Presentation of Comprehensive Income*. The objective of this ASU is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity. The amendments require that all non-owner changes in shareholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments were effective for fiscal years and interim periods within those years beginning after December 15, 2011. The Company has included the required disclosures in its consolidated financial statements.



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

In December 2011, the FASB issued ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company does not expect the adoption of ASU 2011-11 to have a material impact on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. The amendments are being made to allow the Board time to re-deliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the Board is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011.

**Note 2. Securities**

The Company invests in U.S. agency and mortgage-backed securities, obligations of state and political subdivisions and corporate equity securities. Amortized costs and fair values of securities available for sale at September 30, 2012 and December 31, 2011 were as follows:

	<i>(in thousands)</i>			
	September 30, 2012			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	
U.S. agency and mortgage-backed securities	\$ 78,251	\$ 1,559	\$ (230)	\$ 79,580
Obligations of states and political subdivisions	15,585	753	(83)	16,255
Corporate equity securities	1	3		4
	\$ 93,837	\$ 2,315	\$ (313)	\$ 95,839

	<i>(in thousands)</i>			
	December 31, 2011			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	(Losses)	

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U.S. agency and mortgage-backed securities	\$ 76,549	\$ 2,343	\$ (16)	\$ 78,876
Obligations of states and political subdivisions	11,895	781		12,676
Corporate equity securities	26	87		113
	\$ 88,470	\$ 3,211	\$ (16)	\$ 91,665

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

At September 30, 2012 and December 31, 2011, investments in an unrealized loss position that were temporarily impaired were as follows:

	<i>(in thousands)</i>					
	Less than 12 months		September 30, 2012 12 months or more		Total	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
U.S. agency and mortgage- backed securities	\$ 23,118	\$ (230)	\$	\$	\$ 23,118	\$ (230)
Obligations of states and political subdivisions	4,817	(83)			4,817	(83)
	\$ 27,935	\$ (313)	\$	\$	\$ 27,935	\$ (313)

	<i>(in thousands)</i>					
	Less than 12 months		December 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	\$ 3,955	\$ (16)	\$	\$	\$ 3,955	\$ (16)

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

At September 30, 2012, there were thirteen U.S. agency and mortgage-backed securities and ten 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 September 30, 2012.

The Company's investment in Federal Home Loan Bank (FHLB) stock totaled \$1.1 million at September 30, 2012. 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 September 30, 2012, 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.

The composition of restricted securities at September 30, 2012 and December 31, 2011 was as follows:

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*(in thousands)*

	September 30, 2012	December 31, 2011
Federal Home Loan Bank stock	\$ 1,078	\$ 1,910
Federal Reserve Bank stock	845	815
Community Bankers Bank stock	50	50
	\$ 1,973	\$ 2,775

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

Loans at September 30, 2012 and December 31, 2011 are summarized as follows:

	<i>(in thousands)</i>	
	September 30, 2012	December 31, 2011
Real estate loans:		
Construction and land development	\$ 44,725	\$ 48,363
Secured by 1-4 family residential	128,354	122,339
Other real estate loans	175,122	181,141
Commercial and industrial loans	24,216	29,446
Consumer and other loans	8,335	11,151
<b>Total loans</b>	<b>\$ 380,752</b>	<b>\$ 392,440</b>
Allowance for loan losses	14,049	12,937
<b>Loans, net</b>	<b>\$ 366,703</b>	<b>\$ 379,503</b>

Consumer loans included \$109 thousand and \$325 thousand of demand deposit overdrafts at September 30, 2012 and December 31, 2011, respectively.

The Company considers the following risk characteristics of each loan portfolio class:

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

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

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



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

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

The following table provides a summary of loan classes and an aging of past due loans as of September 30, 2012 and December 31, 2011:

	September 30, 2012 <i>(in thousands)</i>				Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due				
<b>Real estate loans:</b>								
Construction and land development	\$ 325	\$ 528	\$ 2,472	\$ 3,325	\$ 41,400	\$ 44,725	\$ 621	\$ 1,851
1-4 family residential	1,272	207	693	2,172	126,182	128,354	1,389	300
Other real estate loans	2,881	1,637	186	4,704	170,418	175,122	6,961	
Commercial and industrial	432	220	25	677	23,539	24,216	15	25
Consumer and other loans	56		25	81	8,254	8,335	12	
<b>Total</b>	<b>\$ 4,966</b>	<b>\$ 2,592</b>	<b>\$ 3,401</b>	<b>\$ 10,959</b>	<b>\$ 369,793</b>	<b>\$ 380,752</b>	<b>\$ 8,998</b>	<b>\$ 2,176</b>

	December 31, 2011 <i>(in thousands)</i>				Current	Total Loans	Non-accrual Loans	90 Days or More Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	> 90 Days Past Due	Total Past Due				
<b>Real estate loans:</b>								
Construction and land development	\$ 2,267	\$ 1,029	\$ 235	\$ 3,531	\$ 44,832	\$ 48,363	\$ 235	\$
1-4 family residential	4,179	471	688	5,338	117,001	122,339	3,043	98
Other real estate loans	3,863	562	722	5,147	175,994	181,141	8,367	361
Commercial and industrial	950	93	5	1,048	28,398	29,446	163	
Consumer and other loans	94	19	14	127	11,024	11,151	33	
<b>Total</b>	<b>\$ 11,353</b>	<b>\$ 2,174</b>	<b>\$ 1,664</b>	<b>\$ 15,191</b>	<b>\$ 377,249</b>	<b>\$ 392,440</b>	<b>\$ 11,841</b>	<b>\$ 459</b>

**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

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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 deserve 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.

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

**Substandard** Loans classified as substandard are inadequately protected by the current net worth and payment capacity of the obligor and/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 non-accrual status.

The following tables provide an analysis of the credit risk profile of each loan class as of September 30, 2012 and December 31, 2011:

	September 30, 2012 (in thousands)				
	Pass	Special Mention	Substandard	Doubtful	Total
<b>Real estate loans:</b>					
Construction and land development	\$ 23,062	\$ 4,206	\$ 17,457	\$	\$ 44,725
Secured by 1-4 family residential	114,120	4,518	9,716		128,354
Other real estate loans	138,949	12,085	24,088		175,122
Commercial and industrial	19,766	836	3,614		24,216
Consumer and other loans	8,261	74			8,335
<b>Total</b>	<b>\$ 304,158</b>	<b>\$ 21,719</b>	<b>\$ 54,875</b>	<b>\$</b>	<b>\$ 380,752</b>

	December 31, 2011 (in thousands)				
	Pass	Special Mention	Substandard	Doubtful	Total
<b>Real estate loans:</b>					
Construction and land development	\$ 23,172	\$ 7,504	\$ 17,452	\$ 235	\$ 48,363
Secured by 1-4 family residential	108,240	5,645	8,266	188	122,339
Other real estate loans	138,255	17,123	22,348	3,415	181,141
Commercial and industrial	23,451	949	4,976	70	29,446
Consumer and other loans	11,058	79		14	11,151
<b>Total</b>	<b>\$ 304,176</b>	<b>\$ 31,300</b>	<b>\$ 53,042</b>	<b>\$ 3,922</b>	<b>\$ 392,440</b>

**Note 4. Allowance for Loan Losses**

Transactions in the allowance for loan losses for the nine months ended September 30, 2012 and 2011 and for the year ended December 31, 2011 were as follows:

	<i>(in thousands)</i>		
	September 30, 2012	December 31, 2011	September 30, 2011
Balance at beginning of year	\$ 12,937	\$ 16,036	\$ 16,036
Provision charged to operating expense	3,455	12,380	9,395
Loan recoveries	240	310	208
Loan charge-offs	(2,583)	(15,789)	(7,137)
Balance at end of period	\$ 14,049	\$ 12,937	\$ 18,502

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

The following tables present, as of September 30, 2012 and December 31, 2011, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology.

	September 30, 2012 (in thousands)					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2011	\$ 2,843	\$ 3,766	\$ 5,192	\$ 963	\$ 173	\$ 12,937
Charge-offs	(369)	(761)	(1,042)	(261)	(150)	(2,583)
Recoveries	1	2	58	24	155	240
Provision for loan losses	1,059	992	1,531	(75)	(52)	3,455
Ending Balance, September 30, 2012	\$ 3,534	\$ 3,999	\$ 5,739	\$ 651	\$ 126	\$ 14,049
<b>Ending Balance:</b>						
Individually evaluated for impairment	1,728	709	762	40		3,239
Collectively evaluated for impairment	1,806	3,290	4,977	611	126	10,810
<b>Loans:</b>						
Ending Balance	44,725	128,354	175,122	24,216	8,335	380,752
Individually evaluated for impairment	6,353	4,758	8,597	164		19,872
Collectively evaluated for impairment	38,372	123,596	166,525	24,052	8,335	360,880
	December 31, 2011 (in thousands)					
	Construction and Land Development	Secured by 1-4 Family Residential	Other Real Estate	Commercial and Industrial	Consumer and Other Loans	Total
<b>Allowance for loan losses:</b>						
Beginning Balance, December 31, 2010	\$ 4,050	\$ 1,681	\$ 9,187	\$ 858	\$ 260	\$ 16,036
Charge-offs	(2,983)	(4,639)	(7,551)	(348)	(268)	(15,789)
Recoveries	50	6		3	251	310
Provision for loan losses	1,726	6,718	3,556	450	(70)	12,380
Ending Balance, December 31, 2011	\$ 2,843	\$ 3,766	\$ 5,192	\$ 963	\$ 173	\$ 12,937
<b>Ending Balance:</b>						
Individually evaluated for impairment	930	848	351	309		2,438
Collectively evaluated for impairment	1,913	2,918	4,841	654	173	10,499
<b>Loans:</b>						
Ending Balance	48,363	122,339	181,141	29,446	11,151	392,440

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Individually evaluated for impairment	7,640	6,860	10,940	480		25,920
Collectively evaluated for impairment	40,723	115,479	170,201	28,966	11,151	366,520

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

Impaired loans and the related allowance at September 30, 2012 and December 31, 2011, were as follows:

	September 30, 2012 (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
<b>Real estate loans:</b>							
Construction and land development	\$ 6,683	\$ 596	\$ 5,758	\$ 6,353	\$ 1,728	\$ 5,516	\$ 238
Secured by 1-4 family	5,801	1,955	2,803	4,758	709	5,244	143
Other real estate loans	12,673	5,569	3,027	8,597	762	10,155	88
Commercial and industrial	165		164	164	40	386	6
Consumer and other loans							
<b>Total</b>	<b>\$ 25,322</b>	<b>\$ 8,120</b>	<b>\$ 11,752</b>	<b>\$ 19,872</b>	<b>\$ 3,239</b>	<b>\$ 21,302</b>	<b>\$ 475</b>

	December 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
<b>Real estate loans:</b>							
Construction and land development	\$ 8,106	\$ 3,531	\$ 4,109	\$ 7,640	\$ 930	\$ 7,077	\$ 367
Secured by 1-4 family	8,566	3,495	3,365	6,860	848	6,519	301
Other real estate loans	15,165	8,135	2,805	10,940	351	23,918	396
Commercial and industrial	480		480	480	309	660	27
Consumer and other loans							
<b>Total</b>	<b>\$ 32,317</b>	<b>\$ 15,161</b>	<b>\$ 10,758</b>	<b>\$ 25,920</b>	<b>\$ 2,438</b>	<b>\$ 38,174</b>	<b>\$ 1,091</b>

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



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

As of September 30, 2012, loans classified as troubled debt restructurings (TDRs) and included in impaired loans in the disclosure above totaled \$5.4 million. At September 30, 2012, \$1.6 million of the loans classified as TDRs were performing under the restructured terms and were not considered non-performing assets. There were \$11.4 million in TDRs at December 31, 2011. The following tables provide further information regarding loans modified under TDRs during the three and nine month periods ended September 30, 2012 and 2011:

	For the three months ended			For the three months ended		
	September 30, 2012 <i>(dollars in thousands)</i>			September 30, 2011 <i>(dollars in thousands)</i>		
	Number of Contracts	Pre- modification outstanding recorded investment	Post- modification outstanding recorded investment	Number of Contracts	Pre- modification outstanding recorded investment	Post- modification outstanding recorded investment
Real estate loans:						
Construction		\$	\$	1	\$ 701	\$ 357
Secured by 1-4 family	1	183	183			
Other real estate loans						
Commercial and industrial						
Consumer and other loans						
<b>Total</b>	<b>1</b>	<b>\$ 183</b>	<b>\$ 183</b>	<b>1</b>	<b>\$ 701</b>	<b>\$ 357</b>

	For the nine months ended			For the nine months ended		
	September 30, 2012 <i>(dollars in thousands)</i>			September 30, 2011 <i>(dollars in thousands)</i>		
	Number of Contracts	Pre- modification outstanding recorded investment	Post- modification outstanding recorded investment	Number of Contracts	Pre- modification outstanding recorded investment	Post- modification outstanding recorded investment
Real estate loans:						
Construction		\$	\$	1	\$ 701	\$ 357
Secured by 1-4 family	1	183	183	2	575	575
Other real estate loans	1	2,426	2,426	12	11,724	11,750
Commercial and industrial						
Consumer and other loans						
<b>Total</b>	<b>2</b>	<b>\$ 2,609</b>	<b>\$ 2,609</b>	<b>15</b>	<b>\$ 13,000</b>	<b>\$ 12,682</b>

For the three and nine months ended September 30, 2012 and 2011, there were no troubled debt restructurings that subsequently defaulted within twelve months of the loan modification. Management defines default as over ninety days past due during the twelve month period subsequent to

the modification.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 5. Other Real Estate Owned**

At September 30, 2012 and December 31, 2011, OREO totaled \$5.3 million and \$6.4 million, respectively. OREO is primarily comprised of residential lots, raw land, non-residential properties and residential properties associated with commercial relationships, and are located primarily in the Commonwealth of Virginia. Changes in the balance for OREO are as follows:

	<i>(in thousands)</i>	
	For the nine months ended September 30, 2012	For the year ended December 31, 2011
Balance at the beginning of year, gross	\$ 9,166	\$ 7,302
Transfers from loans	4,287	8,117
Charge-offs	(1,539)	(2,022)
Sales proceeds	(5,041)	(3,321)
Gain (loss) on disposition	297	(910)
Balance at the end of period, gross	7,170	9,166
Less: allowance for losses	(1,847)	(2,792)
Balance at the end of period, net	\$ 5,323	\$ 6,374

Changes in the allowance for OREO losses are as follows:

	<i>(in thousands)</i>		
	For the nine months ended		For the year ended
	September 30, 2012	September 30, 2011	December 31, 2011
Balance at beginning of year	\$ 2,792	\$ 3,341	\$ 3,341
Provision for losses	595	1,103	1,558
Charge-offs, net	(1,539)	(445)	(2,107)
Balance at end of period	\$ 1,847	\$ 3,999	\$ 2,792

Net expenses applicable to OREO, other than the provision for losses, were \$450 thousand and \$325 thousand for the nine months ended September 30, 2012 and 2011, respectively.

**Note 6. Other Borrowings**

The Bank had unused lines of credit totaling \$98.8 million available with non-affiliated banks at September 30, 2012. 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 September 30, 2012, the Bank had borrowings from the FHLB system totaling \$6.0 million which mature through December 28, 2018. The interest rate on these notes payable ranged from 1.78% to 2.04% and the weighted average rate was 1.91%. The Bank also had a letter of credit from the FHLB totaling \$30.0 million at September 30, 2012. The Bank had collateral pledged on these borrowings and letter of credit, including real estate loans totaling \$101.6 million and FHLB stock with a book value of \$1.1 million.

At September 30, 2012, the Bank had an \$82 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%.

**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 7. Capital Requirements**

A comparison of the capital of the Company and the Bank at September 30, 2012 and December 31, 2011 with the minimum regulatory guidelines were as follows:

	<i>(dollars in thousands)</i>				Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Actual		Minimum Capital Requirement		Amount	Ratio
	Amount	Ratio	Amount	Ratio		
<b>September 30, 2012:</b>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 59,050	15.39%	\$ 30,705	8.00%	N/A	N/A
First Bank	\$ 51,926	13.55%	\$ 30,653	8.00%	\$ 38,316	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 54,138	14.11%	\$ 15,352	4.00%	N/A	N/A
First Bank	\$ 47,022	12.27%	\$ 15,327	4.00%	\$ 22,990	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 54,138	10.28%	\$ 21,071	4.00%	N/A	N/A
First Bank	\$ 47,022	8.93%	\$ 21,060	4.00%	\$ 26,325	5.00%
<b>December 31, 2011:</b>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 50,359	12.51%	\$ 32,192	8.00%	N/A	N/A
First Bank	\$ 49,761	12.38%	\$ 32,154	8.00%	\$ 40,193	10.00%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	\$ 45,231	11.24%	\$ 16,096	4.00%	N/A	N/A
First Bank	\$ 44,639	11.11%	\$ 16,077	4.00%	\$ 24,116	6.00%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 45,231	8.45%	\$ 21,408	4.00%	N/A	N/A
First Bank	\$ 44,639	8.30%	\$ 21,517	4.00%	\$ 26,896	5.00%

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

**Note 8. Trust Preferred Capital Notes**

On June 8, 2004, First National (VA) Statutory Trust II (Trust II), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities, commonly known as trust preferred securities. On June 17, 2004, \$5.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at September 30, 2012 was 2.99%. 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.

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

On July 24, 2006, First National (VA) Statutory Trust III (Trust III), a wholly-owned subsidiary of the Company, was formed for the purpose of issuing redeemable capital securities. On July 31, 2006, \$4.0 million of trust preferred securities were issued through a pooled underwriting. The securities have a LIBOR-indexed floating rate of interest. The interest rate at September 30, 2012 was 2.06%. 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, 2012, the total amount of trust preferred securities issued by the Trusts was included in the Company's Tier 1 capital.

**Note 9. Benefit Plans**

The Bank has a noncontributory, defined benefit pension plan for all full-time employees over 21 years of age with at least one year of credited service and hired prior to May 1, 2011. 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, 2012 and 2011 were as follows:

	<i>(in thousands)</i>			
	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Service cost	\$ 107	\$ 90	\$ 320	\$ 270
Interest cost	67	77	202	231
Expected return on plan assets	(69)	(85)	(206)	(255)
Amortization of prior service cost	1	1	2	3
Amortization of net loss	21	9	64	27
Net periodic benefit cost	\$ 127	\$ 92	\$ 382	\$ 276

The Company previously disclosed in its consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2011, that it expected to contribute \$509 thousand to its pension plan for the 2012 plan year. The Company is planning to make the contribution for the 2012 plan year during the fourth quarter of 2012.

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, 2011 for additional information about the Company's benefit plans.





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**Table of Contents****Notes to Consolidated Financial Statements***(unaudited)***Note 10. Earnings per Common Share**

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. There are no potential common shares that would have a dilutive effect. The average number of common shares outstanding used to calculate basic and diluted earnings per common share were 4,901,464 and 2,955,649 for the three months ended September 30, 2012 and 2011, respectively, and 3,623,191 and 2,952,568 for the nine months ended September 30, 2012 and 2011, respectively.

**Note 11. 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 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.



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

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 assets and liabilities recorded at fair value on a recurring basis in the financial statements:

**Securities available for sale**

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

The following tables present the balances of assets measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011.

Description	Balance as of September 30, 2012	Fair Value Measurements at September 30, 2012 <i>(in thousands)</i>		
		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	\$ 79,580	\$	\$ 79,580	\$
Obligations of states and political subdivisions	16,255		16,255	
Corporate equity securities	4	4		
	\$ 95,839	\$ 4	\$ 95,835	\$

Description	Balance as of December 31, 2011	Fair Value Measurements at December 31, 2011 <i>(in thousands)</i>		
		Quoted Prices in Active Markets	Significant Other Observable Inputs	Significant Unobservable Inputs (Level 3)

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		for Identical Assets (Level 1)	(Level 2)	
<b>Assets</b>				
Securities available for sale				
U.S. agency and mortgage-backed securities	\$ 78,876	\$	\$ 78,876	\$
Obligations of states and political subdivisions	12,676		12,676	
Corporate equity securities	113	113		
	\$ 91,665	\$ 113	\$ 91,552	\$

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

*(unaudited)*

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 being held at September 30, 2012 or 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 Operations.

#### Other real estate owned

Loans are transferred to other real estate owned (OREO) 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.

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

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

Description	Carrying Value at September 30, 2012 <i>(in thousands)</i>			
	Balance as of September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Impaired loans, net	\$ 8,513	\$	\$	\$ 8,513
Other real estate owned, net	5,323			5,323

Description	Carrying Value at December 31, 2011 <i>(in thousands)</i>			
	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Impaired loans, net	\$ 8,320	\$	\$ 7,213	\$ 1,107
Other real estate owned, net	6,374		6,374	

The following table displays quantitative information about Level 3 Fair Value Measurements for September 30, 2012:

Quantitative information about Level 3 Fair Value Measurements for September 30, 2012 <i>(dollars in thousands)</i>				
	Fair Value	Valuation Technique	Unobservable Input	Range
<b>Assets</b>				
Impaired loans	\$ 8,513	Discounted appraised value	Selling cost	10%
			Discount for lack of marketability and age of appraisal	0%-30%
Other real estate owned	5,323	Discounted appraised value	Selling cost	7%



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

The changes in Level 3 assets measured at estimated fair value on a nonrecurring basis during the nine months ended September 30, 2012, were as follows:

	Carrying Value at September 30, 2012 <i>(in thousands)</i>	
	Impaired Loans	Other Real Estate Owned
Balance, December 31, 2011	\$ 1,107	\$
Increase in carrying value	139	
Decrease in carrying value	(126)	
Additions	6,250	
Transfers to OREO	(209)	2,428
Transfers out of Level 3	(171)	
Transfers into Level 3	1,523	2,895
Balance, September 30, 2012	\$ 8,513	\$ 5,323

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

**Cash and Cash Equivalents**

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

**Loans**

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

**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.

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

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, 2012 and December 31, 2011, the fair value of loan commitments and standby letters of credit was immaterial.

The carrying values and estimated fair values of the Company's financial instruments at September 30, 2012 and December 31, 2011 are as follows:

	Carrying Amount	<i>(in thousands)</i> Fair Value Measurements at September 30, 2012 using			Balance
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>Financial Assets</b>					
Cash and short-term investments	\$ 26,219	\$ 26,219	\$	\$	\$ 26,219
Securities	95,839	4	95,835		95,839
Loans, net	366,703		361,931	8,513	370,444
Accrued interest receivable	1,581		1,581		1,581
<b>Financial Liabilities</b>					
Deposits	\$ 456,958	\$	\$ 459,260	\$	\$ 459,260
Other borrowings	6,082		6,263		6,263
Trust preferred capital notes	9,279		8,893		8,893
Accrued interest payable	315		315		315

	Carrying Amount	<i>(in thousands)</i> December 31, 2011	
		Carrying Amount	Fair Value
<b>Financial Assets</b>			
Cash and short-term investments		\$ 29,524	\$ 29,524
Securities		91,665	91,665
Loans, net		379,503	383,557
Loans held for sale		274	274
Accrued interest receivable		1,620	1,620
<b>Financial Liabilities</b>			
Deposits		\$ 469,172	\$ 471,771
Other borrowings		19,100	19,137
Trust preferred capital notes		9,279	8,576
Accrued interest payable		366	366



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**Notes to Consolidated Financial Statements**

*(unaudited)*

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

**Note 12. Capital Purchase Program**

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

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

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

The Company makes forward-looking statements in this Form 10-Q that are subject to risks and uncertainties. These forward-looking statements include statements regarding profitability, liquidity, adequacy of capital, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals. The words believes, expects, may, will, should, projects, contemplates, anticipates, forecasts, 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 ability to raise capital as needed;

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

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

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

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

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

loss or retirement of key executives;

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

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

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

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

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

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

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

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

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

other factors identified in Item 1A. Risk Factors of the Company's Form 10-K for the year ending December 31, 2011.

Because of these uncertainties, actual future results may be materially different from the results indicated by these forward-looking statements. In addition, past results of operations do not necessarily indicate future results. The following discussion and analysis of the financial condition at September 30, 2012 and results of operations of the Company for the three and nine month periods ended September 30, 2012 and 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, 2011. The results of operations for the three and nine month periods ended September 30, 2012 may not be indicative of the results to be achieved for the year.

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### **Executive Overview**

#### The Company

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

First Bank (the Bank). The Bank owns:

First Bank Financial Services, Inc.

Shen-Valley Land Holdings, LLC

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

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

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

#### Products, Services, Customers and Locations

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

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, 27 ATMs and its website, [www.fbvirginia.com](http://www.fbvirginia.com). The Bank operates six of its offices under the Financial Center concept. A Financial Center offers all of the Bank's financial services at one location. This concept allows loan, deposit, trust and investment advisory personnel to be readily available to serve customers throughout the Bank's market area. The location and general character of these properties is further described in Part I, Item 2 of Form 10-K for the year ended December 31, 2011.

#### 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

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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 net charge-offs, asset quality, economic conditions and loan growth. Changing economic conditions caused by inflation, recession, unemployment or other factors beyond the Company's control have a direct correlation with asset quality, net charge-offs and ultimately the required provision for loan losses. The largest component of noninterest expense for the nine month period ended September 30, 2012 was salaries and employee benefits, comprising 51% of noninterest expenses, followed by occupancy and equipment expense, comprising 14% of expenses.



**Table of Contents****Quarterly Performance**

For the three months ended September 30, 2012, net income totaled \$688 thousand compared to a loss of \$2.9 million for the same period in 2011. After the effective dividend on preferred stock, net income available to common shareholders was \$462 thousand, or \$0.09 per basic and diluted share, compared to net loss available to common shareholders of \$3.1 million, or \$1.05 per basic and diluted share, for the same period in 2011. The earnings improvement was primarily attributable to an improvement in asset quality, which resulted in a decrease in the provision for loan losses to \$805 thousand in the third quarter of 2012 compared to \$5.6 million for the same period of 2011. In addition, the provision for other real estate owned decreased \$901 thousand to \$26 thousand for the third quarter of 2012 compared to \$927 thousand for the same period of 2011. Net interest income was 6%, or \$312 thousand, lower than for the third quarter of 2011. Noninterest income was 9%, or \$136 thousand, higher than the third quarter of 2011, primarily from gains on sales of securities. Noninterest expense was 14%, or \$731 thousand, lower when comparing the two periods, primarily from the reduced provision for other real estate owned. Return on average assets and return on average equity were 0.52% and 6.11%, respectively, for the third quarter of 2012 compared to -2.11% and -23.78% for the same quarter in 2011.

**Year-to-Date Performance**

For the nine months ended September 30, 2012, net income was \$1.9 million compared to net loss of \$2.8 million for the same period in 2011. After the effective dividend on preferred stock, net income available to common shareholders was \$1.2 million, or \$0.33 per basic and diluted share, compared to net loss available to common shareholders of \$3.5 million, or \$1.18 per basic and diluted share, for the same period in 2011. The earnings improvement was primarily attributable to a \$5.9 million decrease in the provision for loan losses and a \$1.2 million increase in gains on sales of securities. Net interest income was \$455 thousand, or 3%, lower when comparing the two periods. Noninterest income increased \$1.3 million to \$5.6 million for the nine months ended September 30, 2012, compared to \$4.3 million for the same period in 2011, primarily from gains on sales of securities. Noninterest expense decreased 3% to \$14.0 million compared to the same period in 2011, primarily from reduced provision for other real estate owned. Return on average assets was 0.47% for the nine months ended September 30, 2012 compared to -0.69% for the same period in 2011, and return on average equity was 6.18% for the nine months ended September 30, 2012 compared to -7.75% for the same period in 2011.

**Non-GAAP Financial Measures**

This report refers to the efficiency ratio, which is computed by dividing noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income excluding securities gains and losses. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes, however, such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under GAAP. The components of the efficiency ratio calculation are summarized in the table below.

	<b>Efficiency Ratio</b> <i>(in thousands)</i>			
	For the three months ended		For the nine months ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Noninterest expense	\$ 4,657	\$ 5,388	\$ 13,995	\$ 14,459
Less: provision for other real estate owned	26	927	595	1,103
Less: net (gains) losses on sale of other real estate owned	(47)	(36)	(297)	(28)
	\$ 4,678	\$ 4,497	\$ 13,697	\$ 13,384
Tax-equivalent net interest income	\$ 4,772	\$ 5,124	\$ 14,750	\$ 15,294
Noninterest income	1,609	1,473	5,585	4,298
Less: securities gains	167		1,285	41
Less: premises and equipment gains	2		2	
	\$ 6,212	\$ 6,597	\$ 19,048	\$ 19,551

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Efficiency ratio	75.31%	68.17%	71.91%	68.46%
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This report also refers to net interest margin, which is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for each of 2012 and 2011 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**

	<b>Interest Income</b>			
	<i>(in thousands)</i>			
	For the three months ended September 30, 2012	September 30, 2011	For the nine months ended September 30, 2012	September 30, 2011
<b>GAAP measures:</b>				
Interest income - loans	\$ 5,189	\$ 5,666	\$ 16,001	\$ 17,317
Interest income - investments and other	582	737	1,858	2,061
Interest expense - deposits	928	1,204	2,874	3,810
Interest expense - other borrowings	47	42	192	175
Interest expense - other	60	109	182	327
<b>Total net interest income</b>	<b>\$ 4,736</b>	<b>\$ 5,048</b>	<b>\$ 14,611</b>	<b>\$ 15,066</b>
<b>Non-GAAP measures:</b>				
Tax benefit realized on non-taxable interest income - loans	\$ 7	\$ 14	\$ 22	\$ 40
Tax benefit realized on non-taxable interest income - municipal securities	29	62	117	188
<b>Total tax benefit realized on non-taxable interest income</b>	<b>\$ 36</b>	<b>\$ 76</b>	<b>\$ 139</b>	<b>\$ 228</b>
<b>Total tax-equivalent net interest income</b>	<b>\$ 4,772</b>	<b>\$ 5,124</b>	<b>\$ 14,750</b>	<b>\$ 15,294</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

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

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

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

Residential mortgage loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral.

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

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

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

The allowance for loan losses consists of specific and general components. The specific component relates to loans that are classified as impaired, and is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. For collateral dependent loans, an updated appraisal will be ordered if a current one is not on file. Appraisals are performed by independent third-party appraisers with relevant industry experience. Adjustments to the appraised value may be made based on recent sales of like properties or general market conditions among other considerations.

The general component relates to loans that are not considered impaired. These unimpaired loans are segregated by loan segment and allowance factors are assigned by management based on a three-year loss history, delinquencies, national and local economic trends, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, concentrations of credit, quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The factors assigned differ by loan segment. The general component acknowledges potential losses whose impact on the portfolio has yet to be recognized by a specific allowance. Allowance factors and the overall size of the allowance may change from period to period based on management's assessment of the above described factors and the relative weights given to each factor.

## **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, 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.



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In an effort to manage risk, the Bank's loan policy gives loan amount approval limits to individual loan officers based on their position within the Bank and level of experience. The Management Loan Committee can approve new loans up to their authority. The Board Loan Committee approves all loans which exceed the authority of the Management Loan Committee. The full Board of Directors must approve loans which exceed the authority of the Board Loan Committee, up to the Bank's legal lending limit. The Board Loan Committee currently consists of five non-management directors. The Board Loan Committee approves the Bank's Loan Policy and reviews the loan watch list, concentrations of credit and other risk management reports. The Board Loan Committee meets on a monthly basis and the Chairman of the Committee then reports to the Board of Directors.

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

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, certain appraisals are analyzed by management or by an outsourced appraisal review specialist throughout the year. This is performed to ensure reasonableness of collateral valuations. The Company also obtains an independent review of the loan portfolio on an annual basis to analyze loan risk ratings and validate specific reserves on impaired loans.

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities that are disclosed but not reflected in its financial statements, including commitments to extend credit. At September 30, 2012, commitments to extend credit, stand-by letters of credit and rate lock commitments totaled \$63.6 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 reliability as residential real estate. To manage these risks, the Bank generally obtains appropriate collateral and personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers.

## Commercial Real Estate Lending

Commercial real estate loans are secured by various types of commercial real estate typically in the Bank's market area, including multi-family residential buildings, commercial buildings and offices, hotels, small shopping centers, farms and churches. Commercial real estate loan originations are obtained through direct solicitation of developers and additional business from existing customers. In its underwriting of commercial real estate, the Bank may lend, under federal regulation, up to 85% of the secured property's appraised value, although the Bank's loan to original appraised value ratio on such properties is typically 80% or less. The valuation of commercial real estate collateral is provided by independent appraisers who have been approved by the Board Loan Committee. Commercial real estate lending entails significant additional risk, compared with residential mortgage lending. Commercial real estate loans typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. Additionally, the payment experience on loans secured by income producing properties is typically dependent on the successful operation of a business or a real estate project and thus may be subject, to a greater extent, to adverse conditions in the real estate market or in the economy, in general. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios, the borrower's creditworthiness, prior credit history and reputation. The Bank typically requires personal guarantees of the borrowers' principal owners and considers the valuation of the real estate collateral.

## Construction and Land Development Lending

The Bank makes local construction loans, including residential and land acquisition and development loans. These loans are secured by the property under construction and the underlying land for which the loan was obtained. The majority of these loans have an average life of approximately one year and re-price monthly as key rates change. Construction lending entails significant additional risks, compared with residential mortgage lending. Construction loans sometimes involve larger loan





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balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is the fact that loan funds are advanced upon the security of the land or property under construction, which value is estimated based on the completion of construction. Thus, there is risk associated with failure to complete construction and potential cost overruns. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank typically obtains a first lien on the property as security for its construction loans, typically requires personal guarantees from the borrower's principal owners, and 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 generally provided by independent fee appraisers who have been approved by the Board Loan Committee. In addition to originating fixed rate mortgage loans with the intent to sell to correspondent lenders or broker to wholesale lenders, the Bank originates balloon and other mortgage loans for the portfolio. Depending on the financial goals of the Company, the Bank occasionally originates and retains these loans.

### **Consumer Lending**

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

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

## **Results of Operations**

### **General**

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

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For the three months ended September 30, 2012, net income totaled \$688 thousand compared to a loss of \$2.9 million for the same period in 2011. After the effective dividend on preferred stock, net income available to common shareholders was \$462 thousand, or \$0.09 per basic and diluted share, compared to net loss available to common shareholders of \$3.1 million, or \$1.05 per basic and diluted share, for the same period in 2011. The earnings improvement was primarily attributable to an improvement in asset quality, which resulted in a decrease in the provision for loan losses to \$805 thousand in the third quarter of 2012 compared to \$5.6 million for the same period of 2011. In addition, the provision for other real estate owned decreased \$901 thousand to \$26 thousand for the third quarter of 2012 compared to \$927 thousand for the same period of 2011. Net interest income was 6%, or \$312 thousand, lower than for the third quarter of 2011. Noninterest income was 9%, or \$136 thousand, higher than the third quarter of 2011, primarily from gains on sales of securities. Noninterest expense was 14%, or \$731 thousand, lower when comparing the two periods, primarily from the reduced provision for other real estate owned. Return on average assets and return on average equity were 0.52% and 6.11%, respectively, for the third quarter of 2012 compared to -2.11% and -23.78% for the same quarter in 2011.

For the nine months ended September 30, 2012, net income was \$1.9 million compared to net loss of \$2.8 million for the same period in 2011. After the effective dividend on preferred stock, net income available to common shareholders was \$1.2 million, or \$0.33 per basic and diluted share, compared to net loss available to common shareholders of \$3.5 million, or \$1.18 per basic and diluted share, for the same period in 2011. The earnings improvement was primarily attributable to a \$5.9 million decrease in the provision for loan losses and a \$1.2 million increase in gains on sales of securities. Return on average assets was 0.47% for the nine months ended September 30, 2012 compared to -0.69% for the same period in 2011, and return on average equity was 6.18% for the nine months ended September 30, 2012 compared to -7.75% for the same period in 2011.

### Net Interest Income

Net interest income totaled \$4.7 million for the third quarter of 2012, which was a 6% decrease when comparing the third quarter of 2012 to the same period a year ago. The net interest margin decreased to 3.78% from 3.98% and average earning assets decreased \$8.7 million when comparing the periods. The lower net interest margin was primarily the result of a change in the earning asset mix from higher to lower yielding assets. As a percentage of average earning assets, loans decreased from 81% to 76% while securities, federal funds sold and interest-bearing deposits with banks increased from 19% to 24%.

Net interest income was \$455 thousand, or 3%, lower at \$14.6 million for the nine months ended September 30, 2012 compared to \$15.1 million for the same period in 2011. The net interest margin was 3 basis points lower and average interest-earning assets were \$15.7 million lower when comparing the two periods. The net interest margin was 3.93% for the nine months ended September 30, 2012, compared to 3.96% for the same period in 2011.

### Provision for Loan Losses

The provision for loan losses was \$805 thousand, which resulted in a total allowance for loan losses of \$14.0 million or 3.69% of total loans at September 30, 2012. This compared to a provision for loan losses of \$5.6 million and an allowance for loan losses of \$18.5 million, or 4.52% of total loans, at the end of the same quarter in 2011. The lower provision was a result of a decline in specific reserves on impaired loans when comparing the two periods. Nonperforming assets decreased 49% to \$14.3 million at September 30, 2012 compared to \$28.3 million at September 30, 2011. The reduction was primarily attributable to non-accrual loans decreasing from \$22.7 million at the end of the third quarter of 2011 to \$9.0 million at the end of the third quarter of 2012. Other real estate owned decreased by \$253 thousand to \$5.3 million. Net charge-offs for the third quarter of 2012 declined to \$755 thousand from \$851 thousand for the same quarter of 2011.

For the nine months ended September 30, 2012, the loan loss provision totaled \$3.5 million compared to \$9.4 million for the same period in 2011. During 2012, the provision for loan losses resulted from specific reserves on impaired loans and general reserves driven by the loss history component of the allowance for loan losses. Net charge-offs were \$2.3 million for the first nine months of 2012 compared to \$6.9 million for the same period in 2011. During 2011, the provision for loan losses resulted from unfavorable economic conditions, declines in collateral values and specific reserves on impaired loans.

### Noninterest Income

Noninterest income totaled \$1.6 million for the third quarter of 2012, which was 9% higher compared to the same quarter of 2011. This increase was primarily a result of gains on sales of securities. Lower revenues from service charges on deposit accounts and ATM and check card fees were partially offset by higher revenues from gains on sales of loans and trust and investment advisory fees when comparing the periods.

Noninterest income increased \$1.3 million to \$5.6 million for the nine months ended September 30, 2012, compared to \$4.3 million for the same period in 2011, primarily from gains on sales of securities. Noninterest income, excluding gains on sales of securities, increased was relatively

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consistent at \$4.3 million when comparing the two periods. Revenues from fees for other customer services and gains on sales of loans increased while ATM and check card income and service charges on deposit accounts decreased slightly when comparing the periods.

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### Noninterest Expense

Noninterest expense was \$4.7 million for the third quarter of 2012, a decrease of \$731 thousand, or 14%, compared to \$5.4 million for the same quarter of 2011, primarily from reduced provision for other real estate owned. The provision for other real estate owned, which represents write-downs of carrying values on foreclosed properties, totaled \$26 thousand for the third quarter compared to \$927 thousand for the same period in the prior year.

Noninterest expense decreased 3% to \$14.0 million compared to the same period in 2011, primarily from reduced provision for other real estate owned. Net gains on sale of other real estate owned totaled \$297 thousand for the nine months ended September 30, 2012, compared to \$28 thousand for the same period in 2011. The provision for other real estate owned totaled \$595 thousand for the nine months ended September 30, 2012, compared to \$1.1 million for the same period in 2011.

### 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 month period ended September 30, 2012 and 2011. 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 10 of the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

## **Financial Condition**

### General

Total assets were \$521.7 million at September 30, 2012 compared to \$539.1 million at December 31, 2011. The Company's trust and investment advisory group had assets under management of \$230.9 million at September 30, 2012 compared to \$217.2 million at December 31, 2011. Assets managed by the trust and investment advisory group are not reflected on the Company's balance sheet.

### Loans

Gross loan balances decreased \$11.6 million or 3% to \$380.8 million at September 30, 2012, compared to \$392.4 million at December 31, 2011. The \$11.6 million decrease was comprised of a \$6.0 million or 3% decrease in other real estate loans, a \$6.0 million or 5% increase in 1-4 family residential loans, a \$5.2 million or 18% decrease in commercial and industrial loans, a \$3.6 million or 8% decrease in construction and land development loans and a \$2.8 million or 25% decrease in consumer and other loans.

The Company, through its banking subsidiary, grants mortgage, commercial and consumer loans to customers. The bank segments its loan portfolio into real estate loans, commercial loans, and consumer loans. Real estate loans are further divided into the following classes: Construction and land development; 1-4 family residential; and Other Real Estate Loans. Descriptions of the Company's loan classes are as follows:

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

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

**Real Estate Loans - 1-4 Family:** This class of loans includes loans secured by one to four family homes. Typically, the Bank originates 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.

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

**Consumer and Other Loans:** Consumer loans include all loans made to individuals for consumer or personal purposes. They include new and used automobile loans, unsecured loans and lines of credit.



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

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

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

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

Any unsecured loan that is over 120 days past due is charged-off in full. Any secured loan that is 120 days delinquent and is considered by management to be uncollectible is partially charged-off and carried at the fair value of the collateral less estimated selling costs. This charge-off policy applies to all loan segments.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value (net of selling costs), and the probability of collecting scheduled principal and interest payments when due. Additionally, management's policy is to evaluate substandard loans greater than \$500 thousand and all doubtful loans for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair market value of the collateral, net of selling costs, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, residential and certain small commercial loans that are less than \$500 thousand for impairment disclosures, except for troubled debt restructurings as noted below.

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

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### Asset Quality

Management classifies as non-performing assets non-accrual loans and other real estate owned (OREO). OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. 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 \$5.3 million in OREO, net of the valuation allowance, at September 30, 2012 and \$6.4 million at December 31, 2011. The valuation allowance for other real estate owned totaled \$1.8 million at September 30, 2012 and \$2.8 million at December 31, 2011.

Non-performing assets were \$14.3 million at September 30, 2012, \$18.2 million at December 31, 2011 and \$28.3 million at September 30, 2011, representing 2.75%, 3.38% and 5.22% of total assets, respectively. Non-performing assets included \$9.0 million in non-accrual loans and \$5.3 million in OREO, net of the valuation allowance at September 30, 2012.

The levels of non-performing assets in 2012 and 2011 were primarily attributable to weak local economic conditions that negatively impacted the ability of certain borrowers to service debt. Borrowers that have not been able to meet their debt requirements are primarily business customers involved in hotel and mini-storage operations, commercial and residential rental real estate and residential real estate development. At September 30, 2012, 66% of non-performing assets related to commercial real estate loans, 19% related to construction and land development loans and 15% related to residential real estate loans. Non-performing assets could increase due to other loans identified by management as potential problem loans. Other potential problem loans are defined as performing loans that possess certain risks, including the borrower's ability to pay and the collateral value securing the loan, that management has identified that may result in the loans not being repaid in accordance with their terms. Other potential problem loans totaled \$46.3 million and \$45.1 million at September 30, 2012 and December 31, 2011, respectively. 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 current estimate of the amount required to maintain an adequate allowance for loan losses reflective of the risks in the loan portfolio. The allowance for loan losses totaled \$14.0 million at September 30, 2012 and \$12.9 million at December 31, 2011, representing 3.69% and 3.30% of total loans, respectively. The increase in the allowance for loan losses was primarily attributable to higher net charge-off history and more specific reserves on impaired loans.

Impaired loans totaled \$19.9 million and \$25.9 million at September 30, 2012 and December 31, 2011, respectively. The related allowance for loan losses provided for these loans totaled \$3.2 million and \$2.4 million at September 30, 2012 and December 31, 2011, respectively. The average recorded investment in impaired loans during the nine months ended September 30, 2012 and the year ended December 31, 2011 was \$21.3 million and \$38.2 million, respectively. Included in the impaired loans total at September 30, 2012 are loans classified as TDRs totaling \$5.4 million. These loans represent situations in which a modification to the contractual interest rate or repayment structure has been granted to address a financial hardship. As of September 30, 2012, \$1.6 million of these TDRs were performing under the restructured terms and were not considered non-performing assets.

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

### Securities

Securities at September 30, 2012 were \$95.8 million, an increase of \$4.1 million, or 5%, from \$91.7 million at December 31, 2011. 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, 2012, neither the Company nor the Bank held any derivative financial instruments in its respective investment security portfolios. Gross unrealized gains in the securities portfolio totaled \$2.3 million and \$3.2 million at September 30, 2012 and December 31, 2011, respectively. Gross unrealized losses totaled \$313 thousand and \$16 thousand at September 30, 2012 and December 31, 2011, respectively. Investments in an unrealized loss position were considered temporarily impaired at September 30, 2012 and December 31, 2011.





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### Deposits

Deposits were \$457.0 million at September 30, 2012, a decrease of 3% from \$469.2 million at December 31, 2011. Non-interest bearing demand deposits increased \$2.2 million or 3% to \$83.9 million during the first nine months of 2012 from \$81.7 million at December 31, 2011. Savings and interest-bearing demand deposits increased \$8.9 million or 4% to \$207.1 million at September 30, 2012 compared to \$198.2 million at December 31, 2011. Time deposits, which include brokered deposits, decreased \$23.3 million or 12% during the first nine months of 2012 to \$166.0 million compared to \$189.3 million at December 31, 2011.

### Liquidity

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

At September 30, 2012, cash, interest-bearing and noninterest-bearing deposits with banks, federal funds sold, securities and loans maturing within one year totaled \$125.8 million. At September 30, 2012, 26% or \$99.6 million of the loan portfolio would mature within one year. Non-deposit sources of available funds totaled \$98.8 million at September 30, 2012, which included \$63.0 million available from FHLB, \$32.0 million of unsecured federal funds lines of credit with other correspondent banks and \$3.8 million available through the Federal Reserve Discount Window. During the first nine months of 2012, other borrowing activity included repayment of three fixed rate advances from FHLB totaling \$13.0 million.

### 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.

In order to maintain solid capital levels in light of the current economic environment, the Company's Board of Directors determined in July 2011 to suspend cash dividends on the Company's common stock.

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 15.39% at September 30, 2012 and a ratio of Tier 1 capital to risk-weighted assets of 14.11%. The Bank had a ratio of total capital to risk-weighted assets of 13.55% and a ratio of Tier 1 capital to risk-weighted assets of 12.27% at September 30, 2012. All 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 until March 13, 2014 and thereafter at a rate of 9% per annum. The Warrant Preferred Stock pays cumulative dividends at a rate of 9% per annum from the date of issuance.

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



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

## **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, 2011.

## **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 \$53.5 million at September 30, 2012, and \$48.9 million at December 31, 2011, are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

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

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary. At September 30, 2012 and December 31, 2011, the Bank had \$9.1 million and \$9.8 million in outstanding standby letters of credit, respectively.

The Company had \$1.0 million in locked-rate commitments to originate mortgage loans at September 30, 2012 and \$4.0 million at December 31, 2011. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The Bank does not expect any counterparty to fail to meet its obligations.

## **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not required.

## **Item 4. Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to provide assurance that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods required by the SEC and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2012 was carried out under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer. Based on and as of the date of such evaluation, the aforementioned officers concluded that the Company's disclosure controls and procedures were effective.



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

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There were no material changes to the Company's risk factors as disclosed in its Annual Report on Form 10-K for the year ended December 31, 2011 and Quarterly Report on Form 10-Q for the quarter ended June 30, 2012.

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

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

The following documents are attached hereto as Exhibits:

- 31.1 Certification of Chief Executive Officer, Section 302 Certification
- 31.2 Certification of Chief Financial Officer, Section 302 Certification

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- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
- 101 The following materials from First National Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Operations, (iii) Consolidated Statements of Comprehensive Income (iv) Consolidated Statements of Cash Flows, (v) Consolidated Statements of Shareholders' Equity, and (vi) Notes to Consolidated Financial Statements.

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**SIGNATURES**

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

**FIRST NATIONAL CORPORATION**

(Registrant)

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

November 14, 2012  
Date

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

November 14, 2012  
Date

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**EXHIBIT INDEX**

Number	Document
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